BIPAR Update

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European Federation of Insurance Intermediaries

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1. ESMA public statement on risks from payment for order flows and from certain practices by "zero-commission brokers"

Following up on an earlier warning (see "BIPAR On Another Note" of 2 March), the European Securities and Markets Authority (ESMA), now issued a public statement to remind firms and investors about risks arising from payment for order flows (PFOF). ESMA states that the receipt of payment for order flow (PFOF) raises significant investor protection concerns. It also highlights key MiFID II obligations aimed at ensuring firms act in their clients' best interest when executing their orders. ESMA is of the view that it is in most cases unlikely that the receipt of PFOF by firms from third parties would be compatible with MiFID II and its delegated acts. In addition, ESMA also addresses specific concerns regarding certain practices by "*zero-commission brokers*".

ESMA explains in its press release that PFOF "*is the practice of brokers receiving payments from third parties for directing client order flow to them as execution venues. PFOF causes a clear conflict of interest between the firm and its clients, because it incentivises the firm to choose the third party offering the highest payment, rather than the best possible outcome for its clients when executing their orders.*"

ESMA points out that while being less widespread than in the US, PFOF has also been observed in some Member States of the EU. ESMA is telling firms that they must thoroughly assess whether, by receiving PFOF, they are able to comply with relevant MiFID II requirements, most notably those on **best execution, conflicts of interest, inducements and cost transparency**.

ESMA also requests National Competent Authorities, especially in those Member States in which PFOF has been observed, to prioritise this topic in their supervisory activities for 2021 or early 2022. These activities should aim at assessing the actual impact of PFOF on firms' compliance with relevant MiFID II requirements.

2. Sustainable Finance – European Commission delays application date of SFDR Level 2

According to various press articles, the Director General of DG FISMA, European Commission, announced in a letter of 8 July 2021 to the Council of the EU and to the European Parliament that the **application date of the final Regulatory Technical Standards (RTS)** under the EU Regulation on sustainability-related disclosures in the financial services sector (SFDR) would be deferred until 1 July 2022.

According to the press articles, the letter states: "*due to the length and technical detail of those regulatory technical standards, the late submissions to the Commission* (by the ESAs)*, and envisaged amendments* (Taxonomy RTS)*, we deem it necessary to facilitate the smooth implementation of the standards by product manufacturers, financial advisers and supervisors. We therefore plan to bundle all 13 of the regulatory technical standards in a single delegated act and defer the dates of application of 1 January 2022 by six months to 1 July 2022.*

Background

The draft RTS on the content, methodologies and presentation of sustainability-related disclosures were jointly submitted to the Commission by the European Insurance and Occupational Pensions Authority (EIOPA), the European Securities and Markets Authority (ESMA) and the European Banking Authority (EBA) on 4 February 2021. The Commission was expected to endorse the RTS within 3 months of their publication.

In March 2021, the three ESAs launched a consultation on the revised draft RTS regarding disclosures for financial products that are Taxonomy-aligned. The ESAs agreed to amend the recently proposed draft SFDR RTS, to have the RTS on disclosures rules function as a "single rulebook" for sustainability disclosures at Level 2 for both the SFDR and the Taxonomy Regulation.

The ESAs proposed in the draft RTS that the applications date of the RTS should be 1 January 2022.

For more information, please see our mails sent on 1 April and 8 February 2021.

3. Sustainable Finance – EIOPA Publications on climate change-related risk for the insurance sector

The European Insurance and Occupational Pensions Authority (EIOPA) issued three publications as part of its activities on sustainable finance. The EIOPA work addresses key issues of climate change-related risk for the insurance sector and continues to encourage insurers to play their role of enabling climate change mitigation and adaption.

1. **The pilot dashboard on insurance protection gap for natural catastrophes**
   The pilot dashboard depicts the insurance protection gap for natural catastrophes. The aim is to represent the drivers of a climate-related insurance protection gap in order to identify measures that will help in decreasing society's losses in the event of natural catastrophes. It was published in December 2020 and EIOPA aims to publish a revised version in 2022.

EIOPA is concerned that affordability and insurability of natural catastrophes (Nat Cat) insurance coverage is likely to become an increasing concern. Currently, only 35% of the total losses caused by extreme weather and climate-related events across Europe are insured (EIOPA, 2019). The uninsured part is therefore equal to 65% of the losses for climate-related events, which shows that there is a protection gap.

