

PRODUCT OVERSIGHT GOVERNANCE (POG) IN YOUR ADVISORY PRACTICE: NOW WITH SUSTAINABILITY

Since 2018, the Insurance Distribution Directive (IDD), a European Directive, has been in effect. For investment firms, the Markets in Financial Instruments Directive (MiFID) already existed; the IDD is its counterpart. The IDD has been transposed into Dutch legislation; you can find the legislation in the Financial Supervision Act (Wft) and the Decree on Conduct of Business Supervision of Financial Undertakings (Bgfo).

In this contribution, we delve into the product approval process regulated by the IDD, which was in the making for several years before 2018 but still poses compliance issues. Adhering to various pieces of European legislation, serving the customer's interest, and providing correct and comprehensive information to the customer is not getting any easier. We illustrate this by elucidating the new standards regarding sustainability for insurance-based investment products (IBIPs). These intersect with other European rules regarding sustainability information disclosure, which are simultaneously applicable. As an insurer, intermediary/advisor, or authorized agent, you typically first solve a puzzle regarding the applicability to your activity before you can proceed.

Purpose of the IDD

The aim of this directive is to create a level playing field within the European Union for all market participants offering or distributing insurance products. The directive promotes equal competition conditions among market participants and, through the consideration of customer interests, a suitable standard of consumer protection. The directive also aims to harmonize sanctions for violations within the European Union. The customer must know what they are getting and whether the product aligns with their wishes and needs. And throughout the EU, they must be able to trust that the regulator will intervene if necessary. These obligations already existed in the Netherlands before the IDD. The IDD has added details in the areas of target group determination but also the obligation for the distributor to establish a product distribution process with its own distribution strategy.

Splitting the IDD Between Product Developer and Distributor

The IDD makes a distinction between the product developer and distributor. Despite various publications on this topic, there is often still confusion about when an insurer or distributor qualifies as a product developer or not. Here, a product developer is understood to be insurers or intermediaries who develop, assemble, and make insurance policies available. Distributors refer to advisors and intermediaries. The first step is always to determine which role you have for which product. Are there maybe multiple roles? What product development standards actually apply to you as an advisor? The IDD therefore also applies to advisors of insurance products, whether or not with an investment component. Distributors are intermediaries who advise or sell insurance products that they have not developed themselves. For distributors, the following rules apply:

- Establishment: The distributor establishes a product distribution process.
- Alignment: The distribution strategy and target group are in line with those of the developer.

- Evaluation: The product distribution process is periodically evaluated.
- Information provision upon request from the developer and proactively. To achieve this, the distributor must comply with a number of further rules. They must align their policies and processes with what the developer has determined. They must evaluate their own distribution and

Any specific details about the target audience and any mismatches should be relayed back to the developer. This requires a system of internal product and process controls. New in the IDD is that the developer has already determined in advance whether a product is suitable for execution-only or advisory. As a distributor, you may further limit this but not expand it. How does this relate to sustainability and the product approval process? In a directly applicable regulation on IBIPs, which is part of the IDD, sustainability factors, risks, and preferences for product oversight and governance are integrated. For distributors, they must consider 'the objectives, interests, and characteristics of customers, including sustainability objectives.' Based on what the developer has reported, they must identify the right customers. The IDD regulation stipulates that sustainability factors are integrated into product suitability assessments and the pre-contractual suitability statement for IBIPs. As an advisor, you must take into account the sustainability preferences of the client and also act on them. Advising on a non-sustainable product can therefore mean unsuitable advice. And no, vice versa not. And even more complicated: if there is no suitable advice possible due to (overly ambitious) sustainability preferences of the client, the client may only proceed again if it is recorded that they waive their sustainability preferences for this advice.

Transparency Requirements for IBIPs

Parties offering IBIPs or advising customers on the choice of investments within an IBIP are subject to transparency requirements on sustainability, in addition to the IDD requirements. The customer must receive specified sustainability information. Even if the product is not sold as a sustainable product. This also comes directly from an EU Regulation, called the Sustainable Financial Disclosure Regulation (SFDR). The developer of an IBIP must have labeled the IBIP with a certain sustainability category. If an IBIP is deemed sustainable, this triggers an obligation for further explanation about the sustainability of the product. But even with a non-sustainable IBIP, the developer must indicate the negative effects of the product on ESG factors and what the sustainability risks of the investments within the product are. This results somewhat in the proverbial paperwork. Ultimately, it is the advisor who must be able to explain all these nuances and different flavors of IBIPs. And, from the IDD, the client's preference must match the right product, to ultimately have given suitable advice. With IBIPs, you are therefore dealing with sustainability requirements at both the target group and customer levels. The idea is that customers, thanks to SFDR being well-informed and thanks to IDD being asked about their preferences, will choose sustainable investments.

Findings from the regulator:

Work to be done

The AFM recently found in a series of reports that many market participants do not comply with the mentioned SFDR transparency rules, while the rules are already in effect. From the pre-contractual information for products, it must be apparent to the investor (and therefore also to the IBIP policyholder) how sustainability risks are integrated into investment decisions. Where this does not occur, this may constitute a violation. We quote: 'As a result, the investor does not get a complete picture of the sustainability of the asset management portfolio or investment insurance as a whole. Furthermore, the AFM has not found any of the surveyed websites to have periodic reporting with the prescribed sustainability information, while this has been mandatory since 2022.' Also, pay attention to non-selling investment insurance; you must also have information available on this. AFM: 'This means, among other things, that for these existing IBIPs, the extent to which the sustainable characteristics or objectives of the product are met must be described in periodic reporting. In its research, the AFM did not find such information on websites.'

Taxonomy Regulation

Determining the extent to which an (insurance-based) investment product is sustainable can only be done using the Taxonomy Regulation. This has also been in effect since 2022. This is a kind of reference work, to be used as a measuring instrument, which is perceived as very complex. This regulation must highlight multiple sustainability themes but is not 'complete' and is also not very easy to read. It requires a considerable study to determine whether a product is 'Taxonomy-aligned.' A problem here, alongside the complexity, is that there is still insufficient sustainability data about the underlying investments. Are you yourself an issuer or assembler of an IBIP? Then you have to deal with this. As an advisor, you rely on what the product developer publishes.

In conclusion,

We have described how product governance of insurance products affects not only the providers or assemblers but also the distributors. It is an ongoing task to keep one's own distribution strategy and information provision in order. And if you advise on IBIPs, including the ongoing non-selling portfolio, you must comply with the SFDR without yet knowing exactly how 'taxonomy-aligned' the investment is. Keep in mind that these are already applicable rules, which are continually being further elaborated. An inevitable 'paperwork' for all involved. Hopefully, one that indeed contributes to the larger goal of redirecting capital flows on a large scale towards more sustainable investments.

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