Canadian Life & Health
Insurance Association

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Mr. Tony Toy, Policy Manager
Canadian Council of Insurance Regulators
National Regulatory Coordination Branch
25 Sheppard Avenue West, Suite 100
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Submitted by email to: ccir-ccrra@fsrao.ca

Re: CSA and CCIR Joint Consultation on Total Cost Reporting for Investment Funds and Segregated Funds

Dear Mr. Toy,

Thank you for the opportunity to respond to the CSA and CCIR Joint Consultation on Total Cost Reporting for Investment Funds and Segregated Funds ("Cost Reporting Consultation"). The Cost Reporting Consultation is positive in that it will enhance investor awareness of the embedded fees associated with owning securities and segregated fund policies. The insurance industry supports more detailed cost transparency for segregated fund investors.

The industry believes the new fee disclosures must be provided in a way that is easy for customers to understand, that allows accurate product comparisons by providing comparable information with mutual funds and is completed on a harmonized basis and timeline with the securities sector.

In Appendix A, we provide a summary of the industry's significant issues as well as detailed comments in response to the *Specific Questions Regarding the Proposed Insurance Guidance*.

Thank you again for the continued collaboration on this important initiative. We would be pleased to discuss any questions you may have on the issues we have identified or to provide additional information.

Sincerely,

Lyne Duhaime
Senior Vice President, Market Conduct Policy and Regulation

Appendix A

CLHIA Comments on CCIR Cost Reporting Consultation Issue

The following provides a summary of the industry's feedback, along with detailed comments on the consultation questions identified by CCIR and other key issues identified by the industry.

Summary of Feedback

The following is a summary of our key points:

1) A harmonized basis and timeline with the securities sector

A harmonized basis and timeline with the securities sector is critical to effectively and efficiently completing the total cost reporting project, due to the following:

- Customers should have comparable cost information across the different products available and for which they invest in;
- Customers should start to receive enhanced cost reporting at approximately the same time to avoid confusion around the cost difference between segregated funds and mutual funds;
- Any different formula or timeline requirements between segregated funds and mutual funds will significantly increase the amount of work needed and cost incurred by shared system providers; and
- Updated dealer cost reports for segregated funds (if required) would not be enabled until the Fundserv upgrades are made according to the timeline for cost reporting for the securities industry.

We elaborate in our response to Question 10.

2) TER reporting is problematic, and the MER alone is a reasonable estimate

The TER can be variable as it depends on trading activity in the fund. It can vary, particularly during initial years of a fund, fund closures, or fund mergers. TER reporting based on the prior year's reported values risks overstating or understating the investor's share of the fees. The MER is a more stable value, and we believe makes up the majority of the embedded fees over the long term and is a reasonable approximation of the fund expenses.

Insurers plan to put TER percentages on Fund Facts to ensure harmonization with the securities sector so customers have all the cost information available to them.

We elaborate in our response to Question 6.

3) Breaking out the insurance cost

We believe investors are best served with a total cost figure as opposed to breaking out individual cost components. CCIR has previously noted their research, which led CCIR to not require individual reporting of the distribution cost. We believe this same reasoning should be applied to breaking out the insurance cost. If it is required, it is anticipated to lead to customer confusion and double counting. There is also added complexity due to the many different approaches currently used within the industry for charging and disclosing insurance costs.

We elaborate in our response to Question 9.

Specific Questions

1. Do you anticipate implementation issues related to the inclusion of any of the following in the Proposed Insurance Guidance?

The industry anticipates implementation issues specific to the scenarios in Question 1 options (a) to (d) where they involve contracts being administered on legacy systems as discussed below. We provide additional comments on the scenario described in Question 1 option (d) related to breaking out the insurance cost in our response to Question 9. We provide details on other complexities and resource dependencies beyond legacy systems under Question 10.

An exemption or modified approach for legacy products

The insurance industry anticipates implementation issues with producing the proposed cost disclosures when the contracts are stored on legacy systems. Legacy system changes would present a complex, time consuming and costly endeavour to insurers, many of which support legacy systems by manual processes or, where they are automated, not easily modified. The number of legacy policies is declining over time. For these products, changes to administrative systems would be more costly than for non-legacy systems and these expenses would likely be passed on to the customers using the systems.

It is also possible that the necessary information for producing some aspects of contract statements (e.g., rate of returns "since IVIC contract begin") could be an issue if that information is not currently stored in the back-office system for all old products due to previous system conversions, the age of the system or how it was acquired.

