15 July 2021

Communication from the KNF Board on the issuance of a decision concerning imposition of prohibitions on the marketing, distribution and sale of insurance-based investment products – unit-linked life insurance contracts (product intervention measure)

Pursuant to Regulation (EU) No 1286/2014[1], Komisja Nadzoru Finansowego (KNF Board) issued on 15 July 2021 a decision imposing prohibitions on the marketing, distribution and sale of insurance-based investment products – unit-linked life insurance contracts (hereinafter also: 'unit-linked insurance contracts') which meet at least one of the following two criteria:

- the average return is less than 50% of the interest rate for the period specified in the decision according to the relevant risk-free interest rate term structure (hereinafter: 'criterion 1'),
  or
- the investment rules and restrictions defined in the regulations of the unit-linked fund fail to ensure that the assets of the unit-linked fund will not be invested in contingent convertible instruments[2] (hereinafter: 'criterion 2').

The decision applies to unit-linked insurance contracts concluded as of 1 January 2022, subject to the proviso that:

- the decision does not apply to Employee Capital Plans[3], Occupational Pension Schemes[4], Individual Retirement Protection Accounts[5], Individual Pension Accounts[6],

[1] Regulation (EU) No 1286/2014 of the European Parliament and of the Council of 26 November 2014 on key information documents for packaged retail and insurance-based investment products (PRIIPs) (OJ L 352 of 9.12.2014, p. 1, as amended).
[2] Contingent convertibles are capital notes, subordinated loans and/or other instruments and contracts under which in the case of occurrence of a trigger event defined in the terms of issue or contract, the issuer or debtor cancels the instruments/contracts, by way of an impairment loss or a temporary write-down of the nominal value of the instrument or liability in whole or in part, or converts the instruments/contracts into shares, or cancels the interest, in whole or in part, for the relevant interest period or suspends the interest payments for an indefinite period, if such capital notes, subordinated loans, instruments are issued, or such contracts are concluded, by the debtor to qualify them, or if they have been qualified, as regulatory capital of banks and brokerage houses, or as own funds of insurance undertakings or reinsurance undertakings.
[3] Defined by the Act of 4 October 2018 on employee capital plans (consolidated text: Journal of Laws 2020 item 1342, as amended).
[4] Defined by the Act of 20 April 2004 on occupational pension schemes (consolidated text: Journal of Laws 2020 item 686, as amended).
[5] Defined by the Act of 20 April 2004 on individual pension accounts and individual retirement protection accounts (consolidated text: Journal of Laws 2019 item 1808, as amended).
[6] Defined by the Act of 20 April 2004 on individual pension accounts and individual retirement protection accounts (consolidated text: Journal of Laws 2019 item 1808, as amended).

- the prohibition concerning contingent convertibles does not apply to life insurance contracts if they are related to a unit-linked fund established before 1 January 2022, and the method of investing the assets of the fund ensures that the assets are not invested in contingent convertibles,
- within the meaning of the decision, the insured party's act of joining a collective unit-linked life insurance contract concluded before 1 January 2022 must not be understood as conclusion of a new contract of insurance,
- individual continuation of collective unit-linked life insurance contracts does not fall within the substantive scope of the decision.

The decision applies to all domestic and foreign entities – insurance product manufacturers – that offer insurance-based investment products with a unit-linked fund, i.e. unit-linked insurance contracts, to customers in the territory of Poland. However, insurance product manufacturers established in Poland are also required to comply with the decision when offering unit-linked insurance contracts to customers outside Poland.

The intervention measure in question aims at raising the level of protection for customers by:

- increasing the benefits gained by customers under unit-linked insurance contracts through increased return on the investment component resulting from a reduction in the fees and other costs deducted from the assets entrusted to the insurance undertaking for management within a unit-linked fund,
- reducing the risk that customers entering into unit-linked insurance contracts might be potentially exposed to excessive investment risk, including liquidity risk, arising from the investment of assets of the unit-linked fund in contingent convertibles.

