

OFFSHORE PENSION PLANS

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July's IWM looked closely at single premium investment bonds, which collectively form one of the bedrocks of the offshore life industry. This time the product area under the microscope is the offshore pension plan, a product that forms the mainstay of new *regular* premium business in the offshore life sector. As part of this examination, I will again be using the results of new analytical comparisons developed for the latest LIFEBASE OFFSHORE software.

Scope and Market

Unlike the position in the UK, the pensions market in the offshore community is not massively bolstered by taxation incentives. Very few policies are able to take advantage of tax relief on premiums or to offer genuine tax-free lump sums, both of which provide a massive boost to UK life and pensions companies. On the other hand, it is recognised that the taxation position in the key offshore pensions areas (Far East and Middle East) is often so benign that the concept of tax relief is meaningless.

Returning to the UK, the fiscal incentives there – but not offshore - mean that even with the current UK pensions fall-out, the life industry there is able to add a further 67% to its new business production purely as a result of pensions business. Within this total, the UK market for insured pensions is also underpinned by the fact of life that personal pensions there mean compulsory purchase annuities (CPAs) on retirement: CPAs constituted over 20% of total UK pensions business in 1999 (on an annual premium equivalent basis). There are doubts as to how long this inflexible and anachronistic CPA requirement will persist in the UK: other countries such as South Africa and Ireland are far more advanced in their thinking and practice.

Offshore, in contrast, there is no significant pension annuity market, firstly for the reason that fiscal regimes do not require the use of annuities, and secondly that (individual) offshore pension plans are "unapproved" in the first place and thus can achieve full cash commutation at retirement (which can of course be at any age).

Our estimate at Boal & Co is that total new regular pension premiums for the industry in 1999 were approximately £150m pa annualised production. This figure principally comprises the offshore life industry in the Isle of Man, Guernsey and , to a much smaller extent, Ireland. International pensions in their true sense are relatively untapped by the offshore life community in Luxembourg and Jersey.

The Providers

It is a very notable fact that the offshore pensions business referred to above is concentrated in the hands of relatively few product providers. Our analysis indicates only 10 product providers in the market (to any significant sense). In contrast, our analysis (IWM, July 2000) of investment bonds examined more than 20 product providers.

In the analysis which follows (relating only to individual pensions - corporate pensions constitutes a separate, smaller sector), we focus upon the products and providers shown in Table 1. This list is not intended to be exhaustive - for example it excludes one or two products which are available from other companies but not actively marketed, and it also excludes one "pension" product which is more akin to a recurrent single premium plan than the traditional pensions model.

Table 1 : Principal Offshore Pension Products	
<u>Company</u>	<u>Product</u>
Eagle Star International	Vista
Royal & Sun Alliance IFS	International Pension Plan
Royal Skandia	Managed Pension Account
Scottish Provident International	Momentum
Equitable Life International	International Pension Plan
Friends Provident International	Guernsey International Pension
Generali International	Pension Plus
Hansard Europe	Retirement Programme
Hansard International	Universal Retirement Programme
Old Mutual International	Omega
	Source : www.lifebase.co.uk LifeBase Offshore

In practice, the first four of the companies listed above (all of which are Isle of Man companies) dominate the sector in terms of new business written. Some may be surprised at this, given the extent to which individual pensions in a wider context are historically more associated with the Channel Islands than with the Isle of Man. (For example, Section 131C legislation in Jersey and Section 40(ee) in Guernsey currently have no equivalent in the Isle of Man.)

Even so, the position of the Isle of Man based offices may be strengthened, and their product offerings will inevitably adapt, on account of the international pensions regime presently being promulgated by the Isle of Man Government Insurance & Pensions Authority (IPA). That said, there is nothing, apart from securing distribution, preventing non-IOM offices from breaking into the offshore pensions premier league.

