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THE NECESSITY OF LEGAL ARRANGEMENT OF UNIT-LINKED LIFE INSURANCE PRODUCTS

Nikola Dacev[1]

Abstract
The rapid development of life insurance and its dissemination throughout the world, and the emergence of new types of life insurance products, in order to meet the needs of citizens, raises the question of proper legal arrangement of these issues. This article refers to the life insurance products linked to investment funds (unit-linked life insurance products) as a new type of life insurance products, especially in developing countries. The purpose of this article is to explain the meaning and the types of unit-linked life insurance products offered by insurance companies; to provide the available statistical data regarding these types of insurance products; to analyze the legal framework of unit-linked life insurance products in the European Union and in some Southeast European countries, one member of EU and two candidates for EU membership. The conclusion of the article provides the reasons for additional legal regulation of the unit-linked life insurance products.

Keywords: policyholders, blue-chip stocks, investment funds, mutual funds, EU legal framework.

Jel Classification: K22

INTRODUCTION

Life insurance as one of the main pillars of the insurance in general, is a protection plan that ensures beneficiaries in case of unforeseen events in the form of insured risks covered by the life insurance policy. When an insured risk occurs, the insurance company is liable to pay the beneficiaries the amount insured, provided that the life policy is active. The objective of life insurance is to provide financial security to policyholders and their families. Traditionally, this security has been provided by means of a lump sum payable contingent on the death or survival of the insured life (Hardy 2003). Premiums and benefits associated with traditional life insurance contracts are usually specified as fixed amounts in policy conditions (Christiansen, Denuit, and Dhaene 2014). Moreover, the sum insured is guaranteed. The policyholder would pay one or more premiums during the term of the contract for the right to the sum insured. Traditional actuarial techniques have focused on the assessment and management of life-contingent risks: mortality and

[1] **Nikola Dacev**, PhD, Assistant Professor, International Balkan University, Skopje, Macedonia.

morbidity (Hardy 2003). The two basic types of life insurance are term and whole life insurance.

A sound insurance industry is important for a proper economic system, economic growth and promoting higher employment amongst other factors. On the other hand, investments are one of the main sources of revenue of the insurance industry (Barbara et al. 2017). There is a glaring disconnect between the way most financial advisers sell life insurance and how they sell or promote investment products such as mutual funds (Huang, Milevsky, and Wang 2008). It's because unit-linked insurance plan (ULIP) is a multi-featured product that combines the benefit of insurance, risk sharing and investment. The investment in a unit linked insurance plan works like a mutual fund and does not come with guaranteed returns, unlike money back, whole-life or endowment policies (Saravanakumar and Mahadevan 2001, 190). The investment side of insurance generally has not been regarded as a source of major risk. This was (and still is) a reasonable assumption, where guaranteed benefits can be broadly matched or immunized with fixed-interest instruments. But insurance markets around the world are changing. The public has become more aware of investment opportunities outside the insurance sector, particularly in mutual fund type investment media (Hardy 2003, 1). A logical question arises about the need of adopting amendments to the existing insurance regulation regarding the life insurance products linked with investment funds, also called unit-linked insurance products in the insurance literature.

EU has comprehensive insurance regulatory framework and attempts to comply the insurance legislative with the innovations on the insurance markets in the member states. But also the countries that are candidates for EU membership try to follow the European trends and have introduced similar life insurance unit-linked products. The main focus of this article is to explore the types and growth of unit-linked life insurance products offered in Europe, to inspect the existing legislative regulating this issue and to compare it between Western and Southeast European countries, in order to detect the anomalies in the insurance legislative.

