Autorité de contrôle prudentiel
(Prudential Supervisory Authority)

Recommendation relating to the marketing of unit-linked life insurance policies composed of complex financial instruments, issued in accordance with paragraph 3 of point II of Article L. 612-1 of the French monetary and financial code

****

2010-R-01

15 October 2010

(Non official translation)

1. Background

Given the imbalance of information that exists between non-professional investors and the producers or distributors of structured funds and complex debt securities (in particular EMTN), the difficulty for non-professional customers to understand these products and the risk of non-compliance with their obligations of the people who market them, the AMF has decided to publish its position relating to the direct marketing of these products[1].

The French Prudential Supervisory Authority (Autorité de contrôle prudentiel or ACP), which is responsible for protecting the customers of insurance bodies, examines these financial instruments in the context of life insurance policies. Consequently, the ACP has decided to issue a recommendation concerning the use as units of account of these structured financial instruments that carry a risk of mis-selling, to set out the conditions in which insurers and insurance intermediaries can comply with their legal and regulatory obligations in terms of information and advice.

This recommendation:

- reminds insurers and insurance intermediaries of their responsibilities in terms of information and advice provided to customers/subscribers with regard to financial instruments serving as units of account;
- draws the attention of insurers and insurance intermediaries to the objective criteria for the risk of mis-selling of life insurance policies based on complex financial instruments.

2. On the scope of application of the ACP recommendation

2.1. Units of account concerned

Article L. 131-1 of the French insurance code[2] states:

"In respect of life insurance or capitalisation, the capital or annuity insured may be expressed in unit linked terms comprised of investment securities or assets offering adequate protection of the savings invested and appearing on a list drawn up by decree in Conseil d'Etat".

Article R. 131-1[3] of the same code establishes the list of assets that can be used in unit-linked insurance and sets a ceiling on the portion of the premium that may be invested in some of these assets.

ACP's recommendation applies to unit-linked insurance comprised of:

- French structured funds (referred to in Article R. 214-27 of the French monetary and financial code);
- Equivalent structured funds[4] under foreign law;
- complex debt securities and equivalent financial securities issued based on foreign laws, excluding simple warrants, the latter being defined as structured products in the form of options listed (continuously) on a regulated market or multi-lateral trading facility, giving the right (but not the obligation) to buy or sell a given asset during a given period at a price set on issue.

1. AMF position "Marketing of complex financial instruments" (*Commercialisation des instruments financiers complexes*).
2. All the references to articles hereinafter refer to the French insurance code unless explicitly indicated otherwise.
3. See also Articles R. 223-1 to R. 223-4 of the French mutual code (*Code de la mutualité*) and, generally speaking, for provident institutions Article L. 932-23 of the French social security code (*Code de la sécurité sociale*) which refers back to the insurance code.
4. Structured funds are governed by Article 36 of Commission regulation (EU) No. 583/2010 of 1 July 2010 implementing EU directive 2009/65/EC.

2.2. The persons concerned

The ACP's recommendation applies to persons that produce or market unit-linked life insurance policies in French territory. Accordingly, it applies to insurance companies, mutual insurance companies, mutuals or unions governed by the French mutual code, and provident institutions (the insurers) and insurance intermediaries, including those that operate under free provision of services or freedom of establishment, whenever these market such unit-linked policies in France.

3. On the obligations of insurers and insurance intermediaries in the marketing of the policies concerned

3.1. Reminder of the legal and regulatory provisions

Apart from the list of assets that can be used in unit-linked insurance provided above, the regulations cover three points: adequate protection of the savings invested and the guarantees established by the contract, the obligations in terms of information and the duty of advice.

- Guarantees established by the contract and adequate protection of savings invested

With regard to unit-linked policies, Article L. 131-1[5] of the French insurance code stipulates that "the sums insured shall be defined by contract" and that the transferable securities and assets used for unit-linked insurance must provide "adequate protection of the savings invested".

- Duty to inform

Under Article L. 132-5-2[6] the insurer must provide the subscriber with an information notice indicating the main provisions of the contract stipulated by order, particularly with regard to the guarantees expressed in units of account. Article A. 132-4 requires that the insurer provide the subscriber with an indication of the main characteristics of each unit of account selected.

Article L. 132-27[7] stipulates that the content of information relating to life insurance policies and capitalisation contracts must be "clear, accurate and not misleading". This provision, together with those relating to the insurer's duty of advice as described below, came into force on 1 July 2010.

Also, Article L. 132-28[8], which came into force on 1 January 2010, requires insurance intermediaries to draw up an agreement with the insurer or capitalisation body, setting forth the conditions in which:

- the intermediary must submit the advertising material and fact sheets to the insurer before they are circulated;
- the insurer must make the necessary information available to the intermediary.

