COSTS AND PAST PERFORMANCE – PARTICIPATION PRODUCTS

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Products with profit participation do not offer a clearly identifiable value in the same way as unit linked products, which have a measurable market value at any point. There are a significant number of issues which impact on value at any time and which lead to expected differences between undertakings within States and across borders. Some of these factors include:

1. level of guarantee offered
2. regulatory requirements relating to profit sharing and measurement of the profit sources
3. different sources of profit in bonus, e.g. investment, cost, mortality
4. different methodologies for adding bonuses, including different approaches to the level of reserves available to enhance and smooth profit participation levels
5. different investment features, reflecting investment philosophy and target asset holding period/investment horizon
6. different approaches to establishing values on surrender
7. costs and charges affecting the Reduction in Yield

The decline in interest rates has led to new products or product generations (e.g. maximum guarantee lowered by the regulator, shift from yearly guaranteed to terminal guarantees, shift from year-on-year profit participation to terminal bonus), some of which are fundamentally different from past products. Some of these features are evident in the analysis below.

More detail on the features of profit participation contracts in general and across specific European markets follows:

1) Guarantee offered

There is a variety of contract types on offer, with differing guarantee mechanisms. Traditional contracts, which represent a significant proportion of business in force, tend to offer fixed, yearly interest rate guarantees, sometimes with a guaranteed minimum annuity, with annual bonus additions which, once added, generally cannot be taken away. Within broad categories, products can have individual features such that there may be more than one representative product for each class, creating many different individual products which can just be roughly assigned to one of the classes.

Regular premiums are most common but most products also allow single premium payments. It is common that additional premium payments are possible at the customer's request. New business being written today is often in hybrid form, being a combination of unit-linked funds and traditional business with fixed yearly guarantee. Guaranteed maturity values have traditionally

exceeded premiums paid, though this has become less common in recent years with falling interest rates.

Germany: traditional profit participation products usually have a guaranteed interest rate and a guaranteed minimum annuity, with guaranteed maturity values typically exceeding premiums paid. Minimum surrender values are usually guaranteed based on the same interest rate. Furthermore, the mortality tables are in most cases guaranteed for life. Thus, the guarantees for the annuity phase are based on the same technical interest rate and the same mortality tables as the guarantees up to maturity.

Other types of guarantees are offered by the "New traditional life insurance product", which at maturity (end of accumulation phase) guarantees the amount of premiums paid. At the start of the annuity phase the level of the annuity is guaranteed for life, based on the outcome of the accumulation phase and the technical interest rate and tables which are applicable at that moment. However, it is usual that a minimum annuity is guaranteed from the moment the policy is taken out. Additionally the annuity can increase due to further profit participation during the annuity phase. At the start of the pension payment, the customer can also opt for a lump sum payment instead.

Hybrid products usually have a guarantee mechanism which shifts the assets between the unit-linked and traditional elements based on the development of the capital markets (path-dependent). Different approaches to death benefits apply.

France: most of the French market is composed of hybrid products, e.g. "multisupport" products. These include additional death benefit (called a "floor benefit") which ensures that the death benefit paid for unit-linked investments is not less than the premiums paid net of costs (less amounts surrendered) on these investments. Hybrid products combine traditional guarantees (known as "euro funds") and units of account under the same contract.

More recently, so-called "euro growth" policies have appeared, which are hybrid between the euro and units of account. They have deferred profit-sharing mechanisms, no guaranteed value at all times and a surrender value based on the net asset value of the underlying fund – these are ring fenced products. Older products composed only of "euro funds" still account for a significant proportion of the outstanding amount.

There are also products composed solely of unit-linked funds, but their proportion is much more marginal.

The basic guarantees consist of a life guarantee and a benefit in the event of death of an amount equal to the mathematical provision.

In practice, even if a term guarantee can be defined (this guarantee can be expressed in euros or in number of shares of units of account depending on the case), the contract guarantee is represented by the surrender value of the contract, which is available at any time. The surrender value is equal to the equivalent value expressed in euros of the mathematical provision for each medium.

