AAE's Survey on Profit Participation Products related to the EIOPA's study on Cost and performance

Context and objectives of the survey

EIOPA published its second report on Costs and Past Performance of insurance and pension products in April 2020. This followed a request from the European Commission to the European Supervisory Authorities to periodically report on **costs and past performance** of retail investment, insurance and pension products.

The report identifies differences between profit participation products, and challenges with comparing performance, for example in view of the values of guarantees, the impact of smoothing mechanisms and terminal bonuses of profit participation products, and the impact of risk and volatility. Differences exist in methodology used to compute and allocate the yield of the assets from one market to another and also between companies. The 2020 report contained an analysis of profit sharing mechanisms which was prepared for this purpose by the AAE (cf. annex III of the 2020 report).

EIOPA has asked the AAE to provide further support in gaining insight to participating business for future reports. It is seeking to increase the understanding of methodologies in place now, particularly to analyse the reported Total Credit Rate and Reduction in Yield to understand in terms of numbers where the common ground is and where the main differences sit.

EIOPA seeks to further develop common definitions of costs and common methods for calculation of past performance (cf. page 33 "Next Steps" of the 2020 report), especially for profit participation products, and sees the AAE as having the capacity to provide the expertise to address this gap.

In order to help with this work, the AAE (Consumer Protection Working Group) has prepared a survey, relating to participating business. The intention of this process is to enable us to provide further input to EIOPA on the subject of profit participating business.

Structure of the survey

The questionnaire was drawn up by the Working Group for Consumer Protection, which operates as part of the AAE Insurance Committee, and was circulated to members of the Insurance Committee and the Working Group, who have been monitoring the topics relating to policyholder information for several years, particularly those relating to the application of the PRIIPs regulations.

Attached to the AAE's survey were Excel datasheets including the basic data used for the report:

- "Profit participation data_2020 Report v2.xls"
- "Hybrid data_2020 Report v2.xls"

The first one entails only participation products. The other concerns "hybrid" Multi-Option Products (MOPs), that is MOPs including options with participation features or participation on the product level. Explanations were attached to the survey so that respondents could more easily use the above mentioned file (below referred to as "*EIOPA raw data*").

In the same view, the original templates sent by EIOPA to the insurers so that they respond to the EIOPA request were attached too.

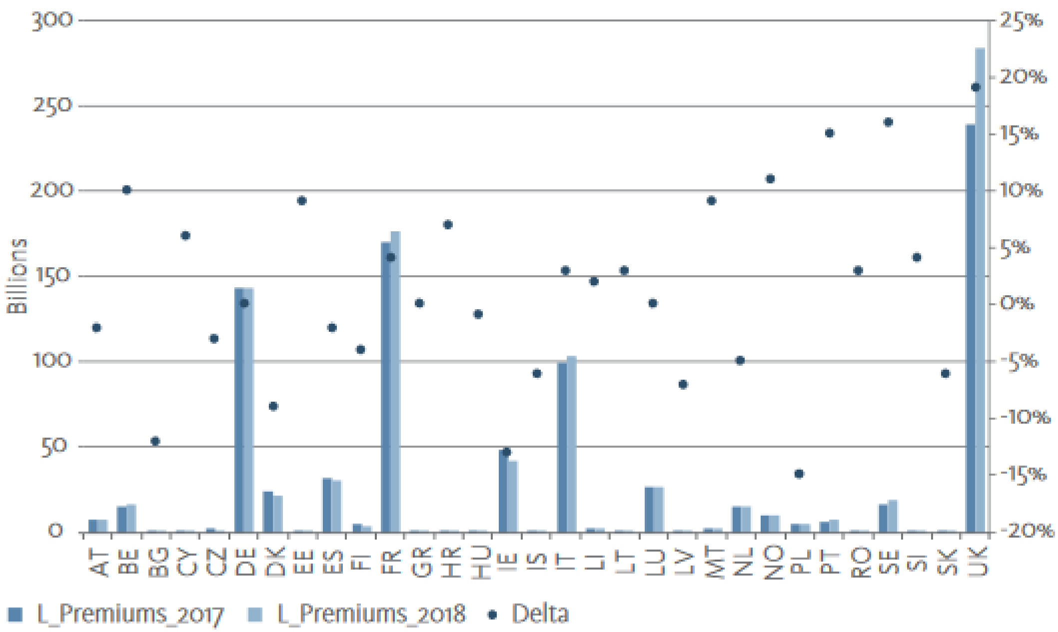
The survey itself consists of a questionnaire with systematic open areas dedicated to free comments and explanation. It suggested that respondents would complete the questionnaire with an example in order to explain the way a typical product of their national market works, ideally in relation to one or more lines contained in the EIOPA raw data.

