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Unit-Linked Products on the Rise

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All across Europe, unit-linked life and annuity insurance and pension products (also known as variable insurance products) are rapidly increasing in popularity. This article highlights the current market position of unit-linked in Europe, examines some of the reasons for the recent increase in popularity, provides a comparison with traditional (with-profit) products from a company perspective, as well as an outlook and possible market opportunities for insurance companies looking to expand into the European markets.

Market Overview

Figure 1 illustrates the current market position of unit-linked business in Europe, using 1998 market statistics. While traditionally strong unit-linked markets like the UK and Sweden continue to lead the way

with market shares exceeding 50% of new business, other markets are rapidly closing in. The Netherlands (43%), Poland (about 30%) and France (26%) have all seen dramatic increases of unit linked new business market shares in the last four years.

In many other markets including Italy, Spain, Germany and Belgium, unit-linked business has recently exceeded 15-20% of new business market share for the first time. Even in markets where unit linked business is still below the 10% threshold (e.g., Austria, Switzerland and Portugal), its share of new business has been increasing lately.

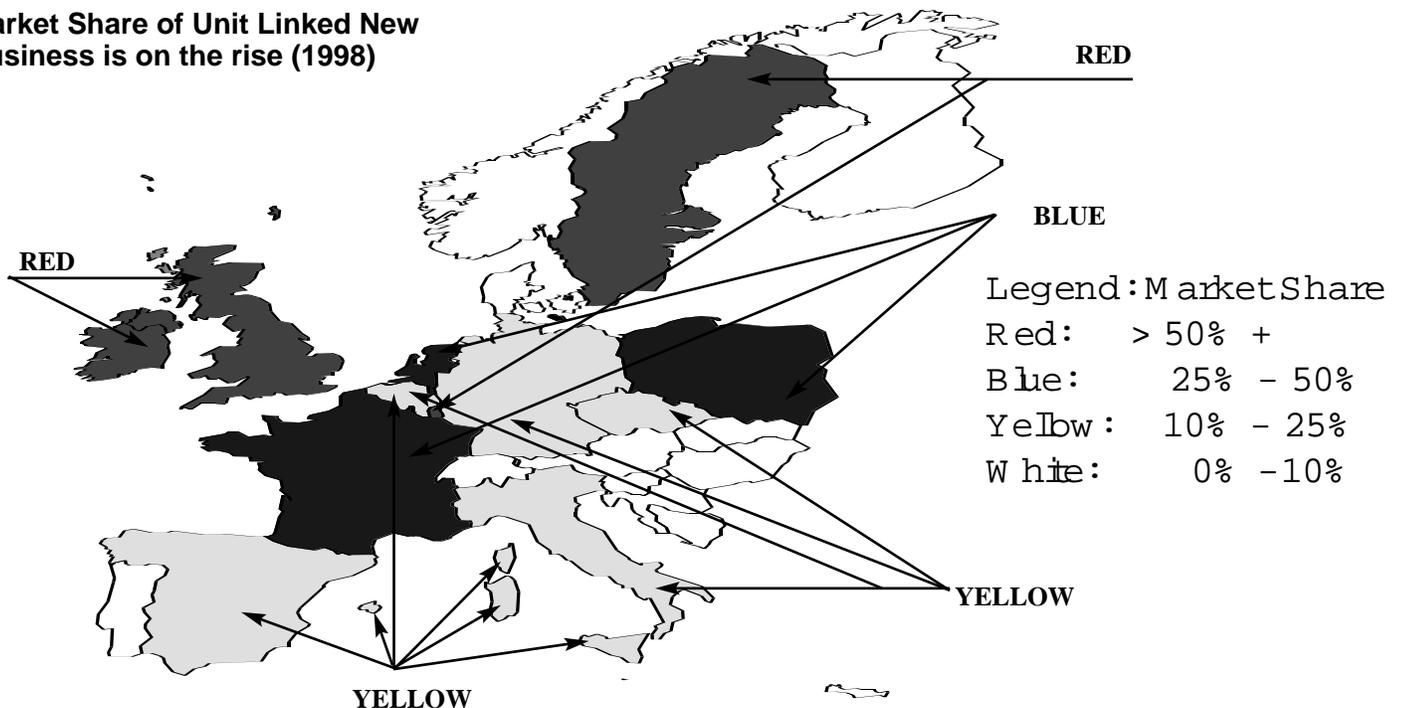
Forces of Change

A number of factors have contributed to the broad recent success of unit-linked products across Europe:

