Consultation Paper

Draft Guidelines on product oversight and governance arrangements for retail banking products
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1. Responding to this Consultation

The EBA invites comments on all proposals put forward in this paper and in particular on the specific questions summarised in 4.3.

Comments are most helpful if they:
- respond to the question stated;
- indicate the specific point to which a comment relates;
- contain a clear rationale;
- provide evidence to support the views expressed/ rationale proposed; and
- describe any alternative regulatory choices the EBA should consider.

Submission of responses

To submit your comments, click on the ‘send your comments’ button on the consultation page by 10.02.2015. Please note that comments submitted after this deadline, or submitted via other means may not be processed.

Publication of responses

Please clearly indicate in the consultation form if you wish your comments to be disclosed or to be treated as confidential. A confidential response may be requested from us in accordance with the EBA’s rules on public access to documents. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the EBA’s Board of Appeal and the European Ombudsman.

Data protection

The protection of individuals with regard to the processing of personal data by the EBA is based on Regulation (EC) N° 45/2001 of the European Parliament and of the Council of 18 December 2000 as implemented by the EBA in its implementing rules adopted by its Management Board. Further information on data protection can be found under the Legal notice section of the EBA website.
2. Executive Summary

Developments in the markets for financial services in recent years have shown that failures in the conduct of financial institutions towards their customers can cause, not only significant consumer detriment, but also undermine market confidence, financial stability and the integrity of the financial system. Conduct failure can give rise to direct costs to financial institutions as a result of, for example, fines and penalties imposed through regulatory proceedings; settlements with regulators; sums paid to third parties as required by regulators, such as redress and compensation; loss of income resulting from conduct failure; or sums paid in relation to litigation proceedings.

In order to address some of the causal drivers of conduct failure, and following the initial work carried out by the Joint Committee of the three European Supervisory Authorities (phase 1), the EBA has developed detailed guidelines for the product oversight and governance (POG) of retail banking products and services that fall into its regulatory remit, i.e. mortgages, personal loans, credit/debit cards, savings products, payment services and current accounts (phase 2).

The guidelines require the establishment of internal arrangements for the design, marketing and life cycle maintenance of products and are aimed at ensuring that products are designed to meet interests, objectives and characteristics of the target market.

The guidelines apply to manufacturers of retail banking products as well as to distributors. The requirements for manufacturers cover the manufacturer’s internal control functions, identification of the target market, product testing, disclosure, product monitoring, remedial actions, and the selection of distribution channels. The requirements for distributors, in turn, cover the distributor’s internal arrangements, identification and knowledge of the target market, and information requirements.

The guidelines are forward-looking in nature; they do not simply address past failings but rather provide a framework for robust and responsible product design and distribution to avoid future cases of detriment. The banking sector must consider the needs of its customers when designing products. Developing products with the consumer’s interest, objectives and characteristics in mind from the outset is a cornerstone in ensuring good consumer outcomes, helping to re-establish and maintain confidence in retail banks.
3. Background and rationale

This section summarises the background of previous work on product oversight and governance carried out by the three European Supervisory Authorities and sets out the rationale for the European Banking Authority embarking on phase 2 of the work.

Background

Developments in the banking, insurance and investment markets in recent years have shown that failures in the conduct of financial institutions can cause significant consumer detriment. Conduct failures occur in many different ways, which may be usefully grouped into:

1. **Retail** conduct failure, which captures consumers experiencing detriment directly as a result of conduct failures in their interaction with financial institutions;

2. **Market** conduct failure, which is about consumers experiencing detriment indirectly as a result of market-wide retail or wholesale conduct failures, such as excessive interest rates for loans charged to consumers across the banking sector.

The conduct of financial institutions concerns regulators not only from a consumer protection perspective, but also from a prudential perspective and their objective to promote market confidence, financial stability and the integrity of the financial system in their national jurisdictions and at the European level. Conduct failure can give rise to direct costs to financial institutions as a result of, for example, fines and penalties imposed through regulatory proceedings; settlements with regulators; sums paid to third parties as required by regulators, such as redress and compensation; loss of income resulting from conduct failure; or sums paid in relation to litigation proceedings.

According to a recent study, ten major global banks from 2008 to 2013 have incurred conduct-related costs of around €170bn. At end 2013, their provisions for future costs stood above €70bn. More than 40% of the total costs were related to banks’ conduct with non-US consumers. The potential risks to the financial system of widespread misconduct of financial institutions have also been identified and analysed in various reports by European and national organisations. Recent reports identify a widening number and magnitude of incidents of mis-selling of financial products, and concerns about insufficient provisions and inadequate disclosure prevail.

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1; See CCP Research Foundation (2014), Conduct Costs Project; Autonomous (2014), Global Banks- Litigation Costs Update
In order to address some of the causal drivers of the failure in the retail conduct of financial institutions as manufacturers of banking, insurance and investment products, the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA), which had been established in 2010/11 to foster consumer protection and to promote the stability, effectiveness and integrity of the financial system, collectively known as the European Supervisory Authorities (ESAs), carried out work in 2013 on the topic of manufacturers’ product oversight and governance (POG) processes.