1. DESCRIPTION AND DEVELOPMENT OF THE TYPES OF UNIT-LINKED LIFE INSURANCE PRODUCTS

Unit-linked life insurance products refer to insurance products, which accumulate capital. They are taken with the purpose of accumulating a financial benefit for the policyholder at a future point in time (e.g. towards retirement). Thus, this type of products contain an investment risk, which is borne entirely or partially by the policyholder. On the other hand, the insurance company bears the risk of survival of the policyholder up to the maturity of the policy. The main difference between unit-linked life insurance products and non-unit linked life insurance products is that unit-linked life insurance products offered by insurance companies allow policyholders to direct part of their premiums into different types of funds (equity, debt, money market, hybrid etc.) and the risk of investment is borne by the policyholder in general, while non-unit linked life insurance products are traditional insurance plans that usually invest in low risk return options and offer guaranteed maturity proceeds along with declared bonuses. Unit Linked insurance plan provides for life insurance where the policy value at any time varies according to the value of the underlying assets at the time. It's a life insurance solution that provides for the benefits of protection and flexibility in investment. The investment is denoted as units and is represented by the value that it has attained called as Net Asset Value (NAV) (Akula and Kanchu 2011). Policyholders that purchase unit-linked life insurance invest mostly in mutual funds. Mutual funds are pools of money that come from individuals or investors and are managed by fund managers from investment companies. Persons who invest in mutual funds buy shares and get a proportional amount of the profits and losses based on person's share. The returns on mutual funds come in the form of stock, cash dividends or capital asset value appreciation. Individuals can diversify with mutual funds to maximize their investment returns.

Investment companies may invest in stocks, bonds and cash. They may also invest real estate, annuities and precious metals. The benefit of mutual funds is that they can create income, whether on a short- or long-term basis and the disadvantage is that investing in mutual funds involves higher risks unlike investing in traditional life insurance. In addition, fees and taxes decrease the amount of the fund's earnings of investments in mutual funds. Interest rate guarantees in unit-linked life insurance products ensure that at contract maturity, at least a minimum guaranteed amount is paid, even if the mutual fund falls below the guaranteed level. Strongly depending on the riskiness of the underlying mutual fund, these guarantees can be of substantial value. However, while insurer pricing is based on the replication of cash flows, customers are more likely to base their decisions on individual preferences (Gatzert, Huber, and Schmeiser 2011).

The cause for development of unit-linked life insurance products is the rapid and continuous growth of life insurance and the expansion and development of investment funds also.

One of the reasons for the development of the investment funds, especially in the emerging markets is that institutional investors such as pension funds and life insurance companies, which have been the main investors in funds, have been growing rapidly. Between 1988 and 1993 the assets managed by institutional investors in OECD countries rose from US$7.5 trillion to US$13 trillion. This, combined with regulatory changes in OECD countries reducing restrictions on foreign investment and a period of low interest rates in the US in the early 1990s, encouraged investors to look at emerging markets (Carter, Kuczynski, and Barger 1996).

New investment funds, such as private equity (PE), hedge funds (HFs), and sovereign wealth funds (SWFs), have developed since the 1970s and especially during the 2000s. They share some common features in that they are all large sums of pooled money which are invested in various assets, including portfolio companies; they are run by professional investment managers who are usually paid on a performance basis; and until recently they have operated outside of much traditional securities regulation. They differ from other institutional investors, such as pension and mutual funds, in that they typically take a bigger share in or acquire whole companies (PE), become more involved in company governance and management (PE and HFs), or mixtures of these (SWFs). In general, these funds are seen as riskier than traditional forms of institutional investment but claim to have correspondingly higher returns (Gospel, Pendleton, and Vitols 2014). Policyholders want to enjoy the benefits of equity investment in conjunction with mortality protection, and insurers around the world have developed equity-linked contracts to meet this challenge (Hardy 2003, 1).

In modern insurance practice there are various types of life insurance products, which serve different purposes. The types of life insurance products that are offered to the customers are determined mostly by the insurance companies. In view of the multitude of existing individual life insurance products, different classifications attempt to place them under several broader categories. For instance, one classification singles out the traditional life insurance which pays an agreed sum of money on the death of the life insured (including term and whole life insurance), endowment policies, annuities and policies linked to investments in securities or property. Another classification identifies three categories: life assurance on the death of the insured (including term and whole life policies), life insurance on the survival of the insured (including insurance with investment functions and annuities) and a combined life insurance (a term life policy with an investment element).

