



FI Supervision

# Product approval process of non-life insurance undertakings

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### FI Supervision

Finansinspektionen publishes regular supervision reports in a numbered series. The supervision reports describe investigations and other supervision carried out by FI. Through these reports, we present our observations, assessments and expectations in various matters. The reports, which are a part of our communicative supervision, are intended to support firms in their operations.

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## Summary

The process for product approval is central from a consumer protection perspective. It aims to ensure that insurance undertakings focus on consumer interests when they develop and maintain insurance products. In an in-depth analysis that Finansinspektionen (FI) has conducted, we have seen a number of good examples of how undertakings work with and apply this process.

Insurance undertakings must ensure that the insurance products they develop and provide meet consumer needs. Consumers should not be offered insurance they do not need. To ensure this, undertakings must have a functioning internal process for product approval.

FI's analysis presents several good examples of how undertakings work with and apply the product approval process. Among other things, we have seen that over half of the undertakings assess the value an insurance product holds for the consumer in relation to its premium and that several of the undertakings take customer complaints into consideration in various parts of the process. FI has also observed that almost all the undertakings have established a target group for all their insurance products, not only for the products developed or significantly changed by the undertaking since the rules of the product approval process came into force. These are a few examples of how undertakings can create the conditions for ensuring that insurance products fulfil consumer needs.

We have also noted that there seems to be uncertainty in the industry on whether add-on cover should be considered an insurance product on its own based on regulatory definitions and thereby should be subject to the process of product approval. The fact that the regulatory framework is not applied uniformly in this respect is problematic and gives rise to the need for FI to follow up on the issue.

The product approval process is central for the undertakings, and in the interest of consumer protection, they must work with it continuously. FI will continue to monitor the undertakings' work with and application of the process as part of our ongoing supervision.

## Insurance products must fulfil consumer needs

Insurance undertakings must ensure that the insurance products they provide meet consumer needs. Consumers should not be offered insurance they do not need. To ensure this, undertakings must have a functioning internal process for product approval.

In 2016, the Insurance Distribution Directive was adopted.<sup>1</sup> The main purpose of the Directive is to improve consumer protection in the distribution of insurance. The Directive contains, amongst other things, rules on product oversight and requirements on governance of insurance undertakings and distributors that develop insurance products to be sold to customers. The Directive has, in this area, been implemented in Swedish law through Chapter 4, sections 7–11 of the Insurance Distribution Act (2018:1219), under the Internal process for product approval heading. There are a number of supplementary acts to the Directive, among them a Delegated Regulation<sup>2</sup> (below, Commission Delegated Regulation) that more closely specifies the product oversight and governance requirements stated in the Directive.

### Why is the process of product approval important?

The process for product approval is central from a consumer protection perspective. It aims to ensure that consumer needs and interests are in focus when insurance products are developed and while they are provided. The process entails that insurance distributors<sup>3</sup> who develop insurance products for distribution must take consumer needs into consideration during the insurance's entire lifespan. The rules also dictate that insurance distributors must also take consumer needs into account when selecting the method of distribution.

To ensure consumer needs and interests, insurance distributors must establish a target group for each insurance product, that is, define which consumers the insurance product is intended for. Based on the target group, the insurance distributor must monitor that the insurance, during its lifespan, continues to fulfil consumer needs and that it is sold to consumers for whom it is compatible.

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<sup>1</sup> Directive (EU) 2016/97 of the European Parliament and of the Council of 20 January 2016 on insurance distribution.

<sup>2</sup> Commission Delegated Regulation (EU) 2017/2358 of 21 September 2017 supplementing Directive (EU) 2016/97 of the European Parliament and of the Council with regard to product oversight and governance requirements for insurance undertakings and insurance distributors.

<sup>3</sup> As described in the "Terms" heading below, *insurance distributor* in this report refers to insurance undertakings and insurance intermediaries.