The dashboard aims to help not only to identify regions, which have protection gap issues, but also to understand the root-cause of the protection gap. If a country's exposure to a given hazard is high, then it would be important, for example, that buildings have low vulnerabilities as well as a high insurance coverage. Decomposing the different elements of the dashboard provides a view on the vulnerability and exposure to each hazard component. These elements should help to identify prevention measures for different perils/regions to reduce the future potential losses.

2. **Methodological paper on potential inclusion of climate change in the Nat Cat standard formula**

According to EIOPA, the frequency and severity of natural catastrophes is expected to increase due to climate change. To ensure continuing policyholder protection and stability of the insurance market, the Solvency Capital Requirements (SCR) for natural catastrophe underwriting risk should reflect the expected impact of climate change.

The methodological paper discusses the methodology used so far for the Nat Cat SCR calibration and presents perils and countries, which may be materially impacted by climate change. EIOPA proposes methodological steps which support the need to formalise an approach to re-assess and, where needed, recalibrate parameters for the natural catastrophe risk module of the Solvency II standard formula on a regular basis. The regular re-assessment or recalibration would integrate new considerations such as use of models, which explicitly consider climate change, as well as the possibility to include new countries. The paper also identifies the need to enhance the understanding on emerging perils such as wildfire or droughts.

What's Next?

As the next step, EIOPA will focus on exploring a risk-based prudential treatment of insurance products related to climate change adaptation. EIOPA will also investigate the ***integration of climate change adaptation and mitigation requirements in insurance distribution and product oversight and governance requirements****. Finally, EIOPA will consider investigating the potential for long-term non-life contracts, considering the need to develop innovative solutions.*

3. **Report on non-life underwriting and pricing in light of climate change**

EIOPA aims to incentivise (re)insurers' efforts in taking a forward-looking approach to covering risks arising from climate change. As underwriters of natural catastrophe risks, the (re)insurance sector can be particularly impacted by climate change. The increasing risk can lead to insurance coverage becoming unaffordable for the policyholder, widening further the insurance protection gap.

A majority of stakeholders did not agree that considering long-term insurance contracts could help insurers maintain availability and affordability of insurance in light of climate change. They highlighted that long-term insurance contracts could decrease flexibility and choice for the customers because they would not be easily able to renegotiate contracts or switch to an alternative insurer. As a result, the competition between insurers could decrease if the policyholder cannot change insurer for the long term. There is also a possibility that during long-term contracts new risks emerge, and the lack of possibility to annually review premiums generates the risk of mispricing which could even lead to insolvency of insurers.

The EIOPA report investigates the opportunity for (re)insurers, as risk managers and underwriters, to contribute to climate adaptation and mitigation, supporting the insurability of climate change-related risks. By applying their data, expertise and risk assessment capacity they can **incentivise policyholders to mitigate insured risks**. Via risk-based pricing, contractual terms, and underwriting strategy (re)insurers should promote **prevention measures for climate change adaptation and/or mitigation**. This is what EIOPA calls 'impact underwriting' in light of climate change.

The EIOPA report mentioned that: t*he insurance sector is evolving. The insurance model is shifting from reimbursing claims to preventing claims. The future of the insurance sector will also involve more customer services.*

4. European Commission clears acquisition of Willis Towers Watson by Aon, subject to conditions

The European Commission has approved, under the EU Merger Regulation, the acquisition of Willis Towers Watson (WTW) by Aon.
The approval is conditional on full compliance with **a substantial set of commitments offered by Aon, including the divestment of central parts of WTW's business to the international brokerage company Arthur J. Gallagher.**

The Commission opened an in-depth investigation to assess the proposed acquisition in December last year. Following this investigation, the Commission had concerns that the transaction, as initially notified, would have harmed competition in the following markets:

- The provision of **commercial risk brokerage services** to large multinational customers based in Europe. Aon and WTW are, along with Marsh, known as the “Big Three” of the brokerage industry. The Commission considers that only a limited number of brokers with a credible presence in Europe have the necessary capability to handle large and complex risks of such customers and a suitable network to provide services internationally. The merger would have hampered competition in particular in the risk classes Property & Casualty, Financial and Professional (FinPro) services and Cyber. Furthermore, irrespective of the customers' size, the Commission had concerns relating to commercial risk brokerage services to customers for Space and Aerospace manufacturing risks, as well as regarding national markets in the Netherlands and Spain.
- The provision of treaty and facultative **reinsurance brokerage services**. The Commission had concerns that the merger would have reduced choice for insurance companies since Aon and WTW are two of the three leading worldwide reinsurance brokers.
- The provision of **pension administration services** to companies in relation to pension schemes offered to their employees for the market in Germany.

