OFFSHORE LIFE - PRODUCTS & DYNAMICS

by Gary Boal

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This article takes a guided tour of each of the offshore product categories featuring in Portfolio International’s Second Annual International Life Industry Awards. It finishes by exploring the current dynamics of the industry and the changing products, players and strategies of the leading product providers.

The tour of product categories starts with a look at Single Premium products

Secured/Guaranteed Protected Products

For the last two-three years, by far and away the most important single premium offshore life category has been Secured/Guaranteed protected products.

In a period where successive twists of the sustained bear market have destroyed investor value and made life difficult for normal unit-linked bonds, insurers have been uniquely able to add value through the provision of guaranteed products, most notably with-profits bonds. Indeed, those companies having with-profits in their product stable have gone from strength to strength (at least in new business terms) and surged ahead, writing new business at a prodigious rate.

The two clear and established market leaders in this category are Clerical Medical (CMI in the Isle of Man and CME in Luxembourg) and Scottish Mutual International (Dublin). Between them, these companies are writing £2 billion of new premiums across a diversified spectrum of markets, including the UK, Germany, Italy, Spain, Austria, Hong Kong and the Middle East. Both CMI and SMI are authorised in Hong Kong (SMI is in fact the first Irish insurer to be authorised in HK), and indeed SMI has lately even created a separate HK$ with-profit fund. Both companies offer with-profit funds denominated in €, £ and US$.

CMI and SMI, the market leaders in this category, share one thing in common, and that is a profitable bank parent with deep pockets in terms of share capital and other financial support. The importance of this cannot be under-estimated, as both companies’ products ultimately carry a minimum 4% solvency margin requirement. In terms of £2bn of premium, being one year’s new business, 4% equates to £80 million of solvency capital, even before taking account of additional statutory reserving margins, so financial strength - and commitment of that strength to support the offshore company - are essential.

Guarantees are an important part of with-profits bonds and the addition of spot guarantees adds considerably to a product’s appeal (but adds to capital consumption). SMI’s "Guaranteed With Profit Bond" is notable in this respect.

Other companies, understandably, have their eyes on this large segment of the market. Some have come and gone: Scottish Widows International have new closed to new business entirely (see comments below) whilst AXA Isle of Man - as with sister company Sun Life in the UK (their with-profits reinsurer) - have temporarily withdrawn in order to preserve solvency cover and ration their financial resources. Similar considerations have aborted Scottish Equitable Dublin’s plans for a with-profits product.

Others are now poised to take the challenge to CMI/CME and SMI. Prudential's "International Prudence Bond", launched in March, is a strong new entrant, combining Prudential's attractive with-profits fund with a financial strength that supports a strong capacity to underwrite significant new business volume. Fellow IFSC company Norwich Union International has now dipped its toes into the offshore with-profits sector with its "With Profit Bond", currently rationed only to selected Channel Islands and Isle of Man intermediaries. Finally, the Friends Provident acquisition of Royal & Sun Alliance IFS (now Friends Provident International) brings important and welcome with-profits capacity to the Isle of Man company. It is logical to expect full roll-out of with-profits products into FPI's product range and its main geographical markets.

It is important to remember that the Secured/Guaranteed protected product category extends beyond with-profits and encompasses capital-protected structured products too. In this sector, Scottish Life International are leading exponents, with a succession of structured product tranches during the year. The year 2002 has also seen the entry of AXA Isle of Man to the guaranteed equity product with their "Guaranteed Growth Bond". Other companies with guaranteed equity product offerings in 2002 include Inora Life, whose products are notable for an unusual degree of complexity.

In-house Products

This category arguably spans two separate classes of bond, as the divisions are somewhat tenuous as between investment bonds linking only to funds managed by the insurer, on the one hand, and bonds linking to mirror funds "managed" by the insurer, but invested wholly in external funds, on the other. Many bonds cross into both camps, having the insurer's "own" funds plus others. Sometimes the "others" are small in number, whilst in other cases they might hugely out-number the "own" funds.

In the first camp are products such as Scottish Equitable International's "Investment Bond", AXA's "Evolution", CMI's "Capital Investor", Friends Provident's "International Investment Bond", Norwich Union's "International Investment Bond" and Prudential's "International Prudence Bond".

In the second camp are multi-manager products such as Royal Skandia's "Managed Capital Account", Canada Life International's "Delta" and Scottish Provident International's "Preference".

Increasingly, many bonds are offered in capital redemption structure, as well as life assurance form, the capital redemption structure lending itself better to inheritance tax uses and corporate/trustee investment.

Personalised/Pooled Products

This single premium category, otherwise known as the pooled fund portfolio bond, is characterised as offering investment in an unfettered universe of pooled investment funds. The product, as such, is a portfolio investment/administration service. Products are therefore not differentiated (generally) in terms of investment range or performance. Instead the key differentiators are service (this being a sophisticated investment product with associated heavy investment administration and servicing demands) and product terms (charges, special deals, commission etc).

The pooled fund portfolio bond did not exist as a product category until 1990. It was born as the industry responded to the Inland Revenue's misguided application of s739 ICTA1988 anti-avoidance legislation to what the Revenue deemed be offensive "highly personalised" portfolio bonds. The new pooled fund portfolio bond fell on the "right" side of the Revenue's new "rules" (flawed as they were) and virtually all UK portfolio bond business is now written in this form. (Whilst the Inland Revenue's arguments and application of s739 were thrown out in the Willoughby judgement at the House of

Lords in 1997, they finally had their way when specific PPB tax regulations came into UK statute as part of the Finance Act 1998.)

