Position Paper

Complexity and comprehension for insurance-based investment products (IBIPs)

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Introduction

Article 30(3) of the **Insurance Distribution Directive (IDD)** contains the option for Member States to allow for certain insurance-based investment products (IBIPs) to be sold by means of execution-only transactions. Member States may permit that manufacturers sell these products – if no advice is given – without the assessment of appropriateness which is normally required under Article 30(2) IDD. This possibility is offered for products which are considered as non-complex in the sense of IDD, i.e. products that either

- only provide investment exposure to non-complex MiFID II instruments and have a structure which does not make it difficult for the customers to understand the risks involved (Article 30(3)(a)(i) IDD, details guidelines IDD) or
- fall into the category of "other non-complex" products (Article 30(3)(a)(ii) IDD, details delegated act IDD).

In parallel, the **PRIIPs Regulation** holds that the Key Information Document (KID) should include a comprehension alert when investment products are not simple and may be difficult for retail investors to understand. Recital 18 of the Regulation names the following criteria for when an investment product is to be considered not simple and difficult to understand:

- it invests in underlying assets in which retail investors do not commonly invest
- it uses a number of different mechanisms to calculate the final return of the investment, creating a greater risk of misunderstanding on the part of the retail investor
- if the investment's pay-off takes advantage of retail investor's behavioural biases, such as a teaser rate followed by a much higher floating conditional rate, or an iterative formula

A link has thus been made in EU legislation between complexity and comprehension and IDD and PRIIPs both address this topic in respect to the same kind of products (ie. IBIPs). However, it is key to highlight that both pieces of legislation have different regulatory aims: while the IDD addresses the conditions to sell IBIPs via execution only, the PRIIPs Regulation establishes that certain products should be labelled as "not simple and difficult to understand" despite the provision of the KID and regardless of the distribution channel chosen by

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the consumer. This considerable difference in regulatory aims should be acknowledged in the criteria developed under IDD and PRIIPs respectively. On the other hand, Insurance Europe acknowledges that these two issues are to a certain extent interrelated and would hence wish to address them both in this paper.

Insurance Europe agrees that the comprehension alert in the PRIIPs KID would lose its value and would not help retail investors if it was used for a wide range of products including some that should not fall under its scope. On the other hand, within the context of IDD, it is also key to ensure that an equilibrium is found and that products are adequately classified as complex or non-complex depending on their specificities. Insurance Europe is for instance concerned that the extensive cumulative list of criteria developed by EIOPA for non-complex products within the meaning of 30(3)(a)(ii) IDD in its consultation paper on IDD Level 2 and the criteria from the Guidelines under Art. 30 (7) IDD, could wrongly classify many non-complex insurance products as complex.

Considering the on-going work currently being undertaken by EIOPA and the other ESAs on non-complex products and comprehension within the frameworks of the IDD (Level 2 and 3) and the PRIIPs Regulation respectively, Insurance Europe wishes to take this opportunity to point out the differences between insurance-based investment products and other financial instruments as well as discuss the criteria that should and could be considered for the categorisation of products.

Differences between insurance products and financial instruments under MiFID

Complex products in the sense of MIFID II include risks and disadvantages that affect customers and may not be apparent or not easy to understand for them. Examples for such products are tailor-made products such as structured products, asset backed securities, and non-standard OTC derivatives. Complexity of products in this regard means a high degree of opacity of the connection between the consumer's investment and the possible risks and returns and even elements of gambling. This involves investment strategies with complex derivative instruments to leverage risks, non-transparent exposure to several market risks and / or credit risks. This is also the reason why the financial crisis led to a reassessment of complex products in MiFID I.

These properties are not common for the vast majority of insurance-based investment products. IBIPs are generally concluded for a very long term (10 to 40 years) with the purpose of protecting the policyholder against financial shortages in the future (mostly at retirement). This is accomplished in part by a biometric component, usually to protect the family of the policyholder in case of death, and in part by the long-term investment of regular contributions or an agreed amount. Due to the non-speculative objectives of these products, the investment is generally very conservative and often subject to guarantees with regard to the pay-out amount. Leverage risk for customers, which are inherent to complex products under MiFID II, are not relevant for most IBIPs.

