Wolfgang Staudinger
Christian Prantner

SALES COMMISSION VERSUS FEE-BASED ADVICE IN DISTRIBUTION OF LIFE INSURANCE TARIFFS

Short version - Summary in English (Februrary 2024)

Wolfgang Staudinger
(CEO fynup GmbH,
www.fynup.at)

Christian Prantner
(Federal Chamber of Labor Vienna,
christian.prantner@akwien.at)

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SHORT VERSION – SUMMARY IN ENGLISH (FEBRUARY 2024)

A fynup study commissioned by the AK (Chamber of Labour) essentially pursues three objectives in order to analyse the costs underlying endowment life insurance policies (classic life insurance and unit-linked life insurance). This question is important **since the costs of a life insurance contract - acquisition costs, administrative costs and other unit costs - are substantially high and consumers** are **frequently uninformed or unaware of** them.

In essence, the question was how the payout on maturity (capital benefit in the case of survival or at the end of the savings phase) and early termination (realisation of the surrender value or deposit value in the case of unit-linked life insurance policies) develop if the following assumptions and scenarios relating to the acquisition costs – essentially the sales commission for insurance brokerage - are applied as the basis for the calculations.

This question of acquisition costs is of such importance because they account for a considerable proportion of a life insurance contract, especially in the initial phase. And this in turn means that the commission "invisibly" included in the insurance premium (acquisition commission and portfolio-based commission) – especially in the initial phase of the contract or in the first 5 years of the term – "eat up" a substantial portion of the premium (the cost portion of the premium) so that only a relatively small portion is really invested (in the cover pool, in an investment fund) (the savings portion of the premium). The fynup calculations are based on the following **assumptions**:

- **Variant 1:** Commission-free policy (the life insurance tariff is not based on any commission payment but on a fee paid by the insurance customer at the start of the contract): This variant is based on the assumption that the tariff is not based on an acquisition commission or a portfolio commission.
- **Variant 2:** Distribution of the brokerage (sales) commission (acquisition costs) over the whole term of a life insurance contract
- **Variant 3:** Distribution of the brokerage (sales) commission (acquisition costs) over the first 5 years of the term of a life insurance contract

This means that variants 2 and 3 are based on the commission system, but the distribution of costs over the term differs.

These three variants have been calculated with two different terms: a) 20 years (EUR 312 premium payment per month and EUR 36,400 single premium) and b) 35 years (EUR 104 per month). There was a further variation in which the above-mentioned model assumptions were calculated with and without indexation of the premium.

The fee models have been presented on the basis of two assumptions: a) expense-based fee assumptions (a. EUR 350 and b. EUR 1000 one-off plus an annual fee of EUR 49) were compared with the asset (status)-dependent fee models.