The pooled fund portfolio bond remains an important product category, although in current stock-market conditions not on the scale of the guaranteed/with-profit bond category. Leading exponents include Royal Skandia, Canada Life International, Friends Provident International (RSAIFS) and Zurich International.

Private Portfolio/Highly Personalised Bonds

The private portfolio bond (PPB) which constitutes this product category is the "original" form of portfolio bond pre-dating the UK Inland Revenue s739 attack.

Now confined mostly to non-UK markets (Far East and Europe, in the main) the PPB remains a highly sophisticated private client investment product (with a minimal insurance wrapper).

Leading providers include those companies listed under pooled fund portfolio bonds (above), together with one or two other specialist providers offering bespoke products, including private company shares.

Named IHT Planning

One of the most important financial planning uses of offshore single premium bonds (of all types) is in connection with Inheritance Tax Planning. This applies even more so in the case of the portfolio bond products aimed at higher net worth investors.

IHT planning, by definition, is associated with UK-resident and UK domiciled/non-resident investors. The sophisticated techniques require trust-based solutions, and those companies who provide the highest levels of technical/trust support add the most value to intermediaries.

Well-known products in this area include Royal Skandia’s "Discounted Gift Trust", Canada Life International’s "Enhanced Estate Preservation Account" and Scottish Equitable International’s "Inheritance Tax Plan".

Next up on the tour are the three regular premium product categories:

Retirement Planning/Pensions

Pension Products represent the largest category of regular premium contract, in terms of new business.

Compared to domestic pensions policies (in the UK and Europe, for example), the offshore pension policy conveys fewer tax privileges but offers considerably more flexibility. Some tax concessions can be obtained in particular cases - for example, in the UK under extra-statutory concession A10 - but in general offshore pension policies do not serve a tax-planning purpose. All of that may now be poised to change, however, following the European Court of Justice ruling in the Danner case.

Pension policies have evolved to only a relatively small degree over the last 20 years. What development that has taken place is confined to areas such as extending the range of optional risk benefits, separation of premium payment term from policy term (for the purposes of initial charging and commission) and evolution of the fund range.

It remains surprising that only a minority of offshore life companies offer pension products. The leading companies include Zurich International, Royal Skandia, Friends Provident International, Generali International and Scottish Provident International.

Regular Savings

Savings products generally differ from pension products (above) only in name and in the marketing message. The same companies compete for savings business as for pension business.

Collectively, the regular premium new business market for pensions and saving plans exceeds £200m of annual premiums.

Protection

The protection products offered by offshore companies fall into two distinct sub-groups:

those aimed at policyholders outside the UK (typically expatriates); and those aimed at the UK-resident market.

For the first category (international protection), price of product is important, but equally important is the known availability of cover in specific countries and a practical underwriting approach, whether for life cover, income protection or critical illness cover.

The second category on the other hand (UK market) is all about price. Gross roll up companies enjoy a price advantage over their UK counterparts insofar as "standard cover" policies are concerned.

Leading offshore protection companies include Friends Provident, Canada Life International, Scottish Provident International and Prudential International.

Future Outlook

Having now covered all of the product categories at the present time, what can be said of the future?

Assuming a return to more positive stock-markets, it is reasonable to anticipate some swing away from with-profits and guaranteed business towards unit-linked business in the future. However offshore with-profits does still have an excellent future (regardless of what Messrs. Myners, Sandler, Tiner *et al* might have to say in the context of the UK market).

Offshore bonds will continue to have a valuable role to play for tax planning, particularly in relation to IHT. With the current tax and spending policies in the UK, it is difficult to see IHT being reduced or eliminated, particularly as rising house prices bring more and more people in to the IHT net and so boost Government revenues.

It is possible too that the offshore UK industry could have to re-define itself if - as is possible - the UK life business moves onto a gross roll-up basis. Such a move is now understood to be back on the possible agenda, and developments will need to be followed with interest.

As for regular premium business, the largest product line - pensions - should be boosted enormously in the cross-border European arena by the ECJ Danner judgement, which closes the door on tax discrimination of pensions sourced from providers in other European countries. At a time when demographics and pension deficits will see more and more shifting of pensions provision onto individuals, the European pensions opportunities are enormous. Several offshore life companies mentioned above are well positioned to benefit.

Turning to the UK market, with the regulator’s current process of "radical reform" it is questionable indeed as to why any new provider would wish to come under the FSA's prudential regulation by locating in the UK, when under European single market rules it could have a far happier existence operating under freedom of services from other European locations. Many continental European life companies have already located in Ireland, for example, in order to avail of regulatory and fiscal arbitrage opportunities. To date, such arbitrage strategies have focused on countries such as Italy, Sweden, Norway and Germany. With the FSA's "radical reform" making the UK less and less attractive for life assurance capital, it seems inevitable that the UK will be added to that list.

Finally, in closing, some words should perhaps be said on the consolidation of the industry, and on the wider perspective. The offshore industry, like its UK counterpart, will continue to be affected by mergers and acquisitions. Recent weeks also have seen the disappointing closure of Scottish Widows International (a Jersey start-up in November 1997). The Scottish Widows news however does not in any way portend doom and gloom for the wider offshore industry. Instead, it reflects factors specific to that company and its business model.

The SWI decision, together with the parent company financial issues at fellow Jersey insurance company London Pacific, does not perhaps augur well for Jersey as a base for international life assurance business. In contrast, other offshore life centres continue to thrive (even the Isle of Man has a new start-up life company, after a gap of many years!) and Ireland continues to be the focus of start-up activity. At the present time, we are working closely with no fewer than three companies on start-up European life operations in Ireland, and see no reduction in such activity looking ahead.

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