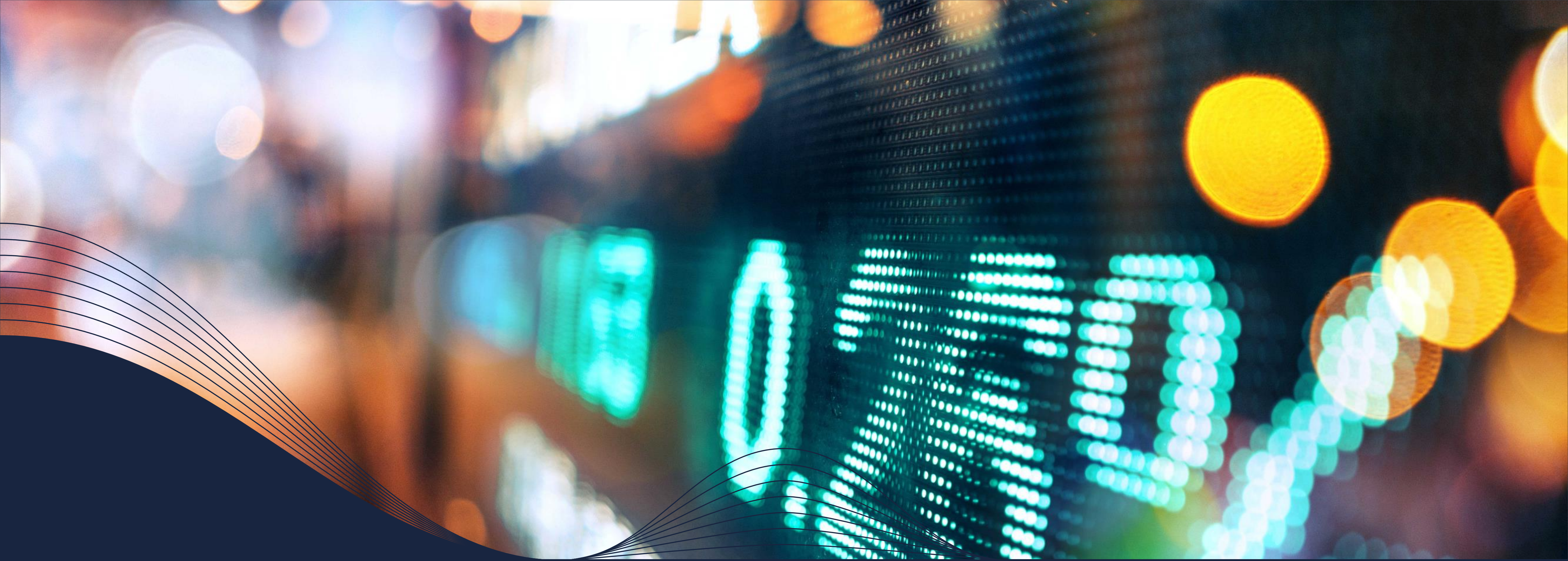

Value for money in the financial sector

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DLA PIPER

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1. History

1. History: since 1975

Among the priorities of the European Commission*:

To promote the more general economic interests of consumers

“In order better to satisfy the individual and collective needs of consumers, solutions should be sought to certain general problems such as:

- *how the individual can obtain better **value for money** for the goods and services supplied;”*

*Council Resolution of 14 April 1975 on a Preliminary programme of the European Economic Community for a consumer protection and information policy (in annex)

1. History: revival and diffusion of the notion

First phase
EIOPA

Second phase
ESMA

Third phase
European Commission

Insurance Distribution Directive (Directive 2016/97/EU, IDD)

1. Framework for assessing conduct risk through the product lifecycle, 2019
2. Consumer Trends Report, 2019
3. Supervisory Statement on assessment of value for money of unit-linked insurance products under product oversight and governance, EIOPA(2021)0045739, 2021
4. Supervisory statement on differential pricing practices in non-life insurance lines of business, EIOPA-BoS-23/076, 2023
5. Methodology on Value for Money benchmarks, EIOPA-BoS-24-332, 2024

