



JOINT COMMITTEE OF THE EUROPEAN
SUPERVISORY AUTHORITIES

JC-2013-77

Joint Position

of the European Supervisory Authorities

on Manufacturers' Product Oversight & Governance Processes

Executive summary

1. The “Joint Committee” is a forum established on 1 January 2011, with the goal of strengthening cooperation and ensuring cross-sectoral consistency between the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA), collectively known as the European Supervisory Authorities (ESAs). Consumer protection is a major objective of the ESAs and, together with the Joint Committee; the ESAs will continue to prioritise consumer protection in 2013.
2. The Joint Committee was tasked with developing a set of high-level, cross-sector principles on financial institutions’ internal product approval process. The aim is to enhance consumer protection by strengthening the process controls by manufacturers before product launch and thus discouraging products and services that may cause consumer detriment from reaching the market. The principles therefore cover responsibilities of manufacturers in organising processes, functions and strategies aimed at designing, operating and bringing products to market, and reviewing them over the life of the product.
3. In accordance with Article 56 (“Joint positions and common acts”) of the ESA regulations¹, the ESAs, without prejudice to any further work in this area, have agreed to the high-level principles on product oversight and governance processes within financial institutions set out in this Joint Position.
4. The principles set out the ESAs’ general view of the product oversight and governance requirements to be placed on manufacturers across the three sectors. The Joint Position therefore provides consistency between the sectors, which should be of benefit to consumers, financial institutions and competent authorities. The Joint Position is not addressed directly at any of them. Rather, it provides a common, high-level agreement based on which each ESA may develop more detailed provisions for their respective sector at a later stage. Only these more detailed provisions will be directed at financial institutions and/or competent authorities, and will be consulted on at that later stage.
5. The Joint Position is without prejudice to work that is being developed by the ESAs within their respective areas of competence, in the context of the on-going review of sectorial directives, such as Directive 2004/39/EC on markets in financial instruments (MiFID), Directive 2002/92/EC on insurance mediation (“IMD”), the Directive 2009/138/EC of the European Parliament and the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (“Solvency II”) and the Payment Services Directive (PSD).

Definitions

6. For the purpose of this Joint Position only, the following indicative definitions apply insofar as they do not conflict with similar definitions in any relevant sectoral legislation that may also apply:
 - *Target market*: a group of consumers for whom the manufacturer is developing the product.
 - *Manufacturer*: any natural or legal person that is responsible for the development and issuance of a product or any natural or legal person that makes changes to, or combines, products, provided that the natural or legal person is, for the purpose of its manufacturing activity, subject to regulation under Union sectoral legislation within the scopes of action of one or more of the ESAs.
 - *Distributor*: any natural or legal person that offers and/or sells the product to consumers.

¹ EBA: Regulation (EU) No 1093/2010, ESMA: Regulation (EU) 1095/2010, EIOPA: Regulation (EU) No 1094/2010

- *Product*: any product, financial instrument or service developed by the manufacturer that falls within the ESAs' scope of action as laid down in Article 1(2) of their founding regulations.
- *Product oversight and governance*: the responsibilities of manufacturers in organising processes, functions and strategies aimed at designing, operating and bringing products to market, and reviewing them over the life of the product. Product oversight and governance is distinct from product approval by regulators in the formal licensing or authorisation sense or regulatory interventions such as 'banning' (i.e. product intervention).

The Principles

7. The ESAs have developed the following principles that they agree to consider when developing policy with regard to manufacturers' product oversight and governance processes within the respective legal frameworks. In doing so, the ESAs will take into account the principle of proportionality and the type(s) of product, financial instrument or service.
 - I. In order to minimise potential consumer detriment, avoid potential conflicts of interest, and ensure that the interests and objectives of target markets are duly taken into account, the manufacturer should establish, implement, and review on an ongoing basis product oversight and governance processes.
 - II. The manufacturer's executive board should endorse the product oversight and governance processes. Senior management should take responsibility for compliance with these processes before and after the launch of a product, and should ensure that adequate records of this assessment are maintained.
 - III. As part of the application of its product oversight and governance processes, the manufacturer should identify the target market of the product; analyse its characteristics; and ensure that the product meets the identified objectives and interests of that target market.
 - IV. The manufacturer should conduct product testing to assess how the product would function in different, likely scenarios, including stressed scenarios, to ensure that the product is aligned with the interests and objectives of, and leads to fair outcomes for the target market.
 - V. When setting the charges and features of the product, the manufacturer should also take appropriate steps to ensure they are transparent for the target market.
 - VI. The manufacturer should select distribution channels that are appropriate for the target market and disclose clear, accurate and up-to-date information to distributors.
 - VII. The manufacturer should monitor periodically the functioning and operation of the product to ensure that it continues to meet the objectives and interests of the target market and should, where appropriate, review the product to ensure compliance.
 - VIII. The manufacturer should take appropriate action when issues that may lead to consumer detriment have materialised or can be reasonably anticipated.

