B.A.J. **1**, III, 421–469 (1995)

AN INTRODUCTION TO OFFSHORE LIFE ASSURANCE BUSINESS

BY G. F. BOAL, B.SC., F.F.A., A.S.A. AND L. S. TYRER, B.SC., F.F.A.

[Presented to the Faculty of Actuaries, 16 January 1995]

ABSTRACT

Over the last 10 years, in centres surrounding the United Kingdom, a cross-border insurance industry has been developing — an industry which is exporting British expertise in life assurance and investment products on a large scale to a world-wide market.

The industry is offshore life assurance. The purpose of this paper is principally to outline what this industry is and why it exists.

The particular financial management and operational management issues resulting from this activity are highlighted and explored in subsequent sections. The paper concludes with an assessment of market trends and future development in what is a very young, dynamic and highly competitive market.

KEYWORDS

Offshore; Cross-Border; International; Life Insurance

1. INTRODUCTION

1.1 A review of the offshore life assurance industry is the case study of an industry which has matured from a fringe to a mainstream business. Enormous growth has been achieved over a relatively compressed period of time, despite the considerable management, regulatory and fiscal challenges that have arisen. Today, the offshore life industry, unlike its United Kingdom counterpart, is a vibrant, expanding business.

1.2 A number of factors have contributed to this success.

1.3 The first of these, in an evolutionary sense at least, is the taxation position of the companies concerned. At a basic level, all of the offshore jurisdictions covered within this paper offer life assurance policyholders the benefit of gross accumulation, without any taxation deduction on exit. Gross roll-up within an office's policyholder funds is not, of course, unique to the offshore market. Many domestic insurers in Continental Europe, for example, enjoy a similar taxation regime.

1.4 What sets the offshore market apart is its product innovation, its equity culture and its insurance expertise. Offshore insurers are based in centres which are well-regulated, but not over-regulated. Companies, consequently, are able to operate with freedom to design good products and with flexible investment options appropriate to their target markets — a background which is ideally suited to actuaries and other executives with a U.K. insurance background. The British tradition in flexible, modern product design has also, of course, to be combined with an awareness of the different cultures around the world, and of

https://doi.org/10.1017/S1357321700001197 Published online by Cambridge University Press

the marketing requirements for each. This essential understanding has been achieved over the passage of time.

1.5 The combination of these factors has produced success on a scale beyond the ambitions of many, for offshore business is now an international business on a truly global scale. The Far East, Middle East, Africa, Continental Europe, the U.K. and Latin America represent the geographical distribution of a typical offshore life office. The business, therefore, transcends languages, cultures, time-zones and currencies, and each of these gives rise to its own operational management challenges.

1.6 A number of British-owned companies have successfully risen to these challenges and are pre-eminent in the market. British-owned companies do not, however, enjoy a monopoly on international cross-border business, and for some the closest competition comes from the international activities of North American and Asian insurers. A study of these insurers is, however, outside the scope of the current paper, and quoted statistics within the paper pertaining to the size of the offshore market exclude their activities.

1.7 The seeds of the current offshore industry were sown in the early 1980s, when the first major entrants arrived. Liberal taxation exemptions and supportive regulatory frameworks subsequently developed to nurture the infant market.

1.8 The end result of this healthy environment — a large-scale influx of new entrants since 1986 — has led to burgeoning growth which has continued unbroken to the present time.

Table 1. New business

	1989 £m	1990 £m	1991 £m	1992 £m	1993 £m
Regular premium	23	41	44	54	96
Single premium	384	444	512	710	1201

Source: Association of International Life Offices

1.9 To put this into perspective, the level of offshore single premium business in 1993 represents almost 20% of the total U.K. single premium linked-life market in the same year, as reported by the Association of British Insurers. These reported levels of business, however, significantly under-state the size of the market, as they exclude both overseas branch business and cross-border business written by North American and Asian offices.

1.10 New business on this scale is, not surprisingly, changing the profile of the U.K. life offices whose specialist subsidiaries are pre-eminent in the offshore market. For a number of U.K. groups, offshore business now constitutes over 30% of total sales, effectively compensating for stagnation of the home market in recent years. Indeed, for some offices, a declining home market and/or unsuccessful U.K. distribution strategies (post Financial Services Act) have created the need for strategic development into overseas business.

https://doi.org/10.1017/S1357321700001197 Published online by Cambridge University Press

1.11 Development of overseas business can take a number of routes, which will, in this paper, be termed, simplistically, domestic business and cross-border business respectively.

1.12 The former of these — domestic overseas business — is beyond the scope of the current paper, but is worthy of separate study elsewhere. Empirical data suggest that a small number of U.K. life offices have successfully penetrated the domestic life assurance market of an overseas country; an even smaller number of U.K. companies have replicated this success in more than one overseas domestic market; but a greater number have invested in start-up domestic operations in overseas markets, failed to achieve critical mass and, ultimately, proven commercial failures.

1.13 The latter of these routes — cross-border business — is, to many readers, interpreted exclusively (and incorrectly) in a European context. Indeed, a great deal of attention is currently being paid to this European market, as potential new entrants explore expansionist strategies. Such strategies, however, are often based on weak foundations and stem from the herd instinct.

1.14 This instinct is (as all marketeers know) best stimulated by the presence of special offers that require attention NOW. The cross-border European market has these in abundance, and newcomers can select any of '1992', 1 July 1994 (implementation of Third Life (Framework) Directive) and 31 December 1994 (establishment deadline in Dublin's International Financial Services Centre for eligibility to concessionary 10% Profit Tax rate). The fact is that, thus far, true cross-border activity in the European market is generally — as far as U.K.-owned operations are concerned — somewhat more illusory than real. In all probability, a true cross-border market will gradually emerge in parallel with general European integration in the medium term, and already, in this respect, a small number of offshore companies have begun to write cross-border European business (e.g. in Germany) on a significant scale.

1.15 These genuine pan-European insurers have succeeded despite the cultural and language difficulties they face — partly through the involvement of one or more local joint-venture partners providing captive distribution, and partly through product pricing or marketing advantages.

1.16 For the remainder, cross-border European activity so far involves little more than satiating the appetite of the U.K. market for gross roll-up products (which is nonetheless considerable).

1.17 The real cross-border market for offshore insurers extends much further than this single European continent. Offshore business is cross-border business on an inter-continental basis, and constitutes the subject matter of this paper.

2. An International Business

2.1 Offshore business, as it exists today, has grown from the seeds of a very specialised market segment — the British expatriate. Second stage development has seen the industry grow to encompass other expatriates around the world. The

https://doi.org/10.1017/S1357321700001197 Published online by Cambridge University Press

dramatic surge in business since then, however, has been the result of a third stage of development — companies penetrating the 'home national' market, i.e. the high net-worth 'international' investor.

2.2 Development of this international investor market has occurred for a number of reasons, principally:

— increased competitor activity;
— a decline in the traditional British expatriate community; and
— liberalisation of investment controls.

2.3 Increased competitor activity began in 1986. The number of offshore life offices more than doubled over the period 1986-89, creating greater awareness of offshore products internationally and fertilising major development of the offshore broker market. By the end of this period, however, the traditional British expatriate market was showing early signs of a decline, forcing offices to diversify in order to satisfy expansionist plans.

2.4 Longer-established, specialist expatriate brokers were also becoming 'naturalised' — particularly in the Middle East and Far East — and increasingly gaining business from the wealthier local resident market, hence giving offshore insurers access to both the resident and expatriate markets in a country. As will be seen in Section 4, offshore products offer a number of benefits to such international investors. The seeds of a major expansion had been sown.

2.5 These activities at the micro level were boosted by developments at a macro level, which were opening up major international markets around the world to non-resident companies. The 1980s witnessed the relaxation of exchange controls and investment restrictions in many major countries. Increasingly the trend has been for governments to liberalise the range of permitted investments, but to impose a regulatory regime on the sale of investments, as has happened in the U.K.

2.6 The interaction of all of these developments has created a burgeoning market in the sale of offshore business to international investors. Statistics relating to the market are still in their infancy, and somewhat incomplete — nonetheless the global nature of the market is evident from even the limited analysis that is available. Table 2 shows the geographical distribution of business

Table 2. Geographical distribution of 1993 new business

Region	%
European Union	39
Other Europe	12
Far East	19
Middle East	14
Other	16
	100

Source: Association of International Life Offices.

https://doi.org/10.1017/S1357321700001197 Published online by Cambridge University Press

on the basis of annual premium equivalent (new annual premiums plus one-tenth of single premium sales). It should be noted that these figures exclude overseas branch business and at least one major offshore company and, as such, significantly under-state the levels of business attributed to 'Other' and the Far East.

2.7 Within these regions, the following countries in particular are significant markets for offshore products:
— Argentina;
— Belgium;
— China;
— Germany;
— Hong Kong;
— Indonesia;
— Kenya;
— Saudi Arabia;
— Singapore;
— South Africa;
— Sweden;
— United Arab Emirates; and
— U.K.

2.8 The attractions of offshore products and their methods of distribution in different world areas are explored later in the paper.

3. Review of Offshore Locations

3.1 Paragraph 1.3 referred to the taxation position of offshore life offices. The choice of domicile for establishing an offshore life office is critical, not only to maximise the tax concessions available, but also to obtain (legal) access to business in the chosen target market(s).

3.2 There are now four established centres for offshore life insurance business in and around Europe. These are:
— Isle of Man;
— Luxembourg;
— Guernsey; and
— Dublin International Financial Services Centre (IFSC).

3.3 There is, in addition, a long list of more exotic emerging offshore European and Asian centres (Mauritius, Labuan and Madeira to name only three), although it is unlikely that these will ever become sufficiently developed to become centres for life assurance business.

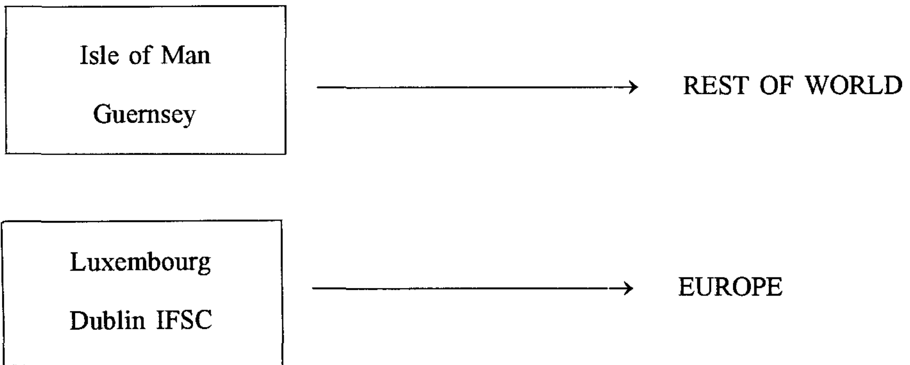
3.4 The developed offshore centres fall, at a simplistic level, into two distinct groups — a dichotomy which stems from the status of the respective locations

https://doi.org/10.1017/S1357321700001197 Published online by Cambridge University Press

with regard to membership of the European Union. Luxembourg and the Republic of Ireland (Dublin IFSC) are full Member States within the European Union (E.U.), so giving companies operating in these locations the right under the Third Life Directive to sell cross-border within the rest of the E.U. A possible shadow, however, hangs over E.U. locations, and Luxembourg, in particular, in the form of the commitment within the E.U. Union to harmonisation of taxation as part of the path towards economic and monetary union. At the time of writing, it is believed that this issue is once again rising to the top of the political agenda.

3.5 The Isle of Man and Guernsey, on the other hand, have a special relationship with the E.U. by virtue of Protocol 3 to the Act of Accession annexed to the Treaty of Accession 1972 by which the U.K. became a member of the European Economic Community. This relationship, whilst within the E.U. for customs and free movement of goods, is outside the E.U. for insurance purposes.

3.6 Offshore insurers consequently locate in Luxembourg or Dublin if cross-border E.U. marketing is the key objective, and in the Isle of Man or Guernsey if targeting the rest of the world (Far East, Middle East, Latin America, etc.).



3.7 Although companies located in Luxembourg or Dublin are not excluded from the Rest of World market, they have, for a number of reasons, yet to make a major international impact outside continental Europe. It is, nonetheless, still a very early stage in the evolutionary process — particularly as far as Dublin is concerned — and this position may change in the future.

3.8 The choice of location, however, is not important insofar as the U.K. market is concerned. Whilst they are not members of the E.U., the Isle of Man and Guernsey are member countries of the Commonwealth and of OECD. Both are Crown Dependencies of the U.K., but not part of the U.K., being responsible for their internal affairs and governed by their own parliaments. By virtue of this special relationship with the U.K. and the equivalent standards of investor

https://doi.org/10.1017/S1357321700001197 Published online by Cambridge University Press

protection in place in all three countries, the Isle of Man and Guernsey hold Designated Territory status under Section 130 of the U.K. Financial Services Act 1986 (FSA). Under the Act, companies operating from either country can freely transact insurance business in the U.K. (see also ¶8.3.6) subject to the same FSA regulatory regime as U.K. insurers.

3.9 The importance of the Rest of World grouping has led to the Isle of Man becoming the principal centre for offshore business. New premium income in 1993 for offshore life companies based in the Isle of Man was approximately £1 billion (Isle of Man Government Insurance Authority statistic). Companies operating from the Isle of Man, in the Rest of World plus U.K. market, dominate the offshore industry.