The market for retail financial products and services is prone to specific failures, in particular due to information asymmetries. In addition, the costs and benefits from mis-sold financial products tend to be distributed rather unequally. As evidenced by the conduct costs referred to above, mis-selling can detrimentally affect a large number of consumers, causing small costs for them individually. The individual consumer has thus little incentives to seek redress. Total profits for financial institutions at the same time can be very high. This combination entails the risk of financial institutions intentionally exploiting consumers’ behaviour.

The ESAs assessed the extent to which consumers across the banking, insurance and securities markets have experienced, or are at risk of experiencing, detriment as a result of the failure of manufacturers in overseeing and governing the development and marketing of their products. Particular attention had been given to manufacturers’ identification of the target market and their taking account of the interests, objectives and characteristics of this market.

As a result, the ESAs published as a first phase approach, on 28 November 2013, a Joint Position on Manufacturers’ Product Oversight and Governance Processes, based on Article 56 of the ESA regulations. The eight high level principles contained therein were not directly addressed at financial institutions that manufacture financial products or services, or to national supervisory authorities. Rather, they constitute a common ground as much consistency as is possible for any more detailed work that may subsequently be carried out in each of the three sectors. Such common grounds were aimed at being of benefit to:

- consumers, who can rely on the same regulatory arrangements no matter where they reside and where the manufacturer is located in the EU;
- financial institutions, who should be able to streamline their internal processes across their product range as a result of a high degree of regulatory convergence between the more detailed sector-specific requirements that may emerge later; and
- national supervisory authorities, who may also be able to streamline their supervisory efforts.

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The Joint Position invites each ESA subsequently to develop more detailed requirements specific to their respective sectors.

These are forward-looking guidelines; they do not simply address past failings but rather provide a framework for robust and responsible product design and distribution to avoid future cases of detriment. The banking sector must consider the needs of its customers when designing products. Developing products with the consumer’s interest, objectives and characteristics in mind from the outset is a cornerstone in ensuring good consumer outcomes, helping to re-establish and maintain confidence in retail banks. Also, having good product oversight and governance arrangements in place might help reduce the need of competent authorities to intervene the markets ex post, for example by making use of a product intervention power.

Rationale

In the second phase of the POG work, and based on the principles referred to above, the EBA carried out work in early 2014 to develop more detailed POG requirements specific to the retail banking products and services that fall into its regulatory remit (i.e. mortgages, personal loans, credit/debit cards, savings products, payment services and current accounts) as well as to credit institutions, including payment institutions, electronic money institutions, creditors, credit intermediaries, and appointed representatives which fall into the EBA’s scope of action. To that end, the EBA conducted various analyses and surveys among the 28 EU Member States to ascertain the extent to which consumer detriment has arisen, or may arise, as a result of manufacturers of retail banking products having failed to have proper POG arrangements in place.

In response, some Member States reported problems with specific types of mortgages that had originally been targeted at a niche group of borrowers, but which, at the height of the market were sold to consumers beyond that target market many of which could not afford them. The arrears rates of these mortgages were a multiple of that of conventional mortgages and would have arguably been even higher if Central Banks across the EU had not embarked on a sustained period of record low interest rates in the wake of the 2008 financial crisis.

Other Member States reported problems with the product governance of mortgages that were sold in conjunction with other products, the aggregate product offering of which did not meet the objectives of the target market. Consumers were also wrongly mis-sold as a result of an inappropriate distribution strategy and it was reported that even if the terms and conditions of some retail banking products are provided to consumers, consumers tend to rely more on oral explanation of manufacturers’ staff.

In other cases still, consumers were sold loans that were exposed to exchange rate risks, the extent of which was often unbeknown to them. Finally, some Member States experienced problems with the poor presentation of risks associated with specific banking products and an excessive degree of complexity given the market segment to which the products were sold.
In order to address the identified failures, the EBA has developed, as a part of the second phase of the POG work, a set of guidelines for a) financial institutions as manufacturers of retail banking products, and b) for distributors of retail banking products. The guidelines follow an activity-based approach: distributors that are involved in the design and manufacture of a product should be considered as manufacturers for setting up POG arrangements, and then should also comply with the guidelines set forth for manufacturers, in addition to the guidelines for distributors.

Financial institutions that manufacture products should firstly establish and implement POG guidelines setting internal arrangements for the design, marketing and life cycle maintenance of products. These arrangements should ensure that products are designed, in principle, to meet interests, objectives and characteristics of a certain type of consumers (the target market), while taking into account factors such as financial capability of the target market, cost effectiveness and the financial efficiency of the product. The arrangements should also identify any need to modify/replace existing product when they no longer meet the interests, characteristics and objectives of the target market for which the product was conceived.