It is also notable that very few of the offshore life company start-ups in the 1990's have entered the offshore pensions arena. For example none of the Scottish start-ups in recent years (Scottish Amicable, Equitable, Life, Mutual or Widows) have moved into the offshore pensions sector, despite generally successful launches into offshore investment and/or protection product sectors, and despite their parents having a significant UK pensions presence. Other notable absentees include Sun Life, Norwich Union and Canada Life.

With average premium levels offshore being so much larger than in the UK (for example £4800 pa equivalent compared to £1400 pa in the UK) and a £150m market to aim at, this is in one sense surprising. However the reality is that most of the newer entrants have a UK (or nascent European) distribution focus, and thus a relatively undeveloped penetration or capability in the traditional offshore regular premium regions. This situation therefore helps the established market leaders to consolidate their position at the head of the pensions market.

That said, however, we would also add the following observations:

- a) That profitability of regular premium contracts for life companies has generally fallen significantly in the past five years. Despite good increases in efficiency and achievement of reduced unit costs by offices, profitability has been eroded - for regular premium business more so than for single premium bonds - by a double whammy of increased commission costs and a decline in persistency. The real financial attractions are therefore questionable for so long as this position persists.
- b) Amongst the current players, the pecking order of the winners and losers may change depending upon which companies make the most of the new opportunities that changing legislation will bring.

Products - Design

The most popular offshore pension plans all share a similar type of design which has evolved very little over the last 15 years. The typical design can be summarised in two words : INITIAL UNITS.

In more detail, most plans feature:

- a bid/offer spread
- use of initial units (with very much higher charges) for premiums in the first 18-30 months
- a policy fee.

The few companies that do not operate initial units operate instead a higher administration charge throughout the term of the policy, or a very high charge if premiums cease or the plan surrenders.

Of the ten pension products listed in Table 1:

- 6 employ initial units
- 2 employ a higher administration charge
- 1 has reduced unit allocations
- 1 has a level unit allocation.

In marked contrast, amongst the 16 leading pension providers in the UK personal pension market:

- none employ initial units
- 14 employ reduced allocations
- 2 employ other approaches

(Source: LifeBase UK www.lifebase.co.uk)

In short, offshore pension plans have not evolved in the same way as their UK counterparts. Undoubtedly, this is due in part to each of:

- lower disclosure requirements offshore (initial units in practice are of course the same in effect as a reduced allocation, except in marketing perception and except (normally) on death – hence, increased disclosure would remove their disguise)
- broker resistance to change
- weaker consumerist pressures (these are more applicable in a local context but difficult in an international or global context)
- absence of trade body/peer group/regulatory pressure or consensus for change
- absence of new entrants.

Until some or all of these factors change, initial unit designs will undoubtedly continue to prevail offshore.

In a similar vein, product designs and remuneration structures offshore still are almost entirely geared to the traditional initial (indemnity) and renewal commission model.

Source: **LIFEBASE** Offshore – www.lifebase.co.uk

Practice in the UK has also evolved significantly here, with most leading pension providers offering in addition level commission (including nil commission) flexible designs. A number of companies also offer a choice of plans: one aimed at high maturity values, another at high surrender or transfer values.

In this regard, however, one notable advantage that pension providers have in the UK over their offshore counterparts is that in the UK plans cannot be surrendered (encashed) before retirement, they can only be transferred from one provider to another. Many offshore life companies wish they enjoyed similar comfort and persistency!

One aspect of offshore designs however that is superior to UK practice is the prevalence of free switching. Whilst common-place with offshore plans, free switches (other than 1 or 2 a year) are rare indeed in the UK.