3.10 The continued growth of the offshore industry as a whole is attributable primarily to the new business success of these Isle of Man companies. A number of these, for example, reported new business growth of 50-60% in 1993 and are likely to report similar growth for 1994. New market entrants — particularly cross-border continental European joint-venture insurers — are now adding to this organic growth, creating a vibrant industry. Dublin's IFSC has attracted the interest of a number of U.K. companies new to the offshore scene, although relatively little business, as yet, is being written, in aggregate, in the Centre. Guernsey, on the other hand, has, in relative terms, stagnated as a centre, with its residence controls inhibiting the growth of an industry recognised for its high labour intensity. A brief comparison of the four offshore centres in this, and other, respects is outlined in Appendix A. More detail on regulatory requirements is contained in Section 8.

3.11 Although this paper concentrates entirely on offshore business from the position of an overseas *subsidiary*, companies seeking to enter the offshore market for the first time can also do so via an overseas *branch*. The branch route can equally facilitate a tax-free return to policyholders, because overseas business is only subject to U.K. tax on profits arising after deduction of a provision for policyholders' liabilities. There are, however, a number of difficulties. Foremost amongst these is the explicit dependence on the U.K. life assurance company taxation regime, the inherent uncertainty caused by potential changes to this regime and a potential loss of confidentiality. Too many aspects are of a discretionary nature, and hence are subject to uncertainty. Another limitation to the overseas branch is that it cannot accept business from U.K. residents. Finally, a more minor disadvantage is that the branch is subject to U.K. tax on all its profits, whereas profits from the overseas subsidiary (provided it escapes a direction under Controlled Foreign Company legislation) are subject only to U.K. tax to the extent they are remitted to the U.K. by way of dividend. This latter point, however, is largely irrelevant in the case of a mutual office.

3.12 At the time of writing, significant changes to the tax treatment of overseas branch (OLAB) business — which are intended to enable U.K. insurers to compete more effectively for business in the single European market established by the Third Life Directive — have just been announced. Legislative

https://doi.org/10.1017/S1357321700001197 Published online by Cambridge University Press

changes in the Finance Act 1995 will amend the current definition of overseas life assurance business in S433(2) Income and Corporation Taxes Act 1988,

> "......business with a policyholder......not residing in the United Kingdom the policy or contract for which was effected at or through a branch or agency outside the United Kingdom".

in such a way as to effectively remove the requirement for European business to be carried on through a branch. Thus U.K. insurers will be able to obtain OLAB tax status — without the need for an overseas branch — for cross-border business written on a services basis where the policyholder is resident in a European Economic Area (EEA) State. As a safeguard, regulations will require U.K. insurers to make checks to confirm that beneficiaries of policies under this new regime are not resident in the U.K.

3.13 These changes now presage a significant shift in the role of U.K. insurers within the cross-border European market. They remove, at a stroke, many of the reasons for establishing a subsidiary in Dublin or Luxembourg (although the offshore subsidiary route still provides the only means of writing gross roll-up life business with U.K. residents) and hence bring the prospect of cross-border E.U. business closer to reality.

4. Product Analysis

4.1 *Overview*

4.1.1 The products offered by offshore insurers today still have much in common with the original product ranges designed for the British expatriate. This investor was typically to be found in low-tax areas, for example Hong Kong, or tax-free areas such as Saudi Arabia and the United Arab Emirates, and hence had a high tax-free, or nearly tax-free, income.

4.1.2 Given this taxation-free background, and in many cases the absence of conventional employer-sponsored pension arrangements, expatriates have a high savings propensity and an affinity to investments providing a gross investment return. Longer-established expatriates, particularly in the Far East, may, therefore, have accumulated significant capital from earnings or from provident fund arrangements (a common situation where the expatriate receives a lump sum from the employer at the end of a contract period), so also giving rise to a significant lump sum market.

4.1.3 The international dimensions of the early British expatriate market, and, in particular, the fact that such expatriates were typically remunerated in U.S. Dollars or in currencies linked to the U.S. Dollar, gave rise to a requirement for multi-currency products. Products denominated in a range of currencies, typically Sterling and U.S. Dollars, were present from day one. This multi-currency capability was also to serve the offshore companies well when the industry entered its next phase of expansion into indigenous 'international investor' markets around the world; a single insurer today typically offers products

https://doi.org/10.1017/S1357321700001197 Published online by Cambridge University Press

denominated in Sterling, U.S. Dollars, Hong Kong Dollars, Deutschemarks, Swiss Francs, ECU and Swedish Krona. As will be seen later, this poses many challenges in the areas of financial and operational management.

4.1.4 This multi-currency capability and hard currency availability is critical for investors living in countries with high local inflation and weak currencies. For this reason, U.S. Dollar products, for example, are in strong demand in Latin America, both to expatriates and indigenous investors.

4.1.5 For such investors, offshore products also carry other important advantages. In less developed or politically unstable countries they provide the means for investors to re-locate capital to a more secure area, i.e. asset protection. Equally, the strong traditions of client confidentiality and total discretion associated with offshore investment can provide a high level of comfort.

4.1.6 Offshore business, because of this background, is a relatively high-value, low-volume business. Minimum premiums (in Sterling-equivalent terms) typically start at £10,000 for a basic single premium investment bond and £100 per month for an endowment or pension regular premium plan. Average premiums, in practice, are in the region of £30,000 - £70,000 and £200 - £400 p.m. respectively.

4.1.7 Offshore business is driven in many areas by special taxation considerations. In some countries taxation relief may be widely available on interest paid in respect of borrowings, with policy proceeds being tax-free. For this reason regular premium product sales linked to geared loan arrangements are common. In certain other countries similar benefits may also accrue for loan arrangements geared to single premium bonds.

4.1.8 Unit-linked products dominate the offshore life market, representing over 90% of new business. There are, however, a number of notable differences in the design of offshore and onshore (U.K.) unit-linked products.

4.1.9 Firstly, product charges overall are, for a number of reasons, slightly higher for offshore business than is the case in the U.K. This is, in part, attributable to the tax-exempt nature of many offshore life companies; the inability to relieve commission and other expenses against a company's tax liability (there being none) means that the full force of these expenses is reflected in product pricing. Operating expenses are also often much higher offshore: the relative youth of the industry, the complexity of products, higher underwriting expenses, long-distance communication costs, and the presence of operations in high-cost areas (such as Hong Kong) are all contributors. In addition, the high-value, low-volume nature of the market puts mass economies of scale beyond the reach of most offices.

4.1.10 A second notable difference, which in many respects masks the differential in charges, is that the large majority of single premium business is written on policies with a back-end loaded design, i.e. no bid/offer spread and 100+% of premium invested (at bid price) combined with short-term surrender penalties. Annual charges — at least for an initial period — are commensurately higher because of the absence of the front-end charge.

https://doi.org/10.1017/S1357321700001197 Published online by Cambridge University Press

4.1.11 Back-end loaded designs began to evolve in the mid-1980s as traditional front-ended products began to encounter sales resistance overseas; high-net-worth investors (the typical target market for offshore companies) have an understandable aversion to front-end charges, and this aversion is particularly strong in the Far East.

4.1.12 The financing of back-end loaded business, as in the U.K., can be achieved through creation of negative sterling reserves. However, the multi-currency nature of the business adds a further complexity (negative dollar reserves, etc.) and imposes limitations on the ability to match negative foreign currency reserves with positive ones (see Section 7.3). Where the financial strength of the parent facilitates a ready availability of capital, it may be preferable simply to avoid negative non-linked reserves and accept a higher new business strain.

4.1.13 Back-end loaded designs generally accentuate new business strain and can, if availability of capital is limited, restrict the level of new business an office can write. There have been instances of companies withdrawing from an offshore product market or radically altering product design for these reasons.

4.1.14 Profitability of offshore business at an industry level is difficult to assess, given the high confidentiality associated with the market and the absence of public financial information and published reports and accounts. Many younger offices are also still on various stages of the start-up path, with a longer-term profitability analysis still to be determined. Some general comments can be offered about individual product groups (see ¶4.2.2.5), but it is impossible, as things currently stand, to pass any wider comment on the profitability of the industry as a whole.

4.2 *Single Premium Products*

4.2.1 *Investment bonds*

4.2.1.1 The traditional unit-linked bond represents a large part of the offshore single premium market. Generally the bottom rung on a company's product ladder, the typical minimum premium is £5,000 - £10,000. Front-end loaded designs are still common in this product sector, with a typical bid/offer spread of 7%, but the majority of new product launches favour back-end loaded designs.

4.2.1.2 As in the U.K. market, three approaches to investment can be found, sometimes in combination:

— in-house managed range of 5 - 25 funds;
— comprehensive range of 50 - 100 externally managed offshore unit trusts, spanning a number of institutional fund managers and a wide range of investment sectors; and
— broker managed funds.

4.2.1.3 The amount of life cover automatically provided is generally minimal, with a typical death benefit of 101% of surrender value. At the time of writing, the legal basis of investment bonds — and in particular whether they constitute

https://doi.org/10.1017/S1357321700001197 Published online by Cambridge University Press

life assurance business — is under question as far as U.K. offices are concerned. Many of the issues under review will have similar implications for offshore insurers, whether selling within the U.K. or around the world. In this international context, certain overseas markets already require a more meaningful level of death benefit (e.g., 105%) in order to qualify for life policy taxation treatment, and, as a result, there is increasingly a move towards flexible additional coverages funded by explicit mortality charges.

4.2.2 *Personal bonds*

4.2.2.1 The personal or private portfolio bond has been the bedrock of the offshore life industry for the past decade, accounting for over 50% of single premium sales. Its complexity, and resulting labour intensity, is not unconnected with the explosion in the number of administrative staff employed within the industry.

4.2.2.2 Personal bonds as a generic product type are not well documented within standard actuarial texts, despite their presence in the U.K. market and offshore sales in excess of £400m p.a. The flagship of a company's single premium product range, personal bonds provide the high-net-worth investor with a full nominee/private client portfolio service. Each bond links to an individual personal fund, selected and managed by the investor or his/her adviser, comprising any or all of individual equities, bonds, deposits, currencies, unit trusts, offshore funds and overseas equivalents of these securities.

4.2.2.3 Freedom from linked asset regulations has even led to some offices permitting investments such as private company shares, fine art, even vintage cars, within a personal bond. Over exuberance, though, is inadvisable. For example, in the case of an offshore subsidiary directly owned by a U.K. life company, the U.K. company may have an understandable desire to maximise the value of the free assets of the subsidiary and admit these as free assets at a group level. Inadmissible assets in the subsidiary must, however, be netted out from this consolidation in the preparation of DTI Returns.

4.2.2.4 A personal bond investment typically starts at £50,000 - £100,000, with a considerable number of £1 million plus policies in force. The benefits provided to investors can be considerable; the life office undertakes all investment administration of the portfolio, including dealing, settlement and dividend collection, and provides frequent (quarterly) portfolio valuations; it also provides the investor with an investment which grows without deduction of tax and which is often taxed ultimately under the life policy regime. In some territories, such as Hong Kong, this means the eventual gain is tax-free; in others such as the U.K., the gain may obtain concessionary tax treatment. As will be seen below, this is not always to the liking of taxation authorities.

4.2.2.5 Personal bonds are, almost universally, written with back-end loaded designs which are generally capital-inefficient. The complexity of the product and its sophisticated administrative requirements result in high unit administrative costs. The new business market is also a highly competitive one, both in terms

https://doi.org/10.1017/S1357321700001197 Published online by Cambridge University Press

of charges and commission. Profitability of personal bond business, for these reasons, is often poor.

4.2.2.6 The profitability of personal bond business can, nonetheless, be boosted considerably through efficient treasury management. For example, cash deposits are a very popular investment within personal bonds, and typically represent as much as 20% of total portfolio investments. Proper treasury management can enable the office to earn a significant interest rate margin across this deposit base. Currency management is an equally important area, given the large number of investment transactions carried out for personal bonds that necessitate currency conversion. Handled effectively, the treasury function is one of the means to writing profitable personal bond business.

4.2.2.7 Brief mention was made above of the tax sensitivity of offshore personal bond business, referring to the fact that it has become a *bête noire* for the U.K. Inland Revenue. Gains for offshore life assurance policies are taxed, for U.K. policyholders, under the U.K. 'chargeable events' legislation, but without relief to income tax at the basic rate. This statutory regime was introduced by special provisions under the Finance Act 1984, effective from midnight on 17 November 1983, and is now consolidated in Section 553, Income and Corporation Taxes Act 1988. An important feature of offshore personal bonds is the tax deferral available under this legislation.

4.2.2.8 In 1990, however, the Inland Revenue's Special Investigation Section — in response to growing sales of offshore personal bonds to U.K. residents — turned its attention to offshore bonds for a second time. Since time immemorial, the Revenue's view has been that a tax deferred is a tax avoided; they therefore countered by turning to the anti-avoidance provisions contained in Section 739, Income and Corporation Taxes Act 1988: Transfer of Assets Abroad. As will be seen later, this has only been partially successful; in the one appeal held to date, the Special Commissioner found in favour of the tax payer concerned, upholding his defence under Section 741.

4.2.2.9 The Revenue's fundamental approach to the issue is noteworthy, having stated in writing that they do not regard offshore life policies *per se* as tax avoidance vehicles; instead, the Revenue will only seek to apply S739 to 'highly personalised bonds':

> "In simple terms the dividing line is between a policy which enables the policyholder to invest in non-pooled assets and one which does not. A policyholder whose policy obliges him to invest in pooled assets from a standard menu of funds offered by the Company to all its customers holding the same type of policy falls into the second category (i.e., is regarded as a non-personalised bondholder and therefore outside the scope of Section 739)".

4.2.2.10 What this means is that offshore personal bonds which facilitate direct investment in equities, fixed-interest securities, deposits, etc. are potentially caught by S739, whereas those which restrict the policyholder's personal fund to 'pooled funds' are not. In this regard:

https://doi.org/10.1017/S1357321700001197 Published online by Cambridge University Press

> "...... the Revenue has no objection in practice to the proposition that external funds such as unit trusts and UCITS over which the policyholder has no control may be described as pooled funds".