In their core business, insurers use professional actuarial methods within the narrow confines of the supervisory law to determine their obligations with regard to policyholders and apply financial instruments to finance them. IBIPs primarily reduce customers' risk exposure, for example by providing certain guarantees which offer protection to customers from the volatility of the market.

Level playing field between MiFID II and IDD

For pure unit-linked insurance products, Art. 30 (3) IDD determines that the level playing field with MiFID II is achieved if unit-linked insurance products are held to be non-complex if they invest in UCITS or other non-complex instruments as defined by MiFID II and do not have a structure that makes it difficult for customers to understand the risks of a particular unit-linked product.

Taking this as a starting point, it can be concluded that the investment of products with guarantees such as traditional with profit insurances are in general easier to understand and less risky for customers since they smooth returns and protect customers from the losses on financial markets. The contractually guaranteed maturity and surrender value is at least the amount of premiums paid by the consumer minus legitimate cost levied, risk premium and insurance premium tax where relevant. Insurers are strictly regulated by Solvency II in order that the guarantees can be ensured at all times. Furthermore, for products with partial guarantees, the partial guarantee should also be taken into account as a mitigating factor when assessing complexity.

As regards the quality of guarantees, there are several differences between guarantees provided by insurers and those provided by structured products.Structured products with guarantees still have clauses and performance hurdles that may lead to the loss of the capital. On the contrary, IBIPs are usually long-term products that aim at providing steady income in retirement and, therefore, do not incorporate such clauses. Furthermore, speculative elements and gambling components are not common for IBIPs. It can be generalised even further: in general, serving as long-term retirement products, insurers try to make their products as predictable as possible.

Thus, to ensure a level playing field with MiFID II, specificities and aims of IBIPs should be assessed thoroughly. A blind copy paste of MiFID rules would wrongly deem many products that are simple from a consumers' perspective as complex.

Criteria for non-complexity under the IDD

Regarding the criteria on non-complexity, all aspects of IBIPs should be evaluated carefully including: investment, early redemption, pay-out profile, guarantees, costs, clauses, taxes, biometric risk protection and information disclosed.

The cumulative list of high-level criteria in the EIOPA's draft technical advice poses a serious concern as all products seem to be deemed complex besides products with a unit-linked investment element.

Complex products in the sense of MiFID II include factors that would make it difficult for the client to understand the risks involved. Examples of these products are investments in derivatives, contracts for difference, structured notes or asset backed securities. They involve investment strategies with complex derivative instruments, non-transparent exposure to several market risks and/or credit risks.

In their core business, insurers use professional actuarial methods to determine their obligations and many financial instruments to match them. Insurance-based investment products primarily reduce the consumer's risk exposure, for example by providing certain guarantees which offer a greater level of protection to consumers, cushioning them from the volatility of the market. Products that reduce the risk for consumers should be seen as non-complex, such as products with guarantees or other security mechanisms (no look-through regarding complexity, only the product itself should be viewed when assessing complexity for consumers) and products with non-significant investment in complex MiFID instruments.

Based on the EIOPA's Draft Technical Advice on criteria to assess non-complex IBIPs for the purpose of Article 30(7)(a)(ii) as well as EIOPA's survey on the empowerment for EIOPA to develop Guidelines in Article 30(7) of the IDD, Insurance Europe wishes to make the following remarks:

- When assessing complexity, it should be taken into account whether products have guarantees at maturity as such guarantees are a key element to the product.

- Whether consumers of an insurance product are also protected by a national insurance compensation scheme does not make the product itself more difficult to understand, nor does it increases its risk exposure. It should be noted that simple bank deposits are also covered by these schemes. An insurance compensation scheme is an additional protection for the insured.

- Surrender values of insurance-based investment products are regulated on individual contractual level. Consumers are informed about the surrender scenarios through the PRIIPs KID, personalised precontractual and ongoing information. Therefore, the surrender value is not relevant for complexity.

- Switching clauses should not be put on the same level as converting rights. This is inaccurate, as switching takes place in the contractual sphere, while converting does not. Switching does not alter the characteristics of the product, but merely places the investment in another investment option within the same product. In this context, the opportunity for the consumer to alter the pay-out profile should not be regarded as detrimental. This flexibility reduces risks in case consumers' life situation changes during the contract. This is a fundamental advantage considering the long-term characteristics of IBIPs.

