

Insurance Europe opposes the phase-out of profit-sharing reserve schemes under Solvency II

Introduction

As per recital 50 of the Directive, it is common practice in some Member States for insurance companies to offer life insurance products where policyholders and beneficiaries participate in the investment return generated by the insurance company. This practice goes back on well-established and recognised profit sharing schemes in these member states, in which policyholders are promised a guaranteed benefit plus a share in any surplus that may arise.

As part of the ongoing Solvency II review, the political party S&D proposed an amendment¹ on the recognition of the profit-sharing reserve schemes as part of the insurance prudential framework. According to the proposal, the Commission would analyse and publish a report on the use of those schemes and their risks in terms of financial stability and policyholder protection. Moreover, based on this report, the Commission shall adopt a legislative proposal to phase-out these schemes over a defined transitional period.

In the context of the prudential framework, the capital intended to be distributed to policyholders is explicitly recognized by Solvency II by the mean of surplus funds. Surplus funds are introduced in the Solvency II Directive under recitals 50-51 and Article 91 (Directive 138/2009/EC) and are defined as the accumulated profits which arise as part of participating life insurance products and have not been made available for distribution to policyholders and beneficiaries. Those reserves should be valued in line with the economic approach² of the Solvency II framework and shall not be treated as liabilities to the extent that they fulfil the Tier 1 classification criteria, as these are set out in Article 94(1).

A decision to phase-out and, thereby, a ban of profit-sharing schemes would impact the economy, the policyholders, and the insurance companies. First of all because those profit-sharing schemes are at the very core of the steering of a life insurance company and participate actively in ensuring a sound risk management. Such a ban will also reduce the insurance companies' investment power and, lower capital capacity and thereby result in lower expected return on policyholders' pension savings. Furthermore, there has been no evidence that policyholders' interests are at risk, while EIOPA and NSAs have not expressed any concerns on consumer protection as part of those schemes. A phasing out of profit-sharing reserve schemes could reduce insurers' risk-taking capacity and limit their capacity to operate, and for some mutual undertakings, e.g. in Sweden, to a severe extent. Moreover, such a ban will affect insurance companies' ability to offer attractive insurance policies. Thus, there will be fewer and less variety of insurance policies, which will be negative for the policyholders. Considering the above, Insurance Europe opposes amendment 795 that was put forward by S&D requesting the phasing out of profit-sharing reserve schemes.

What is the background of participating insurance schemes

Participating policies are offered by life insurance companies and provide both guaranteed and non-guaranteed elements by allowing the policyholder to participate in the profits of the undertaking.

¹Proposal for a Directive of the European Parliament and of the Council amending Directive 2009/138/EC-Amendment 795

²Recital 51 of Directive 2009/138/EC

The key features of a participating insurance scheme are:

- The key aspect is that the benefit (and the respective premium) is guaranteed at the beginning of the contract which often matures many years or even decades later. This ensures the policyholder a certain amount of return which they may rely on.
- However, since the guarantees are provided over a long term, it is necessary to determine them prudently so that they can be fulfilled in the long run. In some member states, e.g. Germany, this is even required by law.
- This prudent requirement results in surpluses in which policyholders participate. This participation is often prescribed in the insurance contracts or in national law.
- Thus, this system of profit participation allows the policyholder to benefit from additional returns, above the contractual long-term guarantee provided as part of the life insurance policy.
- Even in times of very low or even negative interest rates profit sharing schemes made/make it possible to grant appropriate total returns to life insurance policyholders.

Why are there reserves for profit participation?

- Profit participation of a business year can either take place directly in the form of an immediate payout, or in an increase in future benefits, in which case the profits are firstly allocated to a collective reserve and later allocated to the individual policyholders.
- This collective reserve for the profit participation from previous years must be distributed in the upcoming years, sometimes over a finite horizon fixed by law.
- This collective reserve is essential in the steering of a life insurance company, as it allows to maintain an attractive amount of return to the policyholders even in stressed economic environments.
- Since policyholders share the insurance companies' result, the collective reserve may be used to fund the guaranteed benefits and, in some situations and under specified conditions, that reserve can also be used to cover losses.
- Without this smoothing, the total return would show high annual fluctuations and the insurance companies would no longer be able to make any statements about the total return expected in the future. This makes it much more difficult for the customer to choose the product, especially as regards the important aspect of the return. As long as the surplus-funding is part of the own funds, insurance companies are motivated to create and use them. If, on the other hand, the surplus-funding is no longer part of the own funds, interest rate volatility occurs.
- Therefore, the reserve, or part of it, evaluated under an economic approach and defined by the regulation, can qualify as a surplus fund, and thus as eligible own funds to cover the Solvency Capital Requirement (SCR).
- Thus, this system leads to a participation of policyholders in the risk-bearing of a life insurance company.

Why are these schemes advantageous for policyholders and the economy, and therefore should not be banned?

- Policyholders benefit from these schemes by having an indirect access to the returns of a diversified investment portfolio without having to actively manage it themselves. It is a packaged option offering the guaranteed benefit of a life product and the features of an investment product. There has been no evidence indicating that policyholders of participating policies are less protected or are in a disadvantaged position compared to holders of other products.
- Moreover, profit sharing schemes contribute to the growth of the European economy by strengthening equity investments. Companies with profit sharing schemes have more investment power which allows them to invest in riskier asset classes, such as equities, in search of higher returns. This characteristic of participating policies serves one of the main objectives of the Capital Market Union, which is to incentivize institutional investors, and particularly insurers, to make more long-term investments and increase their equity holdings. If a ban was put forward, the EU financial stability could be at stake due to the volatility that would be created from insurers removing their equity investments from their portfolios in favour of less risky assets, such as government bonds.
- Additionally, the formation of collective reserve is clearly more advantageous for policyholders than equity capital. In case of a ban profit sharing schemes and/or their qualification as elements of the own funds as surplus fund, the additional capital to be provided by the financial markets would increase the

costs that policyholders have to bear for these products. In particular, for mutual undertakings operating, the prudential treatment of profit-sharing schemes as surplus funds, as foreseen by Solvency II, still constitutes a proper, risk-based and legitimate alternative to equity capital and, for e.g. Swedish mutual undertakings, cannot be replaced with equity capital.

- These mechanisms increase the own funds of the undertaking and thus its capacity to cover certain underwriting risks and to invest in assets, eg equities, with a higher expected return. This higher return will be to the benefit of the policyholders participating in the result providing them the possibility of an increased pay-out and the flexibility of regular payments as per their needs and requirements.
- Profit sharing has been a long-standing feature of many life insurance markets and has not been questioned by EIOPA or national supervisors so far. EIOPA did not propose any amendments on the prudential treatment of surplus funds as part of its Opinion on the 2020 review of Solvency II and has not expressed any concerns in terms of the impact of these schemes on financial stability and policyholder protection. Therefore, the proposal of a phasing-out of profit-sharing schemes is deemed unnecessary.

Insurance Europe is the European insurance and reinsurance federation. Through its 36 member bodies — the national insurance associations — it represents all types and sizes of insurance and reinsurance undertakings. Insurance Europe, which is based in Brussels, represents undertakings that account for around 95% of total European premium income. Insurance makes a major contribution to Europe's economic growth and development. European insurers pay out over €1 000bn annually — or €2.8bn a day — in claims, directly employ more than 920 000 people and invest over €10.6trn in the economy.