4.2.2.11 As a result, special offshore personal bond contracts were born for the U.K. market, restricting investment purely to pooled funds, and significant new business with U.K. residents continues to be written in this way.

4.2.3 *Guaranteed equity bonds*

4.2.3.1 Guaranteed equity products exist in two forms in the offshore market, the lesser of which is the traditional derivatives-based bond commonly marketed by U.K. life offices in recent years. Offshore companies have generally been free from the asset admissibility confines of the U.K. regulations (only recently relieved in the U.K. through the Third Life Directive), making it possible to hold a pure derivatives contract, as opposed to an artificial hybrid deposit, as the matching asset. This type of guaranteed equity bond has not, however, been successful offshore. One cause of this is undoubtedly the lack of any concentration of suitable product distributors internationally (for example there is no bancassurance presence as yet in the offshore industry). A second factor has been an inability to make the offshore version attractive to the U.K. market *vis-à-vis* the corresponding U.K. contract; U.K. insurers have been able to provide almost the same gross investment performance — but net to the policyholder of basic rate income tax — through the use of aggressive overseas reinsurance arrangements involving the export of investment income. (At the time of writing it is believed that these arrangements may lead to a change in U.K. legislation within the near future.) Consequently, although traditional guaranteed equity bond offerings have occurred offshore, these have been on a relatively small scale and a short-lived phenomenon.

4.2.3.2 There is, however, another form of offshore guaranteed equity bond which has been more durable and successful, albeit still not on anything like the same scale as the traditional U.K. bond. This type of bond links to date-managed unit-linked funds, typically with a guarantee that the unit price at maturity will be the highest ever price for that fund. To provide for this guarantee, the office — assisted by freedom from asset admissibility regulations — runs a series of funds (one for each future year of maturity) investing in guaranteed growth bonds, equities and cash; the proportions of each are varied on a regular basis (generally weekly) such that the 'fixed-interest' proportion increases towards 100% at maturity. The asset allocation will vary also with the performance of the equity element of the fund; new 'highs' will progressively result in small equity disinvestment in order to protect the new higher guarantees.

4.2.4 *With-profits bonds*

4.2.4.1 Being a relatively young market born after the boom in unit-linking in the 1970s, unit-linked products dominate the offshore scene. In the last year or two, however, coinciding with increased volatility in equity markets, a small number of with-profits vehicles have begun to emerge. The traditional financial

https://doi.org/10.1017/S1357321700001197 Published online by Cambridge University Press

barriers to new with-profits funds are just as much an issue offshore as they are in the U.K., albeit that, from a marketing perspective, past performance and financial strength issues are somewhat less important.

4.2.4.2 The sprinkling of with-profits funds now beginning to emerge are generally provided either through the overseas branch route or, alternatively, via reassurance to the U.K. sister company. No offshore company has, as yet, developed its own with-profits fund. However, the success that the early with-profits pioneers have achieved offshore will doubtless mean that this situation will not continue for long.

4.2.5 *Capital redemption business*

4.2.5.1 For a significant part of offshore business, the 'life assurance' policy veneer is often unnecessary. The traditional policyholder taxation reasons for constituting an investment bond as a life assurance product rather than as an investment contract do not apply in locations such as the Middle East and Hong Kong, where policy roll-up and gains are totally tax-free. In other areas, construction of an investment as a capital redemption policy may be positively advantageous in estate planning and trustee applications. From the office's perspective, writing such business as life assurance business will also impose authorisation and regulatory implications which may not be attractive. The marketing of pure investment (capital redemption) products is often easier internationally; in lesser developed financial areas the concept of investment-linked life assurance products is not a familiar one, and capital redemption business neatly avoids the 'life assured' issue.

4.2.5.2 Tax-exempt offshore life companies have started to utilise their ability to write capital redemption business, and a small number have been successful in this area.

4.2.6 *Other non-linked business*

Although representing less than 10% of the total offshore market, some classes of non-linked business are transacted. New business is primarily capital conversion plans and immediate annuities, together with a small level of multi-currency pure endowment (guaranteed growth bond) policies.

4.2.7 *Other investment business*

Following in the path of many U.K. life offices, several offshore insurers have diversified beyond life assurance business into fund management/unit trust operations. For most such operations, Luxembourg SICAVs are the preferred *modus operandi*. The addition of a retail funds operation can be a valuable part of the offshore armoury, particularly in those overseas markets where there is a high sensitivity to life assurance business on a non-admitted basis. An insurer's broker sales force can often freely and legally promote funds business, and in doing so establish an accepted corporate presence for the writing of non-admitted life business. Through vertical product integration, an insurer with a sister fund management company can also capture a double income stream from the sale of life assurance policies.

https://doi.org/10.1017/S1357321700001197 Published online by Cambridge University Press

4.3 *Regular Premium Business*

4.3.1 Although the overall market for international companies has been mainly single premium based, there is now a sizeable fast-growing regular premium market.

4.3.2 The demand for offshore regular premium products has arisen as a direct result of a market being poorly supplied. For many expatriates and high-net-worth individuals, domestic regular premium policies are simply not available or, if they are available, are of limited appeal because of local insurance company restrictions. Some of the more common drawbacks of local policies as perceived by the potential policy holder are:

— the absence of a hard currency;
— inappropriate types of cover that do not satisfy the real need of the policyholder;
— limited potential for good investment performance; and
— restriction on the absolute amount of cover.

4.3.3 *Pensions*

4.3.3.1 Many countries in which offshore companies are active do not have state-provided pensions; pension provision is therefore generally left to the individual. Equally, employment conditions for expatriates — still a key offshore market — do not generally include pension provision.

4.3.3.2 Offshore insurers have capitalised on this clear need by using the experience of the U.K. market-place to design offshore pension plans. Many of the regular premium contracts now being sold for pension purposes are very similar to U.K. personal pension arrangements, but without the normal restrictions on benefits and contributions.

4.3.3.3 In addition, certain offices are beginning to exploit the international market for executive pension schemes, using specially designed multi-currency pension schemes with a full range of benefits to fit the needs of overseas executives of international companies.

4.3.3.4 In many countries, the absence of statutory restrictions on the design of international pension policies means that there are a number of features which can be included to make such plans particularly attractive. Notwithstanding this, where substantial 'approved' pension markets exist, offshore companies are often able to tailor-make their pension plans to fit local legislation and compete with domestic insurers for the same business. In this situation the offshore company may have a marketing advantage, being able to offer flexible international multi-currency products with assets located offshore.

4.3.4 *School fees provision*

The market for policies designed specifically to accumulate for school fees/higher education is growing rapidly. Many of the countries in which offshore insurers operate are dollar based and have traditional links to the United States of America and the U.K. for primary, secondary and tertiary education.

https://doi.org/10.1017/S1357321700001197 Published online by Cambridge University Press

This linkage represents a large and mostly unexploited market and one which can be satisfied by the design of regular premium savings plans with features which provide relevant covers for parents and grandparents funding these plans.

4.3.5 *Protection plans*

Many offshore insurers writing protection business internationally compete primarily against American-based companies. These companies tend to offer a wide range of insurance covers (rider benefits) in areas of the world where domestic U.K. insurers would normally decline to write the cover. Nonetheless, through careful product design and detailed consideration of other factors, the full range of protection covers can be made available in most parts of the world. Section 6 covers the management of such risks and deals with some of the ways in which this can be achieved. A typical range of rider benefits would include waiver of premium, accidental death benefit, family income benefit, critical illness, hospitalisation, medical expenses and dismemberment benefit.

4.3.6 *Premium payment systems*

4.3.6.1 When dealing with expatriates on short-term employment contracts, it is often useful to provide an accelerated premium payment facility. In this respect, payment systems have been developed so that a long-term regular plan can be purchased by a short-term series of regular instalments.

4.3.6.2 Typically, some companies use pre-payment systems whereby the company will guarantee all the premiums for the premium term of the plan for a limited number of instalments. This is very similar to a temporary annuity/life annuity payable by instalments. Other companies will use a unit-linked single premium bond (payable by instalments) where the sustainability of the premiums will be dependent on the growth assumptions being realised.

4.3.6.3 Other methods common with American companies convert the standard long-term regular premium contract into a 'vanishing premium' contract. Typically, such a contract is designed with a much higher premium (vanishing premium) than the standard premium plan, with the vanishing premium calculated in such a way that the contract will be sustainable for the whole of life after a fixed number of premiums have been paid. As an example, a plan may be designed such that, after the payment of seven premiums, all benefits will be fully sustainable for the life of the insured on the basis of realistic assumptions as to fund growth and benefit costs.

4.3.6.4 It is, however, possible that many vanishing premium plans sold during the last ten years (high interest rate period) will have difficulty in sustaining the plan with full benefits without additional funding.

4.3.7 *Trusts*

Trusts are used extensively in connection with offshore life assurance products, to enable policy proceeds to be passed outside the policyholder's estate. Originally only effective in countries where the legal system developed based on

https://doi.org/10.1017/S1357321700001197 Published online by Cambridge University Press

the English style (where the legal system was 'civil' they were ineffective), some types of trust are now recognised around the world.

5. Distribution

5.1 *General*

5.1.1 Few countries in the world are currently regulated as heavily as the U.K. with regard to the distribution of life assurance.

5.1.2 In many countries the laws covering the distribution of financial services products are quite straightforward and simply forbid distribution unless the provider and the advisor are both resident or registered in the country where the advice is being given. In others it may be illegal for the client to buy a foreign life insurance product, whereas in others still the client is free to buy, but it is illegal for the distributor to advise or sell. Clearly it is necessary, before embarking on distribution in any country, to investigate the position thoroughly and establish distribution legitimately and/or minimise the risks involved.

5.1.3 Even in countries where laws prohibit the sale of foreign life policies, it can be common practice for companies and regulatory authorities to turn a blind eye, particularly as far as expatriate sales are concerned. The establishment of permanent distribution on such a basis has to be considered carefully. It is not unknown for companies to invest substantial resources in developing a distribution network, only to find that it is outlawed by a change of regulatory attitude. A considerable amount of expertise has been accumulated in the offshore life insurance industry in tackling these problems and in devising pragmatic solutions to maximise the long-term potential.

5.1.4 The U.K. Financial Services Act is another instance of regulation that needs to be taken into account, even beyond the territoriality of the U.K. Although the Act itself only regulates the sales and marketing of investment business within the U.K., at least one of the Self-Regulating Organisations resulting from the Act (FIMBRA) has, in the past, extended many of its rules to member firms transacting business overseas.

5.1.5 Three core distribution methods are used internationally: independent intermediaries, master agents and direct sales forces. A small degree of direct marketing is also undertaken, often to the client bases of international banks.

5.2 *Independent Intermediary*

5.2.1 The independent intermediary is the main distribution force in many offshore markets, operating on a very similar basis to the pre-FSA situation in the U.K.

5.2.2 Common locations in which the offshore intermediary is based include Hong Kong, Singapore and Dubai. Many advisors also operate from countries such as the U.K., Cyprus, Malta, Gibraltar, Channel Islands, Isle of Man and the Caribbean, and travel to those areas where there are rich expatriate pockets. Recent years have, however, seen a gradual shift from 'travelling' intermediaries

https://doi.org/10.1017/S1357321700001197 Published online by Cambridge University Press

towards 'established' intermediary offices, with a growing number of agents beginning to put down roots in the territories in which they transact business.

5.2.3 The successful motivation and incentivisation of international distribution sources has been a major reason for the industry's success, and it is interesting to note that many of the techniques that were widely used prior to the FSA in the U.K. are employed extensively in international distribution. This does carry some drawbacks however. In particular, the level of commissions is unregulated within this sector, and in recent years there has been a marked increase in commission levels because of the supply/demand effect, as new companies entering the market attempt to secure intermediary support.

5.2.4 The overall level of remuneration is slightly higher, in any event, because of the expensive nature of procuring and servicing international business and very high office expenses in a number of major international markets.

5.3 *Master Agent*

5.3.1 The concept of the master agent (or master distributor) in the insurance industry is similar to the kind of agency commonly found in other types of industry. Essentially, a master agency is an agreement between a supplier of a product and a distribution organisation in a particular territory to sell the supplier's product in that territory. Any agreement would normally include a requirement to sell a certain volume of business and a requirement to expand the distribution of the product over a defined period. In addition, the master agent would be expected to form a 'partnership' with the supplier and advise the supplier on the current state of the market and on how the supplier can best exploit the product in that territory. It would not be unusual for the master agent and supplier to prepare joint business plans and for the supplier to invest capital and human resources to help deliver the plan. High levels of training and marketing support for such agents are essential. The system has some similarities to the 'tied agent' currently found in the U.K. market. Master agents are not necessarily tied to a single life office, however, so a 'multiple tied' description is more appropriate.

5.3.2 The master agent system is found extensively in Latin America, Africa and the Far East. Many of the larger master agents are established on a direct sales force basis, where the structure includes branch managers, district managers and consultants, with the associated commission hierarchy to fund the overall structure.

5.3.3 Many countries in which master agents operate are, from a U.K. life industry perspective, countries which would normally be avoided: the benefits being underwritten and the potential for adverse claims — either naturally or fraudulently — are such that offices have to be extremely careful. Clearly, one of the critical requirements, therefore, is that the master agent be honest and professional. Many American companies who have pioneered Latin America, Africa and the Far East have suffered from poor claims experience as a direct result of basic failure in this critical area.

https://doi.org/10.1017/S1357321700001197 Published online by Cambridge University Press

5.3.4 Master agencies in a particular territory are sometimes established on an 'exclusive basis'. This is often used to control exposure in a particular country; restricting the appointment of master agents to one per country enables an insurer to focus efforts on that agent to develop their mutual business.

