

# *Insurance Internal Audit Perspectives* The Insurance Distribution Directive

January 2018



# The Insurance Distribution Directive

On 20 December 2017 the European Commission proposed to push back the application date of the Insurance Distribution Directive (IDD) by seven months to 1 October 2018 following requests from the European Parliament and 16 Member States. The European Parliament and Council will now need to agree on the final application date in an accelerated legislative procedure ahead of the original implementation date of 23 February 2018.

Once the application date is finalised, the IDD will replace the Insurance Mediation Directive (IMD) and could lead to significant changes for both insurers and intermediaries in the UK and Europe. On 19 January 2018, the FCA released its latest Policy Statement setting out the 'near final' rules for the implementation of the IDD. This included further clarity on certain areas such as Product Oversight and Governance arrangements through the distribution chain and details of transitional arrangements that allow firms to early adopt elements of the IDD should the proposed delay be formally agreed.

Given this regulatory change, IDD features strongly in 2018 Internal Audit Plans across the sector. The delayed implementation date gives Internal Audit functions more scope to consider how they can best add value in this area. For example, the revised timetable gives more scope for a pre-implementation review and allows management additional time to embed revised processes and controls before Internal Audit perform deep dive testing.

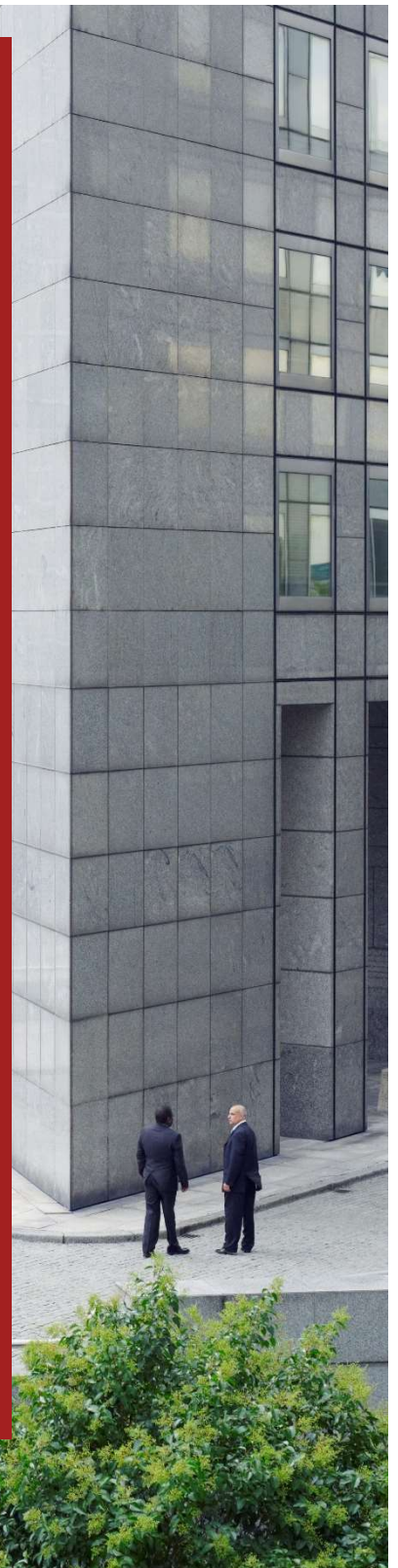
Whilst the delay to the implementation date gives firms some much appreciated breathing space, it does not detract from the potential effort required to ensure compliance. The nature and extent of such activities, including the associated Internal Audit activity, will vary across the market depending on the size and complexity of the business and the extent of readiness activities already underway.

The bar on Conduct regulation continues to rise in the UK and across Europe and the IDD will only accelerate this. In announcing its decision to delay the implementation date, the European Commission specifically cited smaller insurance distributors as being less ready for the change. Conversely, the impact of the IDD will be more significant for larger firms with more complex business models, especially those who operate on a pan-European basis.

Wherever a firm sits across this spectrum, Internal Audit have a role to play in bringing a constructive, well-informed and independent challenge to the table. Given the potential financial and reputational consequences of non-compliance, the stakes can be high and the timescales remain short.

In this paper we explore:

- What is the IDD and how will it impact upon firms?
- How can Internal Audit functions perform a review of the IDD?
- What questions should Heads of Audit be asking about the IDD?