Explanatory notes

8. Recent developments show that products and services can cause consumer detriment. The ESAs were established to foster consumer protection and, at the same time, to promote the stability, effectiveness and integrity of the financial system.
9. Designing, operating and bringing products and services to markets may pose a risk to these two objectives if the target market is not identified correctly; their objectives and characteristics are not duly taken into account; or if products are sold outside of the target market.
10. In seeking to fulfil its task to develop a set of high-level, cross-sector principles, the Joint Committee conducted a survey in 2012 among national competent authorities (NCAs), in order to:
 - gauge problems or failures in the area of product development and governance processes within firms;
 - map national initiatives in the above-mentioned area; and
 - collect the opinions of the NCAs on the need for further development of cross-sectoral high-level principles for manufacturers' product oversight and governance at EU level and, if so, on the scope of the aforesaid principles.
11. The survey revealed numerous instances in which manufacturers had failed to have proper product oversight and governance arrangements in place, which then resulted in consumer detriment; a reduction in consumer confidence in financial markets; and, in cases where compensation had to be paid, an impact on the prudential situation of financial institutions. As set out in Annex 1, these issues have arisen across the three sectors of banking, insurance and investments, and across a few EU Member States.
12. Based on the results of the survey and the subsequent analysis done by the Joint Committee, and taking into account the principle of proportionality and existing and proposed EU legislation, the ESAs have developed this Joint Position on manufacturers' product oversight and governance processes.
13. The above approach is based on the following legal provisions:
 - Article 2(3) of the ESAs' founding regulations provides that the ESAs shall cooperate closely among themselves "*through the Joint Committee, ensuring cross-sectoral consistency of work and reaching joint positions in the area of supervision of financial conglomerates and on other cross-sectoral issues*".
 - Article 56 of the ESAs' founding regulations provides that the ESAs are empowered, within the scope of tasks in Chapter II of said regulations, to reach joint positions among themselves, as appropriate.
14. The aim of the principles is to strengthen manufacturer's internal controls prior to product launch. The principles do not aim at requiring or introducing product approval, licensing and/or prohibition by NCAs.
15. The principles apply to the development of products or services that are predominantly targeted at consumers in the banking, securities and insurance sectors.

16. The principles are without prejudice to any additional requirements that may be imposed on distributors through existing and/or forthcoming EU and national regulations. Distributors will continue to have to comply with those requirements when selecting and bringing products to market.
17. This Joint Position shall be effective on endorsement by the Boards of Supervisors of each ESA.

Next steps

18. The above principles set out the ESAs' general view of the product oversight and governance requirements placed on manufacturers across the three sectors. The Joint Position provides consistency between the sectors, which should be of benefit to consumers, financial institutions and competent authorities. However, the Joint Position is not addressed directly at any of them. Rather, it provides a common, high-level agreement based on which more detailed provisions may be developed at a later stage, jointly or separately for each sector. Only these more detailed provisions will be directed at financial institutions and/or competent authorities, and will be consulted on at that later stage. The ESAs are anticipating to progress further work as follows:
19. ESMA will be undertaking substantial further work on product governance and distribution, based on an expected mandate from the European Commission that may result from the on-going legislative process for the review of MiFID (MiFID2/MiFIR). Following the final legislative text, expected by the end of 2013, ESMA will provide technical advice to the European Commission in this area for the future legislative measures implementing the revised MiFID.
20. Concurrently, ESMA is developing proposals in preparation of technical advice relating to the strengthened regime that MiFID2 will provide on investment advice, information to clients in the distribution of financial instruments, and inducements. Where the European Commission mandate does not extend to product governance obligations for investment firms that distribute financial instruments manufactured by others, ESMA is likely to consider developing output such as guidelines or opinions in this area.
21. EBA, in turn, will be using the above principles to develop more detailed requirements for the oversight and governance of banking products, i.e. mortgages, personal loans, savings products, credit cards, and payment services. The legal basis will be Article 74 of the Capital Requirements Directive, Article 10(4) of the Payment Services Directive, and Article 3(1) of the E-Money Directive which require credit institutions, payment institutions and electronic money institutions respectively to have in place robust governance arrangements and adequate internal control mechanisms.
22. For EIOPA, it is possible that product governance provisions may be included in the Insurance Mediation Directive (IMD1) or any future legislative act replacing IMD1. In addition, Recital 16 of Solvency II sets out the main objective of insurance and reinsurance regulation and supervision, which is the "adequate protection of policyholders and beneficiaries". This general principle is supplemented by additional requirements in Articles 41(1) and 41(6), which include having effective systems of internal control and governance to provide for sound and prudent management of the business.

