BF BETTER FINANCE

The European Federation of Investors and Financial Services Users
Fédération Européenne des Épargnants et Usagers des Services Financiers

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ANSWERS TO EIOPA QUESTIONNAIRE

(stylized version)

Q1: Do you agree with the definition of value for money presented in paragraph 1.7?

"1.7 EIOPA considers that products offer value for money where *the costs and charges are proportionate to the benefits (i.e., investment performance, guarantees, coverage and services) to the identified target market and reasonable taking into account the expenses born by providers and in comparison to other comparable retail solutions on the market*"

BETTER FINANCE welcomes this unique initiative of EIOPA as an example of best practice in terms of supervision and investor protection not only at EU level, but on the global regulatory scene. Given the architecture of the distribution market for retail investment products. EU savers have been slowly diverted from direct investments to packaged, fee-laden products (with certain markets such as France where the sector for insurance-based investment products, IBIPs, is the largest sector), in particular for sensitive investments, such as retirement provision. BETTER FINANCE shares EIOPA and EIOPA's members' concerns over the destruction of value – in real net terms - that occurs with many IBIPs.

EIOPA's attempt to give guidance on *value for money* is aimed in the right direction, but certain elements need to be clarified in how such a concept could be supervised and enforced. To begin with, EIOPA's proposed definition of *value for money* in paragraph 1.7 of the consultation lacks "teeth" as it can be widely interpreted at the level of product manufacturers. BETTER FINANCE stresses that concepts such as "*proportionate*" and "*reasonable*" are, in fact, very general, and EIOPA should either:

- narrow down their meaning within this framework, by including references to other supervisory acts (guidelines, regulatory technical standards, if any) or legislative and legal acts (Regulations, case law, Level 2 acts of the European Commission);
- adjust the definition by changing its focus.

This is because EIOPA allows IBIP manufacturers to justify *proportionality* in relation to benefits and the target market, which ultimately boils down to a case-by-case (client – product) assessment. At the same time, product developing with "hindsight" is not possible either. As such, BETTER FINANCE proposes a simpler approach, based on three rules, and outlines the justification below:

1. Align the product's objective (*purpose*) with the concept of value for money

Value for money (*VfM*) can have two different meanings for retail savers, depending on the objective sought through the investment: if the primary purpose is to obtain capital appreciation, then value for money can only be judged by the real net investment returns delivered (analysed in context of the risk profile). If the primary purpose is to insure against an event, obtain a guarantee on the capital or cover for inflation, then the value proposition rests with such features. Therefore, *VfM* must distinguish between two such objectives.

