As to the difference between (unit linked) life insurance and UCITS

(Unit linked) life insurance and investments funds are different products serving different customer needs. For retirement pensions to be safe it is necessary that benefits are offered on a foreseeable and life-long basis. In providing pension products life insurers accumulate funds. The accumulation of funds is a just one element of insurance. However, it is not sufficient:

• Life insurers provide their clients with a coverage of the elementary risks of life (biometrical risk coverage). From a social policy perspective it is obvious that long term insurance contracts with regular contributions are beneficial: An arbitrary variation and termination of contributions which is sometimes praised as “flexibility” comes to the price of not getting the benefits of risk coverage in an insurance collective.

• Persons who trust only in savings or investment products run the risk

  ➢ to be in case of disability without income and without possibility to provide for old age,
  ➢ to jeopardise their family’s financial situation in case of premature death of the main earner,
  ➢ to prematurely consume his or her assets in case of an unexpected long life.

• By offering long term guarantees insurers provide their clients with the service of bearing their capital market risk. Solvency requirements warrant that insurers are able to meet their clients’ expectations. In Germany, the high level of guarantees is completed by an elaborated multi-layer life insurance guarantee scheme that covers the counterparty risk to 100%.
Unit linked life insurance products

A unit linked life insurance product is a long term insurance contract between a policyholder and an insurance company. The insured makes a liable commitment to pay regular contributions and must constantly renounce consumption today in favour of what is needed in old age. It is true that the capital market risk is beared by the insureds. The insurance company invests the money on the policyholders' behalf. The allegation that insurers pass this risk to their clients in a way that is unnoticed by the latter is, however, wrong. In Germany, supervisory authorities require for unit linked life policies an explicit pre-contractual information about this issue. Unit linked life insurance, therefore, is in fact a product alternative providing the potential clients with the option to choose the investment strategy themselves. The latter can but does not necessarily have to include guarantees. By coordinating the capital market risk and the biometrical risk which are independent from each other insurance companies offer an extra service to their clients: in order to minimize the costs of providing an individually predefined level of financial security the premium share that is devoted to the coverage of biometrical risks is adjusted to the funds value: When the value of the funds is high, the contribution share devoted to biometrical risk coverage is automatically reduced and vice versa. All other features of classical life insurance remain. Unit-linked life insurance policy holders participate on the balance of risks within the collective of insureds and on emerging biometrical surpluses.

UCITS

A UCITS investor, by contrast, is the beneficial owner of an interest in a fund, represented by his/her unit or shareholding. UCITS do not provide coverage of biometrical risks. Fund products are used for short- and medium-term asset investment as can be substantiated by empirical data:

- According to a survey conducted in 2004 on behalf of the Bundesverband Deutscher Investment- und Vermögensverwaltungs-Gesellschaften (BVI)\(^1\) by the Gesellschaft für Konsumforschung (GfK)\(^2\) no more than 20% of German fund shareholders hold their shares for more than ten years.\(^3\)

\(^1\)Federal Association of German Investment and Asset Management Companies.  
\(^2\)Institute for Consumer Research.  
• Investment into mutual funds is not only in Germany motivated by short term considerations: sales of funds that were launched in 2002 in the EU declined from approx. 100 000 m EUR (2002) to 63 000 m EUR (2003), to 38 000 m EUR (2004) and to 25 000 m EUR (2005).  

Coverage of the counterparty risk of UCITS is in Germany much lower than this is the case with insurance. Compensation in the case of insolvency is limited to 20 000 EUR. Within this limit only a 90% protection level is offered. BVI, interestingly, still continues to deny the legitimacy of the “Entschädigungseinrichtung für Wertpapierhandelsunternehmen”.

Briefly summarized: UCITS and (unit linked) life insurance policies serve different customer needs. The crucial differences with regard to clients’ risk exposure have to be recognized when it comes to regulation. Only equal products are to be equally regulated. And level playing field issues cannot be identified arbitrarily with regard to one single element of the value chain. These rules hold also for disclosure requirements.

**Transparency requirements must correspond to the nature of products**

As a general principle, disclosure requirements with regard to risks should - as provided by the directive on insurance mediation - correspond to the extent customers are exposed to these risks. It has to be recognized, in this context, that long term contracts with regular contributions provide an efficient mechanism to reduce the capital market risk: The regular payment of contributions during a long period of time provides protection against the risk of “entering” at the wrong moment or of missing the right moment for leaving (“timing risk”). That this timing risk is real, is shown e.g. by the fact that in Germany in the investment years of 1999 and 2000 more funds flowed into equity funds than in the remaining years between 1990 and today. Investments of this period may still have a negative rate of return. In contrast, in 2004 funds were withdrawn from equity funds so that the 30% yield which would have been possible from 2004 to 2005 was on average not realized (see Annex).

The empirical economic research literature knows innumerable examples where such pro-cyclical or “follow the crowd” behaviour with regard to short-term investment is not the exception but the rule.

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4 Data source: FERI Fund Market Information Ltd.
As to cost disclosure requirements the specific long term character of (unit linked) life insurance contracts has to be taken into account. Sometimes it is argued that the cost burden with insurance companies is comparatively higher. Simulations show, however, that this is normally not the case, in particular not with regard to long term contracts.

In case of long term contracts the main focus should be on the display of the impact of costs, i.e. benefits after deduction of costs. This approach can be exemplified by the information requirements of state-subsidized pension contracts in Germany, the so-called Riester pensions, which are offered by insurers both as "regular" with profit annuities and as unit-linked annuities. For these products information must, inter alia, be given on:

- the acquisition, management and transfer expenses included in the calculation and
- the development of the benefits, i.e. after the deduction of costs, during the first ten years on the basis of a two, four or six percent interest-rate.

Under the amended German Insurance Contract Law which will enter into force in 2008 these information requirements will be assigned, to a large extent, to the entire life business, especially the display of the development of the benefits by 3 interest-rate-scenarios.

Brussels, 23 May 2007
Annex : Short-term investment:

It is hardly ever possible to choose the optimum time for entering and leaving a fund.

Net inflows to German retail equity funds and annual yields achieved in the years until 2005 (1990 - 2005)

Source: Deutsches Aktieninstitut, BVI