The European insurance industry has introduced a simplified classification for statistical purposes: traditional life products, "which offer capital and/or return guarantees", "unit-linked individual contracts in which the risk is borne by the policy holder" and other individual contracts (Expert Group on European Insurance Contract Law Meeting 2013, 1–2).

In general, insurance investment products may be divided into four categories: life insurance where the policyholder purchases "units" in a fund; life insurance where the policy's cash value is tied to the performance of a financial index; life insurance which offers benefits which are partly guaranteed and partly dependent on the evolution of assets chosen by the policyholder; life insurance which offers the policyholder some rights to participate in the profits of the insurance undertaking in addition to a guaranteed return. It should be noted that due to the investment characteristics inherent in this type of life insurance policies, some of these products may be qualified as investments in some EU countries and thus become subject to their investment legislation (Expert Group on European Insurance Contract Law Meeting 2013, 4–5).

There are no investments without risk. Taking into account the fact that for most of the unit-linked life insurance products the investment risk is borne by the client, it's necessary to find a way to reduce the risk as low as possible. Insurance companies achieve this goal by insertion of several mechanisms into the life insurance products. Primarily, investments in shares must be allocated to a number of companies in different industries and different regions which reduces the risk because it is a small possibility that all of these companies would have difficulties in their business activities at the same time. It should be emphasized that unit-linked life insurance constitutes a significant item in the range of products aiming to secure retirement. It is offered to individual customers as well as in form of collective insurance (Kowalczyk-Rolczynska and Pisarewicz 2015, 39). These life insurance products usually last longer than 15 years so the investments are long-term also. This creates the possibility to avoid short-term fluctuations in the value of the shares, provided that there is time for recovery of markets in certain regions or certain activities that could be affected by financial difficulties. As was mentioned above, investment portfolios are managed by professional portfolio managers that monitor the movements of the values of shares in the world markets on a daily basis and take a series of actions in order to achieve better results. Investments are made in shares in different currencies which reduces the impact on the portfolio if a currency losses its value compared to other currencies. In this way insurance companies are able to reduce the risk and make the product more acceptable for the customers.

Certainly, for those who do not want to take any risks on investments of their assets and are satisfied with a lower yield, the traditional life insurance products are available to them. These products can also be adjusted according to the requirements and needs of the clients.

Unit-linked insurance products are hybrid products for life insurance covering risk and have a savings component. Unlike conventional life insurance, with life insurance investment product the assets with a savings component through the investment fund are invested in stocks of large and successful companies listed on international stock exchanges. This type of product provides the customers with the possibility to invest in international markets while at the same time to purchase life insurance for the period of duration of the life insurance policy. Each client decides about the amount of assets that will be used to cover the risk, and how much will be used for investment. The assets of the insureds are invested in "blue-chip" stocks that are considered as relatively low-risk investments. "Blue-chip" stocks are stocks of well-established and financially sound companies that have proven track record, strong balance sheets with average debts, consistent earnings and large market capitalization.

2. ANALYSIS OF THE STATISTICAL DATA REGARDING UNIT-LINKED LIFE INSURANCE PRODUCTS

In order to assess the market condition of unit-linked life insurance products, analysis of the available data must be made. In 2015, in the countries members of the European insurance and reinsurance federation there is a common underlying dynamic in most markets; a shift from traditional, fixed-yield to unit-linked products. The most developed markets of unit-linked life insurance are Italy, France and Germany. In Italy, strong growth in life premiums resulted from a substantial increase (45.8%) in unit-linked policies compared with a small contraction in traditional ones (-5.7%). In France, too, the driver of life premium growth in 2015 was growth in unit-linked contracts of 32%. In Germany, the shift from traditional to unit-linked products continued for the third consecutive year, with the latter now accounting for 16.2% of all contracts. In Belgium the growth of unit-linked products increased by 20%. The ratio of traditional life contracts to unit linked contracts was 81% to 19% for 2015 (European Insurance in Figures 2016). After Latvia, Croatia recorded the lowest amount of gross written premiums (18 million euros) for unit-linked life insurance products out of the countries members of the European insurance and reinsurance federation (Statistics no 50: European Insurance in Figures 2015).