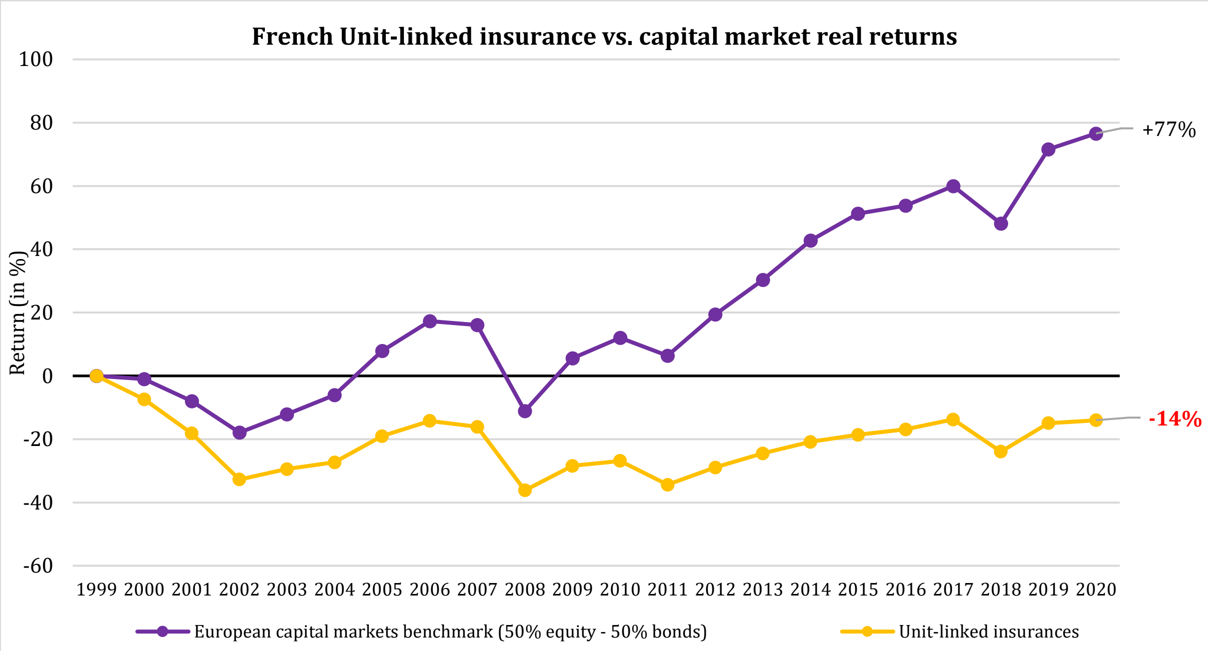
2. Review the product's costs regularly

The manufacturer should be obliged to regularly review the costs of its product in light of the delivered performance. Similarly to the product design phase, if the product's returns are below 1% (still) in real net terms, the manufacturer should lower the costs of the product.

Q2: Do you share EIOPA's concerns about value for money in certain areas of the UL-market?

Yes, BETTER FINANCE shares EIOPA's assessment that certain parts of the UL-market delivers often very poor, even negative returns and it is proven by objective evidence.

It can be illustrated in the example below for the French "unit-linked" market, one of the major UL insurance markets in the EU , with more than € 400 billion in mathematical reserves and growing fast.
For the most of the past 21 years European capital market returns have been positive, delivering a gross compound return of +77%, whereas unit-linked IBIPs have only been negative, reaching -14% of the value of capital invested at the end of 1999. What is worse, in France there are even negative tax consequences when IBIPs are used as long-term investments.



Main sources: French Federation of Insurance, Eurostoxx, Barclays
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The main reasons for this very poor long term real performance for long term and pension savers are:

- The very high, opaque and multi-layered costs of UL products in France: average annual ongoing charges alone on equity units and of the very actively marketed "mixed assets units " are around 3% (including of course the contract wrapper charge - source: goodvalueformoney.eu/documentation/newsletter-n0-40-benchmark-2020-des-frais-factures-au-sein-des-unites-de-compte);
- The biased unit selection process as the insurers and intermediaries are remunerated mainly by the commissions paid by the unit providers (mostly fund managers). That also explains why the above-mentioned costs are so high and why there are hardly any low cost funds included in the UL contracts, in particular low cost index funds and ETFs. Independent research demonstrates that there is a reverse correlation between mid to long term performance and costs (see for example betterfinance.eu/publication/study-on-the-correlation-between-cost-and-performances-in-eu-equity-retail-funds).

The EIOPA's 2021 Cost & Past Performance Report, which covered 57% of EU UL market in terms of gross premiums (GWP) and provides an overall - however incomplete - picture, the median return for UL in the EU in 2019 was **11,4%.** In the timespan 2015-2019, the median return was **2,7%.**

The BETTER FINANCE research (based on non-audited insurance industry data (French Federation of Insurers) covers 100% of French UL market, based on total assets (mathematical reserves). the average (more relevant than the "median" one) nominal return in 2019 was **12,8%.** In the timespan 2015-2019, the

average nominal return was **3,1%**.
The BETTER FINANCE figures are net of most fees (see below box on data sources and computation), including of the annual contract fees.
A specificity of the French UL market is therefore that its average net returns are higher than the European median ones. And despite these higher returns, they reduced the **real** value of their clients' savings over the last 21 years by 14%.
These data were difficult to get. It would be indeed very useful if the insurance industry would also provide the underlying data for the other major UL product markets in Europe, as the French industry organization does for the French one.

Computation of net real returns of EU UL products

Sources: to BETTER FINANCE knowledge, there are only BETTER FINANCE (since 2013) and EIOPA (since 2019) that are publishing data, not the industry.

- BETTER FINANCE:
    - based on weighted average mathematical reserves
    - up to 21 year track record: end 1999 to end 2020;
    - Net of all fees and commissions publicly available on an aggregate average level (so still excluding some important annual charges on assets, in particular the charges for the growing delegated management – "gestion déléguée, sous mandat, profilée", "flexible") service, typically an additional 0,30% or more).
    - Net of inflation: real returns, not nominal ones;
    - By country where available.