Similar approaches to the French approach to death benefit on multisupport products apply in the ***Czech Republic*** and ***Slovakian*** markets.

2) Regulatory requirements relating to profit sharing and measurement of the profit sources

Profit participation

Profit participation is regulated in a number of countries in Europe, e.g. Austria, Germany and France.

Germany: at least 90% of investment yield has to be shared with policyholders as well as at least 90% of the risk result and 50% of the cost result (which covers a number of different items including cost, tax, surrender). Losses in one area can be covered by gains in another. Valuation reserves have to be shared, covering the gap between prudent valuation of assets according to local GAAP and market consistent valuation. Profit sharing reserves for future participation are created, which creates a smoothing effect both over time and across the collective of policyholders. The gross surplus is inserted into the reserves for premium refund. From these reserves the individual profit participation is allocated.

Austria: the amount of profit participation is deducted from the overall profit including risk result, cost result and investment result. It is never required to give profit participation, but for conventional business it is market standard. Profit participation has to be "adequate" by law, and regulation clearly defines the yearly minimum amount which is (mostly) allocated to a reserve for profit participation. It is up to the insurer to set profit participation rates in order to smooth the profit participation allocated to the contracts.

France*:* regulations take into account technical and financial results and determine a minimum amount of profit-sharing to be distributed each year to the insurer's entire portfolio, i.e. 85% of the financial result and 90% of the technical result if it is positive, or 100% of the technical result if it is negative. These constraints apply globally, not individually. The insurer may allocate all or part of the profit sharing to a collective profit-sharing provision, which is to be redistributed within 8 years. Under this global constraint, the insurer is free to stipulate for each product contractual clauses that may differ from the regulatory rule. These clauses can leave a significant part of discretionary profit-sharing.

Where there is no formal requirement for profit participation, practices vary. For instance, the usual practice in ***Hungary*** is for 100% profit sharing of the investment results while, in ***Finland***, a principle of fairness applies, with a "fair share" (possibly 60% to 80% long term observed) of surplus to be paid and customer bonus levels to be kept stable over time. As part of this approach, part of the allocated annual surplus is not allocated immediately to individual contracts but reserved for future years as a smoothing element, allowing reduced bonus level volatility between years.

3) Measurement of profit sources

Germany: different profit sources are measured separately, with the main sources of profits being risk, cost and investment result.

Czech Republic*:* rules vary from company to company, and can be on a sub-portfolio basis, at a per product level or at an overall level.

Finland*:* overall profit for the whole portfolio is the most common approach. The total amount of annual profit for participating business depends on the overall result of the company which may include some profits from unit-linked business. The allocation of this total amount between product sub-portfolios depends on the net result of those sub-portfolios (the "fairness principle" for bonuses). The part of the surplus from unit-linked sub-portfolios may be transferred to with-profit portfolios and losses in one with- profit product portfolio (high guaranteed rate) may be covered by positive results in another (low or nil guaranteed rate). Part of the allocated annual surplus is not allocated immediately to individual contracts but reserved for future years as a smoothing element, allowing lower declared bonus level volatility between consecutive years. The smoothing period is 10 years and Finnish company tax legislation allows this reserving period, with the reserve being tax deductible for the company.

Austria: different profit sources are measured separately, with the main sources of profits being risk, cost and investment result. Profit participation rates are often split into a rate for investment return (dependent on the guaranteed interest rate) and a rate for biometric and/or cost result.

Hungary: profits are based primarily on the investment result of the portfolio.

France: contractual profit sharing in France may take into account other components of the result that may be limited to biometric results only (e. g. excess mortality or under-mortality) or that may include all underwriting results (including overheads and acquisition costs). Profit sharing may be differentiated up to the level of individual policyholders according to the applicable fees or as part of offers to encourage unit-linked investment on the policy. However, the profit-sharing rate is generally the same for all policyholders of the same euro fund.