Discussions within the AAE's Working Group during the preparation of the questionnaire have shown that the subject remains very technical, even for participants theoretically familiar with these issues. This observation seems important to us to underline, as it highlights a certain paradox: on the one hand, the EIOPA survey aims to measure and make public data that may seem very intuitive and directly understandable to savings market observers and even consumers themselves. On the other hand, the relevance of these data depends critically on the understanding that professionals have of the questionnaire, which requires precision, expertise and a good fit with local specificities.

Respondents and representativeness

Four countries responded to the survey. Although limited to four, these responses reflect the disparity of situations.

- Spain (a single PP contract and a hybrid contract) and France have relatively simple contracts.
- Italy shows a more diversified situation, with regular premium contracts and flexible contracts, with profit-sharing that can be acquired at any time or only at term.
- Germany shows a very diversified situation, with several components of profit-sharing, regular, single premium or flexible contracts, MOP and non-MOP hybrid contracts.



Except from UK, the three largest life underwriters have responded. **Those 4 countries represent 70 % of the aggregate life's GWP**[1].

The framework of the EIOPA's Cost & Performance study leaves room for divergent interpretations.

In order to help EIOPA in the elaboration of the new request, we have gathered the elements we thought useful to start from:

- the answers received from the countries that responded to our survey
- the analysis of EIOPA raw data
- the interpretations and expert opinions that we suggest based on these data

For a proper understanding of the following, we distinguish :

- the insurance contract: this is the contract in the legal sense. It can propose several options in the sense of PRIIPs; it is then a MOP.

- the investment option: as regards savings contracts, the options of a MOP take the form of investment options in funds (unit-linked funds, funds with profit-sharing) or of more elaborate options (for example standard portfolios combining several funds in a contractual way). Such investment options, namely unit linked funds and some funds with profit sharing may be considered as financial products. These options may in what follows be referred as "option", "funds", "products", "components" or "supports" (which is the term used on the French market to designate this type of option within a MOP, in a wrapper-type structure).

Consideration of entry costs

The entry costs are the subject of dedicated headings in the EIOPA template and are converted into RIY.

Resulting from the analysis of the EIOPA raw data, it is likely that entry fees are not allocated to the options entailed in the contract on certain flexible MOPs[2]. Accordingly, for those MOPs they are not directly charged to the yield of the products/options concerned but to the higher level (wrapper).

This is not a problem since it is consistent with the "wrapper" approach but the application does not seem to be homogeneous : this may be due to the fact that there are real differences between the contracts or to differences in the way to fulfill the template[3]. Where the entry costs are allocated to the option one must be aware that, since it does not reflect past costs (in some markets, entry fees are not fully applied), the RIY may be somehow theoretical and may overvalue the entry costs.

