



The Revision of the Insurance Mediation Rules at EU Level and its Impact on Consumer Protection

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The European Commission has put forward a new proposal for a directive on insurance mediation which should provide for significant changes in practices of selling insurance products and guarantee enhanced level of consumer protection. This proposal accompanies other regulatory initiatives in the insurance sector, all of them pursuing three main objectives: firstly, a strengthened insurance supervision with convergent supervisory standards at EU level; secondly, a better risk management of insurance companies; and thirdly a greater protection of policyholders. All these initiatives contribute to the EU programme on consumer protection and herald a new approach to EU insurance regulation and supervision. However, while the new supervisory rules are a direct response to the financial crisis and shortcomings of cross-border cooperation between national supervisors, the plans for the revision of insurance mediation rules were conceived much earlier due to scandals with mis-selling of insurance products in the United States and some EU Member States. This article will focus entirely on the Commission's initiative in the consumer mediation area and the aspects of insurance supervision and risk management will be dealt with in separate articles.

Introduction

At the beginning of July, the European Commission presented its long-anticipated legislative proposal for a Directive on insurance mediation¹. With the objective of having equal levels of protection for consumers purchasing insurance products across the EU, the Commission is proposing to tighten disclosure and conduct of business requirements for sales of insurance contracts. In addition, by covering direct-selling and certain insurance-related activities (e.g. loss adjustment), the new proposal significantly expands the scope of the current insurance mediation regime, and subsequently also the number of protected policyholders. Finally, the Commission wishes to enhance consumer protection in relation to a distinct category of insurance products called insurance investment products. It hereby draws upon the rules of the Markets in Financial Instruments Directive (MiFID) regarding the identification, prevention and management of conflicts of interest. Consequently, two different insurance regimes will be now clearly delineated at EU level: one for so-called 'classic' insurance products without an investment element, and another one for products entailing investment factor.

In the European Parliament, the Economic and Monetary Affairs Committee is now discussing the Commission's proposal. Werner Langen, from the Christian Democratic Union in Germany, was appointed the rapporteur responsible for tabling amendments and preparing the Committee's report. Once accepted by the Parliament in its first reading scheduled for May 2013, and if jointly adopted with the Council of the EU, the new Directive will come into force by the end of 2013 and repeal the current Insurance Mediation Directive (IMD1) from 2002. The Member States will dispose of a two-year time period to implement it into their national laws. While the legislative adjustments might be minor in some Member States where reviews of insurance mediation rules were undertaken in recent years (e.g. the Retail Distribution Review in the UK), this new EU Directive will bring about significant legislative changes in other Member States where many aspects of insurance mediation are still not regulated.

The objective of this article is to present the new legal set-up for insurance mediation and to analyse its impact on consumers and the insurance industry.

10 years of insurance mediation regulations: minimum standards of consumer protection at EU level

During the last decade, insurance intermediaries' activities were regulated by the Directive on Insurance Mediation from 2002 (IMD1)². The objectives of this Directive were two-fold: to establish a single market for insurance mediation and to introduce minimum standards on consumer protection throughout the EU.

Professional and information requirements under IMD1

In order to achieve these goals, IMD1 introduced minimum requirements on registration of insurance intermediaries, their professional conduct as well as pre-contractual information

provided for their customers. The fulfilment of professional requirements was indispensable for an intermediary to be registered by a competent authority of his home Member State and it guaranteed a certain level of professionalism *vis-à-vis* his customers. Hence, an insurance purchaser could expect that his intermediary possessed the *appropriate knowledge and ability* to provide intermediation services (Article 4 (1)), was of *good repute*, had a *clean police record* and had not previously been declared *bankrupt* (Article 4 (2)). In addition, intermediaries were required to hold professional indemnity insurance against liability arising from professional negligence (Article 4 (3)).

