Regulatory impact of the Insurance Distribution Directive on the investment services industry

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Directive 2016/97/EU on Insurance Distribution ("IDD"): a new regulatory trap for the asset management and private banking industry rendering services to clients based in the EEA?

This new EU legislation must be applied on 1 October 2018 by a vast group of providers, globally redefined as insurance "distributors".

The objective of IDD is to ensure that "consumers" benefit from the same level of protection despite the differences between distribution channels. A level playing field between distributors presented as essential (see preamble of the Directive, recital 6).

The previous Insurance Mediation Directive merely referred to "policyholders" versus "consumers". The deliberate choice to change terminology gives way to the introduction of completely new liability principles, including the ones applicable to product liability, depending on the civil law sanctions to be adopted on a national level.

Definition of ancillary insurance intermediary v. insurance intermediary

Throughout the EU legislative process, which aims at a minimum harmonisation, the importance of ensuring effective consumer protection across all financial sectors was particularly underlined, with an express reference to current and recent financial turbulence. As an immediate consequence, it was held important to take into consideration the specific nature of insurance contracts in comparison to investment products regulated under MiFID II.

Unlike the definition of insurance distribution which did not undergo substantial modifications (except the reference to electronic distribution activities), the altered definitions of "insurance intermediary" and "ancillary insurance intermediary" can be considered as taking into account the diversity of distribution channels in Member States. However, explicit clarifications also close the door to possible diverging interpretations.

Asset management firms and banking institutions which provide investment services to their private clients residing in the European Economic Area also use, propose and carry out preparatory work to the conclusion of insurance contracts. They may even be providing advice on such conclusion and assist in the performance of such contracts. These financial entities may either assume that they do not perform insurance activities or consider these activities purely ancillary, therefore not complying with specific regulatory requirements.

This is where IDD's new definitions come into play.

Ancillary insurance intermediary means any natural and legal person, ***other than a credit institution or an investment firm***, who, for remuneration, takes up or pursues the activity of insurance distribution on an ancillary basis, provided that:

- The principal professional activity of that natural or legal person is other than insurance distribution;
- The natural or legal person only distributes certain insurance products that are complementary to the good or service;
- The insurance products concerned do not cover life assurance or liability risks, unless that cover complements the good or service which the intermediary provides as its principal activity.

Therefore when investment firms and credit institutions (1) perform insurance distribution activities in addition to their principal professional activity and (2) receive remuneration for this activity, they actually pursue insurance distribution activities on a non ancillary basis according to the wording of the provision set above.

Ultimately, this means that, unless evidence is given that they do not perform insurance distribution services (see art. 2 (2) of IDD, e.g. mere "provision of information on an incidental basis"), upon implementation, these firms and credit institutions must abide by all rules applicable to insurance distributors. This includes, but is not limited to, compulsory registration requirements, information and organisational requirements as well as conduct of business rules.

Remuneration – Inducement policy – Principal activity

MiFID II (Directive 2014/65/EU on financial market instruments and the delegated Regulation 2017/565) has already introduced new disclosure standards for investment firms and remodeled the financial environment: the aim is to increase the protection of investors. MiFID II considerably restricts or in certain cases prohibits the payment of inducements (re. where investment advice is provided on an independent basis, see under Section 2, article 24 (7) (b) "General principles and information to clients" of the Directive: *"where an investment firm informs the client that investment advice is provided on an independent basis, that investment firm shall: (...) not accept and retain fees, commissions or any monetary or non-monetary*

benefits paid or provided by any third party or a person acting on behalf of a third party in relation to the provision of the services to clients").

The delegated Regulation (EU) 2017/2359 ("CoB") supplementing IDD with regard to information requirements and conduct of business rules applicable to the distribution of insurance-based investment products provides a non-exhaustive list of criteria deemed relevant for the assessment of inducements paid or received by insurance intermediaries and insurance companies.

Effective conflicts of interest policies should be established, implemented and maintained by insurance intermediaries and allow them to identify the circumstances which constitute or may give rise to a conflict of interest entailing a risk of damage to the interest of customers. These policies should allow them to manage conflicts and prevent them from damaging the interests of the customer.

According to Article 5 of above mentioned CoB Regulation, procedures and measures under the conflict of interest policy shall notably include the "*removal of any direct link between payments, including remuneration, to relevant persons engaged in one activity and payments, including remuneration, to different relevant persons principally engaged in another activity, where conflict of interest may arise in relation to those activities*".

In order to keep remuneration ongoing, conflicts of interest will need to be excluded ex-ante.

In practice, different schemes enable insurance distributors to receive remuneration when promoting specific UCITS funds to serve as underlying to the insurance contracts.

In some jurisdictions, life insurance products include external asset management services on an advisory basis within the insurance wrapper.

Conflict of interest can typically arise out of the two situations cited above.

The industry will have to face additional challenges and may have to rethink (1) the way entities are structured and operate when it comes to providing investment services and distributing insurance, and (2) the contractual set-up when the conclusion of insurance contracts generates brokerage fees as well as financial fees (such as fund distribution fees).

The instruction given to the industry (article 6 of CoB Regulation) not to over-rely on disclosure, and that disclosure to customers is a measure of last resort when dealing with conflicts of interests will certainly not close the debate.

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