The proposed remedies

To address the Commission's competition concerns, Aon offered a substantial remedy package including several commitments, see press release for detail (*also available in FR and DE*).

Following the results of the market test, in which European customers identified Gallagher, the next closest competitor to the “Big Three,” as the most suitable purchaser of the commercial risk and reinsurance divestment business, the Commission concluded that the transaction, as modified by the commitments, would no longer raise competition concerns. The Commission's decision is conditional upon full compliance with the commitments.

Aon can only implement the acquisition of WTW once the Commission has formally assessed and approved Gallagher as suitable purchaser of the divestment business.

More information can be found on the competition website, in the Commission's public case register.

Commission Executive Vice-President Margrethe **Vestager**, in charge of competition policy, said: *“European companies rely on brokers to obtain best possible solutions to manage their commercial risk. Aon and Willis Towers Watson are leading players in the insurance and reinsurance brokerage markets. The remedy package accepted by the Commission ensures that European companies, including insurance companies and large multinational customers, will continue to have a good choice and good services when selecting a broker suitable for their needs.”*

5. EIOPA Financial Stability Report

EIOPA has published its 2021 Financial Stability Report, addressing key financial stability risks in the European insurance and pension sector.

EIOPA emphasizes that the pandemic crisis is still not over and many uncertainties remain. The impact on the real economy was reduced by extensive fiscal measures, but some negative effects might become visible only when the introduced measures will phase out. In particular, increased unemployment and corporate credit downgrades would have a negative impact on both insurance and pension sectors.

While the EU economy is still subject to high risks, some lessons learnt have already been reflected in the Solvency II review by taking into account the changes in the current economic environment. The ongoing crisis also highlighted the critical importance of **coordinated approaches** among the national competent authorities.

It is also essential to keep the focus on new emerging risks such as **cyber and climate risk**. Remote working arrangements in the pandemic caused increased cyber-attacks reiterating the growing importance of risks related to digitalisation. Environmental, social and governance factors that increasingly shape investment decisions of insurers and pension funds and affect their underwriting, remain one of the focal points for the insurance and pension industry.

The crisis showed that with Solvency II in place, the **insurance industry was overall well prepared**. However, there is a need to continuously analyse all risks. In this respect, EIOPA is currently running an EU-wide insurance stress test exercise assessing the impact of an adverse COVID-19 scenario in a “lower for longer” interest rate environment on both capital and liquidity positions of insurers.

The Financial Stability Report also includes two thematic articles, the first one focusing on the impact of EU-wide insurance **stress tests** on equity prices and systemic risk and the second one focusing on the **risks of climate change** for the real economy and the potential mitigating role of insurance.

6. EIOPA Supervisory Statement in case of breach of the Solvency Capital Requirement

EIOPA published its Statement on supervisory practices and expectations in case of breach of the Solvency Capital Requirement (SCR). The EIOPA supervisory statement aims to foster supervisory convergence in the situations where insurance and reinsurance undertakings breach their capital requirement, in particular addressing the recovery plan required.

According to EIOPA, the supervisory practices in such situations need to be flexible and should consider the specific situation of the insurance or reinsurance undertaking. However, it is important that when certain triggers are reached, such as non-compliance with the SCR, convergent approaches are applied to ensure a similar protection of policyholders and beneficiaries across Europe.

Solvency II allows supervisory authorities to take early actions, therefore acting promptly to ensure supervisory convergence in this area is needed. To comply with Article 138(1) of Solvency II, i.e. immediate information to the supervisory authority as soon as the observation of SCR not being complied with, insurance and reinsurance undertakings should consider as the date of non-compliance with the SCR the date on which non-compliance with the SCR has been observed and communicated to the administrative, management or supervisory body immediately through their on-going monitoring. Insurance and reinsurance undertakings are required to submit to the supervisory authorities a **realistic recovery plan** within two months upon the observation of a breach of the SCR. Insurance and reinsurance undertakings should detail the realistic and timely **recovery measures to restore their solvency position**. Insurance and reinsurance undertakings can foresee in the recovery plan **a period longer than six and up to nine months** to restore compliance, explaining the reason why six months would not be enough.

The EIOPA statement is accompanied by the resolution of comments from EIOPA’s public consultation, the feedback statement to stakeholders and the impact assessment developed based on the input provided during the consultation period.