



DAV

DEUTSCHE
AKTUARVEREINIGUNG e.V.

Kommentierung der Deutschen Aktuarvereinigung e.V.

**ESA's Technical Discussion Paper
Risk, Performance Scenarios and Cost Disclosures In Key
Information Documents for Packaged Retail and
Insurance-based Investment Products (PRIIPs)**

Köln, den 18. August 2015

Summary

The Deutsche Aktuarvereinigung (DAV) is the German association of actuaries and in this capacity appreciates the opportunity to comment on the "Technical Discussion Paper on Risk, Performance Scenarios and Cost Disclosures in Key Information Documents for Packaged Retail and Insurance-based Investment Products (PRIIPs)".

Generally, we wish to point out that we fully support the objective to provide consumers with clear and transparent information on the key characteristics of a product, thus enabling the customer to compare various PRIIPs and make an informed choice according to his interests, risk profile and goals. This initiative will further strengthen consumer protection in the financial services industry.

As many actuaries are advising or working in insurance companies our subsequent comments will concentrate on material issues addressed in the TDP affecting life-insurance products.

In brief, our main recommendations are:

- Risk and Reward:
As regards calculating the underlying distribution of returns for the risk indicator we strongly recommend a forward-looking stochastic modelling approach based on predefined parameters derived not from current market data but from appropriate long-term average values.
- Performance Scenarios:
We recommend applying a "What-if prescribed approach" when choosing appropriate performance scenarios. This approach grants comparability of information, is more understandable for consumers and reduces discretion for manufacturers.
- Costs:
From an actuarial viewpoint we strongly disagree with the assertion that the full biometric risk premium should be considered as cost. Policyholders receive benefit payments from insurance cover in return for these premiums which do not exist for other types of PRIIPs. Moreover, they are not linked to the costs of the investment element of life insurance contracts. Rather, the biometric risk premium should be seen as a sum of the fair value for the cover and an added cost element.
- Cost Indicator:
Considering the specifics of life insurance contracts we also recommend applying a Reduction-in-Yield (RIY) approach when determining the cost indicator of a product.

Question 1:

Please state your preference on the general approach how a distribution of returns should be established for the risk indicator and performance scenarios' purposes. Include your considerations and caveats.

As regards calculating the underlying distribution of returns for both the risk indicator and the performance scenarios we strongly recommend a forward-looking stochastic modelling approach based on predefined parameters derived not from current market data but from appropriate long-term average values.

This approach is particularly suitable for insurance-based investment products. e.g. for life insurance contracts. Due to the long-term nature of life insurance estimating the parameters only from current market information would be as inappropriate as deriving them directly from historical data.

We recommend a prescription of the (basic) model as well as the necessary parameters by a central European authority. This will ensure comparability of results and also grant sound legal protection for the manufacturers. In case the choice of parameters is left to the judgement of the manufacturers more supervision will become necessary to make sure that these are chosen with due diligence.

It would, however, make sense to allow for sufficient degrees of freedom when developing models either for determining the risk/reward indicator or for the performance scenarios. While parameters should be consistent, differences in model approaches might be sensible as the risk classification and the performance of the products in question respond to different objectives: While the former helps differentiating between products on a relative basis the performance scenarios deliver absolute values of possible investment results of products.

Question 2:

How should the regulatory technical standards define a model and the method of choosing the model parameters for the purposes of calculating a risk measure and determining performance under a variety of scenarios?

In order to ensure comparability of products and also to grant sound legal protection for the manufacturers we recommend that model and parameters are set by a central European authority.

It would, however, make sense to allow for sufficient degrees of freedom when developing models either for determining the risk/reward indicator or for the performance scenarios. While parameters should be consistent, differences in model approaches might be sensible as the risk classification and the performance of the products in question respond to different objectives: While the former helps differentiating between products on a relative basis the performance scenarios deliver absolute values of possible investment results of products.

As regards calculating the underlying distribution of returns for both the risk indicator and the performance scenarios we strongly recommend a forward-looking stochastic modelling approach based on predefined parameters derived not from current market data nor directly from historical data but from appropriate long-term average values.

As regards suitable risk measures both the Expected Loss for a given Value-at-Risk and the Conditional Tail Expectation appear to be appropriate. The Expected Loss for a given Value-at-Risk suitably measures the market risk by delivering an average of the expected loss in the worst case. The Conditional Tail Expectation, however, is particularly apt and stable for insurance based products and also relatively easy to explain.