5.3.5 One of the essential tenets in the development of master agency distribution is that it is through heavy support of the master agent — with good marketing, sales training, management development and provision of sales aids (obviously in the language of that particular territory) — that an office can best ensure business success and agency loyalty.

5.3.6 The freedom to be innovative in the design of remuneration systems clearly assists an offshore insurer in the development of its master agency distribution. Many non-standard commissions/bonuses can be used to focus the master agent on issues of persistency, quality business (high premiums) and claims experience.

5.3.7 The master agency route into a territory can be a particularly cost-effective route of entry into a new country/market. The initial burden of cost and risk lies with the master agent/distributor and shields the office from the considerable investment that would otherwise be required for, say, direct sales force entry into a market.

5.4 *Direct Sales Force*

5.4.1 In order to operate an insurance company direct sales force (DSF) overseas, it is necessary to register the insurance company with the relevant authorities and submit either a branch or a subsidiary (or some other form of legal presence that will permit the DSF to sell and promote the insurer's products openly) to local regulation in that territory. Registration of a life operation is, however, expensive. This expense is often increased by the need to localise assets and retain a high level of professional expertise in the local company in order to discharge statutory reporting requirements.

5.4.2 Once established though, the benefits of being able to operate openly and with the company's own brand name can bring great marketing advantages, enabling the company to secure and invest with confidence in its own distribution. Many offshore companies are, because of this, expanding their legal bases with offices being registered in Hong Kong, Luxembourg, Dublin, the Middle East and Latin America.

6. Risk Management

6.1 *Products*

6.1.1 To operate successfully around the world, including in less developed countries, it is critical for a company to limit, as far as possible, its exposure to unprofitable experience. The large majority of offshore business is, as seen in Section 4, purely investment-related. Traditional life assurance on a risk basis

https://doi.org/10.1017/S1357321700001197 Published online by Cambridge University Press

is nonetheless transacted by a growing number of companies, for whom it imposes many risk-management requirements.

6.1.2 *Exchange rates*

Multi-currency products proliferate within the offshore life industry; premiums may be set in one currency, the benefits set in another and the investment funds denominated in a different (third) currency. To further complicate the issue, it is often possible for a premium set in one currency to be collected in another (e.g., Hong Kong Dollars → U.S. Dollars or U.S. Dollars → Sterling). The systems to handle these transactions need to be designed and implemented carefully if the insurer is to avoid any unintentional losses whilst, at the same time, ensuring that the client gets a fair deal.

6.1.3 *Interest rate guarantees*

6.1.3.1 When the offshore industry started to seek regular premium business in Latin America, Africa and the Far East, the principal competition encountered was from North American offices with long-established distribution and accepted products in these countries. It was thus essential in designing products to consider the American products closely.

6.1.3.2 The benchmark regular premium product is a capital accumulation/deposit administration plan offering interest rate (bonus) guarantees. These can be onerous if established in long-term contracts, particularly given the experience of the last 10 years in Dollars and Yen which has, at times, seen long-term Dollar yields fall to less than 6% and Yen yields to 3.5%.

6.1.3.3 Although American offices have maintained high Dollar guarantees, the more prudent U.K.-owned offshore companies have responded by weakening the guarantee, for example restricting the guarantee to premiums paid to the point when the guarantee is changed, or limiting the guarantee term.

6.1.4 *Mortality guarantees*

Mortality guarantees represent another area where offshore companies have adopted a less cavalier approach than American competition. Many U.S. companies have a table of guaranteed mortality rates above which they will not increase the charge. In other words, there is a maximum limit to the amount the company can charge a client for the cover being provided. The past decade, however, has seen the advent of AIDS — particularly in Africa and the Far East, both of which are large offshore markets — and it is possible to see potential risks emerging, despite the heavy tables to which the mortality guarantees, are linked. If, despite this, offices do offer mortality guarantees, it is important to adapt these by inclusion of a hazard loading to cover any environmental conditions in a particular country if, for example, there is a high incidence of violent death or a substantially increased level of terrorist activity.

6.1.5 *Reviewable rates/yearly renewable benefits*

Many offices writing protection benefits throughout the world, and particularly

https://doi.org/10.1017/S1357321700001197 Published online by Cambridge University Press

in high-risk areas, can reduce the degree of risk by operating on the basis of reviewable premium rates and, in the extreme, making certain rider benefits yearly renewable. Most reinsurers will insist on reviewable rates at 3-month's notice, which heavily influences policy conditions. As far as yearly renewable benefits are concerned, although the very principle may be against the needs of the life insured, it may, in some areas, be absolutely necessary for the life office if claims experience turns out to be unacceptably high such that either the rates cannot be increased to compensate or the underlying trend/experience is unable to be managed.

6.1.6 *Thunder and lightning clauses*

The international nature of offshore life business poses significant political danger to insurers which has to be properly managed; where a company holds authorisation or has a registered form of distribution in a territory, and as a result is subject to the law of that territory, it is essential to reserve the right to re-express the policy as a defence against the possibility of external interference beyond the control of the life office. This is particularly advisable because of the politically sensitive nature of many countries both in the developed and lesser developed world. A suitably drafted 'thunder and lightning' clause in policy provisions is the most common defence, giving the company the right to alter the terms of the contract in the event of any change in legislation forced upon the company which, in the opinion of the actuary, materially alters the nature of the contract.

6.1.7 *Incontestability clauses*

Incontestability clauses are very common in North American products and hence, from a marketing perspective, are important to compete effectively with the North American insurers. A typical clause will guarantee that any claim will not be contested on the grounds of non-disclosure, provided the policy has been in force for at least two years. On the face of it, these clauses are onerous and a danger to the industry. The practice in America, however, is to dispute claims outside the two-year incontestability period if it is believed that the original intention was to defraud. Once again careful drafting of the clause can assist the insurer in declining a claim where the policy has been originally taken out with the purpose of fraud.

6.1.8 *Rider benefits*

In order to limit the insurer's exposure, restrictions and amended policy conditions can be used according to the country in which the product is being sold. For example:

- *Waiver of premium* — the actual policy conditions can be varied depending on the territory in which the life assured is resident.
- *Accidental death benefit* — the amount of cover available can be restricted to a percentage of the life sum insured with a maximum level. Both the

https://doi.org/10.1017/S1357321700001197 Published online by Cambridge University Press

percentage amount and maximum amount can be tailor-made for the particular circumstances of the territory in which the life insured is resident.

— *Hospitalisation benefit* — where the benefit provides a cash amount for each day of hospitalisation, restrictions can be made on the overall amount of claim in any policy year or on the waiting period. In addition maxima can be placed on the daily amounts to reflect the cost of medical services in the country in which the insured is resident.

— *Dismemberment benefit* — an office might have to restrict the benefit in certain countries, depending on cultural background.

6.1.9 *Exclusions*

In the more violent or politically unstable areas of the world, it may be necessary to apply violent death and/or passive war risk exclusions.

6.1.10 *The reinsurer*

6.1.10.1 Reassurance plays an important part in the design of products and the minimisation of risk. Many international reinsurers have world-wide experience which can be used effectively to assess the appropriate rate and offer only benefits which can be properly controlled. The quality of distribution is paramount in determining the rate structure and underwriting policy in a particular territory.

6.1.10.2 The original *raison d'être* of the established offshore market was the provision of gross investment returns within a tax-efficient product. This perspective offers little price advantage in traditional protection business, so a number of companies offer risk benefits only where these are essential in order to enhance the basic investment plan (e.g. a term assurance rider or an endowment for mortgage repayment). In such cases it is typical to find the large part of such benefits being reassured with a U.K. sister company and/or an external specialist reassurer.

6.1.10.3 More recently, though, the offshore industry has moved into a higher gear, driven by world-wide cross-border selling. This move has now led to a developing market in flexible whole of life (protection) products, exploiting differentials not only in taxation, but also in price (for example within the European Union).

6.1.11 *Sparsity of data*

6.1.11.1 A major problem faced by any company writing risk benefits world-wide is the absence of credible mortality or morbidity experience data. In this situation, it is desirable when pricing a product to increase target profitability. Contract design is extremely important here; a good product design can satisfy what may seem to be two irreconcilable positions, producing a competitive product, but with risk benefit rates substantially higher than those of local competitors.

6.1.11.2 In general, most lives underwritten by offshore insurers are in the

https://doi.org/10.1017/S1357321700001197 Published online by Cambridge University Press

higher socio-economic groups. From first principles one might not expect the general mortality of, say, an accountant in Buenos Aires with first class medical services available to him to differ substantially from that of an accountant in London. Furthermore, even where there may be an additional force of mortality from violent death on the general population, this will often be absent or negligible in the higher socio-economic groups. (Where violent death is a factor, it also tends to display itself as extra mortality in the age range of 18-40, in which case the standard table can be loaded to reflect this, assuming the alternative of a violent death exclusion is not employed.)

6.1.11.3 This simplistic approach is adopted by a number of offices, but can have limitations. For one thing, it ignores the extra risk of accidental death from road traffic accidents which can be very substantial and indiscriminate in some parts of the world. One or two insurers, once they have become well established in a territory, have begun to recognise the differing mortality experience from country to country and have evolved appropriate underwriting practices, mortality tables and exclusion clauses for each country. For example, one insurer differentiates into approximately thirty world areas for underwriting purposes, employing six different mortality tables in Latin America alone.

6.2 *Procedural*

6.2.1 *Underwriting*

6.2.1.1 The general practitioner system found in the U.K. is not common in other parts of the world, where individuals tend to use doctors as they might use any other services — as and when they need them. As a result of this, one of the most important elements of medical evidence normally used in underwriting risk benefits — the Private Medical Attendant's Report — is missing. This makes it very difficult to detect non-disclosure at the proposal stage if the proposer is intent on non-disclosing. Consequently non-disclosure is common, is only generally detectable at the claims stage, and then only after considerable investigations. To avoid a situation of having to underwrite, in effect, at the claims stage, offices need instead to give careful consideration to the detection of non-disclosure at the initial underwriting stage. This can be achieved by a number of steps, for example detecting non-disclosure of smoking status (prevalent in Latin America) through urine analysis and selective reduction of non-medical limits so that more proposers are submitted to the medical examination process.

6.2.1.2 Medical Examiner's Reports, therefore, form the sole means of performing medical underwriting. The usual medical evidence, such as AIDS tests, ECGs, urine microscopic analysis, etc., is possible; care is, however, needed when appointing examiners in some countries, as cases do occur where the examiner has been persuaded to supply medical evidence which does not accord with the state of the patient. A number of offices, therefore, periodically undertake a vetting process on their list of examiners, involving the use of investigation agencies to identify and remove from the list any doctor or practice

https://doi.org/10.1017/S1357321700001197 Published online by Cambridge University Press

considered to be susceptible to 'inducements'. Photographic or finger-printing evidence is also a common requirement, to ensure that the person attending the examination and the proposer are one and the same.

6.2.1.3 For similar reasons, offices are increasingly relying on independent analysis of blood samples: instances have been found where local HIV testing of a sample is negative, but subsequently proves positive on independent analysis. Thus in Latin America, blood samples, dried blood spot tests and urine samples are increasingly taken by the local medical examiner, but forwarded directly to North American laboratories for analysis.

6.2.1.4 From all of the above, it will be evident that the increased moral hazard in transacting international risk coverages can be very serious. A further step an office can take to reduce the hazard to acceptable levels is to operate, where necessary, on an exclusive basis using a single master agent distributor of high repute.

6.2.1.5 Insurers designing examiner forms for use internationally need to be very much aware of the different illnesses affecting different cultures: for example, diabetes in the Middle East and hepatitis B in the Far East.

6.2.1.6 Care is also needed when operating in countries where there is political instability or organised crime is prevalent. Certain occupations, such as members of the legal profession, judges, government officials, military personnel and embassy staff, would not normally be acceptable.

6.2.1.7 Private Investigators' Reports (PIRs) are used widely in Latin America and the Far East as an additional underwriting procedure to screen proposers prior to acceptance. These reports provide the insurer with third party knowledge of the proposer based on personal interviews with the proposer, neighbours, business associates and, in certain circumstances, press cuttings. PIRs are not, *per se*, used for financial underwriting, but for underwriting 'good standing' and generally for establishing a 'feel-good' factor. This is very much necessary when operating in the higher-risk areas of the world.

6.2.1.8 Where financial evidence is necessary to establish the need for the insurance in underwriting larger benefits, there is often difficulty in obtaining the full facts about a proposer's financial position. The financial position of the proposer may, for example, comprise investments held outside the country of residence which there may be an aversion to disclose. In such circumstances commercial judgement has to play a major part in accepting the risk.

6.2.2 *Collection of premiums/applications/receipts*

6.2.2.1 Many less-developed markets are still cash driven, with premiums consequently collected in cash by the insurer's agent. For this reason insurers need to exercise care in controlling the supply of proposal forms and marketing material. Procedures have to be such that any fraud can be detected very quickly.

6.2.2.2 The potential for loss in this area can be minimised by numbering application forms and ensuring that any spoiled forms are returned to the office. Renewal premiums, whenever possible, should be collected directly from the

https://doi.org/10.1017/S1357321700001197 Published online by Cambridge University Press

client or, where this is not possible, accepted with an official company receipt. The insurer, in such cases, must keep fully up-to-date on any outstanding premium position, issuing reminders directly to clients in their own language so that alarm bells can be sounded in the event that the premium has been misappropriated.

6.2.2.3 International insurers must also be highly vigilant in order to avoid being a conduit for money laundering. Industry standards are already in place, reinforced by existing legislation in some offshore centres and imminent legislation in others, to deter this risk.

6.2.3 *Agent control and regulation*

6.2.3.1 The majority of offshore business is written internationally in areas where, with the exception of only one or two countries, regulations governing the conduct of agents and intermediaries are notable by their absence. At first sight, given the heavy regulatory environment in the U.K., for example, this might seem attractive.