Similarly, in the event of early withdrawal, the insured may have to face extra costs, particularly in the case of regular premium contracts, which he has committed to pay. It is not clear whether the RIY of entry or exit considers such early exits or is a theoretical RIY that assumes holding the contract until RHP. Should it be a theoretical RIY, this approach would reduce the entry costs. It would indeed be very interesting to measure the overall impact of early exit on all consumers. However, measuring this impact is clearly beyond the scope of a study of this type, which can only mention whether no

[1] Without UK. Source : EIOPA.
[2] See col. BK of *Hybrid data_2020 Report v2.xls*
[3] See in *Hybrid data_2020 Report v2.xls* col. BK rows 91 to 95 vs 104 to 110 for French market (same observation for Italy)

allowance is made to this point: in the case of an analysis by generation, the study would have to take place over 30 years and would be of little interest to consumers wishing to subscribe today. Furthermore, in several markets, the legal framework has prevented the impact of such costs from being excessive.

Administrative or distribution costs

Administrative or distribution costs are not always reported in the EIOPA raw data. In some cases, this is due to a lack of ability to allocate them correctly, which makes it impossible to communicate them. Taking into account the complexity often encountered in inducement schemes, we may infer that the significance of the breakdown when disclosed may be theoretical or resulting from a proxy.

Ongoing costs

For flexible MOPs, contracts offering several products/options within a wrapper, it appears from the raw data that the costs on the outstanding amount of the contract (wrapper) are generally not taken into account in the net return (col. BZ to CD) because the answer is made at the level of the product/option[4], which is consistent with the EIOPA template. The Spanish answer to the AAE survey confirms this practice for this country too.

However, the replies do not seem homogeneous: on the French market, the reply in rows 81 to 84 seems to give a rate net of the contract costs, but nevertheless indicates the costs of the contract in col. CE to CI. Conversely, on the German market, it is likely that in l. 67 and l. 68 there is a gross rate of contract costs (very high yield of 2.65 %) but the col. CE to CI are zero.

Categorization between MOP, PP, Hybrids

From our insights of the European markets we may distinguish three situations reflected in the EIOPA raw data :

- Some contracts offer only one option / product: the support / fund with profit-sharing.
- Others are a wrapper with various products / supports (sometimes several hundred) including the euro fund; they constitute a <u>first category of hybrids</u>.
- A *second category of hybrid* is made up of contracts sometimes classified as MOP, sometimes not, visibly linking one or more units of account or other funds with a profit-sharing fund[5]. Such a hybrid "product" may constitute an insurance contract by itself or be only an option of a MOP contract.

It seems that when the unit linked and/or with profits fund cell blocks are filled, the hybrid cell block is not, which is logical. For the French multi-support contracts, the information for the UL blocks and with profits funds is totally independent so that it is not very relevant to show them on the same line, but this is not harmful.

For the second category hybrids (those where only the last cell block (col. CV to EF of *Hybrid data_2020 Report v2.xls*) is filled in, it seems from the EIOPA raw data that this is a unique option. We have not systematically checked that point (like a standard portfolio with arbitrages at the hand of the insurer or the manager). This type of product presented in this way does not allow us to see what the contribution of the with profits support and that of other supports, for which the measurement of past

[4] From *Hybrid data_2020 Report v2.xls*: German market: row. 62 with very low other ongoing costs in col. BN but a reference to the wrapper, French market: rows 70 to 79, 91 to 95 and many other)
[5] From *Hybrid data_2020 Report v2.xls* : row 137 for Italy, 59 for Germany, 69 for Spain

performance may differ. As no examples have been filled in for this type of product, it is therefore difficult to measure the precise meaning of the figures provided. Nevertheless, the information is valuable and useful, despite the fact that one cannot access the intrinsic contribution of profit sharing in the framework of a global survey such as the EIOPA Cost and Performance survey.

It should be noted that the French market offers management options that could be classified as this type of product, but which were not reported in the response to the EIOPA survey.

It is perhaps a case of this type that can be seen in row 65 of *Hybrid data_2020 Report v2.xls* with a multi-support of the German market for which a second category hybrid option type in the sense mentioned above is indicated. Despite 101 options/supports, this is the only option indicated. Surprisingly, the euro / profit-sharing fund is not listed in isolation, except that it is only sold through this or similar hybrid options.