The requirements for pre-contractual information determined the process of selling insurance products by insurance intermediaries. Prior to the conclusion of any initial insurance contract, an insurance intermediary had to inform about his status, commercial links or contractual obligations towards an insurance undertaking and the nature of advice given (Article 12 (1)). All intermediaries were required to specify customers' demands and needs, and underlying reasons for advice given on a given insurance product before the conclusion of a contract. In addition, independent intermediaries (without commercial links or contractual obligations towards insurance undertakings) were required to give advice on the basis of analysing a sufficiently large number of insurance contracts available on the market (Article 12 (2, 3)).

With merely three articles laying down the above-mentioned professional and pre-contractual information requirements,

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the old Directive required only the minimum obvious for any professional conduct and thus provided a fairly basic level of consumer protection. Moreover, its provisions were written in a very general manner, thus allowing for a wide interpretation by the Member States. Lastly, the Directive was a minimum harmonisation legal act, allowing for reinforcement of its minimum standards by the Member States.

Problems with IMD1 implementation

The minimum harmonisation approach was characteristic for the first generation of EU insurance mediation regulation but 'gold-plating' practices used by the Member States has clearly thwarted the EU legislator's attempt to guarantee a similar level of consumer protection within the EU.

In 2008, the Commission carried out an 'implementation check', revealing substantial differences in national approaches to IMD1 implementation, and subsequently a regulatory patchwork of national insurance mediation regulations³.

In countries like the UK, France or the Netherlands, the minimum standards were exceeded by additional stricter rules. This 'gold-plating' brought about significant inconsistencies in applying IMD1 across the EU. Consequently, the IMD1 objective – the introduction of a similar level of consumer protection across the EU – was not achieved.



of their customers. Furthermore, MiFID bans commissions paid by third parties to act as independent advisors. As for other advisors, it allows payments only if they are properly disclosed to the customers and enhance the quality of the service provided. Finally, MiFID introduced detailed rules to guarantee fair conduct of business by investment firms, such as

Conflict of interest and conduct of business rules: IMD1 vs. MiFID

There has been a great deal of negative publicity surrounding insurance industry in the years preceding the financial crisis. In particular, the controversy of brokers' contingent commissions has cast light on intransparent practices of insurance companies and intermediaries which proved to be in conflict of interest with their policyholders⁴. In addition, in some Member States' unfair business practices in the insurance sector were revealed, such as the provision of improper advice on products or insufficient disclosure of information to insurance



purchasers. These selling practices aimed at incentivising purchasers to buy products bringing high returns to insurance intermediaries. As a result, consumers were often sold products unsuitable for them and entailing high investment risk⁵.

These developments urged the Commission to investigate the insurance markets across the EU. In its 2007 report on sectoral inquiry into business insurance, the Commission highlighted proper remuneration disclosure as an effective means to mitigate conflicts of interest between commercial considerations of insurance intermediaries and the objectivity of advice they provide to their clients⁶. Since the publication of this report, the necessity for adequate conflict of interest and conduct of business rules for insurance mediation business came under the spotlight. However, the regime introduced under IMD1 lacked clear and efficient conduct of business and conflict of interest rules, and thus could not ensure transparent selling processes and prevent mis-selling of products. Hence, the Commission had to assess different options to improve the functioning of insurance markets. In 2010, it announced the revision of IMD1 modelled on the conflict of interest and conduct of business rules of MiFID⁷.



When adopted in 2004, MiFID revolutionised the world of financial investment markets by establishing new mechanisms for the prevention and mitigation of conflicts of interest when selling and advising on investment products. Implementing measures detailed in MiFID require investment firms to implement specific processes and controls for the identification, management and disclosure of any risks harming the interests

and appropriateness tests for the assessment of suitability of recommended products for their purchasers. When providing investment advice or portfolio management to customers, investment firms should obtain appropriate information about the customer regarding his knowledge and experience of the specific type of product or service, financial situation and investment objectives. Only after the information provided by a customer has been processed, may the investment firm recommend an investment product that is suitable for the individual customer.