- The deregulation of life markets in Europe since 1994, allowing increased flexibility of new products and a constant influx of new and innovative ideas from cross-border providers
- A general decline in market interest rates, coupled with attractive returns provided by equity investments
- An increasingly positive attitude of individual investors and distributors towards investing in equities, supported by attractive market returns, a range of privatizations and IPOs and a broader availability and awareness of equity markets across Europe
- The introduction of the Euro, eliminating currency barriers and forcing market conversion of interest rates to the lower level of the market

Figure 1: Current Market Position

Market Share of Unit Linked New Business is on the rise (1998)



leaders France and Germany across Europe

- The growing sales success of IFAs (independent financial advisers) in Continental Europe
- The global entrance of investment fund companies into the unit-linked area
- Competition from banks and growth of bank insurance sales in many markets, increasingly forcing product providers to offer unbundled products like unit-linked
- The introduction of unit-linked deferred annuities, providing the option to annuitize at the end of the deferral period
- Demand for increasing product transparency
- Intense competition on traditional life products providing long-term interest guarantees and relatively high policyholder dividends in a low-interest environment
- Growth in the number of software firms providing administrative systems or third-party administration services for unit-linked products.

Unit-linked vs. With-Profit Products

In the low interest rate environment that has existed in Continental Europe in the past four years, insurance companies increasingly see unit-linked products as the solution to the “interest rate dilemma” of providing long-term interest guarantees plus competitive bonuses on traditional with-profit products. In many cases, this has led to a shift of product development, sales, and marketing efforts towards unit-linked products.

The proliferation of innovative unit-linked products has also been propelled by the growing willingness of insurance buyers to accept investment risk in return for a higher anticipated investment return, even

in hitherto risk on average markets like Germany, Italy, the Netherlands and Spain.

At the same time, the growing sales success of IFAs and bank outlets, especially among the younger sales representatives and their propensity to sell mutual fund-type products, has also led to an increasing demand for unit-linked products from the distribution side. At a time when most Continental European insurance markets are reducing guaranteed interest rates and interest bonuses on traditional with-profit products, attractive equity returns on unit-linked products have provided a welcome product alternative in sales discussions with potential life insurance buyers.

Moreover, companies have recognized that unit-linked products, if designed appropriately, can also provide attractive profitability levels, due to:

- An earlier break-even on the initial surplus strain, given the typical front-end loading structure of unit linked products
- An increasing participation in investment management fees at the fund level

The latter issue has led to an increasing attractiveness of sales illustrations for potential buyers at given fund returns (e.g., 3%, 6%, 9% or 12% p.a.), as companies have lowered the level of charges at the product level for benefits and expenses to a break-even return of costs incurred, and a shift of the target profit margin to a spread on the assets under management, based on the participation in investment management fees. Such competitive comparisons are typically used as the basis for deciding on any particular policy by consumers in the various countries, in addition to the range of funds offered and their historical returns.

All this will not lead to a disappearance of traditional life products, however. In all European markets, traditional products will continue to retain a significant market share of new business, for various reasons:

- The strength of tied agent sales forces, who have generally been more reluctant to sell unit-linked products

- The attractiveness of long-term interest guarantees to many potential insurance buyers
- The ongoing subsidization of current policyholder dividend scales on traditional products with a realization of capital gains on the existing asset portfolio, particularly in markets with conservative valuation standards like Germany and Switzerland
- The risk aversion of many insurance buyers in Europe

Based on market estimates from the major life markets in Europe, we estimate that the new business market share of unit-linked has increased from 15% in 1993 to approximately 33% in 1998. We expect this market share to grow further to 50% of new life insurance premiums within the next five years (see Figure 2 on page 16).

Market Outlook and Opportunities

In our opinion, unit-linked products will continue their success story in the next few years, for various reasons:

- Product flexibility and transparency
- An increasing market globalization
- A lack of attractive product alternatives
- The low interest rate environment is expected to continue
- A decline in state-provided retirement benefits
- An increasing attractiveness of defined contribution (DC) plans
- Favorable demographics
- An increasing wealth transfer market

Key success factors for those companies interested in positioning themselves in the unit-linked markets across Europe include:

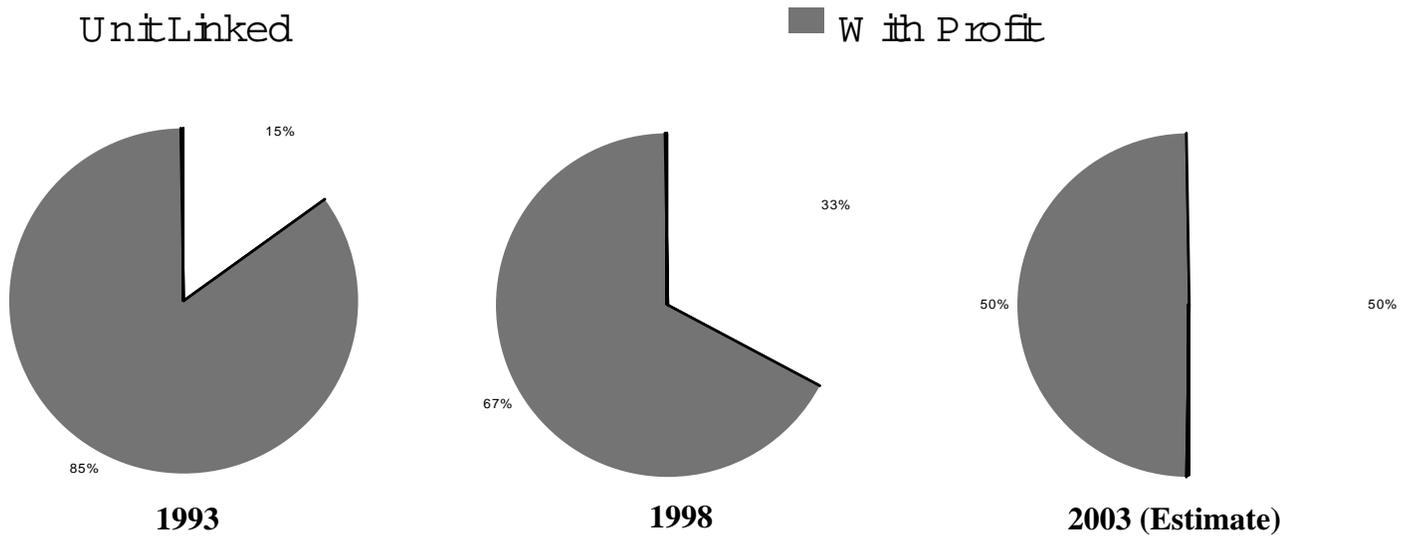
- The attractiveness of investment funds and their historical returns vs. their peers, and the availability of comparative statistics

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Figure 2: Unit-Linked vs. With-Profit Products

A bigger slice of the market in Europe



- The flexibility of product providers and administration systems to accommodate an ever-increasing appetite of distributors and consumers for innovative product features (“bells and whistles”)
- A focus on unit-linked products as an equal substitute for traditional life sales
- The use of cross-border synergies for those companies active in more than one EU market
- Access to local distribution channels, especially IFAs and banks
- The introduction of guarantee features on unit-linked products, designed to attract those insurance buyers who are

unwilling to accept the participation in equity market returns without a “safety net”

To address the last issue, North American insurance companies may want to leverage the knowledge and techniques used to develop some of the guarantees which have recently been introduced on variable products in the United States to the European marketplace.

Guarantees available on variable products in the U.S. and not widely available in Europe include:

- An enhanced guaranteed minimum death benefit (GMDB) on deferred annuities, providing a return of premiums plus accumulation of interest, and/or periodic resetting based upon account values

- A guaranteed minimum accumulation benefit (GMAB) on deferred annuities, providing a minimum account value at the end of the deferral period or after a specified period of 10 or 15 years
- A guaranteed minimum income benefit (GMIB), providing a minimum monthly payment during the payout phase on annuities while policyholder assets remain invested in funds
- A no-lapse guarantee (NLG) on life products.

Most of these guarantees could also be introduced on European unit-linked products, although there are regulatory restrictions in some countries. Finding

an appropriate (asset-based) charge for these additional guarantee features could be accomplished by using stochastic pricing methods and/or capital market methodology.

For any company contemplating expansion into one or more of the European insurance markets, the most promising markets for a potential entry in the unit linked area currently include, in our opinion:

- Belgium
- Germany
- Italy
- Poland

In particular, Poland, following the

privatization of their retirement system in 1999, has seen the recent market entry of several large U.S. insurance companies, including the Prudential, Metropolitan Life and Nationwide.

However, companies need to be aware of local tax and regulatory developments to avoid major problems and pitfalls. In addition, finding appropriate distribution channels is key to success. For those companies willing to take the plunge into another market, opportunities are plentiful. In particular, given the increasing demand for private retirement provision, we expect that the market share of unit-linked annuity products will continue to

increase significantly over the next few years.

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