For these older contracts, it would be appropriate to grant some type of exemption or develop a modified approach to making the necessary information available to investors. Solutions for legacy systems should be reviewed on a case-by-case basis with each insurer.

2. The Proposed Insurance Guidance does not yet include a method insurers must follow when calculating the fund expenses for each Segregated Fund Contract. Please comment on the advantages and disadvantages of calculating the fund expenses for each segregated fund the client holds each day [according to Option 1 and Option 2].

The securities sector's prescribed formula appears to align with the formula in Option 1. By aligning the insurance industry's formula with the formula for the securities sector, customers of both segregated funds and mutual funds can make better financial decisions by having comparable cost information across the different products available and for which they invest in.

In addition, due to the shared third-party service providers between mutual funds and segregated funds that will utilize this formula on their systems, the formula used between the two sectors must be aligned. We elaborate on the reasons for a harmonized basis and timeline with the securities sector in our response to Question 10. The insurance sector, therefore, strongly prefers Option 1.

3. Should all insurers be required to use the same formula to calculate the dollar amount of fund expenses? Please comment on the advantages and disadvantages of:

(a) Requiring all insurers to use the same calculation; or

(b) Allowing an insurer to use a different calculation method if the insurer can create a more precise approximation.

The insurance sector believes that all insurers should be required to use the same formula for calculating the dollar amount of a contractholder's share of fund expenses.

As mentioned, from a customer experience perspective, investors can make better financial decisions when the information provided to them is comparable across the different financial products available or which they invest in. It is therefore critical that investors have a common basis for comparison, which can be accomplished if all insurers use the same calculation.

A common regulatory standard is also needed for third-party service providers. This is very important where these service providers are shared both within the insurance industry and with the securities industry. This will allow insurers and their shared service providers to assign the costs calculated at the fund level to the policyholder administration systems, which hold the client's individual variable insurance contract details, in a consistent way.

It is also worth noting that real-time reporting of fund expenses to investor accounts is not something that is possible within the current system capabilities of the industry. It is therefore unlikely that an insurer will be able to create a more precise approximation than an estimated calculation of the fund expenses.

4. For the calculation described in question 2, what are the costs, benefits, and risks of using the following to calculate the fund expense ratio (i.e., MER + TER):

In line with our response to question 6, we believe that TER reporting is problematic, and the MER makes up the majority of the embedded fees over the long term and is a reasonable approximation of the fund expenses. Therefore, we are responding to your questions below based on our view that the fund expenses in dollars are calculated using the MER only, i.e., excludes the TER.

(a) MER from the most recent Fund Facts document published before the year in question begins and a TER calculated at the same time on a similar basis.

We support an estimated approach to calculating the fund expenses by applying the prior year's reported MER and applying it to the contractholder's daily holdings.

When using an estimated approach for calculating the MER in dollars, it will be necessary to develop standardized language to explain this to contractholders. Insurers would like to retain the flexibility to adapt standardized language to the language in their contracts, so this language should not be prescribed.

(b) MER and TER calculated for the year in question after the year ends.

A factor to consider under this option is when insurers can issue statements to clients. Using the MER from the most recent Fund Facts document will allow insurers to retain current scheduling to get the end-of-year statements out in January of the next year. If insurers are required to use the values calculated for the year in question after the year ends, this would significantly delay the timelines for producing statements. This is because these values are generally not available until April after audited financial statements have been released.

(c) Other estimated MER and TER for the year (please explain how this MER and TER would be calculated if you discuss this option)?

N/A. We do not discuss this option. We would reiterate that the insurance industry and the securities sector need to use the same calculation for the reasons stated in this letter related to a customer's ability to meaningfully compare the costs they pay for their investments and so the insurance industry implementation costs can be shared with the securities sector.

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5. For the calculation described in question 2, what are the costs, benefits, and risks of using

(a) 365 days;

(b) The actual number of days in the calendar year in question; or

(c) Another number that reflects the number of days on which the NAV is calculated for the fund rather than the number of days in the year?

Note that the proposed calculation for securities assumes 365 days.

The industry believes option (a) is the simplest and most common-sense approach for the calculations described in Question 2. Ultimately, we believe that an aligned approach to calculating the fund expenses with the securities sector is critical.