4) Methodologies for adding bonuses

Germany: minimum annual allocation rates are a formal legal requirement, actual allocation rates are in general higher due to competition. For new guaranteed business, the most common guarantee now is a return of premiums, with bonuses added annually and on termination.

France: there are no terminal bonuses in the contracts. A profit sharing is distributed each year on the euro funds. There is no participation in "terminal" profits (although some contracts may provide loyalty guarantees, but these are very marginal products).

Sample annual bonus rates are available, with regular bonus of 1.2% in ***Finland*** and 2.35% in ***Austria*** in 2017 for instance. As mentioned above, annual bonuses generally cannot be taken away once added while terminal bonus can sometimes be partially removed on surrender.

5) Investment features

Investment portfolios used to support profit participation business can also vary from country to country. For instance, in ***Hungary*** and ***Czech Republic***, a portfolio of treasuries is commonly used whereas, in ***Finland*** and ***France***, a more diversified portfolio of investments is typically held.

High level sample portfolio distribution – Finland/France

Investment type	**Proportion of total**
Fixed income	60% or more
Equity	Up to 20%
Real estate and other	Up to 20%

This latter strategy is designed to provide returns in excess of fixed income in the long term, with a moderate risk level, safe cash flow and little or no short term trading. These tend to be simple portfolios with no derivatives.

France: the investment strategy for the assets on which the euro funds commitments are backed takes into account both the guarantees given and the death and surrender laws that determine the duration of the liabilities. It is therefore mainly oriented towards bonds (typical average composition: about 80% bonds, 10% equities and 6% real estate and 4% other assets, including monetary assets). The investment strategy is also linked to the Solvency II driven capital charge which reflects the application of market stresses to the various asset types.

6) Methodology on surrender values calculation

Practices also differ across States in relation to the amounts paid to policyholders on surrender of profit participation policies.

Germany: the surrender value is required to be the premium reserve, calculated according to accepted actuarial rules. Usually minimum surrender values are guaranteed based on the guaranteed interest rate. Some deductions are allowed, and these must be agreed with the customer.

Hungary: premiums are invested in two "pools". A percentage of premium, defined in law, is invested in the "client pool" - 20% in 1st year, 50% in 2nd year and from the 3rd year 80%. Acquisition and maintenance costs are deducted from remaining part of the premium with the rest going to the "loyalty pool". There is no surrender in the first year. The surrender charge is 100% of

the loyalty pool in years 2-10 and from the 11th year it is between 25% and 45% according to the contract's specific term.

Austria and ***Czech Republic****:* surrender values for traditional contracts may be based on mathematical reserve according to premium calculation, usually with a small deduction, e.g. 5%, plus bonus accrued.

France: for multi-support products, surrender value is at all times equal to the value expressed in euros of each of the supports (underlying funds, including euro fund). The features of the product are well known and surrender values are straightforward to calculate based on published profit sharing.

Various other approaches are applied in different States, with differing practices in a number of areas, e.g.

- extent of bonuses applied which is included in surrender values
- surrender penalties, e.g. in Finland, contracts sold after 2000 typically pay only a part of bonuses in case of a surrender with some products having a waiting period of 5 to 10 years for bonuses after which these become fully available to the policyholder on surrender.
- other deductions, e.g. for expenses

7) Costs/charges affecting the Reduction in Yield

France: the items impacting remuneration are the ongoing fees on the outstanding amounts of the saving account (i.e. on the mathematical provision) specific to the contract and the other costs inherent to the euro fund as indicated in the PRIIPs regulations (transaction costs, mandate fees, management costs of any UCITS present in the euro fund).

Germany: total Credit Rate is net of indirect costs like transaction costs or shareholder participation. The direct cost loadings usually differ from policy to policy as they are neither constant nor linear over time. Their impact on the return depends on contract details and differs over time. Thus a part of the costs is taken from each contract individually depending on several parameters.