Sources: always mentioned at bottom of tables and graphs
Method : Annual research report on the real returns of long term and pension savings in Europe, in particular pp. 35-39, 210-211, 217

- EIOPA:
    - According to EIOPA methodology, for UL IBIP net "*The net return* [is] *adjusted for all the costs not included in the NaV in order to be able to compute a net return*" – p. 53 EIOPA report). Is it the NaV of the contract or of the aggregated units ?
      (p. 53 EIOPA Report "*The net return computations is based on the NaV YoY change as unit value, to prevent possible fluctuation due to submission/redemption or dividends*")
    - 5 year track record : end 2014 to end 2019
    - Nominal returns, not real ones
    - No country level data disclosed

Computation of net real returns of French UL insurance
Sources:

- No aggregate data published by the NCA (ACPR)
- Only long term series of published aggregate data available: published by the insurance industry, and not audited: FFA (French Federation of Insurers) : table FR8 page 217 of BETTER FINANCE above-mentioned 2020 Report, 1st column ; 2019 nominal return released by FFA only in October 2020 : +13,9% **-**versus +14,7% estimated by BF in August 2020 before report release **-** adjusted after FFA release for the 2021 graph).
- For 2020 (FFA not yet available) : estimate from research consulting firm GoodValueforMoney.eu

Method:

- FFA :
    - Overall aggregate nominal returns: 1st column page 217
    - Returns gross of management fees on the UL contracts themselves
- BETTER FINANCE net real returns : 2d column p.217

  Adjustments to FFA figures:
    - Real returns: deduction of inflation (Eurostat France)
    - Returns net of all publicly available aggregate average fees:
        - Deduction of average UL contract annual management fees

- Deduction for the first year (1999) of the average entry fee.

In the German IBIPs market, based on the German regulator's (BaFin) assessment, there is also a trend towards unit-linked or hybrid products (move from guaranteed return products), which can deliver of course even negative returns: in 2020, 75.5% of these life-insurance contracts were long-term products, mostly annuities (90.9%), of which 12.6% were unit-linked products and almost a half hybrid products, share of which is estimated to rise to 50% by 2024.

However, while costs would appear to be decreasing in relative (%) terms in some markets (not France), they are actually increasing in absolute (€) terms, without delivering more VfM for clients. BETTER FINANCE suspects that this is because of the high level of fees. In spite of the ESMA and EIOPA reports, because EIOPA is forced to report the *reduction in yield* at recommended holding periods, whereas ESMA reports the Total Expense Ratio (TER) in the last 1, 3, 7, and 10 years.
At the same time, not much more return is delivered by such fee-laden products: in the risk-reward assessment, EIOPA found that the riskiest class of products (7/7) deliver poorer outcomes for clients compared to the less riskier (5/7 or 6/7).

Q3: Do you believe that more emphasis on value for money considerations as part of POG, in particular through product testing, will ultimately improve the value propositions in the unit-linked market?

Yes, there is a need for stricter rules and guidance on the POG consideration, in particular concerning the development (design) phase – target market identification – and product testing. No, BETTER FINANCE believes that such an approach will not deliver viable results. Unfortunately, the POG process (including product design and testing) were specifically designed to ensure that value for money in relation to the target market is delivered. However, many years since its application, and also in other sectors, we can observe that this is not the case. As EIOPA highlighted in the recent analysis on supervision of product oversight and governance procedures that manufacturers must align the design of the product with the needs, objectives, and characteristics of the identified target market.
However, with lack of adequate and harmonized supervision at local level, such requirements – although aimed in the right direction – will not deliver their results.

Q4: Based on the framework presented below, do you believe there may be principles you feel are missing? Please explain.

Yes, explained in Q1 above: EIOPA must first ensure that the product manufacturers clearly (and correctly) identify the purpose of the IBIP, which must be aligned with the target market. This first step is crucial as it gives the benchmark against which VfM can be measured: if the primary purpose of a product – albeit having investment characteristics – is to insure the client against certain events, then the assessment of VfM will be different to products that are meant as an investment, but also offer on the side (as a "bonus") insurance facilities.
In addition, based on feedback received from our German member organisation, EIOPA's principle-based framework should focus also on the orderly use of the demands and needs test of prospective customers and the documentation of the personal recommendations (based on article 20 (1) and (3) IDD) as well as the assessment of suitability and appropriateness (based on article 30 (1) and (2) IDD) by the distributors of unit-linked products.
According EIOPA's proposal in pt. 1.12, should benchmarks be used for the further assessment, a simple rule regarding the appropriateness of a benchmark can be added: the benchmark should be objective aligned with the product's investment objectives and should be objective (i.e. not a peer-group). If the provider claims to have no benchmarks (i.e. no defined investment objectives), then it should be inflation, i.e. ground zero for the purchasing power of IBIPs and insurance-regulated pension products.