Subsequently, manufacturers should periodically assess (i) that the internal product oversight and governance arrangements are being duly complied with, (ii) that the internal product governance and oversight arrangements are still valid and up to date and (iii) whether the specifications of particular products continue to meet interests, objectives and characteristics of the target market for which they were designed.

Distributors of retail banking products should comply with the product oversight and governance arrangements of the manufacturer which are specific to their role of bringing products to the market. Distributors should know and recognise the target market for which the product was designed and should normally only sell and offer the product to end consumers in that target market. When providing advice to a consumer, distributors may sell products outside the target market defined by the manufacturer, provided they justify such decision in the durable medium stating the advice given.

The proposed guidelines are set out in chapter 4 of this document. Chapter 5 then contains an annex listing ‘good practice examples’ on how financial institutions can give effect to some of the guidelines. As examples, these do not form part of the guidelines.
4. Draft Guidelines on product oversight and governance arrangements of retail banking products

Status of these Guidelines

This document contains guidelines issued pursuant to Article 16 of Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC (‘the EBA Regulation’). In accordance with Article 16(3) of the EBA Regulation, competent authorities and financial institutions must make every effort to comply with the guidelines by the date of entry into force provided for therein.

Guidelines set out the EBA’s view of appropriate supervisory practices within the European System of Financial Supervision or of how Union law should be applied in a particular area. The EBA therefore expects all competent authorities and financial institutions to whom guidelines are addressed to comply with guidelines. Competent authorities to whom guidelines apply should comply by incorporating them into their supervisory practices as appropriate (e.g. by amending their legal framework and/or their supervisory processes).

Reporting Requirements

According to Article 16(3) of the EBA Regulation, competent authorities must notify the EBA as to whether they comply or intend to comply with these guidelines, or otherwise with reasons for non-compliance, by dd.mm.yyyy. In the absence of any notification by this deadline, competent authorities will be considered by the EBA to be non-compliant. Notifications should be sent by submitting the form provided at Section 5 to compliance@eba.europa.eu with the reference ‘EBA/GL/201x/xx’. Notifications should be submitted by persons with appropriate authority to report compliance on behalf of their competent authorities.

Notifications will be published on the EBA website, in line with Article 16(3).
4.1 Title I – Subject matter, scope and definitions

4.1.1 Subject matter

These guidelines require the establishment of product oversight and governance arrangements for both, manufacturers (title II) as well as distributors (title III). These arrangements refer to internal processes, functions and strategies aimed at designing and bringing products to the market, and reviewing them over their life cycle. Product oversight and governance arrangements should be an integral part of the general organizational requirements linked to internal control systems of firms. The guidelines laid out herein are without prejudice to any more specific applicable requirements foreseen in other Union legislation.

4.1.2 Scope

These guidelines build in particular on Article 74(1) of Directive 2013/36/EU (“Capital Requirements Directive IV, CRD IV”), Article 10(4) of Directive 2007/64/EC (“Payment Services Directive, PSD”), and Article 3(1) of Directive 2009/110/EC (“E-Money Directive, EMD”) in conjunction with Article 10(4) of the Payment Services Directive. These listed Articles require credit institutions, payment institutions and electronic money institutions to have in place robust governance arrangements and adequate internal control mechanisms.

In addition, the guidelines build also on Article 7(1) of Directive 2014/17/EU (“Directive on credit agreements for consumers relating to residential immovable property, or Mortgage Credit Directive, MCD”), which requires creditors, credit intermediaries and appointed representatives to act honestly, fairly, transparently and professionally, taking account of the rights and interest of the consumers.

These guidelines are addressed to competent authorities as defined in Article 4(2) of Regulation EU/1093/2010 (“EBA Regulation”). With regard to the guidelines for distributors listed in title III, competent authorities should either require distributors directly to comply with them or require manufacturers under their supervision to ensure that distributors comply with them.

Competent authorities may decide to expand the scope of consumers by also including other persons, such as micro-enterprises or intermediaries other than credit intermediaries, by ensuring that the arrangements provided by these guidelines are complied with.

These guidelines supplement other EBA guidelines that may be relevant to product oversight and governance. In particular, the EBA’s Guidelines on Internal Governance (GL 44)\(^7\) include guidelines on the new product approval process that credit institutions should adopt and where relevant, these guidelines refer to relevant guidelines from GL 44.

4.1.3 Definitions

For the purpose of these guidelines, the following definitions apply:

- **Manufacturer** means
  a) a credit institution as defined in point (1) of Article 4(1) of the CRR;
  b) a creditor as defined in Article 4(2) of the MCD;
  c) a payment institution as defined in Article 4(4) of the PSD;
  d) an electronic money institution as defined in Article 2(1) of the EMD;

- **Target market** means the group or groups of end consumers for whom the product is designed, as defined by the manufacturer.

- **Distributor** means a person who offers and/or sells the product to consumers, including business units of manufacturers that are not involved in the designing of the product but are responsible for bringing the product to the market.