Nature of profit-sharing

It appears from the answers to the AAE survey that the simplest profit-sharing structure is found on the French market (only technical interest rate and profit participation rate). The other three countries report profit participation in four categories (technical interest rate, profit participation rate, allocated declared terminal bonus and others).

Italy has a "nominal" credited return which may be available immediately or only at term. Similarly, the guarantee can be ratchet or only at term.

Germany distinguishes two types of terminal bonus (regular terminal bonus, valuation reserves) in addition to the regular lock-in-bonus which relates to the participation rate category above.

When asked whether the profit participation once distributed is guaranteed, the answer is often no, but this can cover very different situations:

- for example, profit participation is switched to risky instruments.
- the profit-sharing is incorporated to the mathematical provision of the euro fund / profit-sharing component, but the latter is not fully guaranteed (e.g. it provides for the possibility of charging charges on outstanding amounts to the mathematical provision)
- The insurer can allocate losses to a part of the allocated profit-sharing (this is the case in Germany for some categories of participation, but that is highly unusual):

The most general ones are:

- Guaranteed rate (credited each year or even sub-annually) (i)
- Profit-sharing allocated to the contract aka regular lock-in-bonus (annually or even quarterly) (ii)

These components of the return are likely to be definitively acquired, with the possible reserve of penalties in case of early exit.

Others are more specific and can be questioned:

- Guaranteed bonus terminal but subject to remaining in the contract until the end of the term (iii)
- Bonus terminal not guaranteed, subject to reduction by the end of the term (iv)
- Unallocated profit-sharing (v)

Items (iii) and (iv) may also be partially included over time in the cash surrender value and therefore vested. It is not clear whether these exceptional losses can be attributed to them.

The profit sharing referred to in (v) is deferred, it is not allocated individually to contracts (the insured does not know about it until he or she receives it): it should be excluded from the EIOPA performance measure - it appears that this is the case. This participation can also in some cases cushion exceptional losses (Germany), and in some cases not (France where it is fully guaranteed at all times and must be redistributed within 8 years).

Specificity of the supports / profit-sharing funds in relation to units of account

In order to shed light on the approach sought by EIOPA to measure past performance, it is useful to specify certain very structuring contextual elements for profit-sharing products in the background of our survey.

Unlike most unit-linked supports/funds, profit-sharing supports / funds, on the one hand, carry a guarantee and, on the other hand, are based on specific accounting and legal standards. These standards make performance much more complex to monitor: the link between the performance served and the return on assets is not direct:

- certain changes in the market value of assets are not recognised or may be only partially recognised
- the wealth created can be stored in reserves that may or may not be guaranteed, redistributed in the more or less long term, allocated to policyholders without being distributed or not distributed

The nature of the premiums can also influence: the effect of front-end loads is more difficult to capture on periodic premiums.

Even if in the long term the final return reflects the return on the asset, the various mechanisms at work to store the assets return, which can extend over very long periods, create a gap, positive or negative, sometimes significant, between the return on the underlying asset and the return distributed. Moreover, pooling mechanisms lead to a complex distribution of returns between products and between policyholders (see several responses mentioning differences in returns according to seniority or assets under management).