Question 9:

Please state your views on the most appropriate criteria and risk levels' definition in case this approach was selected. (Option 1)

Option 1, the qualitatively based indicator combining credit and market risk, complemented by a quantitative market risk measure, is unsuitable for life insurance products.

The main reason for this is that life insurance contracts often contain guarantees granting as a minimum at maturity the sum of all contributions. The indicator as to option 1 is not able to discriminate product types with guarantees on the basis of market risk. Products, where the sum of contributions is guaranteed at maturity are put into the same class. However, consumers that are interested in these products wish to assess different guarantees and different guarantee mechanisms. A qualitative distinction between different types of guarantee mechanisms is practically impossible. Furthermore, the indicator is not stable as minimal changes in the product (e.g. 99.9% guarantee vs. 100% guarantee) would change the risk/reward class of the product.

Therefore, market risk should rather be captured by a quantitative risk/reward indicator complemented with a narrative explanation.

Question 10:

Please state your views on the required parameters and possible amendments to this indicator. (Option 2)

Option 2, an indicator separating assessment of market risk (quantitative measure based on volatility) and credit risk (qualitative measure, external credit ratings) is also unsuitable for life insurance products.

ESA, too, asserts that this option cannot be applied to insurance products as a short term risk measure based on market values does not suit the long-term character of life insurance contracts. We fully agree with this assessment.

Question 11:

Please state your views on the appropriate details to regulate this approach, should it be selected (Option 3)

Option 3, an indicator based on quantitative market and credit risk measures calculated using forward looking simulation models, might be a good starting point for further analyses and developments. We recommend to expand the short term calibration of the model to a longer time horizon so that it will better suit insurance-based investment products.

A qualitative measure for credit risk, however, would be preferable as credit risk is of less relevance for most insurance-based investment products.

Question 12:

Please state your views on the general principles of this approach, should it be selected. How would you like to see the risk measure and parameters, why? (Option 3)

The TDP proposes to set up a public database in order to enable third parties to replicate risk calculations. We believe that this is not necessary as in a prescribed model a transparent parametrisation will suffice to ensure comparability.

Moreover, the prescribed model should be allowed to be replaced by an internal model if the manufacturer is able to demonstrate that his results will lead to equivalent risk indicators.

Question 13:

Please state your views on the potential use of a two-level indicator. What kind of differentiators should be set both for the first level and the second level of such an indicator? (Option 4)

Option 4, the "Two-Level" indicator, presents the best solution for the challenge to define an indicator which is applicable to a large range of PRIIPs.

Life insurance contracts often contain guarantees granting as a minimum at maturity the sum of all contributions. Consumers that are interested in these products wish to assess different guarantees and different guarantee mechanisms.

This will be ensured by applying the "Two-Level" indicator.

Question 16:

Do you think that these principles are sufficient to avoid the risks of manufacturers presenting a non-realistic performance picture of the product? Do you think that they should be reinforced?

We recommend prescribing appropriate performance scenarios. This approach would reduce the discretion of manufacturers, enhance comparability and also grant sound legal protection for the manufacturers. In case the choice of parameters is left to the judgement of the manufacturers more supervision will become necessary to make sure that these are chosen with due diligence.

In addition, the scenarios should be forward-looking as on the one hand especially for products with very long time horizons historical data have little meaning for future developments and on the other hand it is often impossible to find suitable historical data for new products.

Question 17:

Do you think the options presented would represent appropriate performance scenarios? What other standardized scenarios may be fixed?

We recommend applying a “What-if prescribed approach” when choosing appropriate performance scenarios. This approach would reduce the discretion of manufacturers, enhance comparability and also grant sound legal protection for the manufacturers. Furthermore, deterministic performance scenarios are more understandable for retail investors. Moreover, these scenarios are quite stable over time.

Question 18:

Which percentiles do you think should be set?

We recommend applying a “What-if prescribed approach” when choosing appropriate performance scenarios. This approach grants comparability of information crucial to understand the risk and the functioning of a product.

Deterministic modelling with different assumed returns is more appropriate to illustrate possible outcomes than a probabilistic approach.

Only when determining the risk / reward class of a product a probabilistic approach, e.g. application of a sufficiently large set of stochastic economic scenarios, could be considered.

Question 45:

Which of the above mentioned options 1 and 2 for the calculation of aggregate costs would you prefer? Do you agree with above mentioned assumptions on the specificities of the costs of life-insurance products? How should the breakdown of costs showing costs specific to the insurance cover be specified? Do you think that risk-type riders (e.g. term or disability or accident insurances) have to be disregarded in the calculation of the aggregated cost indicator? How shall risk-type rider be defined in this context? (one possible approach might be: A risk-type rider in this context is an additional insurance cover without a savings element, which has separate contractual terms and separate premiums and that the customer is not obliged to buy as a compulsory part of the product).