1. 2020s: revival and diffusion of the notion

First phase
EIOPA

Second phase
ESMA

Third phase
European Commission

Markets in Financial Instruments Directive (Directive 2014/65/EU, MIFID II)
Alternative Investment Fund Managers Directive (Directive 2011/61/EU, AIFMD)
Undertakings for Coll. Inv. In Transf. Securities (Directive 2009/65/EC, UCITSD)

1. Market report (fifth edition) on costs and performance of EU retail investment products, 2023

1. 2020s: revival and diffusion of the notion

First phase
EIOPA

Second phase
ESMA

Third phase
European Commission

Retail Investment Strategy (2023/0167(COD), MiFID II and UCITSD)

1. Proposal for a Directive as regards the Union retail investor protection rules (explanatory memorandum, par 1), i.e. Retail Investment Strategy, 2023.
2. Impact assessment accompanying the Retail Investment Strategy proposal, 2023.

2. Policy objectives and key concepts

2. Policy objectives

Good consumer outcomes

Fairly priced or cost-efficient products

The costs of certain products are unjustifiably excessive or do not provide enough benefits, considering those costs (ESMA 2023, EIOPA 2021)

Distribution to the right consumers

Due to their features, certain products may not be beneficial for all consumers, for example due to excessive financial risk. Therefore, firms must assess whether the product is beneficial for the consumer to whom it is sold (EC 2023)

2. Key concepts

Cost-benefit proportionality

- Balance between costs of the product and its benefits to the target consumer

Examples

- *EIOPA 2021: "when costs and charges are proportionate to the benefits (…) to the identified target market as well as reasonable, taking into account the expenses born by the providers"*
- *ESMA 2020: "whether the costs are proportionate compared to market standards and to the type of service provided"*
- *EC 2023: costs and charges "justified and proportionate"*

Product governance

- Meta-regulation: two mechanisms
- Primary mechanism:
  Firms must evaluate products to ensure value for money for all segments of target market, and demonstrate compliance to supervisor
- Secondary mechanism:
  In case of failure to comply, supervisor provides guidance and where deemed necessary, applies intervention and/or sanctioning powers

Reference points

- Assessment of value for money involves wide range of reference points:
  - Product: costs and (non-)monetary benefits, in general (product features and service)
  - Provider: profit margins
  - Segments: costs and benefits for specific segments, usage data (e.g claims, defaults)
  - Market: competitors' prices for comparable products (benchmarks), economic variables (e.g. interest rates)
- Adds to conceptual ambiguity!

3. Insurance sector

3. Insurance sector: legal basis

Art. 25.1 IDD: obligation to have a product approval process before it is marketed or distributed (EC to adopt delegated rules, 25.2)

Art 6.2 IDD DR: only bring to market products compatible with needs, characteristics and objectives of the customers belonging to the target market.

If differential pricing, also Art. 17 IDD: obligation to always act honestly, fairly and professionally in accordance with the best interests of their customers

Recital 8 - The requirement to assess the product performance should however not be understood as an *interference with the manufacturers' freedom to set premiums or as price control in any form*.

Value for money
(EIOPA August 2024, par 1.9)

3. Supervisory approach

1. **What is Value for Money (VfM)?**
   - A methodology developed by EIOPA to ensure insurance products deliver proportional costs and fair benefits to consumers.
   - Central to EIOPA's supervisory approach since November 2021.

2. **Objectives of the VfM Initiative**
   - Support National Competent Authorities (NCAs) in identifying products with potential value-for-money (VfM) risks.
   - Facilitate a risk-based supervisory approach.
   - Assist manufacturers in performing comparative analyses of products to validate proportional costs.
   - Promote consumer-centric product development and testing in line with regulatory requirements.

3. **Scope**
   - Focused on unit-linked and hybrid insurance products across the EU market.