## What does the product approval process entail?

An insurance distributor that develops insurance products for distribution to customers must establish, apply and continuously review a process of approval of the insurance products it develops. The process must also include significant changes to existing insurance products. The insurance product, or significant change to it, must be approved in line with the process before it is marketed or distributed to customers (product approval).<sup>4</sup>

The process for product approval must be proportional and appropriate in relation to the insurance products to be distributed.<sup>5</sup>

The process must include measures and procedures for designing, monitoring, reviewing and distributing insurance products as well as measures for correcting insurance products that are detrimental to customers. The process must ensure that the design of insurance products:

- takes customer objectives, interests and characteristics into consideration,
- does not have a negative impact on customers,
- prevents or mitigates customer detriment.<sup>6</sup>

In simple terms, the following measures are part of the product approval process:

- Establishing the target group.
- Testing the insurance products.
- Reviewing the insurance products.
- Selecting distribution channels and information to distributors.<sup>7</sup>

## FI has surveyed how undertakings work with the product approval process

FI's assignment includes a responsibility to ensure that the financial system provides comprehensive protection for consumers.<sup>8</sup> As part of these efforts, we have previously published the report entitled *Is there a need for add-on cover and gadget insurance?*<sup>9</sup> This report shows that consumers' need for add-on cover

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<sup>4</sup> For this paragraph, see Chapter 4, section 7 of the Insurance Distribution Act. Chapter 1, section 9, point 10 of the Insurance Distribution Act states that, in the Act, insurance distributor refers to insurance intermediaries or insurance undertakings.

<sup>5</sup> See Chapter 4, section 10 of the Insurance Distribution Act.

<sup>6</sup> For this paragraph, see Article 4 of the Commission Delegated Regulation.

<sup>7</sup> Chapter 4, sections 8–11 of the Insurance Distribution Act and the Commission Delegated Regulation describe the parts of the product approval process in more detail.

<sup>8</sup> Compare to section 2 of Finansinspektionen's Instructions Ordinance (2009:93).

<sup>9</sup> Report Ref. 23-5068, published in 2023. We have also previously surveyed how insurance undertakings handle complaints ("Complaints handling in insurance firms", FI Ref. 21-25585, October 2021) and the prevalence of price discrimination in home insurance

differs by age. Older consumers often have little need for such insurance. The need for gadget insurance is limited in all age groups, and there is often no need for it at all. It is the responsibility of insurance undertakings to ensure that consumers are not offered insurance they do not need. To follow up on how insurance undertakings ensure that their insurance fulfils consumer needs, we have surveyed how the undertakings work with and apply the product approval process.

To collect survey data, we sent out a questionnaire to 23 undertakings. To obtain a representative picture of the market, the selection is composed of both large and small undertakings, including one of the major non-life insurance branches on the Swedish market. The report is limited to non-life insurance undertakings and does not include undertakings that insure major risks as the distribution of major risk insurance is not covered by the rules regarding product approval.<sup>10</sup>

The report presents how the non-life insurance undertakings worked with and applied the product approval process between October 2018 and June 2022.<sup>11</sup>

While working on the report, requirements have come into effect regarding insurance product sustainability and taking consideration to consumer sustainability-related objectives in the product approval process (see Articles 4–8, 10 and 11 of the Commission Delegated Regulation). Because the FI report is based on responses submitted before these additional requirements came into effect, they are not mentioned in the report.

The report structure reflects the sections of the product approval process. As such, it starts with a general section regarding the basic rules of the process and its principles. This is followed by a section on determining the target group, a section on product testing and a section on insurance product oversight. The report is concluded with a section in which we summarise our findings and present our continued work in the area.

## Terms

In the report, we will hereafter refer to non-life insurance undertakings as *undertakings*.

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(contents/building) and private car insurance (“Do loyal policyholders pay more?”, FI Ref. 22-66, July 2022).

<sup>10</sup> See Chapter 4, section 12 of the Insurance Distribution Act. What is meant by major risk insurance is insurance specified in Chapter 2, section 11, first paragraph, classes 3, 8–10, 13 and 16 of the Insurance Business Act (2010:2043), if the policyholder is a business, and under the condition that certain criteria are met, see Chapter 1, section 9, point 22 of the Insurance Distribution Act compared to Chapter 3, section 16, second and third paragraphs of the Insurance Business Act.

<sup>11</sup> The period delimitation is a result of the Insurance Distribution Act coming into force on 1 October 2018 and the report data being prepared in June 2022.