6.2.3.2 It does, in fact, pose a number of serious risks to the offshore insurer which, accordingly, needs to exercise a high level of care and selection over the intermediaries through whom it will accept business. Failure to do so will lead to a proliferation of low quality, poor persistency, unprofitable business for the office and the policyholder alike.

6.2.3.3 A more visible agency-related financial risk is in the payment of indemnity commission on regular premium business, where proper control procedures are essential. Offshore regular premium case size is significantly higher than in the U.K. — for example regular savings plans with monthly premiums of the order of $3,000 - $5,000 are common-place — with the result that indemnity commission fraud is an ever-present risk. In the absence of statutory systems of agent regulation (and accepting that in the U.K. the existence of agent regulation does not eliminate the problem), there is an increased need for due diligence on the intermediary and its principals prior to issuing Terms of Business. Insurers, in this respect, need to recognise the limited extent to which bank and other references can be relied upon.

6.2.3.4 If these controls are strongly advisable in the context of independent intermediary distribution, they are absolutely critical for a master agency distribution system. There has been a move by offices operating through this channel to impose ever more stringent controls on their trading practice. Examples include:

- the use of tightly worded terms of business agreements to prevent the possibility of 'deemed agency';
- strict controls over the issue and use of corporate stationery, business cards and company logo; and
- private investigative reports on the key individuals concerned.

6.2.4 *Claims*

6.2.4.1 Companies operating internationally are exposed to many forms of

https://doi.org/10.1017/S1357321700001197 Published online by Cambridge University Press

fraud which would be more difficult to perpetrate in the U.K. or other European countries. There are generally three types of fraud to guard against. The first is the fairly common situation where the proposer is unhealthy at the point of application and does not make proper disclosure. The second is through substitution (the use of a healthy individual) at the medical examination stage. Finally there is the problem of fraudulent claim, that is the original life insured is still alive, but a death claim is made.

6.2.4.2 This last problem, the fraudulent claim, is particularly a problem in tropical and sub-tropical countries where, for obvious reasons (heat, humidity, etc.), disposal of a corpse by whatever means is normally undertaken on a very rapid basis. Medical examiners are often not entirely reliable in certifying proper cause of death or on certifying only genuine deaths which, in the absence of the body, exposes the insurer even further to fraudulent claims. This risk can be magnified where the sum assured is increased under accidental death benefit riders.

6.2.4.3 International insurers are very much at risk in such cases, because the risk/reward ratio for attempting to defraud is very high. It can, for a number of reasons, be difficult for the insurer to bring a legal case in the event of detection of any fraud. In such situations it is therefore quite normal for the insurer not to press charges and simply to decline the claim. All of this means that international insurers are regarded as fair game.

6.2.4.4 A further type of moral hazard is in relation to cover for minors, which is common in some parts of the world. A very high moral risk is present, even for relatively low and/or restricted sums assured (such as $100,000), in that the value of life (or death) is low in a number of developing countries.

6.2.4.5 Proper risk management, therefore, requires the use of specialist claims investigators. Several investigative firms operate internationally and have access to confidential information in the country in which they investigate. Without such services it would often be very difficult to decline a fraudulent claim.

6.2.4.6 The use of investigators, however, makes claims admittance a very expensive procedure which needs to be properly incorporated into product pricing.

7. Financial Management

7.1 *Asset/Liability Matching*

Asset limitations can affect an insurer's ability to write certain classes of business in foreign currencies. In many cases, investment-grade Eurobonds or government stocks in the appropriate currency do not exist with a long enough term, which has implications in pricing and also in matching itself.

7.2 *Asset Failure*

7.2.1 Given the investment-linked nature of the majority of offshore products, care must be exercised at all times to reduce the risk of asset failure and to

https://doi.org/10.1017/S1357321700001197 Published online by Cambridge University Press

attempt to protect the company as far as possible against the risk of such failure. One example is in the case of personal bonds, where there have been a small number of instances of failure by U.K. and other stockbrokers. In such cases it is critical to determine on whose account (insurer or policyholder) the loss is determined and, if the former, to operate proper credit control on stockbroker balances.

7.2.2 Similar care is required in relation to broker managed funds. The insurer must limit its delegation of management, not abrogate it, if it is to avoid possible catastrophic loss through negligent or fraudulent activity.

7.3 *Sterling Reserves*

7.3.1 Non-linked reserves on unit-linked business pose several complications for offshore insurers. For example, in setting actuarial reserves, the future income stream arising in the policy currency (e.g. Dollars) needs to be compared with per policy expenses in a different currency (Sterling for Manx and Guernsey offices, Belgian Francs for Luxembourg insurers and Irish Punts for IFSC companies). Prudent allowance for currency fluctuation forms an essential part of the valuation basis.

7.3.2 The back-ended nature of offshore single premium business also poses complications if funded through creation of negative non-linked reserves, again of a multi-currency nature. Negative sterling reserves can be easily used to match and offset positive expense and other sterling reserves, but negative reserves denominated in Dollars or Deutschemarks or other currencies may not be so easily manageable. Unless non-linked guaranteed business (for example, growth bonds or guaranteed accelerated payment systems (see Section 4.3.6)) is also written in those currencies, they can only be employed to offset positive sterling reserves after creation of an appropriate currency mis-match reserve.

7.3.3 For many offshore insurers, negative non-linked reserves will outweigh positive non-linked reserves on unit-linked classes of business, to such an extent that they represent a significant, highly complicated asset in the overall asset/liability matching of guaranteed policy classes.

7.4 *Currency Matching*

7.4.1 The huge volume of currency transactions on a day-to-day basis within an offshore life company poses many financial management issues. Failure to monitor properly and execute such transactions on a timely basis can result in large losses from currency fluctuation.

7.4.2 Comprehensive control systems are, therefore, required to ensure that the wide range of currency cross-transactions are properly executed at a net level. Examples include:

— premium received in currency other than policy currency;
— withdrawal / surrender payment required in currency other than policy currency;
— commission payment in currency other than policy currency;

https://doi.org/10.1017/S1357321700001197 Published online by Cambridge University Press

— settlement of investment transactions involving currency exchange, e.g. switch from U.S. Dollar fund to Sterling fund;
— receipt of charge income in policy currency different to the office's reporting currency; and
— movement in non-linked reserves and indemnity commission balances by currency.

7.4.3 An international office's working cash balances are also typically spread across a number of currencies. For offices writing large volumes of single premium/back-end loaded business or regular premium business, this working cash balance is likely to be an overdrawn account.

7.4.4 Careful consideration, therefore, needs to be given, firstly to financial management systems and, secondly, to product design. In the latter respect, most personal bond designs offer 100% allocation of premium to investments at, effectively, bid price which generally rules out the possibility of using under-funding to avoid a cash strain on issue. In core currencies, i.e. Sterling and Dollars, this is generally not a problem, because of the existence of large positive policyholder balances elsewhere (see Section 7.5). However, in other currencies such as Yen and Deutschemark, where high levels of policyholder cash balances may not exist, inability to underfund can result in the company's total cash balances being negative, which could cause practical difficulties in banking arrangements and impose unnecessary costs on doing business. Some companies manage this problem away by requiring personal bond investors to maintain a minimum proportion of their bond (e.g. 5% — in line with the amount of basic commission) in cash in the currency of the bond.

7.4.5 Currency activity can produce significant losses if mis-managed, but equally, if properly managed, can be a significant contributor of profit. A company will generally execute only the very largest currency transactions with its bank. Instead, the large majority of transactions and policyholders are allocated daily 'buy' and 'sell' conversion rates appropriate to the size of their individual transactions. The office, in effect, runs a currency 'box' throughout each working day, off-setting policyholder transactions as far as possible and placing a single series of deals at the end of each day to close out any positions that have accrued. This clearly helps to ensure an efficient operation, as well as ensuring that the company is dealing at the 'wholesale' end of the market, and thus obtaining fine conversion rates.

7.4.6 Clearly, profitable management of this area can only be achieved if administrative systems are stable with little or no back-dating of policyholder transactions.

7.5 *Cash Deposits*

7.5.1 A marked feature of personal bond business is that many investors and/or their advisers hold a relatively high proportion of their bonds in cash. The result of this is that an office writing high volumes of personal bond business

https://doi.org/10.1017/S1357321700001197 Published online by Cambridge University Press

can, at times, have as much as 25% of total assets on cash deposit. Such relatively high cash balances mean that treasury management, including credit control, is an integral part of the business. Client balances accruing 'call' rates of interest on a suitably tiered scale can be aggregated and placed in the money markets at wholesale rates of interest, again earning considerable profits for the office.

7.5.2 In short, offshore life assurance business shares many similarities with traditional deposit-taking operations. The systems and procedures required must be designed with this background very firmly in mind.

8. Regulatory and Operational Issues

8.1 *Regulatory Background — Isle of Man*

8.1.1 The regulatory regime applicable in the Isle of Man, being the largest offshore life office domicile studied in this paper, is a useful starting base in considering regulatory issues.

8.1.2 Isle of Man insurers are regulated and supervised by the local Insurance Authority. In the absence of detailed regulation the Authority places heavy reliance on the actuary, who has to provide an annual statement of solvency and a valuation report detailing the actuarial assumptions and tests employed. The Insurance Authority also retains a firm of consulting actuaries to provide actuarial input to the supervisory process.

8.1.3 Prudential supervision is, therefore, effectively delegated to the Appointed Actuary. In this respect, actuaries who are fellows of either the Institute of Actuaries or the Faculty of Actuaries are subject to the applicable Guidance Note GN5. This Guidance Note (Actuaries Advising Long-Term Insurers in Countries Overseas) considers the extent to which the *principles* of GN1 should apply overseas. These principles, in respect of the business outlined in this paper, can be interpreted as applying without exception.

8.1.4 The Isle of Man regulatory regime is independent of the U.K./E.U. system. For life business, companies must maintain a minimum solvency margin requirement of:

— 0.25% of linked liabilities; plus
— 1.00% of non-linked liabilities.

For this purpose liabilities are taken net of reinsurance and the solvency margin is subject to an overall minimum requirement of £500,000. Insurers must also have a minimum paid-up capital of £500,000 with initial financing, inclusive of share capital, sufficient to support the company's new business plans and provide the requisite solvency levels for the first three years of trading.

8.1.5 During the first three years of operation (at least), a system of quarterly plus annual reporting applies. For an established company subject only to the annual reporting regime, the requirements are not particularly onerous:

https://doi.org/10.1017/S1357321700001197 Published online by Cambridge University Press

Quarterly:
(a) premiums written, analysed by major product class;
(b) commission and management expenses;
(c) value of investments;
(d) cash balances; and
(e) profit profile for any product which is planned to be launched before the next annual return.

Annually:
(a) Report & Accounts;
(b) actuarial liabilities by major product class;
(c) comparison of expense assumptions with experience;
(d) analysis of assets;
(e) summarised Actuary's valuation report; and
(f) statement of solvency margin and minimum requirement.

8.1.6 Report & Accounts and other documents filed with the Insurance Authority are not available for public inspection. Similarly, there is no requirement to file Report & Accounts with the Companies Registrar, thus providing complete commercial confidentiality.

8.1.7 Reliance on the statutory Appointed Actuary system is demonstrated by the absence of detailed valuation regulations for assets and liabilities. All assets of the long-term fund are admissible for solvency purposes. Similarly there is no prohibition on derivative instruments within linked or non-linked funds.

8.1.8 This relative regulatory freedom provides significant flexibility which can reduce the reserving requirements for young offices. For example, paragraph 4.1 of GN5 is valuable support for setting expense reserves on projected, as opposed to current, office experience. Similarly, there is no statutory requirement to write off indemnity commission balances on the balance sheet, so enabling a proportion of such balances to be utilised to reduce the new business strain associated with regular premium business.

8.1.9 As in the U.K., there is no pre-approval requirement for product developments. The Insurance Authority has, however, issued guidance in respect of the use of futures and options and requires to be consulted in advance in connection with some product developments utilising financial derivatives.

8.1.10 Companies applying for authorisation are required to demonstrate that a proper insurance establishment will exist. The Insurance Supervisor, for example, will require to be satisfied that the proposed company will not be operating solely or primarily as a 'front' to earn risk-free income. All directors must also satisfy a 'fit and proper' test and at least two must be residents of the Island (see also ¶8.3.11).

8.1.11 Most life companies in the Isle of Man take advantage of the provisions of the Income Tax (Exempt Insurance Companies) Act 1981; for an annual fee of £2,000 companies are exempted from tax on all profits arising from "risks undertaken outside the Isle of Man". Offshore insurers based in the Isle

https://doi.org/10.1017/S1357321700001197 Published online by Cambridge University Press

of Man therefore operate with gross roll-up *and* nil tax on shareholders' profits. The *quid pro quo* for the economy is the local employment provided by such companies, and of course the income tax payable by their employees.

8.2 *Regulatory Background — Other*

8.2.1 Guernsey insurers were, until recently, required to submit new products and marketing literature to the Guernsey Financial Services Commission for prior approval. This requirement has been relaxed, but still requires the actuary to supply actuarial certification that, overall, the product is financially sound, takes due account of policyholders' reasonable expectations and makes no unreasonable claims.

8.2.2 Guernsey policyholders' protection legislation requires insurers to keep assets constituting a minimum of 90% of the long-term fund on trust with an independent custodian based on the island. These assets are not available to meet obligations of the company, apart from those to its policyholders. The combination of trust and custodian requirements significantly increases operating expenses. Similar requirements and issues affect Luxembourg insurers.