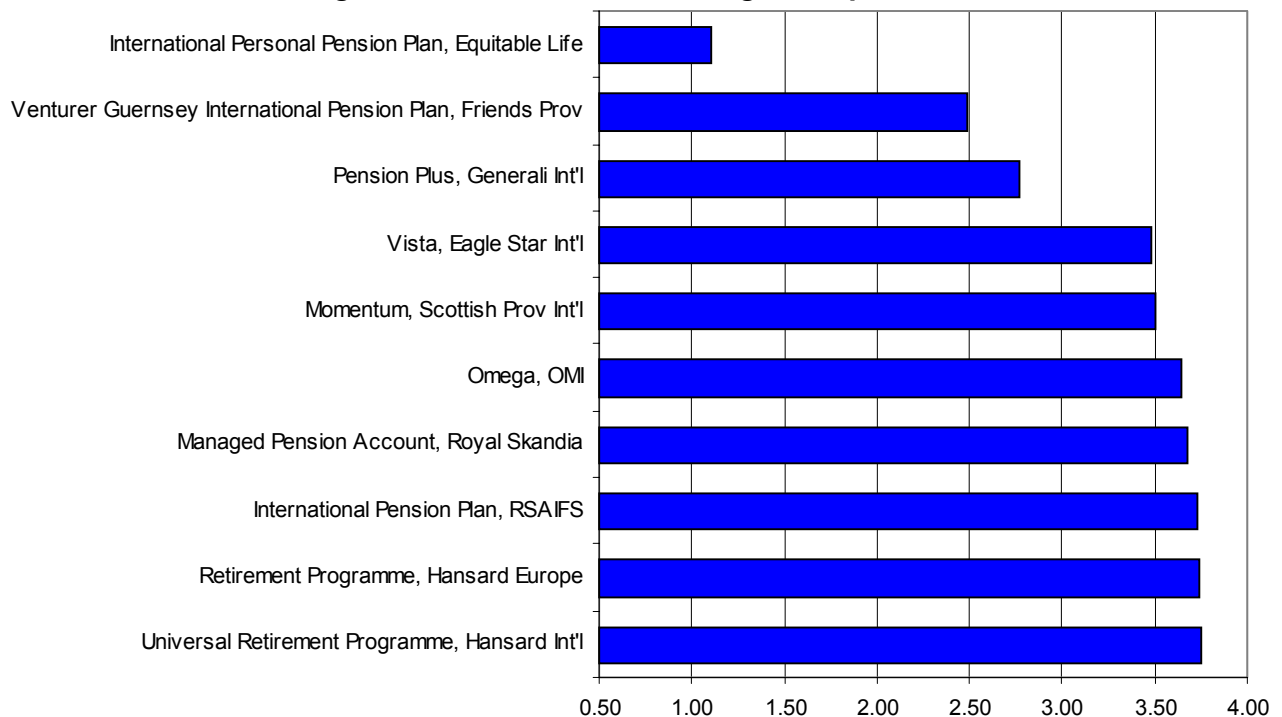
Charges

To readily and succinctly compare the effect of charges across different products and companies, we make use here of the Reduction in Yield (RIY). To recap (see IWM July), for offshore plans the RIY is a measure of the extent to which the illustrative investment return (set at 7% pa according to current PIA rules in the UK) is reduced by the effects of charges. For example, a 2% RIY would reduce a gross return of 7% pa to a net return (after charges) of 5% pa. The lower the RIY, the cheaper the product is.

Before looking at RIYs though, it is worth stressing the point that cost is not everything. In fact, as will be seen later, cost differences are utterly dwarfed by investment over and under-performance.

Figure 1 shows the RIYs for each product (all sourced using LifeBase Offshore), in this case looking only at the life company's own charges (ie external fund charges are excluded). The figures are based upon an assumed premium of £400 pm (or equivalent) over a 15-year term.

Fig. 1 RIY before external charges, 15 years



As can be seen, leaving aside Equitable Life (which does not pay commission), the product-only 15 year RIYs for commission-paying offices range from 2.0% up to 3.0% pa. In other words, the difference between least expensive and most expensive product is equivalent to a reduction of 1% pa in the investment return.