As the report concerns consumer insurance specifically, we will use the term *consumer* throughout instead of customer which is used in the Directive, the Commission Delegated Regulation and the Insurance Distribution Act.

Rather than using the term target market as used in the Directive and the Commission Delegated Regulation, the term *target group* will be used throughout for clarity. There is no difference between the two.

When we use the term *insurance distributor*, we mean an insurance distributor (insurance undertaking and insurance intermediary) that develops insurance products for distribution to customers. This term is also used for the sake of clarity rather than the term manufacturer as used in the Directive and the Commission Delegated Regulation. There is no difference between the two.

# Undertakings' product approval processes

FI has seen several good examples of how undertakings work with and apply the product approval process to ensure that the insurance products they develop and provide meet consumer needs.

## Undertakings' work with and application of product approval process, in general

### Requirements on undertakings' work with and application of product approval process, in general

An insurance distributor that develops insurance products for distribution to customers must have an internal process for product approval.<sup>12</sup> The process must be set out in a written document (Product Oversight and Governance Policy), which must be made available to the relevant staff.<sup>13</sup>

The body or structure of the insurance distributor responsible for developing the insurance products must endorse and be ultimately responsible for establishing the product approval process.<sup>14</sup>

An insurance product or a significant change to an insurance product must be approved according to the product approval process before it is marketed or distributed to customers.<sup>15</sup>

Relevant measures that insurance distributors take regarding their product approval process must be appropriately documented. The documentation must be stored for the purpose of audits and be available to competent authorities upon request.<sup>16</sup>

### How do undertakings work with and apply the product approval process?

A clear majority of undertakings reported that the undertaking's board of directors established their product approval process.

All undertakings reported that it is clearly stated in their written product oversight and governance policy (or in underlying documents) which company bodies, functions or roles are to participate in developing the product approval process and

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<sup>12</sup> See Chapter 4, section 7 of the Insurance Distribution Act and Article 4 of the Commission Delegated Regulation.

<sup>13</sup> See Article 4(2) of the Commission Delegated Regulation.

<sup>14</sup> See Article 4(4) a of the Commission Delegated Regulation.

<sup>15</sup> See Chapter 4, section 7, second paragraph of the Insurance Distribution Act.

<sup>16</sup> See Article 9 of the Commission Delegated Regulation.



approve an insurance product, as well as what each of their tasks is. Some undertakings have reported that their risk management, compliance and actuarial functions participate in developing their product approval process. The majority of the undertakings reported that these three functions also participate in applying the process. The ways in which the functions participate in the process vary. Many of the undertakings reported that the functions participate in some form of risk and product profitability assessments and that they express opinions or issue recommendations prior to the decision to release a product to the market or to significantly change a product. None of the undertakings reported that their internal audit function participates in process development or application.

Several of the undertakings gave examples of the criteria they use to assess whether a change to a product is significant, including

- insurance terms and conditions and changes to these, e.g., increased coverage
- value to customers
- price
- distribution changes.

With regard to the measures undertakings take for their product approval process, they have reported that the following is documented:

- established target group
- distribution strategy
- calculated profitability
- risk analysis
- description of product tests.

The majority of undertakings store the documentation for five years or longer.

Almost half of the undertakings reported that they do not apply the product approval process independently to add-on coverage policies<sup>17</sup>.

## What is FI's opinion?

FI initially notes that the vast majority of undertakings reported that the board of directors is the body that establishes the undertaking's product approval process. FI states that it follows from the rules that it is the body or structure of the insurance distributor that is responsible for developing the insurance products approves and takes ultimate responsibility for establishing the process. This body or structure does not necessarily need to be the board of directors. However, it is positive in our

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<sup>17</sup> Add-on cover is a policy that provides increased coverage of special events or damages. It is always linked to a base cover such as home insurance (content and/or building) and auto insurance. A typical example of add-on cover is all risks insurance. Other examples are expanded travel insurance, golf insurance and pram insurance.

opinion that the process is established by the board of directors. When the board of directors has a good understanding of the undertaking's product approval process, it can apply an initiated consumer protection perspective in its other decision making. It can also indicate to the rest of the organisation that the undertaking takes consumer protection issues seriously, which in turn may increase awareness of these issues.