5. Also Article R. 132-4, see also Article L. 223-2 of the mutual code.
6. Articles L 221-4, L 223-8, L. 223-28 and A 223-6 of the mutual code, L. 932-24-2 of the social security code.
7. "Article L. 132-27: All the information, including advertising communications, relating to a life insurance contract or capitalisation contract shall have clear, accurate and non misleading content. Advertising communications shall be clearly identified as such." (our underlining). See also Article L. 223-25-2 of the mutual code.
8. See also Article L. 116-5 of the mutual code.

Article R. 132-5-1 stipulates that, barring exceptions[9], this agreement must be in writing and must set forth the respective obligations of the insurer and of the insurance intermediaries.

- Duty of advice: assessment and warning of customers

Article L. 132-27-1[10] stipulates that in the case of a sale without any intermediary, the insurer must inquire into the customer/subscriber's financial knowledge and experience and his requirements and needs, and deliver advice, in particular taking this information into account, that is adapted to the complexity of the contract. If the customer/subscriber does not provide this information, the insurer must warn him before subscription to the contract. These provisions are set forth in Decree No. 2010-933 of 24 August 2010 (new Article R. 132-5-1-1 of the insurance code).

Article L. 520-1 extends the provisions of Article L. 132-27-1 to insurance intermediaries.

3.2. Obligations of insurers and insurance intermediaries

The following consequences should be drawn from the regulations outlined above:

- insurers must: choose securities and assets that provide adequate protection of the savings invested; provide the intermediaries that market the policies with the information needed to understand all the characteristics of the unit and of the contract offered; when insurers market the policies directly, they must ensure that their employees have all the necessary elements for providing customers/subscribers with the appropriate information and advice, deliver to the customer the said information and advice and, if the customer/subscriber does not provide sufficient information, deliver a warning;

- insurance intermediaries must provide their customers with the appropriate information and advice and, if the customer does not provide sufficient information, deliver a warning.

4. On the determination of objective criteria to assess the risk of mis-selling

The ACP, in keeping with the AMF position on the marketing of complex financial instruments, has established four criteria to determine whether the units offered within the life insurance policy may result in subscribers/policyholders misunderstanding the risks involved or even misunderstanding the product or policy. Also, as the insurance policy can be surrendered due to the customer/subscriber's death at any time, the risk of loss of capital should be assessed accordingly and not just as at the expiry date of the financial instrument, if it has one.

---

9. Article R. 132-5-2 provides for two exceptions to the obligation to draw up a written agreement: when the intermediary uses only the marketing material provided by the insurer, and, in the case of a so-called L.441 scheme, when the relations between the party to the contract and the subscriber make subscription to the policy mandatory.
10. Article L. 132-27-1: I - Prior to conclusion of an individual insurance contract with surrender values, a capitalisation contract, or before taking out a contract mentioned in Article L. 132-5-3 or Article L 441-1, the insurance or capitalisation undertaking specifies the requirements and needs expressed by the subscriber and the reasons explaining the advice provided on a given contract. These specifications, based in particular on the information supplied by the subscriber concerning their financial situation and investment objectives, are suited to the complexity of the insurance or capitalisation contract being proposed.
"For the application of the previous paragraph, the insurance or capitalisation undertaking takes account of the knowledge of the subscriber or policyholder and of their experience in financial matters".
"When the subscriber does not provide information specified in the first and second paragraphs , the insurance or capitalisation undertaking warns them prior to conclusion of the contract". A State council (Conseil d'État) decree establishes the terms and conditions of application for the first paragraph.
« II – The provisions of paragraph I do not apply to the insurer when conclusion of the contract or subscription results from presentation, proposal by or with the help of an intermediary mentioned in Article L. 511-1. (our underlining). See also Article L. 223-25-3 of the mutual code.

4.1. Risk of the customer/subscriber misunderstanding the risks

Criteria No. 1: poor presentation of the risks or potential losses

The risk of poor presentation is potentially high for unit-linked products whose performance is sensitive to extreme scenarios (sudden market fall, change in economic conditions, etc.), even when there is little probability that these will occur. This is particularly the case when these products are presented as combining capital protection and performance. The possibility of gains is presented as almost certain and the scenarios envisaged in the documentation sometimes reflect only the most favourable assumptions.

The customer/subscriber is likely to misunderstand the risk due to the presentation of a unit-linked product whose performance is sensitive to adverse extreme scenarios.

Example 1

Unit-linked product with a gain/loss profile such as "fixed gain of 10% regardless of the level of the index if it is up relative to its initial level and capital loss equal to the fall in the index if the index falls by more than 40%".