# What is the IDD and how will it impact upon firms?

The IDD is a new EU wide directive aimed at ensuring minimum harmonisation of insurance regulation across the EU, creating a 'level playing field' for insurance intermediaries and distributors, regardless of the channel customers use to purchase their products. The aim is to ensure consistent prudential standards for intermediaries as well as significantly raising conduct standards, improving consumer protection and effective competition. The IDD applies to insurers, insurance intermediaries, price comparison websites/aggregators and ancillary insurance intermediaries. The conduct requirements applying to distributors (which includes insurers) vary according to the nature of the business and customer (including commercial clients). The IDD raises the bar significantly from IMD, and it is expected this time round European implementation will be stricter.

## **Key areas covered by the regulation include:**

- Professional, organisational and prudential requirements, including professional indemnity cover and training and competence requirements.
- Conduct of business general principles including acting in customers' best interest.
- Product Oversight and Governance requirements (POG).
- Remuneration disclosure requirements.
- Conflicts of interest disclosure.
- Pre-contract disclosures.
- Customer demands and needs requirements.
- Complaints handling and out of court redress.

An overarching principle under the IDD is that distributors 'must always act honestly, fairly and professionally in accordance with the best interests of their customers'. This new principle coupled with the continuous focus of the regulator on value in distribution chains and rules on remuneration disclosure should be an area of focus for firms. This is not just about always acting in the customers' best interest but also being able to demonstrate it. The impact of the application of such a broad principle in practice will only become clear once the FCA shows its regulatory appetite to challenge firms in this regard. For now we understand that the FCA is considering issuing specific guidance early in 2018 on the application of this principle in practice.

## **What does IDD mean for UK firms today?**

For more than a decade now the UK has gold plated conduct regulation under IMD. As a result, implementation of the new IDD in the UK is likely to be relatively less problematic than for EU firms and those operating across the EU. However, there are a number of areas where the IDD goes beyond current FCA rules. Consequently, UK firms will need to assess how the FCA implementation of IDD affects their current business models and practices. Those UK firms operating elsewhere in the EU will need to additionally consider how each EU Member State plans to implement IDD.

## **What does IDD mean for firms doing business in Europe?**

IDD is likely to demand greater implementation efforts across the EU than in the UK. For firms looking to restructure due to Brexit, the implementation of IDD in the relevant jurisdictions will be a significant factor in how to manage a smooth transition successfully.





## *How can internal audit functions perform a review of the IDD?*



Internal Audit functions have a crucial role to play in challenging and providing an independent perspective on management's view of their readiness to comply with IDD requirements. This can be achieved through a mix of pre-implementation programme assurance or design adequacy work, or through post implementation reviews incorporating design and operating effectiveness reviews or deep dives in specific areas of the requirements (e.g. Product Oversight and Governance or the impact of cross border transaction flows within the EU).

Internal Audit functions should also consider how they can incorporate IDD readiness or compliance into their existing audit programme, especially if existing audits are dealing with conduct elements of sales and distribution practices. The right approach will also depend on both the nature of the firm's business model and also the assurance being provided by other lines of defence.

Whatever approach is adopted, an audit of IDD is not a trivial, tick box exercise and Internal Audit teams will need to consider the specialist knowledge required and to engage with several areas of the business to perform an effective review.

# What questions should Internal Audit be asking? (1/2)

We have set out below a number of areas for consideration in planning and performing an audit of IDD readiness or implementation and set out some key questions for Internal Audit to be asking. We have also set out additional detail on a selection of key areas where Internal Audit may wish to perform a deep dive.