We also note that all undertakings reported that it is clear in their written product oversight and governance policy (or in underlying documents) which central functions are to participate in developing and applying the product approval process as well as what each of their tasks is. We see the advantage of the risk management, compliance and actuarial functions participating in both developing and applying the process as they can each contribute with their respective expertise. The fact that the internal audit function is not involved in developing or applying the process enables the function to maintain objectivity and independence in potential auditing of the process.

FI acknowledges that several of the undertakings have given examples of the criteria they use to assess whether a change to a product is significant. We state that if the undertaking has established criteria for assessing the significance of a change to an insurance product beforehand, it could facilitate for the undertaking in assessing whether the product needs to undergo new approval in line with the process. Without a clear definition, there is a risk that significant changes are not observed and that the product is not handled in line with the process before being marketed or distributed to consumers. This can, in turn, weaken consumer protection.

FI takes a positive view of the fact that undertakings document their established target group and description of product tests when it pertains to the measures taken in the product approval process. The appropriate duration of storing the documents can vary depending on the type of product the documentation pertains to.

Fulfilment of consumer needs is ensured by applying the product approval process to each product independently. However, FI acknowledges that almost half of the undertakings reported that they do not apply the product approval process independently to add-on coverage policies. The fact that the process is not applied to these policies indicates an uncertainty in the industry of whether add-on cover should be considered an insurance product on its own based on regulatory definitions and thereby should be subject to the process of product approval. The fact that the regulatory framework is not applied uniformly in this respect is problematic and gives rise to the need for FI to follow up on the issue.

## Establishing the target group

### Requirements for establishing the target group, in general

In the product approval process, insurance distributors must establish a target group of end customers for each insurance product. In the process, all relevant risks to the target group and the suitability of the intended strategy for distributing the insurance product to the target group must be assessed. The insurance distributor must take all reasonable measures for distributing the insurance products they develop to the target group.<sup>18</sup>

The target group must be defined on an appropriately granular level and in a way that takes consideration to the characteristics, risk profile, complexity and nature of the insurance product.<sup>19</sup> Insurance distributors should only develop and sell insurance products that are compatible with the needs, characteristics and objectives of target group customers. In determining whether an insurance product is compatible with a target group, the insurance distributor must take into consideration the level of information available to customers in the target group as well as their financial knowledge.<sup>20</sup>

### How do undertakings establish target groups?

All undertakings have reported that they utilise criteria for establishing a product's target group. The majority of undertakings report that these criteria are also specified in their product oversight and governance policy. The undertakings have listed the following examples of criteria:

- The type of product and how complex the consumer perceives it to be.
- The risks covered by the product.
- The consumers' requirements, needs, expectations and interests.
- Consumer characteristics such as age, financial situation, employment and domicile.
- Consumer knowledge and competence.

Two-thirds of the undertakings reported that they use criteria in determining the complexity of an insurance product when establishing the target group. The undertakings have listed the following examples of criteria:

- The product's area of use.
- The number of insurance aspects the product covers.
- Whether a complex aspect of the insurance can be assumed to be of significant importance to the consumer's finances.

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<sup>18</sup> See Chapter 4, section 8 of the Insurance Distribution Act.

<sup>19</sup> See Article 5(1) of the Commission Delegated Regulation.

<sup>20</sup> See Article 5(3) of the Commission Delegated Regulation.

- Whether there are similar products on the market or if it is an entirely new product.

Basically every undertaking indicated that they also define target groups for insurance products that existed before the Insurance Distribution Act came into effect.

### What is FI's opinion?

FI has observed that almost all undertakings have reported that the criteria used for defining their target groups can be found in their product oversight and governance policy. We note that it can facilitate undertakings' efforts to ensure that their insurance is compatible with customer needs, characteristics and objectives.

We state that using previously decided criteria for determining the complexity of an insurance product when defining the target group can facilitate for undertakings to define the target group more in depth. Because insurance policies are to be sold to and meet the needs of consumers in the target group, there is then a reduced risk of selling the insurance to a consumer who does not need it.

FI observes that almost all undertakings have established a target group for all their insurance products, not only for the products developed or significantly changed by the undertaking since the Insurance Distribution Act came into force. We state that this can facilitate for undertakings to live up to their responsibility of not offering consumers insurance that they do not need.