The available statistical data shows that unit-linked life insurance products have stable and constant growth for a ten years period of time (2005–2014). Although the total number of concluded non-linked life insurance contracts is 4 times or more, greater than the total number of concluded unit-linked life insurance contracts in the countries members of the European insurance and reinsurance federation, (Table 1) the amount of concluded unit-linked life insurance contracts is sufficient indicator of the development and growth of these types of insurance contracts.

Table 1. Total number of unit-linked and non-linked contracts in the countries members of the European insurance and reinsurance federation

Year	Total number of non-linked contracts	Total number of unit-linked contracts
2005	13.726.462	1.494.079
2006	13.660.687	1.914.726
2007	16.453.359	2.456.332
2008	21.576.955	4.785.163
2009	21.832.865	5.323.423
2010	23.347.242	5.848.917
2011	21.907.740	5.780.630
2012	28.387.324	9.242.137
2013	29.576.485	9.176.786
2014	38.155.290	9.775.419

Source: European insurance industry database-life insurance data, https://www.insuranceeurope.eu/european-insurance-industry-database.

3. REGULATION OF UNIT-LINKED LIFE INSURANCE CONTRACTS IN EU

The main purpose of this paper is to examine the need for regulation of the unit-linked life insurance products in the insurance framework? In order to answer that question let’s look at the EU insurance legislative setup.

Solvency II (Directive 2009/138/EC) provides a classification of life insurance products, but it does not contain a definition of what constitutes a life insurance contract, which could then be categorized under one of the nine classes. Thus, the question, whether a given product would qualify as a life insurance is open to interpretation. This is particularly relevant for certain insurance products which have similar features to other financial products. In particular, a life insurance product may become subject to the legislation on investments instead of insurance services in another EU country. For example, a certain degree of uncertainty exists whether certain life insurance products with investment functions where the risk is borne by the policyholder would be considered investment products in some EU countries. Such problems often occur with unit-linked life insurance. For instance, the Netherlands has established rules helping to draw the distinction between life insurance and investments. Member States have developed further rules in their national laws, taking advantage of flexibility that minimum harmonization of EU rules in the area grants. Additional requirements have been put in place in particular in relation to insurance products with investment functions. The following examples illustrate various additional rules for unit-linked policies: - Information on the provider: one Member State requires insurance undertakings to provide their entry number in a commercial register (not only in case of electronic sales alone, pursuant to the Directive on Electronic Commerce). Another Member State requires an identification of the financial group to which the undertaking belongs; - Information on product characteristics and contract terms: One Member State requires that the consumer signs that he received a written guide containing information about the product with sufficient evidence about a life assurance policy. Another Member State requires the consumer to confirm by signature that descriptions of investment options chosen by him have been presented to him before concluding a unit-linked life insurance contract; - Information on the service: Some Member States require information on whether the intervention of the intermediary terminates upon signature of the contract or whether it also includes assistance during the period of validity of the insurance contract. Furthermore, a number of Member States have introduced additional requirements for the disclosure of costs and charges associated with the management of the contract (e.g. annual fund management charge, annual advisor remuneration, additional charges, such as early cash-in/surrender charges or charges due to tax or regulatory changes); - Way of providing the information: Some Member States require that key items are brought to the attention of the consumer, that the method of presentation must not disguise, diminish or obscure important information, statements and warnings, that comparative information is meaningful and presented in a fair and balanced way, or a product information sheet. For instance, Italy established detailed rules stating that the insurer should provide information in a synthetic form, including an information note, insurance conditions, glossary and an answer form (Expert Group on European Insurance Contract Law Meeting 2013).

The EU adopted a new act expressed through the Regulation on key information documents for packaged retail and insurance-based investment products (PRIIPs) that entered into force on 29 December 2014 and applies from 31 December 2016 (Regulation 1286/2014). This Regulation obliges producers or sellers of investment products to provide investors with ‘key information documents’ (KIDs) concerning the products, even before any agreement is made. The aim is to help investors to understand and compare the key features and risks of these products. KIDs should include the following information: the name of the product and the identity of the producer; the types of investors to whom it is intended to market the financial product; the risk and reward profile of the financial product, which includes a summary risk indicator, the possible maximum loss of invested capital and appropriate performance scenarios of the product; the costs associated with the investment in the financial product to be borne by the investor; information about how and to whom an investor can make a complaint in case there is a problem with the product or the person producing, advising on or selling the product.