Q5: What additional measures could EIOPA facilitate to advance value for money in unit-linked and hybrid products?

In line with rule no. 3 highlighted in Q1, regular reviews and assessment are needed to ensure that the product delivers VfM as, in fact, VfM cannot be adequately assessed ex-ante, but only ex-post. National supervisors must closely monitor product and report on the returns and costs in their jurisdiction, as EIOPA does in its annual report.
At the same time, enhanced cost disclosures are needed in order to enable policy holders to compare the returns and costs of UL and hybrid products with other similar solutions on the market. In addition, the practices at the point of sale must be closely monitored as well: as suggested by BETTER FINANCE'S German member as well (BdV), national supervisors should be encouraged to regularly ask for the documentation of distribution procedures by the life-insurers, their agents and the connected brokers.

Q6: Do you agree that costs and charges need to be due?

It is very difficult to assess ex-ante whether costs are due, especially considering the uncertainty and lack of reliability of performance (and, thus) cos estimation. However, BETTER FINANCE makes two recommendations to EIOPA in this light, based on the approach taken:
- if EIOPA decides to implement a forward-looking approach to measuring whether costs are due, then we firmly recommend using the *Reduction-in-Wealth* indicators used for the PEPP KID; in this sense, we particularly recommend that EIOPA does not make a link or connection to the PRIIPs KID's Reduction-in-Yield;
- if EIOPA decides to implement an approach based on actual cost and returns, then we refer to our answer to Q1: before the product is launched, costs need to be assessed in light of the average cost and returns of the peer group, with an emphasis on decreasing costs where returns are very poor (below 1% in real net terms); after the product is launched, the costs need to be assessed also against the product itself and regularly reviewed.

Q7: Do you agree that for evaluation purposes, costs and charges should be assigned to specific benefits and services?

Yes, we agree, and this is – in fact – in line with an already existing legal requirement (Art. 29(1) IDD).

Q8: Do you agree that the costs which cannot be directly linked to a specific product component, should be assigned to the dominant product feature? If not, do you have an alternative proposal?

No, costs always have a source and it should not be meant for product manufacturers to disguise certain costs or "blame" the dominant feature for it. For instance, costs linked to distribution (such as commissions paid for advisors) should not be assigned to the dominant feature of the product.
Again, as highlighted for the previous questions and in Q1, EIOPA and national supervisors should clearly define and enforce how a product is designed, i.e. what is primary purpose is. This is because having a clear primary purpose not only facilitates, but also determines directly the dominant feature of the product. For instance, UL or hybrid products are mainly aimed as investment products, thus investing is the dominant feature, whereas biometric risks are additional components. As such, if the dominant part of the premium is not paid for the dominant feature, this leads to mis-selling and consumer detriment by not delivering value for money.

Q9: Do you agree that active investment management involves additional costs and benefits?

Yes, but active management (and higher costs) are only justified when it delivers better results; otherwise, active management is only a tool to charge more without any consequences. In the academic and specialized literature (including several BETTER FINANCE reports) there are ongoing reports pointing to the limited added value of active management.
Moreover, should this consideration be taken into account, the burden of proof must lie with the product

manufacturers, i.e. to demonstrate – on the long-term – how active management delivered its promises compared to low-cost passive management (such as index funds or index ETFs).

Q10: Do you agree that each product feature should deliver Value for Money as well as for the product as a whole?

Yes, we agree. In order to strengthen this principle, we propose to use the analogy of cross-selling: „When an insurance product is offered together with an ancillary product or service which is not insurance, as part of a package or the same agreement, the insurance distributor shall inform the customer whether it is possible to buy the different components separately and, if so, shall provide an adequate description of the different components of the agreement or package as well as separate evidence of the costs and charges of each component." (article 24 (1) IDD).

Q11: Do you agree that value for money is dependent on the target market's characteristics, needs, and objectives?