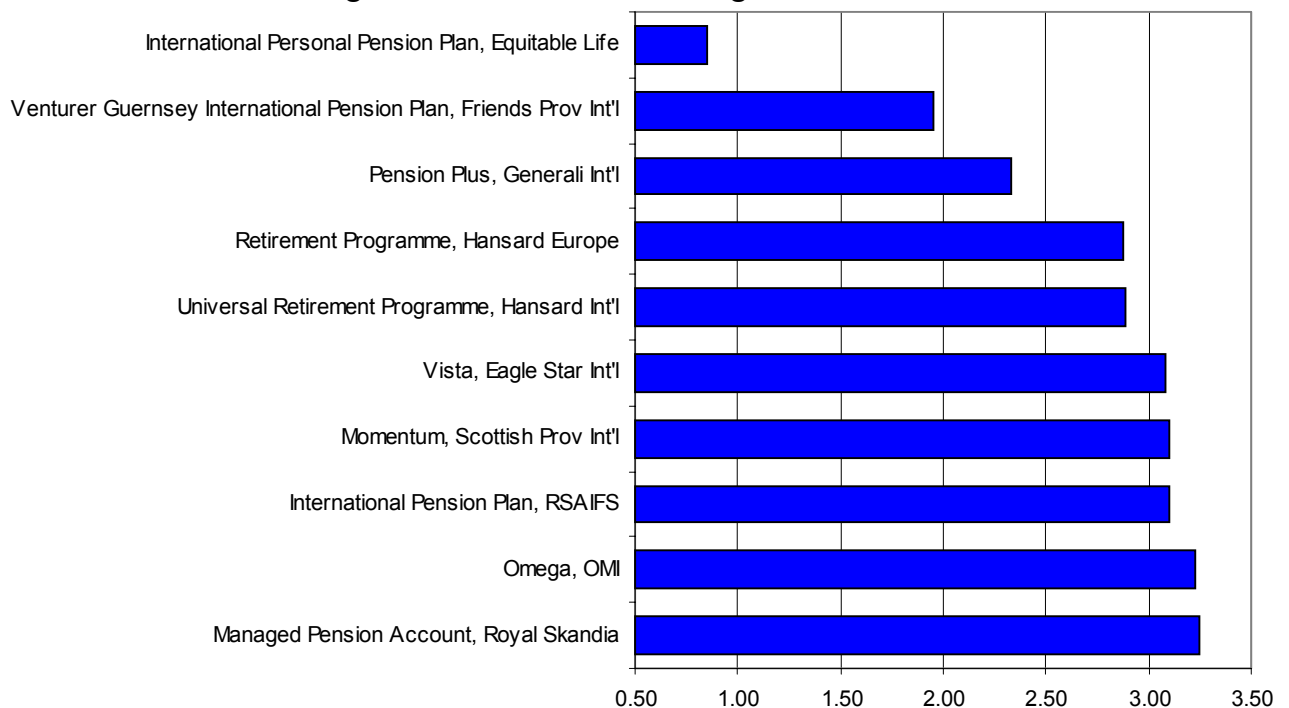
As with investment bonds, comparisons here can be made with UK charges. An average UK pension plan in contrast has an RIY in the range 1.2% - 2.9% (source: LifeBase UK). So,

whilst this is evidence that more of the offshore return goes on charges than is the case in the UK market, the differences are not as high as are often imagined.

To complete the view on product charges, Figure 2 shows the RIYs for plans of a 25 year term, in this case with external/underlying fund charges included (typical balanced managed fund).

As is to be expected, the RIY order changes somewhat according to whether a company offers internal or external funds. As with investment bonds, however, compliance arbitrage means that Figure 2 is not necessarily a representative like-for-like comparison.