Undoubtedly, detailed MiFID rules provide for a high level of consumer protection and can serve as a good benchmark for the future changes to IMD1. However, these rules were designed for investment products and cannot be copied for the insurance sector without necessary adjustments. The following chapter will explain to what extent the Commission was inspired by MiFID rules.

IMD2 and new approach to consumer protection standards in the insurance mediation sector

In the explanatory memorandum attached to the proposal for IMD2, the Commission refers to the current financial crisis and the necessity of shifting the focus to strengthening consumer protection and ensuring a level playing field between different insurance distribution channels. The Commission is trying to achieve these objectives by extending the scope of IMD2, tightening provisions on professional requirements and pre-contractual information, and including more stringent rules on conflicts of interest for the investment insurance products.

Scope of the IMD2

In the future, consumers buying insurance products directly from insurance companies will benefit from the expanded scope of IMD2, as it will also apply to employees of insurance companies responsible for direct selling (Article 1 (1)). Changes brought about by the IMD2 will be of added value for consumers living in those countries where this channel is often used for purchasing insurance policies⁸. Until now this distribution channel remained unregulated at EU level. Although conflict of interest rules relating to remuneration disclosure might be of low relevance here, consumers will definitely benefit from enhanced professional and information requirements for insurers' employees.

Secondly, IMD2 will cover various groups of professionals either selling insurance on an ancillary basis (e.g. travel agencies or car rental shops) or providing after-sales services (e.g. loss adjusters and experts appraising claims). The information requirements imposed by IMD2 on these distribution channels will help consumers, for example with understanding the coverage of insurance policies offered in addition to certain products or services (e.g. when renting cars or buying holiday packages).

By broadening the scope of the new rules, IMD2 will first of all provide the same level of information given to purchasers of insurance products irrespective of the channel. Additionally, a level playing field between 'traditional' intermediaries and other distribution channels will be guaranteed. Such a modification will also contribute to coherent application of insurance mediation rules in different Member States⁹. However, IMD2 requirements may be adapted according to the complexity of products sold, for example with regard to professional requirements for sellers of ancillary insurance products of low risk (Article 4 and 8 (1)). This will help to avoid disproportionate burdens for businesses.

Professional requirements

The proposal in its current form does not foresee any significant changes to the professional requirements in comparison to the old directive. All persons involved in insurance distribution shall possess an appropriate level of knowledge and ability, and demonstrate appropriate professional experience to perform their duties adequately (Article 8). However, the Commission has decided to make use of its new competences and empowered itself to supplement IMD2 by delegated acts. These future non-legislative acts will specify the notion of 'adequate knowledge and ability' and the criteria for determining the appropriate level of qualifications, experience and skills of carrying insurance mediation (Article 8 (8)). Hence, the IMD2 will become a framework directive reinforced by Level 2 measures providing for more detailed rules. This will allow for a more coherent interpretation by the Member States of certain notions which were unclear under IMD1, as well as legal certainty for both consumers and distributors.



Conduct of business rules and remuneration disclosure

The most significant change to be introduced by the IMD2, which will be of high relevance for the future purchasers of insurance products, concerns the disclosure of remuneration received by persons pursuing insurance mediation activities from third parties (Article 17 (1 f)). Modelled on examples from MiFID, the proposal for IMD2 requires all insurance distributors to inform their consumers about the different elements of the total price of insurance policies, including the nature (e.g. commissions or fees), structure and amount of their remuneration. The advantages of this new disclosure regime for consumers are two-fold: firstly, it will contribute to greater transparency when selling insurance products and allow consumers to better assess total costs of these products (e.g. parts of premiums paid to cover intermediaries' fees) and thus make better informed decisions. Secondly, adequate information on all costs and additional charges associated with insurance products will allow consumers to compare different channels and choose the cheapest one.

The MiFID conduct of business and conflict of interest rules has now become a clear benchmark for insurance selling practices; but it remains to be seen whether these rules will prove applicable for insurance.