## Product testing

### Product testing requirements, in general

Insurance distributors must test their insurance products appropriately, including scenario analyses where relevant, before releasing the product on the market, or significantly changing it, or in the case that the target group has significantly changed. The product testing should assess whether the insurance product over its lifetime meets the identified needs, objectives and characteristics of the customers belonging to the target group. Insurance distributors must test their insurance products in a qualitative manner and, depending on the type and nature of insurance product and the related risk of detriment to customers, quantitative manner.<sup>21</sup>

### How do undertakings test products?

Over half of the undertakings reported that they have defined what constitutes a significant change in the target group. Of these, some undertakings reported using

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<sup>21</sup> See Article 6(1) of the Commission Delegated Regulation.

the following criteria in determining whether the target group has changed significantly:

- Changed product contents such as age limits or decisions to exclude certain property.
- Customer complaints.
- Changes to claims trends and costs.
- Changed knowledge level of consumers in the target group.
- External circumstances such as changed legislation.

Some undertakings have reported that they have developed criteria to use in qualitative testing, including:

- Feedback from consumers such as complaints, interviews and customer surveys.
- Whether the product is understandable to target group consumers.
- Whether the product's payment model is appropriate and transparent to target group consumers.
- Whether the price of new policy subscriptions or changed subscriptions is in balance with the value of what the insurance is to cover.

About half of the undertakings reported that they quantitatively test their insurance products. Almost all undertakings have, however, reported that they take expected claims costs and combined ratio into consideration in their product tests.

More than half reported that they, in their product testing, determine the value the insurance provides individual consumers in relation to the premium paid. How the undertakings determine this varies, but a recurring example is calculating how much goes back to the consumer through payments. Another example given by the undertakings is the benefit to consumers when a product is changed compared to a potential premium increase. The undertakings report that they obtain this assessment information through, e.g., customer surveys and from various parts of their organisation such as from actuaries, claims adjustors and salespeople.

The undertakings have also reported that they in their qualitative and quantitative tests study such things as

- expected consumer value
- customer satisfaction
- how premiums and benefits compare on the market.

### What is FI's opinion?

FI states that it facilitates for undertakings to determine what constitutes a significant change in the target group if they develop a set of criteria for

determining such changes beforehand. Good examples of such criteria are changed product contents, changes in claims trends and claims costs and in the target group's knowledge level.

In addition, FI also states that if the undertakings develop criteria to be used in qualitative testing of their insurance products beforehand, it will facilitate for the testing of products to be consistent and set out from the same criteria. It also facilitates for undertakings to ensure that their insurance is in line with the needs of the target group.

We note that about half of the undertakings report doing quantitative tests of their insurance products. However, almost all undertakings reported taking expected claims costs and combined ratios into consideration in their product tests. FI states that all undertakings thereby conduct some form of quantitative testing.

With regard to consumers, we take a very positive view of the fact that the undertakings, in testing their products, evaluate the value of the insurance in relation to the premium the consumer pays. This reduces the risk that consumers are offered insurance that they have very little or no need of.

## Oversight of insurance products

### Requirements for insurance product oversight, in general

In their product approval process, insurance distributors must regularly review the insurance products they offer or market. In their oversight, the insurance distributor must take into consideration the events that could significantly impact the risks to the target group. The distributor must then determine whether the insurance product still meets the needs of the target group and whether the distribution strategy in question is still valid.<sup>22</sup>

Insurance distributors must continuously monitor and regularly review the insurance products they have released on the market in the interest of discovering events that can have a significant impact on the products' main features, risk coverage and guarantees. They must determine whether the insurance products remain in line with the needs, characteristics and objectives of the established target group and whether the products are distributed to the target group or reach customers outside it. Insurance distributors must determine appropriate intervals for overseeing their insurance products. They must then take into account the size, scale, contractual duration and complexity of the insurance product, their respective distribution channels, and any relevant external factors such as changes

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<sup>22</sup> See Chapter 4, section 9 of the Insurance Distribution Act.

to the applicable legal rules, technical developments or changes to the market situation.<sup>23</sup>

## How do the undertakings review their insurance products?

The regularity of oversight varies among the undertakings. Close to half of the undertakings reported conducting annual oversight. A few undertakings reported a somewhat longer time interval or a varying time interval depending on the type of insurance product.