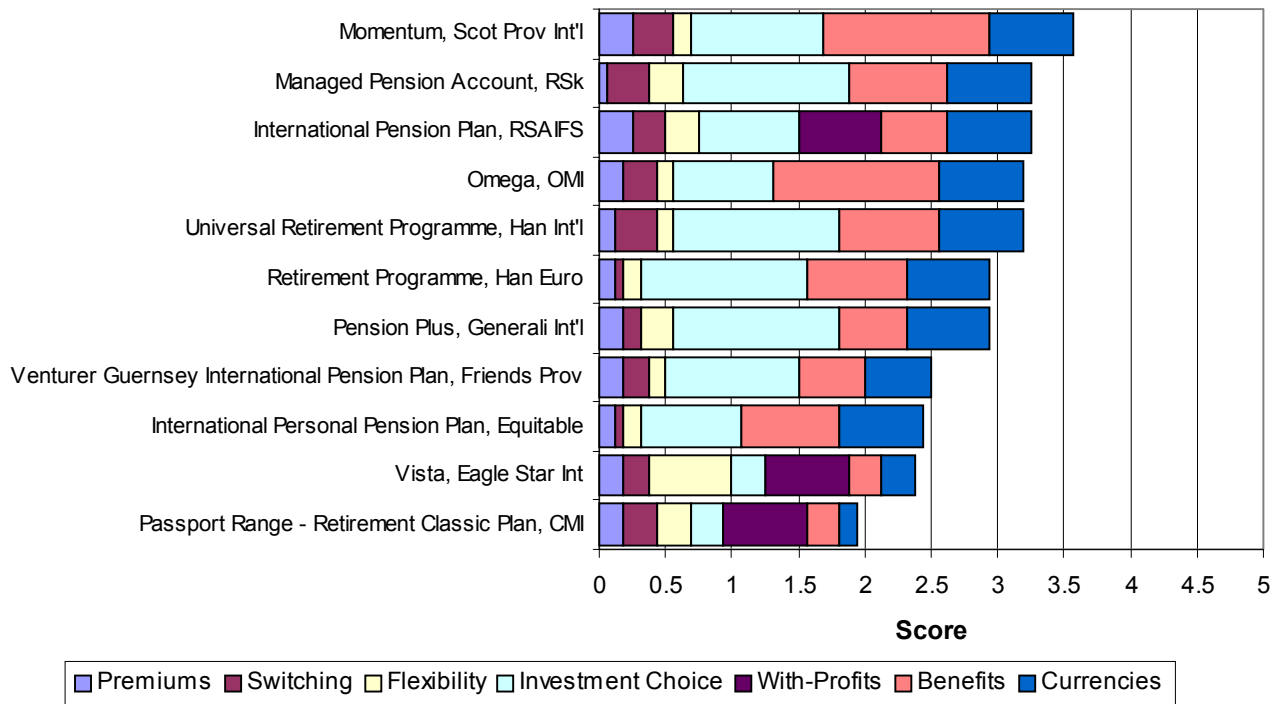
Fig. 2 RIY, after external charges, 25 Years



Product Features

The 10 products studied differ quite widely in their range of features. As extra complexity and flexibility may well be commensurate with extra cost, it is only fair that they be brought into the reckoning.

LifeBase Offshore scores products using the Investment Flexibility & Access (IFA) Rating, with scores of 1-5 denoting theoretical extremes of least and most complex/flexible product. The offshore pension plans range from a low IFA Rating of 1.9 (Friend Provident) up to a high of 3.6 (Eagle Star). Figure 3 shows the differences in more detail.



As regards features, pension products differ principally in the following respects:

- choice of fund sectors
- range of benefits - some have no additional risk benefits, others have a choice up to 5
- availability of with-profits funds
- choice of plan/premium currencies etc.

As with investment bonds, there is generally a *positive* correlation between product complexity and product price, ie a higher IFA Rating is generally associated with a higher RIY.

Overall Performance Results

And so to the final reckoning: how do the various pension plans compare on an analysis which takes account not just of cost but also of achieved investment performance? We can answer this by turning to LifeBase's unique Overall Performance (OP)TM measure.

The OP measure recognises that differences in investment performance will over time drown the effect of differences in charges. For this reason, it is useful (to say the least) to go back in time and look at product charges (in their entirety) in combination with fund performance. The LifeBase OPTM measure does just this.