Criteria No. 2: Unusual nature of the financial instrument for the customer/subscriber due to the underlying(s) used.

Some financial instruments use underlyings that are hard for customers/subscribers to understand and which cannot generally be individually identified on the markets, such as the volatility of an asset or the correlation between various assets.

The products based on these underlyings therefore run the risk of being poorly understood by the customer/subscriber who, in the case of underlyings with limited public availability, are not in a position to monitor their movements.

Example 2

Unit-linked product whose performance is linked to the correlation over a given period between an oil company's shares and the level of a commodities index.
➢ The investor must, in this case, anticipate trends in the correlation between the share and the underlying index, which usually requires a high level of expertise.

Example 2 bis

Unit-linked product indexed to the VSTOXX index which exposes the customer/subscriber at term to a loss of 50% of the capital invested if the index falls by 50%.
➢ The underlying, the EURO STOXX 50 volatility index, is hard for the customer/subscriber to understand.

Criteria No. 3: gains or losses that depend on the simultaneous occurrence of several conditions across at least two different asset classes

Some unit-linked products offer returns linked to the simultaneous occurrence of several conditions across several asset classes (equities, fixed income products, real estate, etc.), making it difficult for the customer/subscriber to construct the market scenario that he should expect.

Example 3

A unit-linked product offering at terms the average performance of the CAC 40 index over a five-year period increased or decreased by an annual coupon linked to bond market trends:
(i) Each year, if the 10-year CMS rate exceeds the 2-year CMS rate by more than 55bp and the CAC 40 index records a gain, a coupon of 4% will be earned at term.
(ii) Each year, if the 10-year CMS rate exceeds the 2-year CMS rate by less than 20bp and the CAC 40 index is down, the end performance decreases by 1%.
➢ Two asset classes determine the unit-linked product's end performance: equities and fixed-income products. It is difficult, or even impossible, for the customer/subscriber to construct the macroeconomic market scenario he should expect.

4.2. Risk of unintelligibility of the unit-linked product

Criteria No. 4: multiple mechanisms incorporated into the formula used to compute gains or losses on the unit-linked product

Understanding the risk taken requires a good understanding of the product's calculation phases, the formula mechanism used and the type of underlying asset. When there are more than three different calculation mechanisms to determine the overall return on the product, directly or through a structured underlying index, it is difficult or even impossible for the customer/subscriber to assess the "bet" he is placing, i.e. to understand the mechanism that results in a gain or a loss according to a given market scenario
.

Example 4

Unit-linked product offering the following gain/loss profile at maturity:
(i) **The average quarterly performance** over 5 years of a strategy index that overweights the 20 stocks in the CAC 40 that performed best over the previous month and underweights the 20 worst-performing stocks.
(ii) If at a quarterly measurement date, the index has gained more than 10% relative to the previous quarter, a coupon or bonus of 6% is earned at maturity.
(iii) If at a quarterly measurement date, the index has fallen by more than 30% relative to its initial level, the product is wound up (or terminated early) and the customer/subscriber receives early repayment. His initial capital is thus reduced by the entire fall in the index and increased, if applicable, by the bonuses earned in the preceding quarters.
➢High risk of unintelligibility. Four different mechanisms are used to calculate the final return: an average effect, a strategy intrinsic to the underlying index, a bonus in the event of crossing an upward threshold and a loss in the case of crossing a downward threshold.

Indicative but not exhaustive list of strategies that could be considered formula mechanisms:

- underlying calculation algorithm of a proprietary strategy index;
- averaged performance;
- ceiling/floor effect;
- deactivation of a protection when a downward threshold is crossed;
- a "memory" effect;
- crystallisation of gains.

5. Recommendation

By their nature, unit-linked life insurance products run the risk that customers/subscribers may not properly understand the potential losses they might be exposed to, or even that the product is unintelligible.

In particular, unit-linked life insurance comprised of structured funds or complex debt securities that meet at least one of the criteria defined above carry a high risk of non-compliance with the legal and regulatory requirements relating to the marketing of such products. Given the characteristics of these financial instruments, the insurers and insurance intermediaries may not be in a position to comply with the requirements set forth above. For these financial instruments used as a support for unit-linked products and not providing at least 90% protection of the capital invested over the life of the instrument, the ACP recommends, in accordance with point 3 of paragraph II of Article L. 612-1 of the monetary and financial code, that insurers and insurance intermediaries:

5.1. With regard to financial instruments whose performance is sensitive to extreme scenarios:

5.1.1. provide intelligible information in all the marketing documents given to customers/subscribers so that they may be reasonably enabled to understand the nature of the underlying units and the associated risks, and in particular:

5.1.1.1. present the underlying unit as a risky investment and not as a product offering attractive returns that are virtually certain except in the case of extreme scenarios that are highly unlikely to occur;

5.1.1.2. clearly present the situations in which there is maximum risk without minimising the likelihood of occurrence;

5.1.1.3. present the maximum loss scenario in clear comparison with the maximum returns scenario;

5.1.1.4. inform the customer/subscriber in a comprehensible manner, prior to choosing the support, of the consequences on invested capital of early surrender, termination due to death before maturity of the financial instrument (if there is one), or at term if unfavourable or extreme scenarios materialise.