- **Consumer** means a natural person, who is acting for purposes which are outside his trade, business or profession.

- **Product** means
  a) ‘credit agreements relating to immovable property’ as defined in Article 4(3) MCD;
  b) ‘deposits’ as defined in Article 2(3) of Directive 2014/49/EU ("Deposit Guarantee Scheme Directive, DGSD ");
  c) ‘payment accounts’ as defined in Article 4(14) PSD;
  d) ‘payment services’ as defined in Article 4(3) PSD;
  e) ‘payment instruments’ as defined in Article 4(23) PSD;
  f) other means of payment, as listed in Annex 1(5) CRD IV (e.g. travellers’ cheques and bankers’ drafts);
  g) ‘electronic money’ as defined in Article 2(2) EMD; and
  h) other forms of credit, in addition to that in (a), provided by the manufacturers listed above, in line with Article 1(5)(e) of the EBA Regulation.

- **Management body** means an institution’s body or bodies, which are appointed in accordance with national law, which are empowered to set the institution’s strategy, objectives and

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8 Deposits include all forms of deposits, including ‘structured deposits’ as defined in point (43) of Directive 2014/65/EU (MiFID 2). Financial institutions issuing them are subject to the Capital Requirements Directive (CRD IV) and the Deposit Guarantee Scheme Directive (DGSD). In addition, the Commission is currently developing delegated acts under Art 16(3) and (12), in line with Article 1(4) of the Markets for Financial Instruments Directive (MiFID2), on specific aspect of the **selling and advising** of structured deposits. The EBA will monitor the development of the Commission’s delegated acts, so as to ensure the respective requirements are clearly expressed and delineated in the final EBA Guidelines.
overall direction, and which oversee and monitor management decision-making, and include the persons who effectively direct the business of the institution, as defined in Article 3(7) CRD IV.

- **Senior management** means those natural persons who exercise executive functions within an institution and who are responsible, and accountable to the management body, for the day-to-day management of the institution, as defined in Article 3(9) of CRD IV.

### 4.1.4 Outsourcing

In the case where the activity of manufacturing and/or distributing is in whole or in parts outsourced to third parties, or carried out by another entity in other ways, manufacturers and, where applicable, distributors should ensure that in doing so, they comply with the requirements established in the CEBS Guidelines on outsourcing. ⁹ This includes, in particular, guideline 2, which provides that “the ultimate responsibility for the proper management of the risks associated with outsourcing or the outsourced activities lies with an outsourcing institution’s senior management”.

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4.2 Title II - Guidelines regarding the product oversight and governance arrangements of retail banking products for manufacturers

1. Establishment, proportionality, review and documentation

1.1 The manufacturer should establish, implement and review effective product oversight and governance arrangements. The arrangements should be designed to minimise potential consumer detriment, avoid potential conflicts of interest, and ensure that the interests, objectives and characteristics of consumers are appropriately taken into account.

1.2 The product oversight and governance arrangement should be reviewed and updated by the manufacturer on a regular basis.

1.3 When launching a new product the manufacturer should ensure that the product oversight and governance arrangements are considered in the new product approval policy (NPAP) in line with Guideline 23 of GL 44 in cases where GL 44 applies.

1.4 All actions taken by the manufacturer in relation to the product oversight and governance arrangements should be duly documented; kept for audit purposes and made available to the competent authorities upon request.

1.5 Product oversight and governance arrangements should be proportionate to the level of complexity of the product as well as nature, scale and complexity of the relevant business of the manufacturer.

2. Manufacturer’s internal control functions

2.1 The manufacturer should ensure that product oversight and governance arrangements are an integral part of its governance, risk management and internal control framework as outlined in GL 44, where applicable. To that end, the manufacturer’s management body should endorse the establishment of the arrangements and subsequent reviews.

2.2 Senior management, with support from representatives of the manufacturer’s compliance and risk management functions, should be responsible for the continued internal compliance with the product oversight and governance arrangements. They should periodically review that the product oversight and governance arrangements are still appropriate and up to date and propose to the management body to amend the arrangements when this is no longer the case.

2.3 The responsibilities for the oversight of this process by the Risk Control function and the Compliance function should be integrated in their normal line of duties as outlined in Guidelines 25, 26 and 28 of GL 44, where applicable.
2.4 Senior management should ensure that staff involved in designing a product are familiar with and follow the manufacturer’s product oversight and governance arrangement; are competent and appropriately trained; and understand and are familiar with the product’s features, characteristics and risks.

3. Target market

3.1 Manufacturers should include, in their product oversight and governance arrangements, steps and features that need to be followed to identify the relevant target market of a product.

3.2 The manufacturer should, having first identified the target market, ensure that the product is deemed appropriate for interests, objectives and characteristics of the identified target market(s).

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

3.4 The manufacturer should consider how the product fits within the manufacturer’s existing product range and whether the presence of too many product variants prevents the consumer from making informed decisions.