OP simulates the total annualised return from a product after both product charges and fund charges. Product charges allowed for include:

- bid/offer spreads
- management charges
- initial unit charges
- policy fees
- allocation rates
- loyalty bonuses etc

throughout the policy term.

Of course there is no guarantee whatsoever that a high Overall Performance in the past will continue into the future. Equally:

- a) Knowing the winners and losers in the past enables advisers to ask the right questions, to assess the reasons why and then to come to a judgement as to whether these same reasons are valid or probable in the future. For example, if out-performance for a company was associated with a high performance volatility (*beta*), then it might be concluded that one should draw no meaningful conclusions as to the future.
- b) Any analysis which focuses only on charges is entirely missing the point; it is overall performance after costs (ie value for money) not cost alone which is the final arbiter. A comparison of Figure 1 with the results below, for example, shows that excluding the most expensive product on price would have meant excluding the best performing product (by a long way). In short, selecting products on grounds of cost alone can be very dangerous.

All of the Overall Performance (OP)TM figures which follow are based on performance periods ending 30th June 2000 and are for a typical £400 (or currency equivalent) monthly premium plan written for a 15 year term. (Fund performance figures only are sourced from Reuters Lipper Hindsight.) Although a large number of OP analyses are possible, for the sake of brevity we will look at results from just 3.

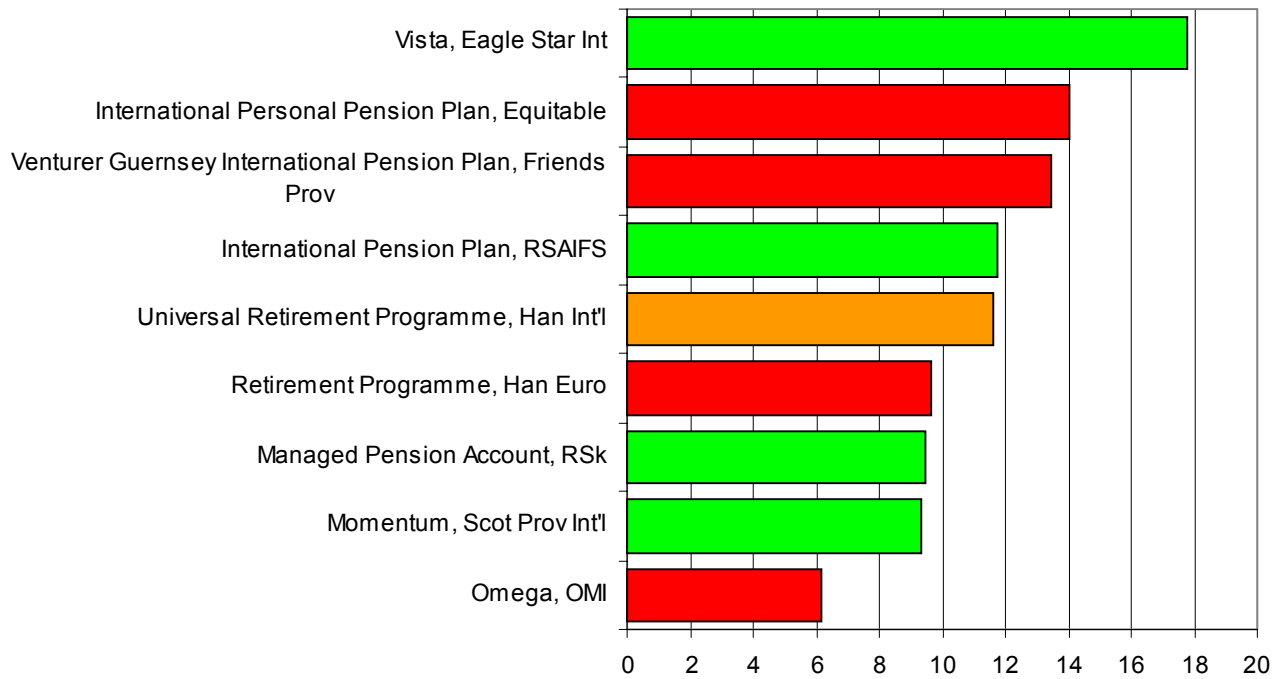
Figure 4 shows OP results for pension products linked to **International Managed** Funds over a 5-year period, for a £-investor.