Criterion 1 is designed to prevent the low value of unit-linked insurance contracts for customers in Poland, as seen by the UKNF (Polish Financial Supervision Authority), in particular due to low or negative level of the effective rate of return achieved for customers and to high level of fees charged under such contracts. Those factors disrupt the balance between the value of the product for customers and the margin generated by insurance undertakings. Such imbalance can be seen in other countries too but the scale of the phenomenon of low value generated for customers in the Polish market is greater than in other European countries in which unit-linked insurance contracts are offered, as pointed out by EIOPA in its opinion on the intervention measure.

Criterion 2 aims at preventing the exposure of customers acquiring unit-linked insurance contracts to excessive investment risk, including liquidity risk, arising from the possibility of investing the assets of unit-linked funds into contingent convertibles. Placing assets in contingent convertibles requires the investor to accept a very high level of investment risk associated with the embedded loss absorption mechanism and risk arising from incorrect valuation of those instruments. The KNF Board has concluded that in view of the proposed amendment to the Polish laws aiming at removing legal barriers related to the issuance of contingent convertibles by KNF-supervised entities, there is a legitimate fear that those instruments will also be used to invest assets of unit-linked funds to a much greater extent than before. By imposing the prohibition, the KNF Board considered the warnings from the Joint

Committee of European Supervisory Authorities in its reminder of 31 July 2014[7] and from the European Securities and Markets Authority (ESMA) in a statement, made on the same day,[8] on investing in contingent convertible instruments.

Under the Regulation on PRIIPs, the KNF Board was required to carry out consultations and to notify competent supervisory authorities in other EU Member States and the European Insurance and Occupational Pensions Authority (EIOPA) about the planned intervention measure. On 31 March 2021, EIOPA published on its website an opinion on the proposed product intervention measure[9]. In view of that opinion, the KNF Board adapted the scope of the decision accordingly, by limiting it in relation to the original version reviewed by EIOPA.

The objectives of the intervention measure were also discussed with the Polish Insurance Association and insurance undertakings offering insurance products specified in Division I Class 3 of the Annex to the Act of 11 September 2015 on the business of insurance and reinsurance (Journal of Laws 2021 item 1130), hereinafter: 'Act on the business of insurance'.

The assessment of fulfilment of the criteria of the intervention measure will be part of the ongoing supervisory activities. Nevertheless, insurance undertakings are expected to assess the unit-linked products they market, distribute or sell for compliance with the said decision of the KNF Board. Such assessment should be done through a test of compliance with the decision (compliance test), performed as part of the product oversight and governance process.

Considering the need to enhance customer protection in the area of unit-linked insurance contracts also in other aspects, not addressed in the decision, the UKNF is planning to:

- submit to the Ministry of Finance a proposal for legislative amendments aiming at introducing, pursuant to Article 133(3) of the Solvency II Directive, provisions of law to regulate investment activity involving the assets of unit-linked funds in a comprehensive manner,
- formulate an official position on the inclusion of costs and fees in a unit-linked insurance contract, to be addressed to insurance undertakings carrying on the business of insurance specified in Division I Class 3 of the Annex to the Act on the business of insurance. The adaptation of practices of insurance undertakings to the said position will be reviewed in the course of on-site and off-site supervisory activities.

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[7] Reference: JC 2014 62, https://www.esma.europa.eu/sites/default/files/library/2015/11/jc_2014-62_placement_of_financial_instruments_with_depositors_retail_investors_and_policy_holders_self_placement.pdf

[8] Reference: ESMA/2014/944, https://www.esma.europa.eu/sites/default/files/library/2015/11/2014-944_statement_on_potential_risks_associated_with_investing_in_contingent_convertible_instruments.pdf

[9] https://www.eiopa.europa.eu/content/opinion-of-european-insurance-and-occupational-pensions-authority-proposed-product_en