8.2.3 Guernsey insurers, on the other hand, have, at £100,000, a lower minimum capital requirement than similar Isle of Man insurers. Furthermore, the minimum solvency requirement in Guernsey is nil for linked business (and 2.5% of the long-term fund held in respect of non-linked business) subject only to a minimum margin requirement of £50,000.

8.2.4 Solvency requirements in Luxembourg and the IFSC follow E.U. legislation and are, therefore, in line with those applicable in the U.K.

8.2.5 In addition to the regulatory regime applicable in the country of domicile, offshore insurers must also be cognisant of authorisation requirements in the countries around the world in which they market business. The vigour with which such requirements are enforced varies markedly from country to country, and many regulatory authorities are relaxed insofar as expatriate business is concerned.

8.2.6 In a number of countries (for example Hong Kong and Singapore) it may in practice be impossible to obtain authorisation, other than through acquisition. This can result in a high value for companies which do hold authorisation. Companies transacting business in such countries on a non-admitted basis, no matter how low profile their operation, clearly run a commercial risk.

8.3 *U.K. Taxation and Management Issues*

8.3.1 Irrespective of the country in which offshore domicile is chosen, U.K.-owned companies transacting offshore business need to exercise care in their activities within the U.K., particularly if writing business with U.K. residents. No individual policyholder information should be allowed to migrate to the U.K. where it could fall within the powers of the Inland Revenue. For this reason, all policy administration should be carried out in the offshore operation.

https://doi.org/10.1017/S1357321700001197 Published online by Cambridge University Press

8.3.2 In the case of in-house managed funds, care is needed in order to avoid adverse taxation assessment where management is performed by an associated U.K. company. Similarly, some overseas regulators have, rightly, begun to follow the U.K. line in tightening the operation of broker managed funds.

8.3.3 Offshore companies transacting business with U.K. investors are not subject to U.K. Corporation Tax, provided proper control is exercised. For example, companies must avoid at all costs anything which might be construed as a 'permanent establishment' within the U.K. Distribution through direct sales channels of a U.K. sister company may be dangerous in this regard. Policies must also be clearly underwritten and accepted, and premiums received, in the offshore domicile. No U.K. agent or employee can have any authority whatsoever to bind the company in the acceptance of a policy.

8.3.4 Insofar as U.K. employees are concerned, many offshore life companies employ all U.K. staff (such as broker consultants) through a separate marketing services company, typically U.K. based. The marketing services company (MSC) may typically be remunerated on a 'cost plus' basis, and thus be subject to tax on its profits, under the terms of a formal agreement clearly restricting the activities of the MSC as regards policy acceptance. Subject to this type of safeguard, offshore insurers are deemed to be trading 'with' the U.K. (as opposed to trading 'in' the U.K.) and not subject to Corporation Tax.

8.3.5 The MSC route is generally considered virtuous in operational management, effectively ring-fencing U.K. activities in a separate operation to the life company. It thus provides comfort to the Appointed Actuary in consideration of reserves for contingent taxation liabilities.

8.3.6 These same operational management controls that are so important for taxation purposes also ensure that offshore companies can trade legitimately 'with' the U.K. without the required authorisation under the U.K. Insurance Companies Act 1982.

8.3.7 It will be evident that U.K. companies contemplating an offshore operation must have full regard to their *modus operandi*. Any operational transgression which might bring the company within the territoriality of the Inland Revenue or the Insurance Companies Act would be a commercial disaster. The discipline required has already been called upon in practice in recent years when the Inland Revenue, pursuing their investigation of 'highly personalised bonds' held by U.K. residents (see Section 4.2.2), demanded policyholder names and addresses from U.K. directors of a number of offshore life companies. These demands were successfully resisted, firstly on the grounds that the directors had no day-to-day access to policyholder records and, secondly, by the non-U.K. directors exercising their majority presence on the offshore board.

8.3.8 The determination of the Inland Revenue in such matters must not, however, be under-estimated. The Revenue were subsequently able to assemble the information sought by serving statutory S745(1) ICTA 1988 notices on the directors of a number of U.K. intermediary firms.

8.3.9 U.K. companies contemplating an offshore operation must also be

https://doi.org/10.1017/S1357321700001197 Published online by Cambridge University Press

cognisant of the Controlled Foreign Companies (CFC) legislation introduced by the Finance Act 1984 and should formulate policy to satisfy the provisions of this legislation. Failure to satisfy the CFC requirements will lead to the U.K. parent being assessed to a deemed tax charge on the profits of its offshore subsidiary.

8.3.10 Regardless of the country of incorporation (unless U.K.), a company's tax residence under U.K. Inland Revenue CFC practice is regarded as the place where control and management are exercised. While this will often be equivalent to the place at which meetings of the board of directors are held, it can be overridden if control is *de facto* exercised by an executive person or body other than the board, in which case the location of that person or body may take precedence.

8.3.11 It is paramount, in short, that the offshore company is managed, and is seen to be managed, via its full board of directors, and not simply by U.K. shareholder representatives on the board. Appropriate documentation should be prepared and maintained to demonstrate that actual decisions concerning the formulation of policy relating to the business of the company are taken *de facto* by the board, meeting outside the U.K. There must be no delegation or usurpation of the board's powers or discretions by the parent company or its U.K. employees. U.K. directors must constitute a minority of the board; at best it may be wise to avoid having any U.K. resident board members at all.

8.3.12 Although properly controlled and managed offshore operations should normally satisfy the 'exempt activities' or 'motive tests' set out in the CFC legislation, additional comfort can be achieved by meeting the 'distribution test', i.e. remitting at least 50% of distributable profits by way of dividend.

9. Future Trends

9.1 Offshore life companies have, as seen above, been successfully transacting cross-border business around the world for the past decade. This experience will be put to good use if a genuine cross-border European market begins to develop in the next decade. A small number of established offshore insurers have incorporated, or are presently incorporating, sister Luxembourg or IFSC operations for this purpose.

9.2 In the meantime — and development of a true cross-border European life market may take no mean time — the future of the offshore industry is assured as companies continue to penetrate new markets and deepen penetration of existing international markets. This latter activity will increasingly see offshore companies partly domesticating business through establishment of fully authorised subsidiaries or branches — stimulated in part by increased personal pension markets in some countries, and necessary in part as a response to increased regulation and enforcement in a number of other countries.

9.3 The basis of taxation of life assurance in the U.K. is under review at the time of writing this paper. One possible outcome may be a change from the current I minus E basis towards gross roll-up. In this event the U.K. may conceivably emerge as a competitor to the offshore market.

https://doi.org/10.1017/S1357321700001197 Published online by Cambridge University Press

9.4 New entrants to the offshore scene will nonetheless continue for the foreseeable future, particularly with the likely impact of hard disclosure in the U.K. being a reduction in traditional U.K. business. Offices faced with the heavy regulatory burden in the U.K. will increasingly find the temptation of a return to lighter regulations — through the offshore market — overwhelming.

ACKNOWLEDGEMENTS

The authors are grateful to their respective employers for their support in exploring the subject matter of this paper. The authors also wish to thank a number of their industry colleagues for suggestions and comments on the earlier drafts of the paper. The views expressed, however, and any errors or omissions, are those of the authors alone.

https://doi.org/10.1017/S1357321700001197 Published online by Cambridge University Press

APPENDIX A

SUMMARY OF CONDITIONS IN OFFSHORE LOCATIONS

	ISLE OF MAN	LUXEMBOURG	GUERNSEY	DUBLIN IFSC
Target Market	Rest of World (including U.K.)	Europe (including U.K.)	Rest of World (including U.K.)	Europe (including U.K.)
Office Accommodation	Readily available, at reasonable cost (£10-£15 per sq ft).	Readily available, at reasonable cost.	Shortage of larger units of office space. Rents consequently higher (£20-£25 per sq ft).	Restricted to Custom House Docks area. Existing space largely occupied. New space only available at high cost (£25 per sq ft) on long leases. Rental costs obtain a double tax deduction.
Employment / Recruitment	Full employment, but large availability of experienced insurance staff. Salary costs broadly in line with U.K.	Full employment. Highest staff costs (13 month salaries, 15 days public holidays).	Full employment. Salary costs typically 12% higher than Isle of Man but not as high as Luxembourg.	High local unemployment means ready availability of staff. Salary costs slightly below Isle of Man, considerably (20-40%) below Luxembourg levels.
Regulatory Background	Life companies regulated by Isle of Man Government Insurance Authority. Insurance Act 1986 is simple, yet thorough, and reporting requirements are relatively light. No asset or liability valuation regulations. E.U. Life Directives do not apply.	Life companies regulated under a number of insurance laws by the Commissariat aux Assurances. Regulation is pragmatic, within the flexibility permitted by the E.U. Life Directives. Assets of long-term fund must be segregated and held with approved Luxembourg custodian.	Life companies regulated by Guernsey Financial Services Commission under The Insurance Business (Guernsey) Law 1986. Appointed Actuary required to formally sign-off new products prior to launch. Minimum of 90% of the assets in the long-term fund must be held in trust with approved custodian.	Life companies regulated by the Department of Enterprise & Employment, principally via the 1984 Life Regulations and Life Accounts Regulations. Regulation is full, with heavy reporting requirements akin to the U.K. system. E.U. Life Directives apply.
Life Fund Taxation	Policyholders funds are tax-exempt.	Policyholders funds are tax-exempt.	Policyholders funds are tax-exempt, by extra-statutory concession.	Policyholders funds for the benefit of non-Irish residents are tax-exempt. Large network of Double Taxation Agreements to reduce foreign withholding taxes.

https://doi.org/10.1017/S1357321700001197 Published online by Cambridge University Press

APPENDIX A (CONTINUED)
SUMMARY OF CONDITIONS IN OFFSHORE LOCATIONS

	ISLE OF MAN	LUXEMBOURG	GUERNSEY	DUBLIN IFSC
Target Market	Rest of World (including U.K.)	Europe (including U.K.)	Rest of World (including U.K.)	Europe (including U.K.)
Corporate Taxation	Profits are tax-exempt under Income Tax (Exempt Insurance Companies) Act 1981. Annual tax-exemption fee £2,000.	Consolidated corporation tax rate: 33.33% of profits. + 0.5% net worth tax + municipal business tax.	20% tax on the increase in actuarial surplus.	For companies established in IFSC before 31 December 1994, profits taxed at concessionary 10% (maximum) tax rate up to 31 December 2005. Comprehensive range of tax allowances available.
Personal Taxation	Low. 20% top rate of tax on income above £14,700.	Graduated tax scale of 10% - 50%. Top rate 50% on income above £27,800.	Low. 20% standard rate of tax on income above £4,800.	High. 48% top rate of tax on income above £10,550.
Labour Controls / Quotas	No controls on residence. Employment controls exist in the form of a Work Permits system. Permits are readily available for key and technical staff.		Labour controls exercised through housing market as opposed to employment legislation. Two housing markets exist: 'Local' and 'Open'. Open market prices (including rental accommodation) very high.	Entitlement to reduced 10% tax rate is conditional on issue of Tax Certificate. Application for Tax Certificate must include preparation of business plan outlining achievement of specified employment targets and contribution to the IFSC / Irish economy.
Expense of Operation	Moderate.	High.	High, but slightly less than Luxembourg. Guernsey life offices tend to operate with a smaller staffing establishment.	Moderate.

https://doi.org/10.1017/S1357321700001197 Published online by Cambridge University Press

ABSTRACT OF THE DISCUSSION

The President (Mr G. M. Murray, C.B.E., F.F.A.) welcomed guests, including Dr Hastings, Chief Executive and Insurance Supervisor of the Isle of Man Government Insurance Authority, and Mr William Berry, Chairman of Scottish Life Assurance Company.

Mr G. F. Boal, F.F.A. (introducing the paper): Our original mission in writing the paper was to correct a widespread lack of knowledge within the profession about a life assurance market accounting for a significant, and increasing, proportion of sales. For example, a mere two years ago, when this paper was first a twinkle in our eyes, not a single Scottish life assurance subsidiary could be found in the offshore market. Today there are two, and by the end of 1995 there will be at least four.

Our paper represents an introduction to the offshore life industry. It is not, and has no pretensions to be, an all-embracing study of every international life assurance market beyond these shores. The subject matter is international cross-border business transacted from an offshore base — a business which, for a growing number of medium-sized United Kingdom life offices, accounts for over 30% of total new premium income. In the paper, although Luxembourg and Dublin are not offshore in any literal sense, some artistic licence is taken.

Offshore companies writing cross-border business inevitably find themselves operating alongside what we have termed domestic overseas life offices. Offshore products, though, are poles apart from those of such offices, and so with only one or two exceptions — for example in the U.K. — there is little real competition between the two sectors. Our paper does not, therefore, examine domestic overseas business further. Similarly, while we comment upon the international activities of North American insurers, the paper is not a study of their activities.

Despite the fact that we were able to make amendments to the paper as late as November 1994, it is already out of date. I will attempt to correct for this with a brief update on three recent developments. The first is the announcement that the 1994 deadline for the authorisation of companies wishing to establish in Dublin's International Financial Services Centre has been extended until December 2000, with the agreement of the European Commission. All projects approved by then will be entitled to the special 10% profit tax rate until the end of 2005.

The second update is the dismissal at the Court of Appeal, in December 1994, of the appeal by the U.K. Inland Revenue against the judgment referred to in ¶4.2.2.8. The Court of Appeal found — and here I quote from Lord Justice Morritt:

> "I do not see why the choice of an offshore bond or policy, for the taxation of which Parliament has made express and recent provision, should be regarded as tax avoidance at all".

As if that was not enough, the Revenue's position, as set out in ¶¶4.2.2.9 and 4.2.2.10, was dismissed, the Court finding that there is no material difference between the taxation position of policyholders with ordinary offshore bonds on the one hand, and with highly personalised bonds on the other. The case may not be finished with yet, and the Revenue may well take it to appeal, but it is interesting and significant in the context of the paper.