Source: **LIFEBASE** Offshore – www.lifebase.co.uk

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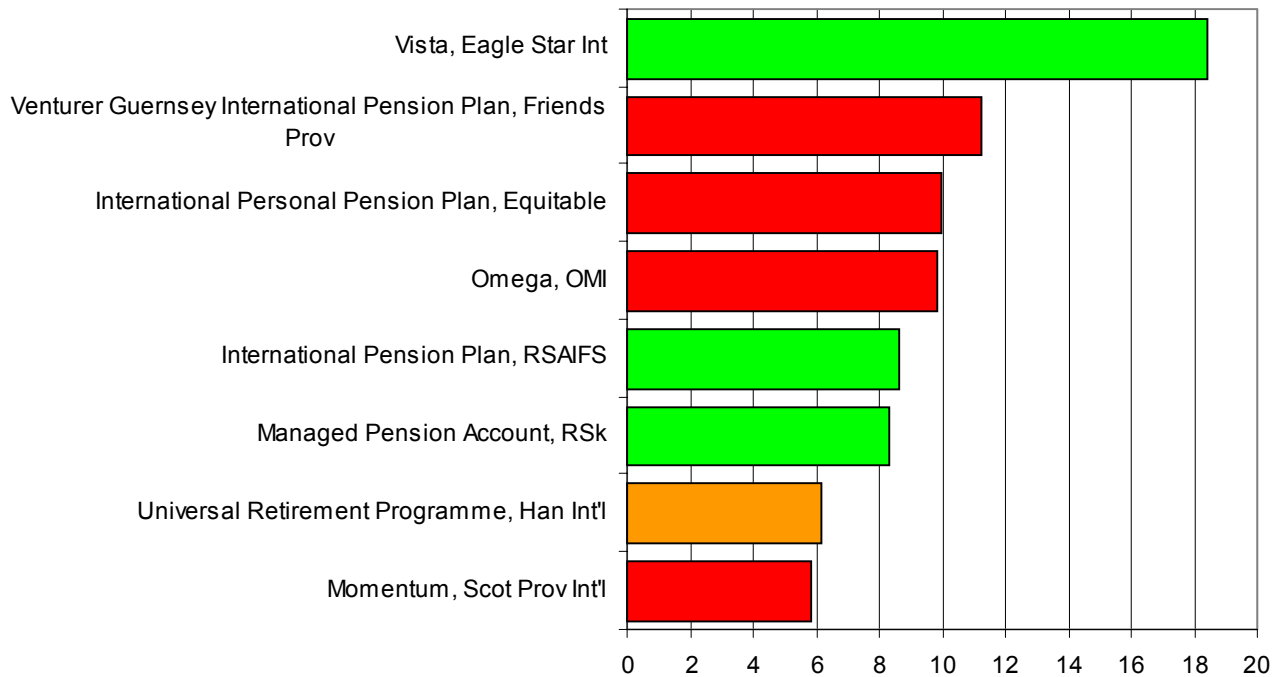
Fig. 4: International Managed Funds, 5 Years, £



The OP range in this example is from 6.1% pa at the bottom end up to 17.8% pa at the top.

The next example (Figure 5) is for a shorter performance horizon, in this case 3 years, for all products linked to **International Equity** funds and calculated for a £-investor.