3.5 The manufacturer should also identify the market segments for which the product is considered likely not to meet their interests, objectives and characteristics and prevent that the product is offered to these market segments.

3.6 When deciding whether a product meets the interests, objectives and characteristics or not of a particular target market, the manufacturer should assess the degree of financial capability of the target market.

4. Product testing

4.1 Before product is designed and brought to the market; an existing product is sold to new target markets; or significant changes to existing product are introduced, the manufacturer should conduct product testing, in order to be able to assess how the product would affect its consumers under a wide range of scenarios, including stressed scenarios. Manufacturers should make appropriate product changes where the scenario analysis gives rise to poor results for the target market.

4.2 The product testing should also ensure that information provided by manufacturers to distributors and the target market is understandable to the end-user.
5. **Product monitoring**

5.1. Once the product is brought to market, the manufacturer is ultimately responsible for product monitoring and should monitor on an on-going basis that the product continues to meet the interests, objectives and characteristics of the target market.

6. **Remedial action**

6.1. If the manufacturer identifies a problem related to the product in the market, or when monitoring the performance of the product as required in Guideline 5.1 above, the manufacturer should take the necessary action to mitigate the situation and prevent a re-occurrence of detriment.

6.2. The remedial action should include promptly notifying the distributor of changes or modifications to the existing products and any additional actions that need to be taken to remedy the situation.

6.3. Product oversight and governance remedial action is without prejudice to remedial action given to individual consumers in case some problem occurs with the product on the market.

7. **Selection of distribution channels**

7.1. The manufacturer should select distribution channels that are appropriate for the particular target market. To that end, the manufacturer should select distributors that have the appropriate knowledge, expertise and capability correctly to place each product in the market and to provide appropriate information to the target market. When selecting its distribution channels, the manufacturer may consider limiting the distribution of a specific product to channels that offer specific features to consumers.

7.2. The manufacturer should ensure that the products are distributed to the identified target market and only sold outside the target market on a justified and exceptional basis.

7.3. The manufacturer should take all reasonable steps to ensure that distributors act in compliance with the objectives of the manufacturer’s product oversight and governance arrangements. The manufacturer should take appropriate action when concerns about the appropriateness of the distribution channel are raised, for example by ceasing to use the particular channel for a particular product. In particular, the manufacturer should ensure, on an ongoing basis that the products mainly reach the particular intended target market through the distribution channels used.

7.4. Where different business units of the manufacturer are involved in the design and distribution of the product, the manufacturer should require the staff in charge of designing the product to communicate to the staff in charge of distributing the product the relevant information needed to (i) place the product appropriately in the market, (ii) to allow them appropriately to recognise the target market for each product and (iii) to identify when the
product no longer meets the interests, objectives and characteristics of the target market and to take the appropriate action to remedy the situation.

8. Information for distributors

8.1 Where relevant, the manufacturer should provide the distributor with a description of the main characteristics of the product; its risks and any limitations; the total price of the product to be borne by the consumer, including all related fees, charges, and expenses.

8.2 The information and details of the products to be provided to distributors should be of an adequate standard, clear, precise and up-to-date, to enable distributors to understand and place the product properly in the market.

8.3 The manufacturer should ensure that the information given to the distributor includes all relevant details to enable them:

   a) to understand and place the product properly on the market;
   b) to recognise the target market for which the product is designed, and also to recognise market segments whose objectives, interests and characteristics are considered likely not to be met; and
   c) to meet any other obligations under already applicable European legislation.
4.3 Title III- Guidelines regarding the product oversight and governance arrangements of retail banking products for distributors

1. Establishment, proportionality, review and documentation

1.1 The distributor should establish, implement and review effective product oversight and governance arrangements which are specific and proportionate to their size and to their role of bringing products to the market. The arrangements should be designed to minimise potential consumer detriment and to avoid potential conflicts of interest.

1.2 The distributor should review and update the product oversight and governance arrangement on a regular basis.

1.3 All actions taken by the distributor in relation to the product oversight and governance arrangements should be duly documented; kept for audit purposes and made available to the competent authority, or the manufacturer, upon request.

2. Distributor’s internal control functions

2.1. The distributor should ensure that product oversight and governance arrangements are an integral part of the general systems and controls within the distributor. To that end, their management body, if relevant, should endorse their establishment and subsequent reviews.

3. Knowledge of the target market

3.1 The distributor should use the information provided by the manufacturer and have relevant knowledge and ability to determine whether a consumer belongs to the target market. The distributor should in particular take due account of all relevant information allowing him to recognise the target market for which the product is designed, and also to recognise market segments for which the product is considered likely not to meet their interests, objectives and characteristics.

4. Information

4.1 The distributor should take into account disclosures provided by the manufacturer and disclose to the target market a description of the main characteristics of the product; its risks; the total price of the product to be paid by the consumer, including all related fees, charges, and expenses and provide additional material supplied by the manufacturer for using the target market. These arrangements are without prejudice to any requirements that may be imposed on distributors through existing and/or forthcoming EU and national legislation on disclosure regimes relating to specific products, or services. Distributors will continue to have to comply with those requirements.
4. 2 The distributor should be able to provide information to justify to the manufacturer why they offered a product to a consumer who does not belong to the target market.