3. EIOPA's Methodology August 2024

Background on VfM Initiative

- Initiated after the Supervisory Statement on VfM (November 2021).
- Focus: Address risks in unit-linked and hybrid insurance products with customer-centric approaches.
- Objective: Enable NCAs to implement consistent supervisory measures and provide clear guidance for insurers.

Stakeholder Engagement

- Benchmarks developed based on stakeholder requests and approval by EIOPA's Board of Supervisors (BoS).
- Objectives:
  - ✓ Support NCAs in identifying high VfM risks for risk-based supervision.
  - ✓ Assist manufacturers in comparing products to verify proportional and justified costs.

Complementary Nature of Benchmarks

- Benchmarks complement POG activities such as product testing during design phases.
- Emphasis: Products must independently deliver VfM regardless of benchmark alignment.

3. Categorization of Investment Based products (IBIPs)

1. **Product categories defined by EIOPA**
   - Unit-Linked Products (ULPs): Pure unit-linked policies tied to fund performance.
   - Hybrid Products Type 1: Flexible allocation between unit-linked and profit participation options, as chosen by the consumer.
   - Hybrid Products Type 2: Pre-determined allocation strategies between unit-linked and profit participation components.

2. **Multi-Option Products (MOPs)**
   - Categorization of MOPs considers the most sold, cheapest, and most expensive combination plus specific investment option.

3. **Clustering Features for Categorization (5)**
   - Product Category, Recommended Holding Period (RHP), Premium Frequency, Biometric Coverage and Summary risk indicator (SRI)

3. Product Oversight and Governance (POG) Analysis

1. **Role of VFM and POG Assessments**
   - Ensures consumer-centric product design, validation, and testing.
   - Embeds VfM principles during all product lifecycle stages, from design to distribution.

2. **Alignment with VfM benchmarks**
   - POG analysis uses benchmarks to validate product features, costs, and benefits.
   - Benchmarks facilitate comparisons with competitors’ product-price offerings, but are not: (i) a **Safe Harbour** and (ii) **not intended as price regulation.**

3. **Key POG Activities**
   - Regular product testing.
   - Cost-benefit analysis to justify proportionality.

3. Development benchmarks with NCAs

1. Three-Steps Development Process

Define Product Clusters

- Group products (e.g., unit-linked, hybrid) based on shared features and policyholder needs.
- Reflect diversity across EU insurance markets.

Identify Indicators

- Use metrics like: entry costs, total costs, insurance benefits, Reduction in yield (RIY), surrender, IRR, Break even return refined through stakeholder feedback.

Data Collection and Calibration

- Leverage existing data (e.g., CPP report).
- Reduce reporting burdens.

3. Zooming in on clustering

Minimum clusters and key features – Step 1

1. **Minimum cluster**
   - 204 clusters ensure product homogeneity and market representativeness

2. **Clustering features:**
   - Product Category: Unit-linked, Hybrid Type 1, Hybrid Type 2
   - Premium Frequency: Single vs. regular payments
   - RHP: Short (<10 years), medium (10-20 years), long (>20 years)
   - Biometric Coverage: Significant or other
   - Asset Class: Equity, asset allocation funds, or other
   - Summary Risk Indicator (SRI) will allow to differentiate between risk of the investments and foster comparison between similar products.

3. Zooming in on indicators

Identifying and evaluating indicators - Step 2

1. **Purpose of Indicators**
   - Assess costs, benefits, and performance for
     - ✓ Supervisory oversight.
     - ✓ Product design refinement.

2. **Key Indicators**
   - **Entry Costs**: Costs at subscription as a percentage of: (i) premiums (ii) total costs.
   - **Total Costs**: All policyholder costs relative to premiums.
   - **Reduction in Yield**: (RIY): Impact of costs on returns.
   - **Surrender Value**: Comparison of surrender value to premiums paid.
   - **Internal Rate of Return (IRR)**: calculated according to PRIIPS KID methodology with the RHP of the underlying investment.
   - **Insurance Benefit Ratio**: Insured event scenarios / total premium.
   - **Break-even Return**: Minimum returns (net) required to recover costs.