The final recent development I wish to mention may be of interest to any actuaries in the audience who, like me, have had the delight of holding compliance responsibilities. Paragraph 5.1.4 refers to the territoriality of the U.K. Financial Services Act, and its range when it comes to offshore business. SIB have since issued Consultative Paper 84 which, among other things, readdresses the territorial scope of the Act.

What does the future hold for offshore life assurance business? I know we can expect to see the arrival of both offshore bancassurers and international with-profits funds. We may also see more U.K. offices entering the fray — at least in Europe — both as a positive result of the current Finance Bill

https://doi.org/10.1017/S1357321700001197 Published online by Cambridge University Press

changes to the definition of overseas life assurance business, and as a negative result of the impact of hard commission disclosure. Later we may see a further market shift with gross roll-up for U.K. business. Who knows? I will leave you with the philosophical thought from a favourite author, which is that "The past exists only in our memories, the future only in our dreams. The present is our only reality".

Mr R. W. King, F.I.A. (opening the discussion)**:** The paper describes a commercial environment where controls and regulation are light, where innovation and flexibility flourish, and, as a consequence, where actuaries are commercial managers rather than purely technicians.

As the authors mention in ¶9.4, U.K. offices will be considering their strategic options in response to the challenges facing their domestic market. This will involve a number of key decisions: what products to offer; where to offer them; how they will be distributed; and where to operate from. The paper explores each of these issues in the context of one of the strategic initiatives open to life offices; namely, the establishment of an offshore life insurance operation.

The paper is not an esoteric discourse on actuarial theory. It is interesting and informative, and its content will be of value beyond our own profession.

The First Life Directive was adopted in 1979, and shortly thereafter the Faculty established its European Research Group to encourage research into life insurance in other European countries. Five years later, that group presented to the Faculty a paper entitled, 'Life Assurance in Four European Countries' *(T.F.A.* **39**, 170).

In the week immediately preceding that meeting in 1984, the Budget removed LAPR on new policies, fundamentally altering the taxation position of life assurance from a policyholder's perspective. Concerned at the effect this would have on the U.K. market, many life companies were reported in the discussion to be looking for new markets abroad, and the paper was regarded as a timely source of useful information. I expect that the prospects for the domestic life insurance market and tax considerations will also feature strongly in the discussion, as they did in Mr Boal's introduction.

In ¶1.3 the authors introduce the subject of taxation, which recurs throughout the paper from several different aspects. They state that policyholders are offered gross roll-up. However, I believe that that is not entirely the situation, as overseas withholding taxes may be incurred. In ¶1.9, the authors set out to indicate that the volume of offshore business, and in particular single premium business, is substantial compared to U.K. volumes. They state that offshore single premium business in 1993 represented almost 20% of the total U.K. single premium linked-life market in that year. The ABI statistics that the authors quote show that the proportion exceeded 20% throughout the period from 1990 to 1992. If the authors' prediction, in ¶3.10, for offshore business growth is fulfilled, then we can anticipate a significant rise in its size compared to U.K. business in 1994. Therefore, any notion that this paper considers a small market of marginal interest has been totally dispelled.

Readers may conclude that their broader knowledge of overseas markets, cultures and intermediary channels would give the U.K.'s composite offices an advantage over life offices whose interests have tended to be much more domestic. However, that does not appear to have been borne out by results. As far as Isle of Man based operations are concerned (which form the bulk of the subject matter of the paper), U.K. mutual life offices have been at least as successful as the composites in terms of sales volumes. The reason may be that the composite offices' overseas expertise and contacts relate to a different market segment from offshore life assurance business. However, maybe the U.K. banks will be able to create a better synergy between their overseas banking operations and their insurance operations — possibly unhindered by regulation governing the distribution of financial services.

In ¶¶1.13 and 1.14 the authors refer to the 'herd instinct' arising from a perceived need to 'act now', but based on weak foundations. I wonder whether we might be in precisely that situation at the moment. The U.K. life insurance industry is in the throes of significant changes, and life offices are responding in different ways. Some strategies will succeed; others will not. A major contraction in the number of U.K. life insurance companies has been forecast. Opportunities abroad beckon. They can be beguiling; but will they be seen to have been based on weak foundations?

The paper describes a market where volume growth has been rapid and is expected to continue, but

https://doi.org/10.1017/S1357321700001197 Published online by Cambridge University Press

what of profitability? You have probably heard the saying that volume is vanity, whereas profit is sanity. Life offices are in business to make profits for distribution to their with-profits policyholders and, where they exist, to their shareholders. Any strategic expansion should be based upon a planned outcome which improves the financial out-turn of the company and recognises the risks involved. In Sections 6 and 7 the authors give a comprehensive description of the financial risks and the business risks to which offshore life insurers are exposed. These should not be underestimated.

When I was employed by a life insurance company in Wellington, New Zealand, I was told about a court case that the company had lost in a South Pacific country whose business was administered from Wellington. A local businessman had died of a heart attack a few months after effecting a life insurance policy. After investigations, the claim was contested on the grounds of non-disclosure of hypertension and medication, both on the proposal form and also at the medical examination. We were confident that we would win the case. However, we lost. The court ruled that the company had to pay out, as its chosen medical examiner had failed to identify that the proposer's blood pressure was being controlled by medication. That is a clear example of how circumstances overseas can be different from what one would expect here.

The paper is somewhat uninformative about the likely profitability of offshore business. The authors state, in ¶4.1.14, that this is partly because publicly available financial information is largely non-existent. Possibly that is an example of the downside of light regulation. However, the paper contains several comments which indicate that costs may be a concern. Paragraph 4.1.9 gives several reasons why internal operating expenses are often much higher offshore. Perhaps the forecast new entrants to the market will increase competitive pressure on policy terms and the standards of service to be delivered without any reduction in costs incurred. Mass economies of scale are described as being unlikely in most product lines.

The bargaining power of the overseas distribution channels, described in Sections 5.2 and 5.3, appears to be considerable, with the absence of regulation giving free rein to the economic supply-demand relationship. Perhaps a greater local presence than has operated hitherto might be a strategy worth considering.

Mr I. A. Morris, F.I.A.: As an actuary working in Guernsey, I would like to offer a different perspective from that given in the paper. I believe that the authors' view largely reflects the offshore industry operating in the Isle of Man.

The industry in Guernsey differs from that in the Isle of Man. The Isle of Man is dominated by subsidiaries of U.K. companies transacting unit-linked type contracts and with significant business written into the U.K. Guernsey has subsidiaries of major Italian, French, Scandinavian, South African and U.K. companies. The business written is more diverse, reflecting the different marketing strategies and the products offered in those countries. The business written by such subsidiaries does already include with-profits contracts, but these are not always identical in format to conventional U.K. with-profits contracts. In my experience, the costs of operating in Guernsey are less than stated in the paper. However, recruiting staff into Guernsey is strictly controlled and can be a constraint. Therefore, Guernsey has also developed as a location for branch business. The advantages of branch business are understated in the paper. There is an absence of capital requirements, lower costs because less of the operation needs to be in the offshore location, and the ability to offer with-profits contracts from an existing U.K. fund. Only a limited presence is required in the offshore location, and therefore staff recruitment is not such a constraint.

The paper mentions the cost of policyholder protection provided by means of custodian arrangements in both Guernsey and Luxembourg. However, the benefits are not considered. The merits and disadvantages of the Isle of Man's own policyholder protection arrangements (by a levy scheme from a small number of companies) are not mentioned. The importance of trust business is mentioned in the paper, but it is not noted that currently trusts must be written in a jurisdiction other than that of the Isle of Man (often Guernsey or Jersey). The freedom, and hence responsibilities, of the actuary in both Guernsey and the Isle of Man are greater than in the U.K. due to the absence of statutory regulations. The competition noted with American companies has some dangers. There have been failures of American companies more frequently than in the U.K. in recent years.

https://doi.org/10.1017/S1357321700001197 Published online by Cambridge University Press

There is growth noted in annual premium business. I think it is an open question as to whether this is attributable to the demand from policyholders or the attractive terms offered to intermediaries. The actuary must still try to design a product that is adequately profitable, despite high costs and, sometimes, poor persistency. However, the product must still be marketable, and the actuary should take account of policyholders' reasonable expectations in reviewing marketing literature and quotations. Where significant profits arise from treasury management and foreign currency dealing, this is an additional complication for the actuary in pricing products and performing profit tests. It also raises further issues relating to policyholders' reasonable expectations.

It is interesting to note that Luxembourg's offshore life assurance industry is dominated by Continental companies. Is this a matter of logic or is it that the location is more convenient geographically and culturally? Are these the reasons that the U.K. companies have focused on the Isle of Man and Guernsey?

I suggest that there could have been a mention of the Swiss companies operating in the industry.

I agree with the authors' description of the Isle of Man as a successful part of the offshore life assurance industry. However, I suggest that other centres, such as Guernsey, Luxembourg and Dublin may have different roles in this industry, focusing on different distribution strategies and products.

Mr H. R. D. Taylor, F.F.A.: It seems from the paper that a significant part of the distribution back into the U.K. is driven by taxation. The authors mention a particular Revenue case concerning personal bonds, and also state that a significant portion of distribution into the U.K. is through bonds written using 'dead settlor' trusts. I wonder to what extent there is a risk to this distribution through possible future changes in U.K. taxation legislation?

This can be broadened to the more general question of the effects of convergence of tax regimes in the European Union. Inevitably, in say five or ten years, there will have to be greater convergence of European taxation. What impact could this have on European distribution for the offshore companies? The paper indicates that about 39% of the distribution is back into the European Community.

It is clear from the paper that there are risks associated with the unregulated environment and global nature of the business that many of the offshore companies are involved in. From an actuarial point of view, there are a number of ways to take account of such business risk. For example, in the context of unit-linked contracts there are two obvious ways of doing it. You can increase the risk discount rate to a level significantly higher than for U.K. business; the level depending on the nature of the offshore business and the risk to capital. Another approach is to operate with a standard U.K. risk discount rate, but to increase profit targets to amounts higher than would be common in the U.K. I would be interested in the authors' views on these approaches, and whether it is necessary explicitly to load for risk in this way when designing products and calculating embedded values.

Mr M. Iqbal, F.I.A.: It is unusual these days for an own-initiative paper — to use offshore jargon — to be presented either to the Institute or to the Faculty. Most papers are by-products of research working parties, and it is pleasing to see a paper which is, not only the inspiration of two authors, but is also on a subject with significant financial implications.

Like the domestic U.K. market, the offshore market is challenging. However, unlike its U.K. counterpart over the past three or four years, it is also quite exciting. As someone with a foot in both camps, there is no doubt in my mind which gives me more pleasure and less stress. However, there are areas of concern for genuine offshore business — that is excluding business done by a company that is registered and authorised locally and sells to local nationals. Let me take a simple example — one very close to home — actuarial supervision.

How many actuaries of companies registered offshore can truthfully say that the degrees of prudence shown in setting the mathematical reserves are comparable to those shown by their counterparts — sometimes the same individual — in the U.K.? In ¶4.1.12 the authors refer to the possibility of actuaries not having sufficient positive sterling reserves to cover negative sterling reserves. How many show the proper prudence that the authors call for in such circumstances? More

https://doi.org/10.1017/S1357321700001197 Published online by Cambridge University Press

generally, the financial supervision is usually not as stringent as in the U.K. The amount of risk that a company carries, expenses, currency, interest rates, asset default, to say nothing of Big Bang risks such as inadvertently trading in territories that you should not be trading in, or even U.K. tax, can be immense and, unless very good reporting systems exist, unquantified.

A much bigger concern, however, is that of control of sales and marketing. I would be the last person to wish the Financial Services Act on anybody, but its total absence is a cause for concern in other territories. We used to say in the U.K. that the FSA would force the cowboys out of the industry. In practice, it has often forced them out of the U.K. industry into Hong Kong, the Middle East and Europe. Very tight controls are required to stop matters getting out of hand when you are operating in these areas, particularly if you use forms of distribution other than independent intermediaries. We had a case last year of one company where £20m worth of broker fund money went where it should not have gone.

Those of us in the U.K. who are thinking of setting up these operations from scratch should try to learn from the U.K. experience. For example, if we are thinking of master agency as a route, what has our experience been in managing tied agencies and direct sales forces in the U.K.? If we have been no good at that, what makes us think that we can manage master agencies in other countries, with different cultures, thousands of miles away from home?

We know from experience, having run unit-linked companies for 10 or 15 years, of the actuarial myth of expense over-run. There is no such thing. It is under-estimation of expenses. My own U.K. company had two attempts at eliminating it. It kept reappearing. You need to have a very clear idea of what your operating costs are — probably with a hard nosed accountant's estimates rather than wishful thinking, which is what many business plans are based on.

I sound these words of caution because many U.K. companies are getting very excited about offshore operations, as their U.K. base declines. However, the 1980s flirtation with banking and estate agency should be a salutary warning. There are tremendous opportunities, but we need to be very careful before we pursue them.

Mr D. M. Pike, F.F.A.: I have been involved in offshore life business over a number of years from two aspects:
(1) in advising the superintendent of insurance in an offshore territory; and
(2) in advising on the valuation of offshore life offices for purchase or sale.

Notwithstanding what Mr Iqbal has said, I believe that the reserving standards offshore are just as stringent as in the U.K. — certainly in the territory in which I am involved. Indeed, to maintain 'designated territory' status under Section 130 of the Financial Services Act, it is necessary to satisfy the DTI that supervision does match U.K. standards. The main reason for maintaining supervisory standards is to avoid the bad publicity which could result if they were relaxed. However, the style of supervision is very different. Because of the much smaller number of companies, it is possible to minimise the formal requirements and concentrate on developments in the individual companies — for instance, by meeting with the company actuary of each on-going company once a year.