Yes, we agree – see answers for Q1, Q5 and Q6.

Q12: Do you agree that active and passive investment management have different target markets?

No, these are two asset management techniques in order to deliver positive real returns net of overall costs over the time horizon of the unit-linked contracts. It is up to the provider to choose one or the other or a mix in the best interest of clients. Evidence shows however that low cost "passive" index funds are very rarely offered and promoted in unit-linked contracts, as they do not provide commissions ("inducments") for the distributor nor for the insurer. It will be interesting to follow the emergence of "clean share class" unit contracts (e.g. Allianz in France).

Q13: Do you agree that distribution costs which are charged to the consumer as a percentage of the premium paid or the performance of the units can create a risk of being poor value for money?

Yes, in particular if those costs are related or generated from the manufacturer paying distributors certain fees and commissions for selling or recommending an investment product. If the costs are charged on the performance of the units, then those are performance fees, and should be assessed separately – see BETTER FINANCE's response to the ESMA Consultation on the *Guidelines on costs and performance fees for UCITS*, which can be applied mutatis mutandis in this respect as well.

Q14: Do you agree on the assumptions to be made when assessing the reasonableness of the expected break-even point and of the expected returns?

No, we do not agree, for two reasons:
First, these concepts are very difficult to estimate accurately, reason for which the expected return and break-even points are pseudo-doable, and not always because of the VfM – manufacturers can argue that, in fact, it was the market's performance that precluded the product from reaching its breakeven point.
Second, we disagree with the assumption given to life cycle products that these can have a late breakeven point: it is a very risky strategy and the breakeven point should be assessed throughout the entire life of a product: although it is not necessary to reach this theoretical point at any period of time, manufacturers should "raise an alarm" if the performance of the product diverges (negatively) significantly from the breakeven point at any given period.
It would be easier and more effective to ban toxic products, toxic being defined as having a very little probability of delivering flat or positive net real returns over the recommended holding period. For example, one finds on unit-linked contracts EU sovereign bond funds with 2% or more total annual cost, and euro money markets funds with 1.5% or more such total annual cost: given the current level of interest rates in Europe, savers will start to lose in real time as soon as they are exposed to these products.

Q15: Views on other criteria / ways to assess reasonableness are sought:

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Q16: Do you agree that manufacturers have a duty to review costs and charges, performance and the services offered on a regular basis?

Yes, we agree: this obligation is highlighted first by the fiduciary duty (or generally duty of care) to act in the best interest of clients and, second, in Art. 25(1) IDD, which is further elaborated in the Level 2 IDD Regulation (EU 2017/2358 – Art. 4).

Q17: Do you agree that policyholders should expect returns that are in line with market returns over the long run?

Yes, in line with but not mandatorily at the same level as capital markets returns are without any costs. It depends on the product sought: if the defined investment policy and objectives of the product are to overperform the market, then policyholders should expect that long-term ***net*** returns overperform the market (or any other benchmark chosen and disclosed by the manufacturer) and vice-versa.
The problem here is that life insurers are not required to disclose their investment objectives , nor to disclose their long term net past performance compared to that of their investment objective (benchmark), unlike UCITs funds under the UCIS KIID requirements. Most unfortunately, the new PRIIPS KID is depriving all EU savers of any information on this critical issue. They cannot even know if the UL product as ever made money or not and if it has ever met the investment objectives of the provider.

The problem, in this light, is also more of financial literacy and awareness rather than technical details: BETTER FINANCE's annual flagship research report on the real returns of long-term and pension products explains what factors pension savers should take into account when analysing long-term and pension savings, most strongly by showing the real net returns (over 20 years) of pension products, even after taxes when possible.

Q18: Do you agree that actively managed underlying funds should be reviewed in relation to their performance against that of their related benchmarks?

Yes, Yes, it they have failed to reach their own investment objectives over their recommended holding period or longer, they need to be urgently reviewed. Moreover, this is a long-term position and recommendation of BETTER FINANCE: a product must be assessed against a benchmark (long-term, at least the past 10 years), which must be an objective comparison (i.e. not peer-group of products, but the market itself or at least a low-cost tracking option that reflects the market).
In this light, we reiterate our proposals to assessing and assigning the adequate benchmark made in ESMA's consultation on benchmarks (2019) and we reiterate our answers to Q9: the burden of proof must lie with the product manufacturer.