6. Would you consider it acceptable if, instead of information about each segregated fund's fund expense ratio (MER + TER), the MER alone was:

(a) disclosed in annual statements for each fund; and

(b) used in the calculation of the total fund expenses for the Segregated Fund Contract for the year?

What are the costs, benefits, and risks of using (MER + TER) versus only using MER?

MER

The MER is generally a static number. Using the MER from the most recent Fund Facts is likely to produce a reasonable approximation of the fund expenses.

TER

While the MER is generally stable day-to-day, the TER can be variable as it depends on trading activity in the fund. It can vary based on the fund manager's investment decisions as well as client inflows and outflows that would also drive investment trading activity. Therefore, there are situations when using the most recently published TER will not be an accurate reflection of TER costs if reporting the TER in dollar terms for the year in question.

Examples of where using the prior year's reported TER cost may not represent future years' TERs are when large changes are made to the fund's holdings during the initial years of a fund, fund closures, or fund mergers. Using those published TERs to estimate future investors' TERs in dollar terms would be inaccurate and report higher trading costs than were actually incurred. This may influence consumer behaviour and cause them to redeem assets held in specific segregated funds because they incorrectly perceive that their trading costs are higher than they actually are.

Only using MER

The TER is not generally a material cost associated with investing and the MER makes up the majority of the embedded fees over the long term. The industry believes that using the prior year's reported MER rate is therefore a reasonable approximation of the fund expenses and is still in line with the policy objective of improving investor awareness of the ongoing embedded fees that form part of the cost of investing.

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Ultimately, the industry believes that customers should be provided with information about the costs of investing that is reasonably comparable between the different products available and which they invest in. It is critical that the same information is being reported in the prescribed formula for fund expenses for both the insurance industry and the securities sector.

Having the same information included in the formula for both the insurance industry and the securities sector will also be critical from a system-build perspective, due to the shared third-party service providers between mutual funds and segregated funds. Again, ultimately we believe an aligned approach to annual statement disclosures at the fund level and at the contract level with the securities sector is critical.

Including the TER on Fund Facts

To ensure that segregated funds customers are receiving all the information about the costs associated with investing and to harmonize with the data points provided by the securities sector, insurers are planning to put TER percentages on Fund Facts as part of the total cost reporting project.

7. Might Segregated Fund Contract customers incur significant costs, other than for deferred sales charges, if they withdraw all funds from their Segregated Fund Contracts? If so, what are those costs?

Similar to securities, there could be short-term trading fees (e.g., 2% of the value of the trade) if the funds are held for a very short period of time or if a certain number of switches are exceeded per year. Short-term trading fees were introduced to discourage investors trying to time the market.

8. The guidance describes annual statements. Do you anticipate any issues in connection with the guidance as drafted in cases where an insurer provides semi-annual statements to customers?

We would like to confirm that insurers, as with the securities industry, are only required to report costs on an annual basis for segregated funds and if insurers provide half-yearly or more frequent statements, those are provided on a voluntary basis only and are not required to include cost data.

9. Do you anticipate any other implementation issues related to the Proposed Insurance Guidance?

Breaking out the insurance cost

Client confusion

We are concerned that separating the insurance cost from the total cost figure in dollar terms may result in double counting and misunderstanding to customers, with little to no added benefit to contractholders' knowledge about the costs associated with their investments.

Previously, in light of research the CCIR conducted on the effects of compensation disclosure on consumers, the CCIR indicated that insurers would include these costs in the total cost figure in dollar terms, but the insurer would not need to explain how much of the total costs relate to distribution. We believe this same reasoning should be applied to breaking out the insurance cost.

The potential for confusion can be illustrated by reviewing the CCIR's prototypes, which are unclear in two areas relating to the insurance cost:

- The definition for Fund Expenses in footnote 4 of page 2 of the prototype at Annex H does not include 'insurance costs'. However, when calculating costs and comparing to the figures on

page 3 (i.e., 'Details of charges for the year 2020') it appears that $45 of insurance costs are included.

- In the definition of footnote 7 on page 3 at Annex H for 'Insurance cost for your guarantees', it is not clear what is meant by 'You paid this cost by withdrawing investments in your contract.' Some companies charge the insurance cost directly to the client by redemption of units (at the contract level), while others have this cost embedded in the MER (at the fund level). There are also hybrid arrangements. This wording could imply that the CCIR only requires the insurance cost to be disclosed if it is paid directly by the client through the redemption of units.