Moreover, the IMD2 will address the problem of contingent commissions paid on the basis of achieving a pre-determined target. It will require intermediaries to tell their customers about such targets and amounts of commission paid upon achievement of such targets (Article 17 (1g)). Although contingent commissions will not be prohibited directly, the obligatory information on their existence will sensitise consumers to the risk of potential conflict of interest.

By requiring intermediaries to act honestly, fairly and professionally in accordance with the best interests of their customers, IMD2 will introduce only high-level rules on conduct of business and will therefore not raise consumer protection standards to the level guaranteed by MiFID (Article 15).

Strengthened consumer protection requirements for insurance investment products

The Commission decided, in line with its earlier announcements, to propose a set of distinct rules for insurance investment products. These products are sold in many countries as unit-linked life insurance policies or other investments packaged as life insurance policies. In contrast to classic insurance products, investment insurance products entail investment risk for their purchasers and are therefore classified as high-risk products. Nevertheless, in many countries they are either not regulated or fall under general insurance regulations; as a consequence, insurance intermediaries are not being required to disclose to their customers the costs and risk associated with these products. Most mis-selling cases concern this

type of products as consumers are often unaware of any risks involved and potential financial losses they may incur when buying these products. With a separate set of rules included in IMD2, the Commission wants to address this problem and at the same time fit into a broader discussion on the 'Consumer retail Package' and the regulation of so-called packaged retail investment products at EU level¹⁰.

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Insurance investment products will undergo a more stringent and MiFID-inspired regime on the identification, mitigation and disclosure of

conflicts of interest to provide consumers with even greater protection than when selling classic insurance products. Consumers buying insurance investment products will need to obtain information about the product's insurance coverage and all costs and investment risks related to it. Enhanced requirements also concern the provision of appropriate advice to customers with a proper assessment

of suitability and appropriateness of products during the selling process. Finally, IMD2 will introduce a revolutionary change concerning a ban on commissions and fees for independent insurance brokers selling these types of products. All these requirements are a copy-paste of MiFID rules; only their application in practice will help determine whether or not they are workable for the insurance sector.

Does IMD2 continue minimum harmonisation approach?

As mentioned before, IMD1 is a minimum harmonisation directive and its implementation resulted in many gaps and inconsistencies. Nonetheless, the Commission decided to maintain the same features for the IMD2. Such a solution might be an attempt by the Commission to accommodate different legislative developments in the Member States in the aftermath of the IMD1. For instance, when transposing IMD1 some countries (e.g. Finland and Denmark) introduced so called net-quoting system, namely that intermediaries were prohibited from receiving commissions from insurance firms. Maintaining a minimum harmonisation approach should allow these Member States to maintain stricter national rules. At the same time, countries where the remuneration has not yet been regulated (e.g. Poland), will be required to lift their regulatory standards to the level of IMD2.

However, parts of IMD2 relating to insurance investment products follow the MiFID approach, with high-level rules supplemented by detailed Level 2 delegated acts. Since MiFID is considered to be a maximum harmonisation Directive, this level of harmonisation might be unavoidable for insurance investment products. For the time being, it is not clear how much flexibility will be left to the Member States in this respect. Since the Commission strives to significantly raise minimum standards, the final outcome might be a high degree of harmonisation with consistent rules and the same consumer protection level across the EU.

Conclusions

The flaws in the IMD1 regime can be summarised in four points:

- Regulatory patchwork due to minimum harmonisation character;
- Insufficient information requirements to guarantee transparency for consumers;
- Lack of clear and efficient conduct of business and conflict of interest rules to prevent mis-selling of products;
- No level playing field between intermediaries and other distributors of insurance products.

The new IMD2 will address these issues by firstly expanding the scope of its application and thus creating a level playing field between different distribution channels. Consumers will definitely benefit from the same level of protection irrespective of the distribution channel through which they will buy insurance products.