The question also arises as to which point of view should be adopted:

- From the consumer's point of view, in an annual view, the change in redemption value is a simple indicator that is compatible with an annual (or limited number of years) view of performance, which is that of the EIOPA study; it also offers a close relationship with the expectations of an investor investing in UCITS. On the other hand, it may not be consistent with the long-term design of some insurance products. For Germany it is important to understand that the change in surrender value from one year to the next is highly dependent on the contract. For a contract that has just been running only for a few years there might be a significant adjustment for the change in holding period. However, for a contract in its last ten years there might not even be a handling fee for surrender. In markets where this value is directly correlated to the mathematical provision, it is easy to calculate. But this is not necessarily the case in all markets. Moreover, it does not reflect the future rights of the consumer (bonus terminal), guaranteed or not. A major difficulty is that the concept of profit-sharing covers categories (i to v above) that are not homogeneous among themselves;

- to remain from the consumer's point of view, an overview of the regulatory requirements for annual information in each country may provide a relevant and a priori better adapted insight into the products; but it is likely that while the result would be significant at the level of each market, it will not lend itself to a uniform approach for all markets. The EIOPA Costs and Past Performance report takes an aggregated view on products and not on single contracts. Therefore, it does not reflect a single customer but an average contract. Annual statements take the contract view. We would need to devise methodology which could allow aggregation from single contract view and it is not a given that companies will be able to aggregate these indicators.
- From the insurer's point of view, profit-sharing can be assessed on the basis of the management of income within the balance sheet and its allocation to the various provisions: revaluation of mathematical reserves, allocation to reserves, etc. This more comprehensive approach requires income statements that are sufficiently consistent to highlight the sources of income (financial, biometric, management, etc.) and their allocation. The effort made by the insurer in terms of profit-sharing can thus be measured by the effort made in setting aside provisions for policyholders (under local GAAP). This approach, which is complementary to the previous one, is of definite interest for market analysis but requires expertise that does not fit well with the essentially statistical approach adopted by EIOPA in its survey. On the other hand, it can highlight the hybrid nature of profit-sharing (in particular, the distinction is not always clear-cut between certain provisions and quasi-equity; in this respect, the effort made by the insurer in favour of policyholders is not comparable between an allocation to a guaranteed provision and a reserve capable of absorbing shocks and protecting shareholders' equity).

Findings and recommendations

Analysis of the survey results and the figures reported by EIOPA confirms both the diversity of situations (which in part generates some heterogeneity in the responses) and the answers received from AAE members confirm the fact that the meaning of the returns reported is variable.

A few suggestions can be made:

The search for improvements could take into account the fact that the EOPA seeks a global vision not at the level of an individual but at the level of a product, which is a different exercise from PRIIPs. In this respect, several countries give performances that are averages at the product level.

Even if the performance includes heterogeneous components (guaranteed or not guaranteed) it seems that the different contributors were able to provide performance figures. The question seems to be rather to respect the meaning of these figures rather than the impossibility of providing them (which, conversely, may be the case for the distinction between administrative and commercial costs, for example).

Reflections on this subject have highlighted very important differences between contracts with periodic premiums and flexible contracts, as well as between contracts with significant biometric guarantees and those without. In this respect, the results of the EIOPA files show that there are likely to be differences of interpretation regarding the proportion of the premium that covers the biometric risk. To a lesser but nonetheless significant degree, particularly when compared with the results of a UCITS, the inclusion of the guarantee may give rise to different considerations:

- on the one hand, insofar as the increase in the net asset value of a UCITS and non guaranteed fund does indeed constitute its performance, it is legitimate to take into account profit-sharing, even for the part that is not guaranteed (without a ratchet effect)

- on the other hand, the comparison between a performance benefiting from a surrender faculty and one not benefiting from it requires this fundamental feature to be specified

One way forward could therefore be to take greater account of the very great diversity of the market by establishing a categorization that represents a compromise between a sufficient degree of aggregation while maintaining the significance of the figures. Since it would require a refined understanding of the contracts and of the reporting abilities of the contributors, as a first step a warning in the report could be useful to enhance the reader's understanding of that underlying discrepancy.