To determine whether the insurance products remain in line with the needs, characteristics and objectives of the established target group and whether the products are distributed to the target group or reach customers outside it, several undertakings mention that they take various factors into consideration, including:

- customer complaints
- number of denied claims
- sales to and outside the target group
- whether the product meets the needs, interests and characteristics of the target group
- assessment of the value for consumers
- claims percentage and combined ratio
- events that impact the distribution strategy.

Close to half of the undertakings reported that they take into consideration the value in relation to the premium paid for individual consumers. The undertakings reported the following examples of the methods used to determine this:

- customer satisfaction surveys
- internal information (from e.g. distribution and claims units) regarding the expected value for customers
- competitive comparisons
- claims cost in relation to paid premium.

The majority of undertakings reported taking claims percentages and combined ratios into account in their monitoring and oversight.

Barely half of the undertakings reported that insurance products were sold outside the established target group.

## What is FI's opinion?

As indicated above, the process for product approval must be proportional and appropriate in relation to the insurance products to be distributed. Considering this,

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<sup>23</sup> See Articles 7(1) and 7(2) of the Commission Delegated Regulation.

it is natural, in FI's opinion, that the time interval of regular oversight of a product can vary depending on the type of product in question.

It is our view that the factors the undertakings reported taking into consideration in their oversight of insurance products (presented above) are good examples.

FI takes a positive view on the fact that the undertakings, in the framework of their product oversight, assess the value a product provides in relation to the premium paid by the individual consumer as this can indicate whether or not the insurance meets the consumers' needs.

We take a positive view on the undertakings monitoring the damage claims percentage and combined ratio over time as it can facilitate for them when determining whether their insurance continues to meet the needs of the consumers.

FI states that there can be a number of reasons for insurance products being sold outside the established target group. For example, it may be an indication that the target group was not clearly enough defined from the start. It can also be an indication that, against better judgement, the insurance products are sold outside the target group. For this reason, any sales outside the target group need to be followed up.



## FI continues to safeguard consumer protection

FI has seen several good examples of how undertakings work with and apply the product approval process. For example, we take a positive view of the board of directors being the body that establishes the process. We are also positive to the product oversight and governance policy listing the central functions that are involved in the work and application of the process as well as what their respective roles are. We are also positive to the fact that the undertakings document established target groups and product test descriptions as measures in their product approval processes. We take a positive view of the undertakings assessing the value of insurance in relation to the premium paid by consumers when testing their insurance products within the framework of their product oversight. It is also positive that the undertakings monitor the claims cost percentage and combined ratio over time.

We have also observed that the undertakings take various measures to facilitate for themselves in complying with the regulatory framework and their internal product approval processes. They do so by, e.g., using pre-defined criteria for defining the target group and for assessing the complexity of an insurance product when establishing the target group. Another example of the measures they take to facilitate regulatory compliance is pre-emptively establishing criteria for defining when there has been a significant change in a target group and when an insurance product, therefore, needs to be reassessed. Another example is undertakings having established a target group for all their insurance products, not only for the products developed or significantly changed by the undertaking since the rules of the product approval process came into force. We also observe that customer complaints are also taken into consideration in parts of the process. These are a few examples of how undertakings can create the conditions for ensuring that insurance products fulfil consumer needs.

We note that the undertakings often times also take consideration to customary business and profitability assessments in their product approval process. There is nothing preventing this. However, FI would like to highlight that since the product approval process rules aim to promote effective consumer protection, the consumer perspective and importance of consumers being offered insurance that meets their needs should be prioritised over business and profitability assessments.

We have also noted that there seems to be uncertainty in the industry on whether add-on cover should be considered an insurance product on its own based on regulatory definitions and thereby should be subject to the process of product approval. The fact that the regulatory framework is not applied uniformly in this respect is problematic and gives rise to the need for FI to follow up on the issue.

In conclusion, FI states that product approval is a central process that undertakings must continuously work with to safeguard consumer protection. FI will continue to monitor the undertakings' work with this process as part of our ongoing supervision.