- Beneficiary clauses do not influence the performance or return of the product. It is in the best interest of the consumer if certain adjustments can be made during the term of the contract. The right of a customer to alter a product based on their particular needs should not be hindered. It is essential that criteria for non-complexity do not ignore the fact that modifiable beneficiary clauses are in the interests of customers as they enable them to keep control over the beneficiary of their investments. Since most IBIPs often have a term of more than 30 years, it is not uncommon for consumers to change the beneficiary for payments. The ramifications for such a change are not difficult to understand.

- The relationship between the IBIP and tax regulations is not relevant when assessing products complexity. First, only gains are taxed which means that no risks are involved. In addition, in case of losses, there are no additional taxes that worsen the losses.

- The total commitment (ie. the biometric risk premium and the investment) is fixed and does not vary over time. The actuarial premium varies over time since the biometric risk of people varies over time. However, the exact amount each year is known and fixed. Due to prudent calculation methods, however, the total investment remains the same and the risk surpluses are shared with consumers. Therefore, if the total commitment remains the same, there is no risk involves which is difficult to understand for consumers.

Criteria for the comprehension alert under PRIIPs

Insurance Europe considers that the comprehension alert would lose its value and would not help retail investors if it was used for a wide range of products including some that should not fall under its scope. At this stage, the criteria set out in recital 18 do not provide for complete legal certainty as to which products' KIDs should bear such a comprehension alert. There may be, therefore a risk that some PRIIPs manufacturers face a situation where they choose to disclose the comprehension alert although their products should not bear it. If applied too broadly, the warning may lose its differentiating impact.

In this context, Insurance Europe proposes to clarify each criterion introduced in the PRIIPs Regulation so as to identify PRIIPs that should include a comprehension alert. An investment product is to be considered not simple and difficult to understand if:

- **1. It invests in underlying assets in which retail investors do not commonly invest**

    - If a product includes a capital guarantee, then the focus should be on the guarantee itself and not on how the insurance undertaking is generating the guarantee. Guarantees are subject to strict regulatory requirements and hence, products with guarantees at maturity should directly be considered as products that do not require a comprehension alert.

- In addition, for multi-options products that propose some underlying options considered as complex and some underlying options that are not considered as complex, the generic document should include a disclaimer explaining clearly to consumers that the product may be complex depending on the chosen underlying options.

- A comprehension alert is thus necessary, if the product does not have a guarantee at maturity (which is at least the amount of premiums paid minus legitimate cost and tax levied) and if it invests in one of the following:

  - so-called 'unconventional assets' that are not correlated with the traditional financial market and are speculative and complex in their nature (such as virtual currency, art, certain types of commodities, life settlements, …)

  - a derivative component that has a strategy that is considered overly complex because of the difficulty in determining the value offered by the product (such as where a teaser is being used for the distribution of the product, the investor may incur capital loss without being able to participate to at least the same degree in the increase of the underlying, a minimal change in the performance of the underlying can have a disproportionate impact on the payment of a return)

  - underlying options that are made up of one or more underlying financial instrument(s) that are difficult to value, or are combined in such a way to make it difficult to assess the risks involved and the likely performance scenarios

  - underlying options that have a fixed investment term of a number of years with barriers to exit (that are not clearly explained) – whether that is due to the lack of a secondary market, or significant penalties or losses on early exit

  - underlying options that use more opaque indices that are for example set up by the product manufacturer, rather than using standard market indices

  - derivatives or embed a derivative

  - underlying options that include capital protection that may be conditional or partial, or that can be withdrawn on the occurrence of certain events

- **2. It uses a number of different mechanisms to calculate the final return of the investment, creating a greater risk of misunderstanding on the part of the retail investor**

  - The calculation formula for the return is overly complex, i.e. when the formula comprises more than three mechanisms (with the exception both of mechanisms that provide for a minimum return or that limit the volatility of the underlying, such as a floor or a "cliquet").

  - The product should bear a comprehension alert if its return may vary frequently and/or markedly at different points of time over the duration of the PRIIP either because certain pre-determined threshold conditions are met or because certain time-points are reached. However, this criterion should not apply to surpluses, as they are subject to comprehensive consumer protection legislation and only increase the yield. The aim of surpluses is to smooth the return over time and provide consumers with steady yield by increasing the return.

- **3. if the investment's pay-off takes advantage of retail investor's behavioural biases, such as a teaser rate followed by a much higher floating conditional rate, or an iterative formula**