Q19: Do you agree that mass marketed UL products should provide a limited number of options?

Too much choice kills choice: unit-linked products with hundreds of units please the distributors, but not the clients! BETTER FINANCE agrees with EIOPA's assessment and proposals regarding the product governance controls over a product's complexity and suitability for the target market, where we highlight also the need to define and implement the concept of toxic products, i.e. products that destroy the value of the capital invested (e.g. a product based on money market funds which costs more than the interest rate on the money market itself!). As such, there should be a specific control of quality of the funds used or proposed as the underlying investments and the relationship with the total costs. Moreover, as highlighted by our German member association (BdV), with regard to the biometric risk coverage, there should be independent advice stressing the priority separation of risk coverage and long-term saving processes.

Q20: Do you see alternative measures to mitigate risks associated with a high number of options?

The key here is to ensure (the EC CMU Action plan goal) that advice provide by intermediaries on these complex products is bias-free. Then they will not inundate their clients with long lists of options. Also, UL insurance products are complex, but IDD – unlike MiFID – does not have any specific protection rules for complex products.

Q21: Do you agree that UL products require a high degree of financial literacy for consumers to understand?

Not all unit-linked products require a higher degree of financial literacy, but in general these tend to be more complex than other non-IBIP solutions such as capital guaranteed contracts (misnamed as "with profit policies" in the UK and also unfortunately used by EIOPA), in particular from the point of view of costs and functioning. In this light, we underline the negative impact aggressive marketing or selling practices can have on financial literacy (as it is currently the place where most financial education for adult savers takes place), in particular non-independent advice.
As such, we agree with EIOPA's assessment that the target market should be more granular and must consider the additional complexity and risks when dealing with products with a higher degree of complexity. UL products are complex products for the vast majority of EU households given their level of financial literacy, and the complexity and opacity of these products.

Q22: Do you agree that products with many different options carry additional conduct risks?

Yes, BETTER FINANCE agrees with EIOPA's assessment (in line with our answer to Q21 above).

Q23: Do you agree with the variables to be taken into account to determine product groupings? Or do you believe more/less variables should be taken into account?

Yes, BETTER FINANCE agrees.

Q24: For each of the variables identified provide views on options which EIOPA should consider:

BETTER FINANCE highlighted throughout this consultation the framework and factors that need to be considered when assessing *value for money* in UL products. In addition, we highlight the importance of independent (bias-free) advice as a goal of the EC in its current CMU Action Plan) which is almost non-existent within the EU, except in the Netherlands: besides the POG process, this is one of the most important steps as, ultimately, the intermediary that is best placed to assess whether a product is aligned with a particular client and can deliver value for money (as an additional safeguard for EIOPA's framework, which essentially circles back to POG) is the financial advisor.

Q25: Do you think there may be other criteria to be followed when grouping products?
Customer's risk appetite, life cycle are also important considerations.

We agree with EIOPA's proposal that "the protection component of the products should be unbundled from the investment component. All the costs and benefits linked to the protection module should be excluded from the model." At the same time, in line with the comments of our German member BdV, BETTER FINANCE highlights that the exclusion of biometric costs must be applied only to death or disability risk coverage. In addition, the longevity costs must have a significant weight in the evaluation of the payout-phase especially since (based on input received from BdV) it can happen that insurance companies over-calculate or even exaggerate the biometric costs.

Q26: Considerations on the model are sought:

In line with all previous answers, BETTER FINANCE makes three final remarks:
First, the initiative of EIOPA is timely and extremely important for EU individual, non-professional investors and policy holders as the performance of UL and hybrid products can and must be improved. At the same time, it will constitute an important and necessary tool for closer supervision by EIOPA and national regulators, which is very much needed at the moment. Second, in order to be viable and not circumvented, the framework for VfM must clearly identify what it aims to deliver and, ultimately, prevent mis-selling of

products. If the framework (and concept itself of VfM) is to loosely defined, it may generate the counter-effect of labelling product as delivering VfM (as per the Guidelines of EU and national authorities), when this does not occur UL products should disclose and specify their long term objectives (already manufactures of "units" have to do that in the UCITS KIID and in the PRIIPS KID). Last, having clearly identified the purpose and target market of a product, VfM must deliver adequate results in line with its purpose, e.g. a UL product, which is essentially an investment product, must aim to deliver decent real net returns over the long-term, as this is their dominant feature.