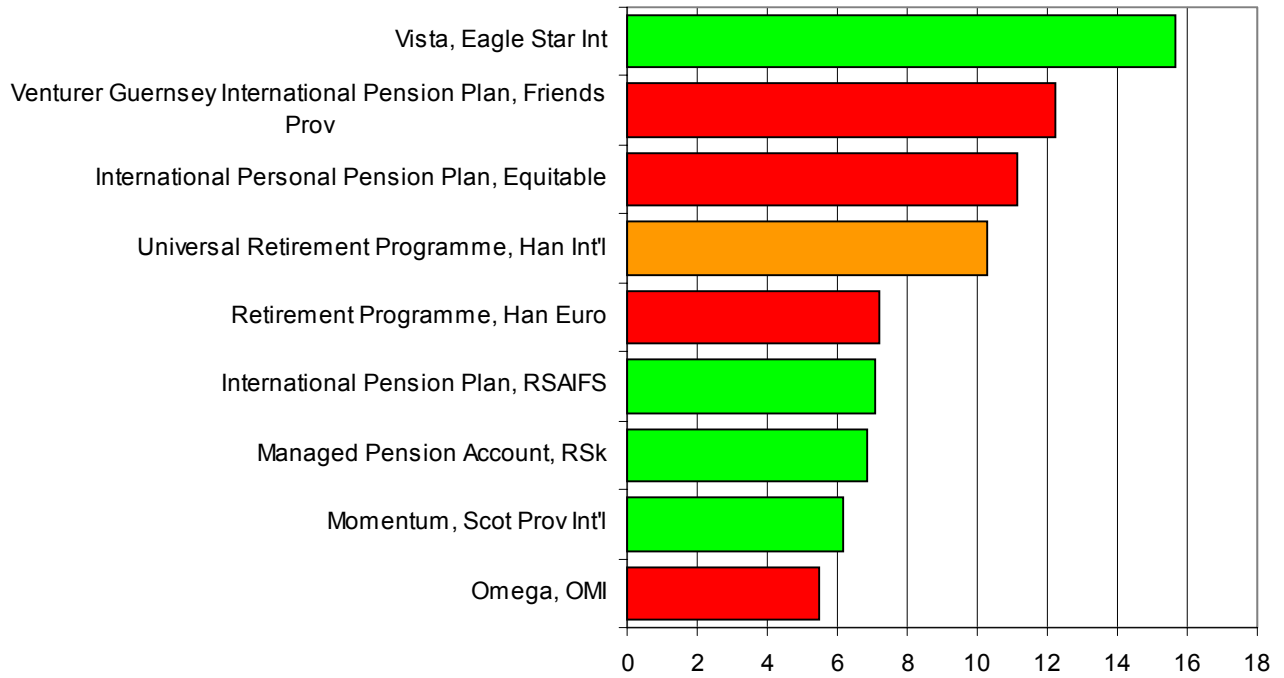
Fig. 5: International Equity, 3 Years, \$



The OP range in this case is from +5.9% pa at the bottom end to + 18.4% at the top.

Finally we present the example shown in Figure 6 which in this case takes into account **all life funds** (on Lipper) linked to each pension plan, for a 5-year performance horizon and again for a \$-investor.

Fig. 6: All Life Funds (on Lipper), 5 Years, \$



The OP range is again very wide, from a low of +5.5% to a high of +15.7% pa.

To their credit we have to recognise that in all of these examples, Eagle Star International's Vista tops the Overall Performance table. Other performance comparisons are, of course, possible and could, of course, give different conclusions. Regardless, the position will also move over time.

In Conclusion

The conclusions reached when comparing pension products are remarkably similar to those reached in last month's survey for investment bonds. In short:

- cheapest does not always mean best, and dearest is most certainly not worst
- fund performance differences from one company to another can be massive
- advisers should seek to learn about performance differentials in the past, and thus come to a judgement about their applicability to the future
- more funds and sectors does not necessarily mean better performance.

If there is a theme emerging, it is that mirror funds and external funds are not automatically a virtue. What is for certain is that they introduce a greater variability and volatility of return. Much also depends on the value being added by the life office in its selection and de-selection of funds and groups, if they are picking winners before they have won and losers before they have lost. Otherwise, simply following fashion does not deliver the best results.

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