All assets held in respect of life insurance contracts where the investment risk is borne by the policy holders shall be invested in such a manner as to ensure the security, quality, liquidity and profitability of the portfolio as a whole and shall be invested in the best interest of all policy holders and beneficiaries taking into account any disclosed policy objective (Article 132 of the Solvency II Directive 2009/138/EC). Some insurance companies offer the possibility the insurance clients by themselves to choose the investment companies in which they will invest their assets. Thus the question arises, what will happen in case of assessment of the insurance company that by investing part or all of the assets of their client in investment company is an investment of high risk? Will the insurance company prohibit the client to invest money in the particular investment find? If insurance companies let their clients to invest assets in investment funds by their own choice, they would violate Article 132. Under Solvency II there are no rules as to what assets firms should invest their technical provisions in. Equally there are no permitted link rules. Article 133 of the Solvency II Directive, however, permits member states to apply permitted link rules “only where the investment risk is borne by a policy holder who is a natural person and the rules shall not be more restrictive than those set out in the UCITS Directive” restricting the types of assets or reference values to which policy benefits may be linked (Directive 2009/138/EC). The permitted links rules in Ireland are more generous than in the UK and allow policies to be linked, for instance, to hedge-funds. Luxembourg is an interesting case with permitted link rules that are quite strict, but has developed unit-linked life insurance. A unit-linked insurance contract does not offer any guarantee as to the surrender value which will vary according to the value of the underlying assets. The premium paid by the policyholder is invested pursuant to the policyholder's instructions and in compliance with the investment profile chosen as well as the applicable regulations. The premium paid by the policyholder of a unit-linked life insurance contract may be invested in different types of assets. All assets underlying a life insurance contract are solely owned by the insurance company which enters into a management agreement with asset managers for the purpose of managing such assets in compliance with the regulatory framework and the investment policy defined by the policyholder. Where the premium paid by the policyholder is considerable and the wealth invested in transferable securities by such policyholder is substantial, the applicable investment restrictions will be extremely flexible. On the other hand, if premiums paid by the policyholder and the wealth invested in transferable securities by such policyholder are less substantial, the list of admissible assets will be more restricted or the applicable investment limits will be lower. Also Luxembourg has put in place a strong protection regime when implementing the European directive on the reorganization and winding-up of insurance undertakings.

4. OVERVIEW OF THE UNIT-LINKED LIFE INSURANCE LEGISLATIVE IN SOME SOUTHEAST EUROPEAN COUNTRIES

Southeast European countries are still significantly lagging behind in the development of life insurance compared to Western European countries. But, as life insurance has evolved in some Southeast European countries in recent years, unit-linked life insurance has simultaneously developed also. Let's take a look at the legal setup of unit-linked life insurance in some of these countries.

In Croatia the activity of investment funds and scope of activity and competence of the Croatian Financial Services Supervisory Agency in the field of investment funds are regulated by the Act on Open-Ended Investment Funds with Public Offering and Alternative Investment Funds Act.

Investment companies in Croatia are granted approvals for performing additional and other activities related to the organization of training and training activities aimed at participants and customers on the capital market, insurance representation and others, if they fulfill the conditions in accordance with the provisions of the Ordinance on Additional Activities of Investment Firms (Article 4 of the Ordinance on Additional Activities of Investment Firms 2014) .

The Law on Insurance of Croatia enumerates the entities that may have employees who would perform activities of insurance representation provided that they meet the necessary conditions and investment companies are included in those entities (Article 400, paragraph 3 of the Law on insurance of Croatia 2015).