The distinction between contracts based on the profit-sharing product/fund alone and hybrid contracts should be extended: the notion of product or component, which is different from that of contract, should be favoured, as it alone makes sense in terms of performance (a MOP, when the options to which it refers are, as in many cases, investment products/supports/funds, does not have a performance: it is the products that the consumer subscribes to that have performance and fees - on the other hand, the contract itself generally has its own fees in addition to those of the products). The study shows that the notion of product covers different notions:

- Sometimes a contract in the case of contracts based on the fund/product with profit participation only ("profit participation data" file)
- Sometimes an investment product (such as a French euro fund or segregated funds (so called Gestioni Separate in Italy, a unit of account, or a dedicated fund in Luxembourg): this is clearly in line with the logic of a MOP where the options are the investment products offered and freely accessible to the insured: in this case, it makes no sense to combine unit of account and euro on the same sheet of the template for the EIOPA survey.
- Sometimes, the product within the contract consists of the management of several investment vehicles/funds (like a standard portfolio) which is in the hand of the insurer and without the intervention of the insured. This type of management can correspond to the contract itself (which is not a MOP but whose main purpose is to offer this single management); this type of management can also be an additional product within a MOP that also allows a free management of the various available products/support. This type of management can attract large amounts of outstanding loans. The distinction between these three categories could be made for the EIOPA survey. A fourth category should be added, since the templates only consider units linked funds in addition to the euro fund. However, just as hybrid products may be based on the insurer's management of the euro fund and several units linked funds, some contracts offer products consisting of the insurer's management of a basket of units linked funds.

Furthermore, it would be legitimate to separate contracts with periodic premiums from flexible contracts.

For contracts whose performance includes a significant biometric component, they should be treated separately if the contribution of this performance cannot be neutralised. Apart from an actuarial study carried out at local level, it is difficult to see how the specific nature of such contracts could be understood.

It would be like this:

- PP contracts (distinguishing between regular and flexible premiums): current file "2_Costs and past performance survey IBIPs_PP".
- Hybrid contracts: current "3_Costs and past performance survey IBIPs_Hybrids" file by redesigning the tabs
  - funds in euros / profit-sharing products ("pure", without units of account)
  - units of account and specific management combining several units of account
  - hybrid products (2nd category hybrids as defined above). The distinction between unit linked funds according to their level of risk does not seem relevant (too few representative unit linked funds in certain categories). Moreover, the duty to provide advice generally leads the insurer to propose a combination of unit linked funds and not a single fund/support (except for the euro fund which is guaranteed).

The number of tabs would thus remain of the same order of magnitude as in the current version.

With regard to euro funds / profit-sharing products, a distinction should be made between the various components of profit-sharing :

- those increasing the redemption value (immediate profit)

- those that do not increase the surrender value (bonus terminal), possibly by breaking down the guaranteed part from the non-guaranteed part, where possible

As far as fees are concerned, it makes little sense to take into account the impact of entry fees in the net return for flexible contracts. The measure of the entry fee actually charged during the year is also irrelevant because it is low for a low-turnover product and high for a strongly developing product (moreover, it is not certain that the insurer has it readily available on a product-by-product basis). The indication of theoretical costs, even if it constitutes a surcharge, remains the most relevant data.

As regards ongoing costs, the template seems satisfactory but is not filled in in a homogeneous manner. It offers the possibility of charging all layers of fees to the net return (which would logically be the case for a contract offering a single option/product) or of specifying separately the charges not charged to the net return (in the case of wrapper-type contracts - homogeneous treatment with that of unit-linked UCITs); hybrid products can be treated in one way or another. Some explanation could be provided so that the respondents could better appreciate the most suitable way to proceed in relation to their specific situation.

A further clarification could be made with regard to the distinction between regular premium contracts, single premium contracts and flexible contracts as there are probably also heterogeneities in the answers observed in the raw data. The following clarification could be made:

- single premium contracts: a single premium to be paid with no possibility of subsequent payments

- regular premium contracts: regular premiums to be paid on the basis of a contractual obligation, without excluding the possibility of additional payments by the insured

- flexible contracts: the right to make subsequent payments once the contract has been taken out and during its term, but without obligation.