From an actuarial viewpoint we would first like to emphasize that considering the full biometric risk premium as cost is not appropriate.

Premiums for protection against biometric risks are not costs as policyholders receive benefit payments from insurance cover in return for these premiums.

Moreover, these premiums are not linked to the costs of the investment element of life insurance contracts. Rather, the biometric risk premium should be seen as a sum of the fair value for the cover and an added cost element.

Consequently, we strongly favour option 1 to disclose the biometric risk premiums and / or the cost part of these separately, i.e. by choosing different cost indicators.

In Germany, the Minimum Policyholders' Dividend Regulation (“Mindestzuführungsverordnung”) imposes a (minimum) 90% share of risk surplus and a (minimum) 50% share of cost surplus for the customer. Therefore, shifting cost charges into the biometric risk premiums in order to circumvent the cost disclosure would be of no use for the life insurance company.

Question 49:**Do you think this list (of ongoing costs) and breakdown is comprehensive?**

The costs section of the KID should include costs that correspond to the regular execution of a PRIIP. However, costs that incur through optional decisions by the retail investor should not be taken into account:

First of all, the amount and the timing of these costs is not known upfront: a retail investor might not make use of them at all. Second, the KID is a pre-contractual non-personalised information document. Finally, it is commonly accepted that services consumer purchase, might cause additional optional costs in its lifetime, these are not only inherent in PRIIPs. In our view, a narrative explanation that additional options might incur costs is sufficient and understandable for consumers.

Question 56:**Which above mentioned or further options do you support, and why? More generally, how to measure costs that are passed to policy holders via profit participation mechanisms? Would you say that they are known to the insurance company? Do you think an estimate based on the previous historical data is the most appropriate methodology for the calculation of these costs?**

We fully agree with the assertion in the TDP that cost surpluses should be deduced from the costs and taken into account in the costs section of the KID. The PRIIPs manufacturer should be able to prove the adequacy of these surpluses, e.g. they should be explicitly stated by the manufacturer or the amount should be actuarially justifiable. The same arguments apply to the biometric risk premium if taken into account in the summary cost indicator.

However, we wish to emphasize that in our view it is inappropriate to include the biometric risk premium in the costs section of the KID (see also answer to Question 45). In any case, it is necessary to ensure that the costs are not double counted.

Question 83:**For some life-insurance products, the costs will differ on the age of the customer and other parameters. How to take into account this specific type of PRIIPs for the purpose of aggregating the costs? Should several KIDs for several ages be considered?**

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Question 84:

Do you agree with the abovementioned considerations? Which difficulties do you identify in the annualisation of costs?

The Total Cost Ratio (TCR) does not fit to the specifics of life insurance contracts and is not suitable to disclose the cost of these contracts appropriately:

- TCR is unable to take into account the timing of cost deductions, which is particularly relevant for life insurance contracts with upfront costs,
- and is thus unable to take into account the effects of interest
- TCR is based on so-called "average investments" which do not apply to long-term insurance products with regular contributions

Annualisation of costs is of paramount importance when PRIIPs with highly varying time horizons are to be compared. Thus, it is important to apply a suitable, transparent, comprehensive and comparable cost indicator.

Considering the specifics of life insurance contracts we therefore recommend applying a Reduction-in-Yield (RIY) approach when determining the cost indicator of a product as it fulfils the above mentioned requirements. It takes into account the timing of cost deductions and shows the impact of cost on the benefit at maturity far more accurately than TCR.

The annex "Comparison of RIY- and TCR-approach" of the TDP clearly reflects these differences.

Question 87:

What would be other options to define the TCR ratio in the case of life-insurance products? What about the case of regular payments or regular increasing? Which definition would you favour? How to ensure a level playing field and a common definition with the other types of PRIIPs in this regard? Another possible approach could be to use the ratio between the total amount of costs over the holding period and the average net investment (assumed during the whole period, in order to take into account future additional investments, partial withdrawals, payments (i.e. programmed investments or disinvestments)). Do you think this approach would be appropriate? To what extent do these possible calculation methodologies fit the case of insurance products with regular payments?

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Question 91:

To what extent do the principles and methodologies presented for funds in the case of on-going charges apply to life-insurance products?

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(The remaining questions were not responded to.)