According to the Law on insurance of Montenegro, when concluding life insurance contract, the insurance initiator is required to provide data for the contracts where the policyholder bears the investment risk (unit-link insurance) regarding the fund's prospectus and investment structure (Article 81d of the Law on insurance of Montenegro 2006).

An insurance company engaged in insurance activities where insured person undertakes an investment risk (unit-linked insurance) shall also be obliged to establish special technical provisions for such insurance. (Article 83 of the Law on insurance of Montenegro 2007).

In the Law on insurance supervision of the Republic of Macedonia, life insurance in relation to shares in investment funds, when the insured undertakes the investment risk in relation to the change of value of the investment coupons and other securities of the investment funds, is determined as one of the classes of insurance (Article 5 of the Law on Insurance Supervision of Macedonia 2002). Only one insurance company performs activities within this insurance class, starting from 2015 and has rapid growth covering almost 30% of the total gross written premiums for life insurance of the particular insurance company.

In the Law on insurance supervision of the Republic of Macedonia there are special provisions for insurance in case when the investment risk is borne by the insured. According to these provisions, when the rights of the insured that are derived from the insurance contracts, directly depend on the value of the share or the stock in one investment fund, the investment of funds for covering the mathematical provisions that are specially set aside by the insurance company in regard to those insurance contracts, shall to the highest possible degree include investments in shares or other securities that are considered part of the ownership structure of the particular investment fund (Article 94, paragraph 1 of the Law on Insurance Supervision of Macedonia 2002).

The poor insurance legislative related to unit-linked products in these Southeast European countries is obvious.

CONCLUSION

Although Laws on Investment Funds regulate the activity of the investment funds, with the rapid development of the unit-linked life insurance, it is necessary to regulate this matter in the laws on insurance also, especially in the Southeast European countries that follow the steps of the Western European countries. Which are the causes for it? For example, in the general terms and conditions for life insurance related to investment funds offered by some insurance companies, the owner of the shares in the investment fund is the insurance company and the investment risk is borne by the insured. It is unreasonable, for the duration of the contract, the owner of the assets invested in the investment fund by the insured in the form of shares to be the insurance company, because as initiator of the insurance the policyholder chooses the investment portfolio of the offered investment funds by the company for management of investment funds and the investment risk is borne by the insured when there is alteration in value of the investment shares and in case of loss of these assets.

The recommendations in this article are in direction of adopting amendments to the insurance laws in terms of extraction of the investment funds as a separate category of insurance intermediaries, as is the case with banks. The reason for this is that in case of occurrence of the insured event in these contracts, when the insurance policy is used to ensure payment of the loan, the insurance company will pay the insured amount to the financial institution, instead of to the insureds, which is identical to the products offered by banks to cover consumer and housing loans with life insurance in the form of security or collateral. In this case banks play the role of intermediaries in the sale of insurance products. Unlike investments funds, banks could bring an information advantage to insurance companies through telephone marketing by providing a customer list based on the customers' records in the bank. Bancassurance can play a role of integrating the information that is transferred from the bank to the insurance company (Peng and Wang 2015). Although there are obvious differences between banks and investment funds as insurance intermediaries, with the emergence of the investment funds as intermediaries in the sale of life insurance products linked with investment funds and the development of these products in general in recent years, a distinction between banks and investment funds as intermediaries in insurance must be made, especially because of the possibility of conflict of interests between these subjects.

The necessary amendments to the national insurance laws of the countries that have no regulation concerning the insurance related to units of investment funds should refer to the contracting party that bears the investment risk; to the definition of investment units that are tied to fees; and the Prospectus of the Investment Fund, especially on the structure of investment. It’s very important to regulate the insurance law in direction of higher protection of the insureds and their assets, especially because there are types of life insurance investment related products that pass most of the asset risk to the policyholder and involve little or no investment risk for the insurer.

It’s necessary for every country to arrange the insurance legislative tailored to the needs for investment and insurance of the customers that buy unit-linked life insurance products, especially the newly promoted, modern and innovative unit-linked life insurance products, which will also give a positive impact to the development of this type of insurance. These recommendations refer to the countries that lack legal arrangement of this issue, especially to the Southeast European countries.

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