5.1.2. Describe in a comprehensible manner, in the document formalising the advice provided for in Article L. 132-27-1 of the insurance code/L. 223-25-3 of the mutual code, the information provided to the customer/subscriber.

5.1.3. Be in a position to prove to the ACP that they have taken the necessary measures for customers/subscribers to understand that the financial instrument being marketed is a risky investment and to be aware of the situations in which there is maximum risk and their consequences on the invested capital, in the event of early surrender, termination due to death before maturity of the financial instrument (if there is one), or at term if unfavourable or extreme scenarios materialise.

5.2. With regard to financial instruments whose underlyings are difficult to understand and which cannot be individually identified on the markets:

5.2.1. Describe, including in the marketing documentation, in a manner that can be understood by the customer/subscriber, the underlyings used by the financial instrument offered and the means of monitoring these underlyings;

5.2.2. Describe in a comprehensible manner, in the document formalising the advice provided for in Article L. 132-27-1 of the insurance code/L. 223-25-3 of the mutual code, the information provided to the customer/subscriber to enable him to apprehend and understand the underlyings used by the financial instrument serving as the support for the insurance policy and to provide himself with the necessary means of monitoring such underlyings;

5.2.3. Be in a position to prove to the ACP that they have taken the necessary measures for customers/subscribers to understand the underlyings used by the financial instrument serving as the support for the insurance policy and to provide themselves with the necessary means of monitoring such underlyings.

5.3. With regard to financial instruments whose gains or losses depend on the simultaneous occurrence of at least two conditions across different asset classes:

5.3.1. Describe, including in the marketing documentation, in a manner that can be understood by the customer/subscriber the gain/loss profile of the financial instrument whose performance is conditioned by the simultaneous occurrence of at least two conditions across different asset classes and the means available to the customer/subscriber for anticipating trends in these asset classes;

5.3.2. Describe in a comprehensible manner, in the document formalising the advice provided for in Article L. 132-27-1 of the insurance code/L. 223-25-3 of the mutual code, the information provided to the customer/subscriber to enable him to apprehend and understand the gain/loss profile of the financial instrument whose performance is conditioned by the simultaneous occurrence of at least two conditions across different asset classes and to provide himself with the means of anticipating trends in these asset classes;

5.3.3. Be in a position to prove to the ACP that they have taken the necessary measures for customers/subscribers to understand the gain/loss profile of the financial instrument whose performance is conditioned by the simultaneous occurrence of at least two conditions across different asset classes and that they have the means to anticipate trends in these asset classes.

5.4. With regard to financial instruments with more than three mechanisms incorporated into the formula used to compute gains or losses at maturity:

5.4.1. Describe, including in the marketing documentation, in a manner that can be understood by the customer/subscriber the mechanisms incorporated into the formula used to compute gains or losses at maturity according to a given market scenario;

5.4.2. Describe in a comprehensible manner, in the document formalising the advice provided for in Article L. 132-27-1 of the insurance code/L. 223-25-3 of the mutual code, the information provided to the customer/subscriber to enable him to apprehend and understand the mechanisms incorporated into the formula used to compute gains or losses at maturity according to a given market scenario;

5.4.3. Be in a position to prove to the ACP that they have taken the necessary measures for customers/subscribers to understand the mechanisms incorporated into the formula used to compute gains or losses at maturity according to a given market scenario.

5.5. For all these financial instruments, the ACP recommends that insurers and insurance intermediaries document proof, by any means appropriate to the type of clients, that investors understand the nature of the underlying instrument marketed in the unit-linked contract and its associated risks.

5.6. For all these financial instruments, customers/subscribers must be provided with information that is precise, clear and not misleading on the guarantees offered under the policy in the event of early redemption, whether because of the policyholder's death or partial or total surrender.

5.7. Lastly, insurers must be in a position to provide evidence in their internal control report of the means and procedures put in place to limit the risk of mis-selling.

This recommendation applies to all marketing acts after 31 December 2010.