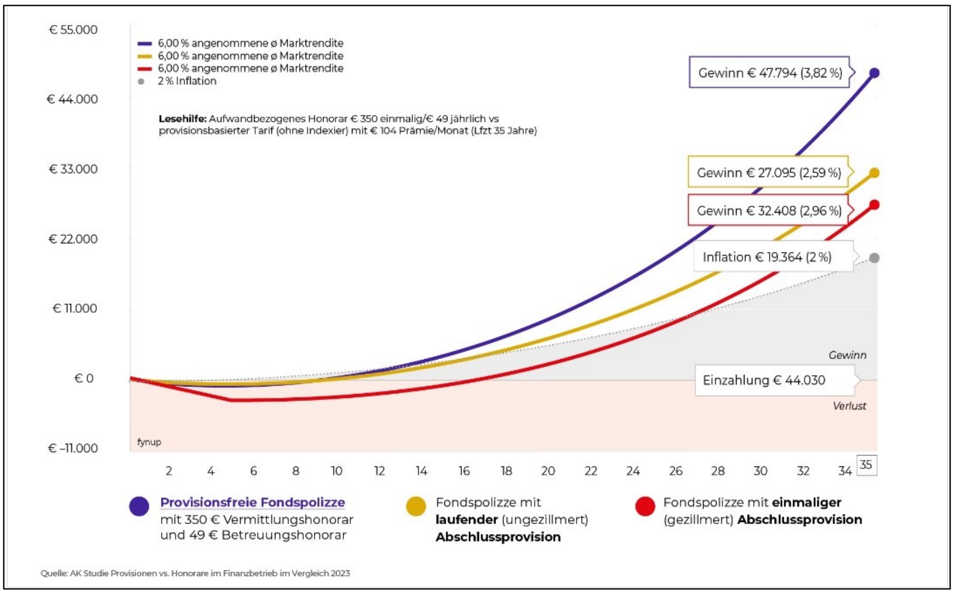
Key findings

The calculations show that in all model assumptions, expense-based fee-based advice (assumption: a. EUR 350 one-off and b. EUR 1,000 one-off plus ongoing annual fee) produces non-cash benefits when considering maturity benefits and surrender values. The model assumptions also show that the tariff which spreads the acquisition costs over the entire term frequently results in a higher maturity benefit than the tariff that spreads the costs over the first 5 years of the term. The current statutory regulation - distribution of the acquisition costs over the first 5 years - results in considerable disadvantages for all policyholders. **This statement also has an economic dimension because there are many existing capital-forming life insurance contracts and**, according to year-on-year statistics from the Austrian Insurance Association (VVO), **approximately 220,000 new contracts** will be concluded in 2022 **(policy-based new business)** - based mainly on the commission system.

However, practice shows that there are various fee-based advisory models. The asset-dependent, fee-based advisory models - where the fee is calculated as a percentage of the current securities or portfolio value - do not show any earnings or cost advantages as compared to commission-based tariffs according to the model assumptions included in this study.

The **following graphic illustrates** the cost advantages of fee-based advice compared to commission-based tariffs:

Much higher returns on advice-based insurance tariff than on commission-based tariffs!



Source: Study, page 12

The blue line represents the maturity benefit (capital at the end of the term) of a **fee-based tariff** (without sales commission), which is much higher than the benefit of a **commission-based tariff distributing sales commission over the whole term** of the tariff (yellow line) and of a **commission-based tariff** distributing sales commission **over the first five years of the term of the contract** (red line).

The conclusion to be drawn here is that fee-based advisory models do not have cost benefits when compared to commission-based tariffs in all cases. It therefore depends on which cost (levels) are taken as a basis for the comparative calculations.

Loss of returns due to high costs

Apart from this study, we can refer to a fynup cost study from 2020 which shows that consumers lose an average of 50% of the return generated on the market because of costs and taxes. It should be noted that taxes account for only a small proportion of this. The fact is that the larger part of the cost erosion is due to high sales and acquisition costs. Experience shows that consumers are not aware of the overall cost dynamics of endowment life insurance policies.

The key findings of the study by the Center of Finance at the University of Regensburg show that consumers are left with more income in the case of fee-based advice than with commission-based tariff models.[1]

Disadvantages of commission-based life insurance tariffs

- Most consumers are **uninformed or unaware** of the problems outlined above before taking out a policy.
- **Experience has demonstrated that consumers only become aware of these issues** when policyholders receive **value notices** that show losses. It is all too often only then - as so many complaints received by the AK consumer advisory service demonstrate - that consumers become aware of the fact that high costs have been charged and commissions have been paid that were - without consumers' knowledge - paid via the premium. A frequent consequence: Policyholders terminate the contract or suspend it in order to avoid further losses. The high termination rate with life insurance policies is therefore also largely due to these **high costs which only become visible after (a few) years** (mostly due to the value notices, but also due to disappointing surrender or deposit values). "Had I had been aware of this" is a typical reaction of policyholders when the previously unknown cost dynamics are explained to them by the AK consumer advisory service.