4. 3 In order to assist the manufacturers in their obligation of product monitoring, the distributor should collect information whether the product they bring to the market meets the interests, objectives and characteristics of the target market on an on-going basis.

4. 4 If the distributor identifies any problems regarding the product features, product information or the target market when offering and selling products, the distributor should promptly inform the manufacturer of the issue.

4. 5 This remedial action by the distributor is without prejudice to remedial action given to individual consumers in case some problem occurs with the product on the market.
4.4 Title IV- Final Provisions and Implementation

Competent authorities should implement these guidelines by incorporating them in their supervisory processes and procedures by 1 April 2016.
Consultation Questions

General questions

Question 1: Do you agree with the proposed approach of capturing the entire product life cycle by covering distributors as well as manufacturers?

Question 2: Do you agree with the delineation of the two sets of requirements for manufacturers and distributors?

Question 3: Are there any additional requirements that you would suggest adding to either of the two sets of requirements? If so, why?

Specific questions regarding Guidelines for manufacturers (Title II)

Question 4: Do you agree with Guideline 1 on establishment, proportionality, review and documentation?

Question 5: Do you agree with Guideline 2 on manufacturers’ internal control functions?

Question 6: Do you agree with Guideline 3 on the target market?

Question 7: Do you agree with Guideline 4 on product testing?

Question 8: Do you agree with Guideline 5 on product monitoring?

Question 9: Do you agree with Guideline 6 on remedial action?

Question 10: Do you agree with Guideline 7 on the selection of distribution channels?

Question 11: Do you agree with Guideline 8 on information for distributors?

Specific questions regarding Guidelines for distributors (Title III)

Question 12: Do you agree with Guideline 1 on establishment, proportionality, review and documentation?

Question 13: Do you agree with Guideline 2 on the distributor’s internal control functions?

Question 14: Do you agree with Guideline 3 on the knowledge of the target market?

Question 15: Do you agree with Guideline 4 on information?
5. Accompanying documents

5.1 Good practice examples

Good practice examples relate to the conduct of manufactures’ and distributors’ tasks towards particular product oversight and governance arrangement that, if applied, will enhance consumer protection and will, as such, also contribute to ensuring the effectiveness of the financial system more generally. These approaches are considered as good examples and are aimed at promoting common practices amongst financial institutions. Competent authorities are likely to want to consider how the good practices, alongside measures already in place or to be implemented, might support their own national supervisory objectives.

The EBA has identified several good practice approaches and they are listed in this section after the relevant requirement.

**Good practice examples for manufacturers**

**Establishment, proportionality, review and documentation**

A limit for regular review and update could be established, and/or factors that are relevant to the regularity of the review should be identified, e.g. significant changes in retail strategy, complexity of the product lines, complexity of distribution methods and distribution chain.

**Target market**

Manufacturers could consider the following:

- (i) tax status implications for different products,
- (ii) level of risks of the product to be designed,
- (iii) liquidity accessibility that the consumer is expected to get,
- (iv) level of risks that the consumer is willing to bear,
- (v) demographic factors,
- (vi) level of knowledge and understanding of the complexity of the product, or
- (vii) potential creditworthiness of the consumer or financial capability of the consumer.

Consumers could be provided with different scenarios or simulations of the amount of payment of the loan depending on the variation of the interest rate.

In case of deposits, an assessment could take account of the various competing product features, such as accessibility, yield, and security, and whether the combination of these meet said interests, objectives and characteristics.
Product testing

In the case of a loan with a variable interest rate, the assessment could include the borrower’s repayment requirements at reasonably higher interest rates.

Disclosure

In the case of a deposit, this could include, but it is not limited to, the accessibility, yield and security of the funds, as well as any guarantee scheme that may apply.

Product monitoring

The manufacturer could only make changes to product features such as charges, interest rates, and applicability of protection schemes that are consistent with the interests, objectives and characteristics of the target market.

Remedial action

A remedial action could be taken when the product no longer meets the general needs of the target market or when the product performance significantly differs from what the manufacturer originally expected and in a way that causes consumer detriment.

Distribution channels

In the case of mortgages or consumer credit, the manufacturer could monitoring the sales volumes across various risk characteristics, such as loan-to-income ratios and loan-to-value ratios; and, where possible, a comparison of such characteristics between its own staff and external distribution channels.

Good practice examples for distributors

Knowledge of the target market

In case of deposits, the distributor could take account of the various competing product features, such as accessibility, yield, and security, and whether the combination of these meet said interests, objectives and characteristics.