Different approaches to how customers pay insurance costs

There are many different approaches currently used for charging and disclosing insurance costs, leading to variability in how these costs are charged and disclosed. Different approaches that have been taken within the industry include:

- An insurance cost is included in the MER, and the amount of the insurance cost is not disclosed.
- An insurance cost is included in the MER, and the amount of the insurance cost is disclosed in the information folder and / or in Fund Facts.
- A separate insurance cost is charged directly to the client through a redemption of units, which is disclosed on statements.

In addition, some companies' products have separate costs for optional features of segregated funds contracts (e.g., resets and GMWB), which are charged directly.

There is added potential for misunderstanding with new fee information being added to statements due to the different fee structures available. There are concerns consumers may see this as a separate cost over and above the MER in cases where it is just one of many elements that make up the MER. This would be even more complicated and ambiguous than breaking out the distribution costs.

Therefore, we believe investors are best served with a total cost figure as opposed to a requirement that individual cost components, such as the insurance cost, be broken out.

Insurance costs charged directly to contractholders would however continue to be disclosed on transaction statements. There is not the same risk of double counting and ambiguity relating to directly charged insurance costs since they are not included in the MER.

Cost reporting by IIROC/ MFDA dealers on segregated funds

Securities industry Self-Regulatory Organizations (SROs) have issued guidance either requiring or strongly recommending (for all other products) that the firms they regulate include in their CRM2 reports information regarding investments that are not securities (i.e., segregated funds, GICs) if their client holds these investments in their dealer account.

If total cost reporting is needed for non-security products at IIROC and MFDA firms, then further consideration is needed on who will be responsible for this reporting.

Clarification is requested – 'Contract values since issue' on the prototype

We would like to confirm that 'deposits' and 'withdrawals' are only required to be reported in annual statements at the contract level and not the fund level. While this appears to be what is required in the 'Minimum Content of Annual Statement' schedule of the Consultation, it is not clear in the prototype under the heading 'Contract values since issue'. This table lists deposits and withdrawals at the fund level. The insurance industry believes that deposits and withdrawals should be required to be reported at the contract

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level only since requiring to include all funds ever held by the contractholder could make statements very long and be unnecessary information for contractholders. It is also possible that this information is no longer available.

10. Do you anticipate any issues specifically related to the proposed transition period?

The industry continues to believe that a harmonized implementation timeline for total cost reporting for the insurance industry and the securities sector is critical.

An unaligned approach may lead to poor outcomes for consumers

We believe that clients are best able to make informed financial decisions when they are provided with relevant and equivalent information about the products they purchase, and a harmonized implementation timeline will mean that investors have a common basis to compare the costs they pay across different financial products at the same time.

Further, we would be concerned that if segregated funds began total cost reporting before the securities sector that the inconsistency in reported fees could lead to customer confusion. This is because the cost difference between segregated funds and mutual funds will appear to be significantly larger than it actually is. This could lead to poor consumer outcomes if contractholders decided to sell a particular fund or cancel a contract based on an incorrect perception of the costs.

Accordingly, we believe that it is critical that the insurance industry and the securities sector move together towards total cost reporting.

External dependencies shared with the securities sector

The third parties involved are required to do significant work that will play a large role in determining what is achievable from a timing perspective. Ultimately, the CCIR’s final requirements for this work will need to be known before a final implementation timeline can be determined.

These third-party service providers are shared with the securities industry and facilitate the flow of information required for reporting fund expenses. For example, insurers rely on third-party service providers such as LTI and IFDS for the data used in the production of client statements and to produce client statements. It is economically efficient for service providers to make needed IT upgrades for both their mutual funds and segregated funds clients (i.e., insurers and fund manufacturers) at the same time. Segregated funds are only a small portion of the overall investment fund market (less than 10%). A harmonized implementation timeline will mean that the system enhancements are developed in the most efficient way to minimize any associated cost increases to contractholders.

Fundserv is another example of a shared dependency with the securities industry a small portion of segregated funds are held at IIROC and MDFA registered firms. Updated dealer cost reports for segregated funds (if required) will not be able to be enabled until the Fundserv upgrades are made according to the timeline for the cost reporting for the securities industry.

Additional collaboration needed on transition period

Additional collaboration is needed between regulators and the insurance and securities sector as well as shared third-party service providers to land on an implementation timeline that is both achievable and leads to timely implementation.

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