3. Zooming in on benchmarks setting

1. **Setting benchmarks**
   - Derived from product cluster data
     - ✓ Benchmarks are calculated based on data collected for each cluster
   - Quartile Methodology
     - ✓ For most indicators, higher values indicate worse VfM (e.g., costs).
     - ✓ For indicators like IRR and surrender value, higher values indicate better VfM (e.g., returns).

2. **Caution areas**
   - Benchmarks include caution ranges to highlight areas requiring further scrutiny.
   - Purpose: Support NCAs in identifying potential VfM risks that demand additional analysis.

3. Deviation from benchmarks

Non-clustering features and adjustements

Purpose

- Recognize qualitative and quantitative product benefits that justify deviations from benchmarks.
- Equip NCAs to assess products outside benchmark ranges more effectively.

Key Features

- **Guarantees**
  - Premium guarantees (≥80% at RHP).
  - Flexibility in withdrawal options enhances value for consumers.
- **Digitalization:** Improved digital tools supporting better consumer experiences during sales and usage.
- **Risk Mitigation:** Dynamic allocation strategies to reduce financial risks (e.g., diverse asset types or currencies).

Special Features

- Products with **pension benefits** (e.g., annuitization or increasing returns during accumulation).
- **Sustainability attributes** (e.g., Article 8 or 9 under the Sustainability Disclosures Regulation).
- These features may justify adjustments in caution areas during benchmark evaluations.

4. Investment sector

4. Legal basis MiFID II

Art. 16.3 and 24.2: manufacturers design financial instruments meeting needs of target market and operate product approval process

Art. 24.2: distributors to assess compatibility of financial instruments with the needs of clients, target market (16.3), only offer if in interest of client

Art 9.12 DR/593: charging structure: (a) costs and charges must be compatible with needs, characteristics and objectives of the target market, (b) charges do not undermine the financial instrument's return expectation.

Art 10.2 DR/593: ensure that products and services they intend to offer or recommend are compatible with the needs, characteristics, and objectives

Value for money
(ESMA guidance 2023, p 78)

Art. 25.2: suitability assessment includes costs and features in light of personal financial situation and investment objectives

Art 54.2 DR/565: alignment with client's objectives, ability to bear risk

Suitability guidelines
(ESMA 2022, par 76)

Value for money
(ESMA report 2023, p 10)

4. Legal basis: UCITS/AIFMD

Art. 14.1.a UCITS: acts honestly and fairly in conducting its business activities in best interests of UCITS it manages (and market integrity)

Art. 12.1.b AIFMD: act in best interests of AIFs or investors of AIFs they manage (and market integrity)

Art 22.4 UCITS DD/43: no undue costs being charged to the UCITS and its unit-holders.

Art 17.2 AIFMD DR/231: AIFs or the investors in these AIFs are not charged undue costs.

What are undue costs (ESMA briefing 2020)

Undue *quantum* (ESMA opinion 2023, 23-28)

Value for money (ESMA report 2023)

4. Retail Investment Strategy – Omnibus Directive

Inter alia, codification of VfM rules in MiFID II Level 1 POG rules for selected products

New Art 16-a (product governance requirements for manufacturers, par 1)

Product approval process

Only if FI is packaged retail investment products ex Art 4(1) PRIIPs Regulation

Pricing process (sub e)

A — clear identification and quantification of all costs and charges related to financial instrument

B — assessment of whether those costs and charges are justified and proportionate (J&P), considering characteristics, objectives, strategy, performance of FI

VFM = J&P
Recital (10)

C — Other reference points?

Mandatory comparison with relevant ESMA/EIOPA benchmark on costs and performance

No deviation – no issue?