Information In the case of a deposit, this could include, but it is not limited to, the accessibility, yield and security of the funds, as well as any guarantee scheme that may apply.
5.2 Cost-Benefit Analysis / Impact Assessment

5.2.1 Introduction

As per Article 16(2) of the EBA Regulation, any Guidelines developed by the EBA shall be accompanied by an annex setting out an Impact Assessment (IA) which analyses ‘the potential related costs and benefits’. Such annex shall provide the reader with an overview of the findings as regards the problem identification, the options identified to remove the problem and their potential impacts. This chapter presents an impact assessment of these guidelines on product oversight and governance arrangements for manufacturers and distributors of retail banking products.

5.2.2 Problem definition

The market for retail financial products and services is prone to specific failures, in particular due to information asymmetries.\(^\text{10}\) In addition, costs and benefits from mis-sold financial products tend to be distributed rather unequally. Mis-selling can detrimentally affect a large number of consumers, causing small costs for them individually. The individual consumer has thus little incentives to seek redress. Total profits for financial institutions at the same time can be very high. This combination entails the risk of financial institutions intentionally exploiting consumers’ behaviour. Conduct failure can also damage consumers’ confidence and financial markets’ integrity.

The potential risks to the financial system of widespread misconduct of financial institutions have been identified and analysed in various reports by European\(^\text{11}\) and national\(^\text{12}\) competent authorities. Recent reports identify a widening number and magnitude of incidents of mis-selling of financial products and concerns about insufficient provisions and inadequate disclosure prevail. The negative effect on institutions’ profitability is increasingly subject to supervisory scrutiny.

According to a recent study, ten major global banks from 2008 to 2013 have incurred conduct-related costs of around €170bn.\(^\text{13}\) At end 2013, their provisions for future costs stood above €70bn. More than 40 % of the total costs were related to banks’ conduct with non-US consumers.

At the same time, the results of a survey conducted by the EBA reveal significant heterogeneity as regards the existence, level of compulsion and detail of current national requirements related to product oversight and governance arrangements.\(^\text{14}\) Whereas a few Member States confirm to have already restrictive requirements implemented at national level, the majority of Member

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\(^{10}\) European Parliament (2014), Consumer Protection Aspects of Financial Services


\(^{13}\) CCP Research Foundation (2014), Conduct Costs Project, at http://conductcosts.ccppresearchfoundation.com/

\(^{14}\) In order to inform the cost-benefit analysis for these guidelines, in August 2014 the EBA conducted a survey amongst NCAs which focused on existing arrangements in the different Member States. 17 Member States provided information.
States has not implemented any or only very limited (regarding scope and / or level) arrangements governing the manufacturing and distribution of retail banking products. Some have only issued non-binding guidance or have only more general, high-level governance requirements in place.

Even Member States that are home to a relatively large number of manufacturers of banking products (> 500) do not necessarily require strict regulatory product and governance arrangements. Except from European legislative obligations regarding disclosure, hardly any Member State applies requirements to distributors of banking products.

5.2.3 Policy objective

The primary high-level objective of these guidelines is the protection of consumers from detriment in retail financial markets. This is expected to contribute to improving the confidence in these markets and the integrity of the financial system in general. More specifically, these guidelines aim to correct failures and reduce information asymmetries and information costs in retail financial markets. They are drafted to mitigate moral hazard and solve conflicts of interests and principal-agent problems associated with those market imperfections and behaviour patterns.

At the operational level, these guidelines – by establishing requirements on the oversight and governance arrangements in the development and selling of banking products and services – intend to ensure that manufacturers’ and distributors’ provision of products and services meets consumers’ objectives. The design and bringing to market of products should have adequate structures and processes in place to reduce the misalignment between firms’ and consumers’ interests.

Given the existing limits to financial capabilities of consumers, these guidelines in particular aim at the protection of consumers from being offered or sold inadequate products. For that purpose, the requirements contained in these guidelines intend to make the manufacturers and distributors – and their management – assume more responsibility for placing products on the market, mainly through the proper identification of the target market. Operationally, these guidelines envisage product oversight and governance arrangements to become an integral part of financial institutions’ risk management and internal control systems.
5.2.4 Baseline scenario and options considered

The baseline scenario – relying on financial institutions and consumers to correct the above-mentioned market failures and behavioural biases – would coincide with the do-nothing option to abstain from regulatory intervention (Option 1).

Without policy intervention, the problems described above would persist. More precisely, the significant costs related to conduct failure of financial institutions could continue to negatively affect their profitability and solvency. Similarly, the depressed confidence of consumers would most probably prevail, resulting in a dampening of the demand for banking products. Overall, without financial supervisors taking action, financial institutions’ conduct failure would negatively impact the effectiveness and efficiency of the functioning of the EU financial market.

With respect to the extent to which these guidelines’ requirements cover the lifecycle of banking products, the EBA could either chose to

- issue Guidelines establishing requirements on the manufacturing of banking products only (Option 2);
- issue Guidelines establishing requirements on the distribution of banking products only (Option 3);
- issue Guidelines establishing requirements on both the manufacturing and distribution of banking products (Option 4).

