

Recommendation of the *Autorité de Contrôle Prudentiel* concerning the marketing of unit-linked life insurance contracts, with debt securities issued by an entity that is financially linked to the insurance undertaking as underlying assets

2011-R-03 of 6 May 2011

(Non official translation)

1. Background

The *Autorité de Contrôle Prudentiel* (ACP) has noted an increase in the sales of unit-linked life insurance contracts with debt securities issued by an entity that is financially linked to the insurance undertaking as underlying assets.

Indeed, the same group may altogether be the producer of the insurance contract, the issuer of the debt security, the distributor of the contract and the entity setting the value of the security.

The ACP wishes to highlight two sources of potential conflicts of interest that must be managed in order to protect the interests of policyholders¹:

- **At the time the issuance interest rate is set**

Debt securities are often offered by the insurance undertaking before they are issued, through the selection of an interim investment unit; an arbitrage to the target investment unit is carried out once the security has been issued. Depending on the reference value used to determine the number of selected investment units², the choice of the issuance interest rate can result in a loss of value that is detrimental to the interests of policyholders.

- **In the event that the contract is surrendered, arbitrated, or terminated before the underlying security reaches maturity**

In most cases, the issuer will either repurchase its own securities, or the life insurance subsidiary will reinvest them in general assets.

However, the number of transactions effected on the markets to which the securities are admitted is not always sufficiently large to set an objective market value for the securities. This is particularly the case for securities that are offered exclusively to customers of the group. Therefore, the value of the selected

1. For the purposes of this recommendation, this term includes not only policyholders (subscribers and members) but also potential policyholders (at the pre-contractual stage), who are natural persons.
2. The provisions of the life insurance contract are a decisive factor in determining the value of the units.

investment units should be determined objectively and disclosed to the policyholders, throughout the entire lifetime of the contract.

Under these circumstances, the ACP has decided to recommend sound practices for managing conflicts of interest when policyholders are offered investment units consisting of bonds or other debt securities of an issuer that is financially linked to the insurance undertaking.

2. Scope

2.1. Investment units concerned

This Recommendation shall apply to investment units consisting of bonds and other debt securities listed in paragraphs 2^o and 2^o ter of section A of Article R.332-2 of the Insurance Code³. This set of securities is collectively referred to as “debt securities” in the remaining of this document.

2.2. Parties concerned

This Recommendation shall apply to insurance undertakings governed by the Insurance Code, to mutual institutions and unions governed by the Mutual Insurance Code, to provident institutions governed by the Social Security Code (these three categories are hereunder collectively referred to as “insurance undertakings”), and to insurance intermediaries. The recommendation shall apply to undertakings and intermediaries operating in France in accordance with the principles of freedom to provide services and freedom of establishment, when they offer unit-linked contracts in the French territory.

3. Obligations of insurance undertakings and intermediaries

Insurance undertakings and intermediaries are subject to legal obligations relating to the protection of the invested savings, information and advice duties.

3.1. Sufficient protection for the invested savings

Regarding unit-linked contracts, Article L.131-1⁴ provides that the underlying assets and securities of the investment unit shall offer “sufficient protection for the invested savings”, and that they must appear on the list of Article R.131-1⁵.

3.2. Information requirements

Article L.132-27⁶ provides that the information relating to life insurance contracts and capitalisation contracts shall be “accurate, clear, and not misleading”.

Articles L.132-28⁷ and R.132-5-1 require insurance intermediaries to enter into a written agreement with the insurance or capitalisation undertakings. The respective obligations of undertakings and intermediaries shall be specified in this agreement, as well as the circumstances under which:

- the intermediary is to submit advertising documents to the insurance or capitalisation undertaking prior to their distribution;

3. All of the following references are to articles in the Insurance Code, unless otherwise indicated.

4. See also Article R.132-4. See also Article L.223-2 of the Mutual Insurance Code.

5. See also Articles R.223-1 to R.223-4 of the Mutual Insurance Code. For provident institutions, see also Article L.932-23 of the Social Security Code, which refers to the provisions of the Insurance Code.

6. See also Article L.223-25-2 of the Mutual Insurance Code.

7. See also Article L.116-5 of the Mutual Insurance Code.

- the insurance or capitalisation undertaking is to provide the intermediary with all information necessary to understand the characteristics of the contract.

3.3. Obligation to advise

Article L.132-27-1⁸ provides that, when a life insurance contract⁹ is marketed without an intermediary, the insurance or capitalisation undertaking should inquire into the policyholder's understanding and experience in financial matters and into his requirements and needs. An advice suited to the complexity of the contract shall be provided, taking into specific consideration this information. If the policyholder does not provide this information, the insurer should warn him before the contract is entered into.

Article L.520-1 imposes the same obligation on insurance intermediaries.

4. Recommendation

When a debt security that is part of an investment unit has been issued by an entity that is financially linked to the insurance undertaking, the ACP hereby recommends, in accordance with paragraph 3° of section II of Article L.612-1 and paragraph 2 of Article L.612-29-1 of the Monetary and Financial Code, that insurance undertakings and intermediaries take such steps as may be necessary to protect the interests of policyholders, including:

- 4.1. For debt securities where pay-outs are expressed as a function of an interest rate applied to the nominal amount: asking an independent body to provide an objective assessment of the interest rate that might be offered in the primary market at the date the terms of the issuance are set.
- 4.2. For the securities listed in paragraph 2° of section A of Article R.332-2 of the Insurance Code, resorting to:
 - either debt securities, which are part of a public offering of financial securities, and which are partly distributed by entities that are not financially linked to the issuer or to the insurance undertaking, on their own behalf or on the behalf of third parties, and whose realisation value can be determined on a recognised market;
 - or debt securities for which the relevance of realisation value can be assessed by comparing it with a valuation based on the nominal value of the security and taking into account interest rate risk and counterparty credit risk, but not liquidity risk. This valuation, which should be disclosed to policyholders at regular intervals – no less frequently than every two weeks – may be carried out:
 - by an independent entity,
 - or by applying a valuation framework¹⁰ adopted prior to the issuance of the debts securities in question, based on their specific characteristics. The valuation framework, as well as any changes made subsequent to the issuance, should be approved by an independent entity.

The independence of the entities asked to provide the assessments and valuations mentioned above, or to approve the valuation framework used, should be assessed both in financial terms (absence of financial links to the insurance undertaking or the issuer) and in technical terms (possession of the resources and skills needed to provide an objective valuation of the securities).

8. And also Article R.132-5-1-1. See also Article L.223-25-3 of the Mutual Insurance Code.

9. More precisely, this applies to individual life insurance contracts that have a surrender value, to the contracts mentioned in Articles L.132-5-3 and L.441-1 of the Insurance Code, and to capitalisation contracts.

10. This framework includes the methodology and the data used in the valuation process.

- 4.3. Mentioning, in an appropriate document given to the policyholder prior to the selection of the investment unit concerned, that in the event that the contract is surrendered, arbitrated or terminated before maturity, the issuer or an entity financially linked to the issuer can decide to purchase the debt security. This disclosure should include prominently the words “potential conflicts of interest concerning the surrender or realisation value”.
- 4.4. Obtaining the resources and establishing the procedures necessary to ensure proper internal control of compliance, by the insurance undertaking or intermediary, with its information and advice obligations in accordance with paragraphs 4.1, 4.2 and 4.3 above. These resources and procedures should ensure that the valuation framework used is monitored, covered by permanent control, and periodically reviewed in order to assess its objectivity and reliability and to correct any deficiencies that may be identified.

This Recommendation shall apply to unit-linked life insurance contracts marketed after 31 July 2011.