Annex 1: National markets survey

1. In the *securities sector*, for example, the UK reports that, in recent years, traditional investments have been volatile and often disappointing for investors, which has prompted many to consider alternative investments. Some of these have included unregulated collective investment schemes and close substitutes, which invest in assets that are not always traded in established markets, are therefore difficult to value, may be highly illiquid, and have risks to capital that are generally opaque. The products use legal forms that are not subject to rules that apply to regulated collective investment schemes, which means that they are not subject to the rules governing investment and borrowing powers, disclosure of fees and charges, management of conflicts of interest, all of which may heighten the potential for a product to fail.
2. Denmark, in turn, has experienced cases of large scale mis-selling to inexperienced and risk-averse retail investors of highly complex structured products, and of units in funds based on hedging strategies. And Belgium as well as Finland have identified issues with the increasing complexity of products, such as structured products in Belgium or product wrapping in Finland, which prevents consumers from comparing features, prices and charges and, thus, from making well-informed investment decisions. Actions, such as the FSMA's moratorium on particularly complex structured products, have been undertaken to address these issues.
3. Spain has experienced issues with banks placing financial instruments such as hybrid products with their own retail clients. The risks were in some cases not disclosed or sufficiently explained and some consumers claim that they were given the impression that the investment was a protected deposit.
4. In Italy during reviews in 2007-2008 it was noted that the financial crisis led intermediaries to search for alternative sources of funding and to the issuance and distribution of complex products to retail investors. These products may lack a liquid secondary market, and run a higher risk of being mis-valued, mis-charged and mis-sold. Actions have been undertaken to prevent and address conflicts of interests, poor internal arrangements and distortive staff incentives, as well as to favour the designing and distribution of products to the best interests of investors.
5. In the *insurance sector*, in turn, France has experienced some difficulties in the marketing of complex underlyings that were sold as units of account. Consequently, the ACP has adopted a recommendation to improve disclosure and transparency towards clients when they are sold such a product. The Netherlands has experienced high costs and opaque cost structures for unit-linked investment insurance and investment pension products, with a cost to consumers estimated at €20-30bn.
6. Latvia reports issues with Packaged Retail Investment Products (PRIIPS, i.e. structured products that have their returns linked to the performance of underlying assets, such as market indices, equities, interest rates, fixed-income instruments, foreign exchange, or a combination of these), because not all of these products fall under the scope of MiFID, which means that some manufacturers and distributors are not subject to any regulatory obligations.
7. Norway reports structured insurance products with investment elements that are often sold cross border but contain only 1% of mortality risk, which the country cannot stop even if it is of the opinion that the product does not contain a sufficient insurance element. The country considers it therefore to be desirable to set common standards. And in Slovenia, insurance companies have been found to offer life

insurance products combined with fund investment, without any concomitant reporting requirements (to the NCA or the consumer).

8. The UK, in turn, has experienced large scale mis-selling of Payment Protection Insurance products by some of the country's largest banks. Many consumers were often required to pay via a single premium that was added to the loan; faced significant barriers to switching; were not eligible to claim; were captive and unable, or unwilling, to search for alternative products; and/or were pressurised into buying the product. The resultant regulatory action has led to a substantial compensation scheme amounting to £12bn (as of June 2013).
9. In the *banking sector*, Estonia and Spain have experienced problems with: (a) the poor presentation of risks associated with structured products; (b) an excessive degree of complexity (e.g. of index-linked deposits) given the market segments to whom the products were sold; and (c) with certain hedging products with the aim to protect borrowers on flexible rate mortgages.
10. France, and to some degree Hungary, have identified regulatory issues with the sale to natural persons of loans that are exposed to exchange rate risks, the extent of which is often unbeknown to the consumer.
11. The UK has experienced issues with self-certified mortgages, a product that was originally targeted at the self employed as a niche segment but which, at the height of the market, was sold in more than half of the cases to employed consumers.
12. Lastly, Poland reports concerns about the product governance of mortgage insurance products, when the bank acts as insurance broker and beneficiary at the same time; when the insured (or their heirs) are not able to claim directly from the insurance company; or when the terms and conditions are submitted to the bank, and not to the borrower.