The costs of implementing these guidelines will increase with the extent to which the requirements cover the banking products’ lifecycle. Requirements covering only the distribution of banking products would be the least costly, requirements targeting only the manufacturing of banking products more costly and the inclusion of both phases of the product lifecycle the most costly option to implement.

Benefits would be inversely distributed, with Option 3 being of the most limited benefit and Option 4 being the most beneficial one. Option 3 would not tackle the designing of the product and would maintain manufacturers out of related responsibility. Product oversight and governance is made to involve manufacturer is a fair designing of products, taking into account end-consumers.

NCAs responding to EBA’s survey indicated that there are many times more distributors than manufacturers of banking services registered in their jurisdictions to which the guidelines might apply. Consequently, the number of institutions affected by the issuance of these guidelines increases significantly with the extension of these guidelines to include requirements on manufacturers as well as on distributors. Option 4 would imply higher costs for financial consumers.

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institutions and NCAs to implement and monitor compliance with these guidelines. In a similar way, the beneficial effects of these guidelines – accruing mostly to consumers – would be the highest when including requirements on manufacturers as well as on distributors of banking products. According to the NCAs’ responses to the EBA survey those benefits of these guidelines are expected to be related to governance and oversight arrangements of both, the distribution and the manufacturing of banking products. In order effectively to promote consumer protection and mitigate the risk of retail conduct failure, the issuance of guidelines entailing requirements on manufacturers as well as distributors of banking products is the preferred option (Option 4).

5.2.5 Analysis of overall costs and benefits of these Guidelines

Overall, the costs and benefits of the policy choice (Option 4) would be unequally distributed across stakeholder groups as well as across Member States. For NCAs, the costs of implementing these guidelines (one-off costs) and supervising compliance (on-going costs) would depend on the current national regulatory framework and the national characteristics of the retail market for banking products. NCAs’ responses to the EBA’s survey indicate that the implementation of these guidelines would require roughly between 0 and 5 additional staff members to be employed. On average the costs for NCAs of choosing Option 4 can be considered to be low.

In a similar way, the costs for financial institutions of implementing these guidelines would depend on the current national regulatory framework and the national characteristics of the retail market for banking products. For financial institutions currently acting without national regulatory requirements on product oversight and governance in place and in large markets for retail banking products, the costs for implementing these guidelines will be higher.

Given the level of detail and restrictiveness of the requirements entailed in these guidelines and the scope across institutions and product lifecycle chosen, those costs for financial institutions would be of medium level. Those costs would include one-off and on-going costs and fall into a broad range of categories. The most important cost categories affected by the requirements entailed in these guidelines would include costs for product development and market research, costs for the documentation of the implemented arrangements and disclosure of product information and HR costs (training of sales staff and resources at management level).

However, parts of these costs may be absorbed within some financial institutions as a result of similar functions being performed by departments responsible for product development, marketing, or other related functions. In addition, those costs should, should be compared to the current very significant amounts paid by a large number of financial institutions to redress and compensate for mis-selling of financial products and other conduct related costs. Assuming compliance with these guidelines, the costs of their implementation would outweigh the costs resulting from retail conduct failure observed in recent years. Regarding the material risks to solvency that large-scale conduct related costs can cause to financial institutions, the

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implementation of these guidelines could generally be expected to contribute to the promotion of fair business conduct and sustainable business models in banking.

The largest benefits of the implementation of these guidelines would effectively accrue to consumers of banking products. The implementation of these requirements by manufacturers and distributors of banking products would reduce consumers’ risk to face detriment and increase their trust in retail financial markets. Consequently, consumers could be expected to more confidently demand and enjoy the benefits which financial services generally may offer to them. Those beneficial attributes could be related to the smoothing of private households’ income streams over their lifetime or their insurance against severe adverse risks.

In addition, the requirements entailed in these guidelines would particularly protect consumers from being offered or even sold products which do not meet their actual needs and reduce excessive product variety and information costs. Those benefits would most probably by far supersede moderate increases in prices which might result from financial institutions trying to pass-through at least fractions of their costs related to the implementation of these guidelines.

Finally, the results of EBA’s survey mentioned above demonstrate the case for an EU-level initiative on governance and oversight arrangements. Bearing in mind the general objectives of promoting the internal market for banking products and ensuring a level playing field in the EU, there are significant benefits to be reaped by the harmonisation of supervisory practices in the EU. These EU-level guidelines will for the first time establish common regulatory requirements to address conduct risk.

Overcoming the current differences in product oversight and governance arrangements across Member States implies that financial institutions do not need to incur costs for tailoring their processes to different frameworks across Member States, thus producing economies of scale to financial institutions. In a similar way, consumers can build on an equal level of protection in the EU wherever they purchase a retail banking product. These guidelines are conceptually consistent with similar guidance applied to the insurance and securities sectors. All in all, these guidelines benefit the confidence in the financial system and improve its functioning and service to the EU economy at large.