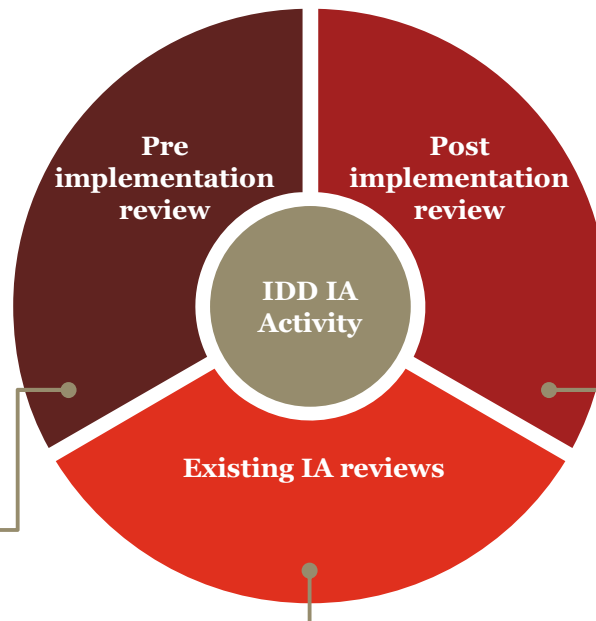
## Pre implementation reviews

### 1. Programme Assurance:

- Do management have appropriate governance and oversight structures in place?
- Are appropriate plans in place for any known gaps in compliance? Are these action plans on track to deliver ahead of the revised implementation date?

### 2. Design adequacy:

- Have management undertaken an appropriate impact assessment?
- Has there been appropriate senior stakeholder engagement in the design of relevant controls, processes and work-arounds in response to new IDD requirements?



## Existing IA reviews

- Which audits in the Internal Audit Plan already incorporate conduct risk?
- What assurance activity is there from other lines of defence?
- What is the additional time and/or resource commitment which will be required to consider IDD readiness/compliance?

## Post implementation reviews

### 1. Design adequacy:

See questions under pre-implementation design review.

### 2. Operating effectiveness testing:

- Are processes and controls fully embedded? If not, are they on track to be embedded and operating effectively within BAU activities by October 2018?
- Is there clear governance and accountability for all areas?
- Is the IDD implementation plan aligned to the firm's Brexit planning activity?

### 3. Deep Dives:

See specific questions on page 5.



# What questions should Internal Audit be asking? (2/2)

## Deep dive specifics:

Area	Description	Questions for internal audit to ask
<b>Product Oversight and Governance arrangements for manufacturers (POG)</b>	POG applies to insurers and intermediaries that manufacture insurance products. The requirements include: identifying a target market and market segments for which a product is not considered appropriate, carrying out product analysis and reviews to check product performance and potential consumer detriment, identifying relevant distribution channels, monitoring distribution channels and providing appropriate information on the product to distributors.	<ul style="list-style-type: none"> <li>• How have management identified which activities and products are in scope? For example, how did management identify 'large risks' in the book which are out of scope of the IDD?</li> <li>• Have management considered how the new regulations will impact current design governance?</li> <li>• Have management implemented appropriate oversight over distribution chains to ensure all distributors are offering the right products to the right clients?</li> </ul>
<b>Product Distribution arrangements for distributors</b>	Insurance distributors that do not manufacture products are subject to product distribution arrangements that include establishing measures and procedures for the products they intend to distribute, obtaining all relevant information from the manufacturer and defining a distribution strategy.	<ul style="list-style-type: none"> <li>• How do management obtain appropriate knowledge about the approval process of the manufacturer, its target market and other information to be able to distribute the product?</li> <li>• How do management ensure that the right information is being captured by distributors? For example, data on sales made outside target market or complaints per product.</li> </ul>
<b>Insurance Product Information Document (IPID) and other product information disclosure requirements.</b>	The IDD introduces a requirement for non-life insurance distributors to provide the customer with a standardised Insurance Product Information Document (IPID), prior to the conclusion of a contract. The IPID should provide standardised information about non-life insurance products, before the conclusion of the contract.	<ul style="list-style-type: none"> <li>• How do management ensure that the IPID contains all the necessary information based upon the nature of the policy and the needs of the customer?</li> <li>• What was the approval and governance process for the design of the IPID?</li> </ul>
<b>Training and competence</b>	<p>The IDD introduces a minimum of 15 hours CPD for employees with responsibility for insurance distribution. This might include for example call centre operatives whose role may be limited to conducting non-advised, script-based sales but the CPD can be tailored to allow for the nature and complexity for the employee's role.</p> <p>The FCA have defined minimum knowledge criteria covering areas such as product coverage, the claims process and insurance regulation. The FCA expects insurers to train their employees in these areas.</p>	<ul style="list-style-type: none"> <li>• How have management established, maintained and kept appropriate records to demonstrate compliance with employee knowledge and ability requirements?</li> </ul>

## Our team

If you would like to explore how the IDD may impact your firm and how Internal Audit can play a role in this, please contact:



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