[1] Download der Studie unter: https://epub.uni-regensburg.de/54035/4/Sebastian-Noth-Grafe_Commission-Ban.pdf)

Advantages of fee-based advice as compared to commission-based insurance tariffs

One result of the present study is therefore that commission-free insurance investment products in combination with expense-based (non-asset-based) fee-based advice provide a number of advantages:

- Higher maturity benefits and surrender values are possible
- Fee-based advice includes a defined price for the advice which ultimately leads to greater transparency.
- A clear price for advice achieves a clear price awareness amongst consumers which is not the case with commission-based models because the acquisition costs are "invisibly" included in the premium payment.
- Clear prices for advice make it possible to compare price models more effectively.
- Clearly defined prices for advice render other cost elements more visible because the cost items are separated from each other; they are not paid "invisibly" in a block via the premium.
- Increasing cost awareness makes an active contribution to financial education. Clearly defined prices increase the willingness to look at products, compare prices and choose products more consciously and actively.

Possible disadvantages of fee-based advice:

- Consumers are unwilling to pay fees. This argument cannot be dismissed out of hand. However, the price sensitivity of consumers with fee-based advice is not an argument in support of commission-based tariffs. This is because in the case of zillmerized tariffs the commissions – invisibly hidden in the premium payment – are in some cases considerably higher than usual fee models. The effect: In the case of commission-based tariffs, the remuneration is hidden for which reason consumers are not aware of it.
- Due to the price sensitivity of consumers in relation to fee payments, fee-based advice leads to an advice gap. This is the main conclusion of a study by KMPG. However, the assumptions made by the authors of the study must be questioned since they are unrealistic. This is because the authors presume that one consultation takes place per year, which was estimated at EUR 180 per hour. An annual consultation meeting lasting one hour is impractical in view of the assumed investment amounts,

irrespective of whether the consultation is paid for by commission or a fee. This assumption is unrealistic, in particular because it is not normally necessary to have ongoing consultations about the (chosen) investment strategy for a savings plan, for example with a deposit of EUR 100 per month; there are also no annual discussions about a possible product change. This product review should take place every 5 years.

- Other studies that have looked at EU countries and other countries with commission bans and restrictions have also not found any significant evidence of "advice gaps".

Proposed solutions

- More cost transparency in the Life Insurance Information Obligations Regulation. This includes an obligation to explain to customers the earnings and losses over the course of time - as well as the cost dynamics.
- Promotion of fee-based advice
- Mandatory presentation of various remuneration models to choose from, so that consumers can decide under their own responsibility. Specifically, it involves the obligatory pre-contractual information of following variants:

1. The currently legally effective distribution of the sales commission costs over the first 5 years of the term of an insurance investment product (Section 176 Insurance contract law act)
2. The variant of an even distribution of sales commissions over the whole term of a product
3. A commission-free policy (fee-based tariff)

The EU Retail Investment Strategy presented by the EU Commission in May 2023 not only provides for (partial) commission bans in the securities and insurance sectors, but also disclosure obligations for costs resulting from remuneration (“inducements”). The cost information should provide numerical values broken down into euro amounts. The remuneration provisions drawn up in the EU Retail Investment Strategy are complicated and - especially the commission bans - come with a number of additional conditions.

Conclusion: The BAK proposes - in addition to the partial commission bans in the securities and insurance sectors proposed by the EU Commission - that advisors and intermediaries be required to present various remuneration options in order to a) provide consumers with the various costs and/or to visualize compensation scenarios and b) to enable independent choice of a compensation model. In this way, commission-free policies should lead to greater awareness and distribution, which are ultimately advised/sold via fee models. This remuneration-related pre-contractual information (i.e. the presentation of various remuneration models) should be implemented if the partial ban on commissions pursued in the EU retail investor strategy is not implemented.

Link to study (full version only in German available: („Provisionen vs. Honorare im Finanzvertrieb Lebensversicherungen) im Vergleich"):

https://emedien.arbeiterkammer.at/resolver?urn=urn:nbn:at:at-akw:g-6582526

Further study which may of interest: **Transparency of incentives in various distribution channels of financial services** (full version only in German available: Vergütungstransparenz im Finanzvertrieb (Materialien zur Konsumforschung 13)

https://emedien.arbeiterkammer.at/resolver?urn=urn:nbn:at:at-akw:g-6580566

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