Secondly, IMD2 will be a starting point for identifying, managing and mitigating conflicts of interest for classic insurance products and it will introduce a more enhanced regime for investment insurance products. The increased transparency on selling practices will help to avoid conflicts of interests and to regain consumer confidence and trust in insurance markets.

Furthermore, by reinforcing advice standards in relation to insurance investment products, IMD2 will introduce more transparency and help consumers to better understand the characteristics of different offers and whether products will be suitable for them.

Three points are worth mentioning when it comes to certain risks associated with the proposal for a new directive. In the financial services world new costs are often passed on to end-users, in our case insurance policyholders. New requirements for insurance business will involve costs which might, at the end, result in higher premiums for policyholders. Secondly, the mandatory disclosure of remuneration is a revolutionary step forward and will be a clear novelty for the insurance industry. However, it may incentivise intermediaries and insurance companies to look into new forms of cooperation and new commercial structures to circumvent this requirement. Finally, the new regime will distinguish between classic and investment insurance products, resulting in insurance distributors following different rules in the future. To provide for more simplification, the Commission might decide to align these rules when taking up a new revision exercise in the future. This might cause certain problems as MiFID rules might not always address the specificity of insurance business.

Notes

- ¹ COM(2012) 360/2; text of the proposal can be downloaded from http://ec.europa.eu/internal_market/insurance/docs/consumers/mediation/20120703-directive_en.pdf.
- ² Directive 2002/92/EC of the European Parliament and of the Council of 9 December 2002 on insurance mediation, OJ L 009, 15 January 2003
- ³ See a study prepared by CRA International: http://www.cityoflondon.gov.uk/business/economic-research-and-information/research-publications/Documents/2007-2000/Comparative%20Implementation%20of%20EU%20Directives%20III_Insurance%20Mediation.pdf.
- ⁴ Contingent commissions are paid by insurance companies to insurance intermediaries on the basis of the business generated for these insurance companies. While such commissions paid to insurance agents are less controversial due to fiduciary duties of the latter towards insurance companies, they might bias insurance brokers who owe fiduciary duties to their policyholders not to consider the best interest of the latter. The practice of paying contingent commissions to insurance brokers was investigated by the New York Attorney General Elliot Spitzer in 2003-2005. For more information on Spitzer investigations see <http://www.economist.com/node/3308447>.
- ⁵ Problems with the mis-selling of insurance products were encountered e.g. in the Netherlands, Belgium and in the UK; European Commission's Impact Assessment accompanying the proposal for a Directive on insurance mediation, http://ec.europa.eu/internal_market/insurance/docs/consumers/mediation/20120703-impact-assessment_en.pdf, pp. 20-22; van Dijk, M., The price of free advice, *CPB Discussion Paper* No 66, pp. 12-14, July 2006.
- ⁶ Remuneration disclosure concerns the disclosure to an insurance purchaser of any commissions, fees and other means of remuneration an insurance intermediary may receive from an insurance company when selling this company's product. See the final report of the European Commission at http://ec.europa.eu/competition/sectors/financial_services/inquiries/final_report_annex.pdf, page 74.

- ⁷ See Commission's consultation document http://ec.europa.eu/internal_market/consultations/docs/2010/insurance-mediation/consultation-document_en.pdf.
- ⁸ For statistics, please see the report of the Insurance Europe *Insurance distribution channels in Europe*, March 2008, <http://www.insuranceeurope.eu/uploads/Modules/Publications/cea-statistics-nr-39---distribution.pdf>, pages 17 ff.
- ⁹ For instance, French and UK legislation transposing IMD1 included car dealers in the scope of the Directive and in other countries this distribution channel remained unregulated.
- ¹⁰ Packaged retail investment products are financial products (from banking, securities and insurance sector) offered through different legal structures. They may appear as non-investment products but in reality entail an investment element and risk for the customer through exposure to the performance of assets. They may have different legal structures but the same economic function – return through exposure to assets. An element of packaging and indirect investment risk are key characteristics of these products. The Discussion on regulating these products started in 2007 and a separate proposal was put forward by the Commission in 201