Deviation

D — Additional testing and further assessments to establish J&P

J&P established?
Approval

J&P not established?
No approval

Distributors (Art 16-a par 4)

- Step A must refer to costs of distribution and other costs/charges not already considered
- Step B J&P must consider objectives and needs target market
- Deviation relates to FI and costs of services

4. Retail Investment Strategy – State of play

Diverging positions between trilogue parties and ESMA (e.g. manufacturers under MiFID)

Position (see previous slide)

- NB: new Commission may have different views, which impact the trilogue negotiation process

COMMISSION

- Standard of assessment replaced with 'value for money', J&P is implementation
- Steps C and D integrated:
  (1) appropriate product testing and assessments, which includes market comparison (peer group analysis)
  (2) Peer group defined by MiFID II and delegated act of EC.
  (3) If 'significant distance from peer group average to client's detriment, additional testing/further assessment.
  (4) if necessary, manufacturer determines and takes appropriate actions to ensure VFM.
- Option MS to allow comparison with Union supervisory benchmark, instead of peer group

COUNCIL

- Assessment manufacturer must also consider objectives and need target market
- Monetary and non-monetary benefits
- Regular review of any event/risk materially affecting target market
- New 4a: costs and charges compatible with objectives, needs characteristics target market
- Manufacturer and distributor to perform peer group analysis (group defined by the firm), ESMA to develop guidelines.
- Benchmarks as supervisory tool, and national benchmarks if no cross-border manufacturing and distribution (Art 69a)

PARLIAMENT

- ESMA and EIOPA believe that European benchmarks contribute to the 'objectivity of the product pricing process' and help supervisors to 'prevent that products not offering value for money are marketed to retail investors'
- Effectiveness weakened by
  (i) national benchmarks, no ESMA supervisory powers;
  (ii) dual system of peer grouping requirements and European supervisory benchmarks (which have limited role, no clear powers);
  (iii) Non-public nature of peer grouping database (Council position) is not efficient, and consumers not empowered through information.
- Council's cross-border supervisory collaboration regime creates hurdles.

ESMA and EIOPA

5. Banking sector (credit)

5. Potential legal basis: CRD, MCD, CCD2

Credit institutions and mortgage credit

Art. 74.1 CRD: obligation to have robust governance arrangements, …including effective processes …

Art. 7.1 MCD: obligation to act honestly, fairly, transparently and professionally, considering consumers' rights and interests

EBA 2016 guidelines on product oversight and governance, 3.3: The manufacturer should only design and bring to the market products with features, charges and risks, that meet the interests, objectives and characteristics of, and are of benefit to, the particular target market identified for the product.

EBA does not use VFM, but could it revise update these guidelines to incorporate VFM? CJEU cases C-911/19 and C-501/18 suggests so…

Consumer credit

Art. 31.1 CCD2: MS measures to prevent abuse and to ensure consumers not charged with excessively high prices

Art. 32.1 CCD2: obligation to act honestly, fairly, transparently and professionally, considering rights and interests, if manufacturing, granting credits

EBA only to publish report, no express delegation.

- *However, CCD1 was in remit EBA regulation, so it is free to adopt guidelines to promote supervisory convergence.*
- *That said, CCD2 tasks MS with price control…*

6. Considerations

Conceptual ambiguity

- Problematic to implement
- Difficulties to value certain product attribute (e.g. IT platform, ESG) in the pricing
- Intensive to supervise

Legal basis

- Principle of free competition
- VFM restricts pricing discretion
- Price Regulation mandate ?
- Not clear that obligation to act honestly, fairly and professionally includes substantive fairness
- Needs / characteristics / objectives requirement does not include price, without legislative basis (e.g. IDD DR recital!)

Economic consequences

- Reduced product diversity, especially for specific consumer segments
- Increase costs for product manufacturers
- VFM may ultimately cause prices to *rise*, due to reduced competition

Misconceived emphasis on costs

- Problem of price differentiation
- Problem of product differentiation (superior quality)
- Homogenisation of heterogeneous customer needs

Q&A

Thank you!

Merci!

Dankeschön!

Villmools merci!