Turning to the valuation of offices for purchase, there are too few transactions for us to determine a market value purely by reference to transactions in offshore companies, so it is usually done by reference to U.K. transactions. There are two major problems which arise in this. The first problem is tax. By this I do not mean policyholder tax, which is discussed in the paper, but shareholder tax, the tax status of the owner or purchaser.

In the U.K. it is reasonable to suppose that market prices are driven by U.K. corporate investors and to determine prices net of the tax such a shareholder would bear. Offshore, however, the owner or purchasers may or may not be U.K. based. If they are, dividends will be subject to U.K. tax on remission to the U.K. If the vendor and/or the purchaser is not U.K. based, then tax may be suffered at a significantly lower rate, and thus the same stream of income may have a significantly greater value. In the case of an actual transaction, tax is a factor which may make it easier or more difficult to strike a deal, depending on the circumstances. If an actuary has to estimate a market price not

https://doi.org/10.1017/S1357321700001197 Published online by Cambridge University Press

connected with an actual transaction, tax is a problem that needs to be discussed carefully with the client.

The other problem I mention is the determination of economic assumptions. In the U.K. we usually determine the assumed earned rate or unit growth rate, the discount rate, the expense inflation rate and the new business growth rate, such that these four are mutually consistent and are also consistent with current U.K. economic conditions. Offshore, we have to consider each assumption in turn to decide which economy, or indeed combination of economies, it is appropriate to link it to. For instance, the unit growth rate should reflect the diversity of economies applicable to the underlying investments. Actual unit fund performance will also depend on the currency in which unit prices are expressed, although in an appraisal valuation we would not normally take a view on future changes in currency exchange rates.

Mr D. J. Whitaker, F.I.A.: I am a practitioner in the industry for one of the largest offshore carriers, and I should like to touch on a number of issues.

On the choice of offshore location, the paper overplayed the Isle of Man case. I think there is a good case for Luxembourg and for the use of branches. When brokers look at offshore companies, they sometimes get worried about the financial strength of the company. This is an important reason why many companies use branches, and I think you would find it very difficult to transact in some of the very high net-worth markets without the use of a branch and the security and strength of your parent.

Another area that worries me is the situation in the U.K. regarding the future of life policy taxation. If the U.K. changes its mind and goes to a gross basis, I cannot foresee such a bright future for the offshore life industry. I think the branch route would be the preferred alternative for business outside the U.K.

Another reason for locating branches overseas is that, in the U.K., it is difficult to get language skills. Often that is an attraction in certain centres within Europe. For example, in Luxembourg staff in my company have knowledge of 15 languages, all in one office.

The paper indicated that with-profits contracts would soon be on offer. My company launched a 'smoothed yield' contract in January 1995. We cannot sell it into the U.K.; but I do not think it will be a long time before such funds are available. There are significant difficulties running a with-profits fund as opposed to a unit-linked operation. One such difficulty is the requirement in some territories for localisation of assets.

The paper concentrates quite properly on the U.K. style offshore companies, and what they offer in international markets. To be successful, you have to not only offer value, but to be seen to do so at the point of sale. To achieve this, it is necessary to consider the nature of the competition from other types of international companies. The paper touches on this in Section 6.1, referring to the less prudent approaches to guarantees by American companies. This can be taken further when considering illustrations where they show improving mortality, improving interest assumptions and leave out a significant number of charges.

The nature of competition is of considerable concern to the U.K. actuary when faced with, for example, competition on illustrations of a nature echoing some of those less responsible practices followed in the U.K. in the 1980s. In such circumstances, the actuary will have to consider carefully his view as to the nature of the policyholders' reasonable expectations and the impact of the illustrations on PRE. This judgement is made more difficult with international business, as it is likely that marketing literature will be in several languages. The actuary may have difficulty over the quality of translation and the subtle implications of the wording. There may also be doubt as to the applicant's fluency in the language of the literature in some cases. It is important to ensure that the applicant receives the marketing message that the company wishes to give. It is necessary to go to considerable lengths to control the sales channel so that, for example, unauthorised sales materials or illustrations cannot be introduced and that the material intended to reach the applicant does, in fact, do so.

Our company, working through AILO (Association of International Life Offices), has been helping

https://doi.org/10.1017/S1357321700001197 Published online by Cambridge University Press

in establishing proper trading practices. The subject of trading practices in overseas markets is huge, and is probably worthy of a separate paper.

Mr P. L. Towers, F.I.A.: I must first declare a vested interest, as I work in marketing in one of the Isle of Man operating companies.

The comments I wish to make reinforce the thrust of the paper concerning, particularly, the vibrancy and the entrepreneurial nature of the industry. However, I should also like to emphasise the complexity of it.

From a marketing perspective, offices have to deal with issues of culture, language, and compliance with local marketing rules. On the legal side, there are issues of contract law and authorisation. From an operational point of view, there are issues of multi-currency handling, together with the mere logistics of getting premium payments from across the world, each of which involves dealing with people of many different backgrounds, in many different languages, in many different countries. So, the complexity that companies operating in the U.K. face and the issues they have had to address over the last year in getting to grips with disclosure, can be multiplied many-fold when you are operating across the E.U., in Hong Kong and in many other regulated or unregulated markets; all of which requires a heavy investment in a dedicated specialist infrastructure to accommodate the growing complexity of the business.

I think that you have to ask the question whether the business generated by the offshore life assurers is stable enough to make that investment prudent and viable. I think that the answer is yes, which is good news for those of us in the industry, but, if people believe that the industry can be built purely on fiscal and tax-related attractions, then they are sadly deluding themselves. Reference has already been made to the U.K. tax changes being made to enable U.K. companies to market gross funds into the E.U., and, in the not too distant future, we are likely to see gross roll-up for U.K. residents as well. At a stroke, in four or five years' time, the market for the Isle of Man or other offshore insurers marketing back in the U.K. could be cut from under their feet. We have seen this happen before. For example, three or four years ago there was an extremely large and lucrative market selling offshore policies to Danish expatriates, which gave them all sorts of wonderful tax benefits when they went back to Denmark. It lasted for a while, and then, not surprisingly, the rules changed and that business stopped. Tax-based business opportunities are great while they last, but are no basis upon which to build a business.

Leading on from that, the title of the paper is, perhaps, a little misleading in referring to the 'offshore' life industry. Perhaps, four or five years ago, that was the case, but these days it is very much more an 'international' life assurance industry. Tax is obviously still extremely important in many markets in which we operate, but so are more fundamental issues such as confidentiality, the product choice that we can offer in terms of currency and protection benefits — protection covers which are, perhaps, not available from domestic providers — plus access to the equity culture, which is an acknowledged strength of U.K. insurers. The skills developed in the industry — the market segmentation skills, the distribution skills, the ability to deal with many different cultures and in many different languages — are, in my view, fairly solid foundations on which this international life business can continue to grow.

Picking up on the point that Mr Iqbal made about the business risks in terms of regulation or non-regulation, in many areas of the world business is completely or largely unregulated, particularly on the distribution side. Increasingly, however, companies operating in these markets are recognising that some of the U.K. regulations that we all struggle with, do actually represent good business practice and are being adapted in a more pragmatic and practical way for use internationally. There are initiatives being undertaken by individual offices, for example, intermediary vetting, client disclosure, broker fund operation and management; but, increasingly, industry-wide initiatives are taking place. Finally, I regret that this paper was not available three or four years ago, when I was helping to set up a life operation, because my life would have been much easier if it had been.

Mr P. H. Grace, F.F.A.: Early in the paper, in ¶1.3, the authors refer to the benefit of gross accumulation without any taxation deduction on exit. While it is true that there may be no

https://doi.org/10.1017/S1357321700001197 Published online by Cambridge University Press

withholding tax at the instigation of the authorities in the state of the insurance company, as already mentioned by the opener, there is the question of withholding tax on investment income which may not be recoverable, and, as far as U.K. residents are concerned, there is a tax charge at their marginal rate on any profit they have made. This is likely to apply even if the policy is written under trust. However, unless the company is established in the U.K. or has a branch in the U.K., there are no requirements for the company to advise the U.K. tax authorities of any payments they make to U.K. residents, and thus the Inland Revenue must rely on the individual advising them about the policy.

In ¶8.3 the authors draw attention to the dangers for U.K. owned offshore companies. I have heard that the Inland Revenue believe that they can pursue U.K. policyholders of such companies, but ¶¶8.3.7 and 8.3.8 highlight the difficulties that the Revenue face.

One contributor has drawn attention to the possible move to gross roll-up within the U.K. However, this would not solve the problem, as the Inland Revenue would, I believe, introduce an exit charge. The difficulties in policing policies effected with companies based outside the U.K. are seen as a threat to the U.K. life assurance business by both the ABI and the Government.

I now comment on one other aspect of taxation to which the authors draw attention in ¶3.4. That is the E.U.'s commitment to harmonisation of taxation as being a shadow over E.U. locations for offshore life assurance companies. Whilst I agree that it is difficult to see how full economic and monetary union can be achieved without such harmonisation, I see little movement on the taxation front. It is interesting to note that a Directive on Interest and Royalties, which dealt with, among other things, interest paid net of tax, has been abandoned through the failure to reach agreement. What hope is there for agreement across the whole board of personal taxation? Each member state will wish to protect some aspect of its system, and will use its vote at the Council of Ministers to block any adverse change. In the case of tax, these decisions have to be unanimous. Clearly, if Luxembourg has a successful offshore life assurance industry, it will choose to block moves that would destroy that industry. I suspect that there are other shadows that threaten, not only Luxembourg, but also other offshore centres.

One feature of the Luxembourg life assurance market not mentioned by the authors is the extension of their banking secrecy laws to life assurance business. This feature may have mixed blessings, but it must make the centre attractive.

Mr C. S. Fairclough, F.I.A.: I should like to refer to Section 8.1, and the relative freedom in respect of the valuation of the assets and the liabilities compared to the U.K. The authors indicate that this offers flexibility in actually reducing the reserving.

However, as an ex-Appointed Actuary in the U.K., I would ask, in particular, where the parent is a U.K. insurer, whether the U.K. Appointed Actuary would insist on the reserves and the valuation of assets being at least as stringent as the basis that would apply in the U.K. in order to consolidate into the U.K. accounts. Therefore, I would question whether the flexibility is more illusory than real, or, alternatively, whether there are advantages in the offshore company being a subsidiary of a holding company as opposed to a direct subsidiary of a U.K. insurer.

Mr A. F. K. Kennedy, F.F.A.: It is always interesting to compare any market, and particularly this offshore market, with markets with which we are already familiar. Regarding the U.K., we see familiarity with products, systems (other than in multi-currency and multi-lingual areas), administration and the actuarial requirements.

I move on to the area of expatriate sales, which started in the single premium area and developed to annual premiums, as is described in the paper. This gives companies an exposure to foreign domestic markets since, even with expatriates, they come across the new issues of underwriting, claims, language, collection of premiums, payment of claims, not to mention the cultural and legal issues that have been mentioned by other speakers. For example, I found it an interesting learning experience to discover, in an overseas market, that I had to decline a critical illness claim because of the fact that the client had had a heart attack shortly before he applied for the policy.

Strategies are now being developed further in the context of more general cross-border sales,

https://doi.org/10.1017/S1357321700001197 Published online by Cambridge University Press

particularly into the E.U., although this is a different concept from other offshore business. However, companies need to start from somewhere, and current offshore expertise is clearly an appropriate starting point. In general, sales in new international markets call for a return to a back-to-basics approach to life insurance, since we are having to go back to our early textbook days in some instances.

We certainly need to consider the reasons for embarking upon a business activity such as this. These can determine the location, whether the company should be a branch or a subsidiary, what products should be offered and what it is going to cost the parent company. Clearly one issue is whether the intention is to sell back into the U.K. or whether to seek a greater geographical diversification; and another is whether one would tie in with the parent's other product ranges, for example in investment products. It would appear that an offshore company should be relatively capital efficient because of its ability to push its single premium product as opposed to its regular premium business. It also provides an exposure, as I said earlier, to foreign markets via expatriate sales initially, which would lead to a greater knowledge of the domestic market and enable the parent, or the subsidiary itself, to be better able to judge whether to enter a domestic market where there may be an opportunity for a greenfield operation, a joint venture or a distribution arrangement. The decision on location depends, not just on the previous items, but also on aspects of culture, language skills and confidentiality. Those in favour of Luxembourg would certainly agree with those comments.

In the paper reference is made to the fact that an offshore company must clearly be seen to be controlled locally. I believe that we must also take account of the fact that main board responsibilities in the U.K. may impact on that to some extent. Parent companies have responsibilities for their subsidiaries.

What does the future hold? Clearly, in the E.U. there is going to be a great deal of hard work for any company that is interested in operating there; but at least there is a single supervisory regime. Apart from Europe, which may be an easier market to tackle at first, other markets are not currently very developed and are much less regulated. However, inevitably, they will become developed, will become regulated and the cost of operating in these markets will increase. The question that must then be asked is how and where the international and offshore markets will develop thereafter?

Mr O. Thoresen, F.F.A. (closing the discussion): On reading the paper for the first time, the only area of slight discomfort that I experienced was in the authors' almost interchangeable use of the words 'offshore', 'international' and 'cross-border'. Mr Towers alluded to this in his contribution. To me these words mean very different things, different markets, different investors and different marketing requirements, and the decisions on location, distribution, etc., will be different accordingly. If we start with what I describe as the legitimate offshore market, the issue here is really one of taxation and confidentiality. The existence of a jurisdiction, which is also well regulated and a secure haven for their accumulated wealth, meets exactly the needs of the expatriate described in the paper. These attributes are also attractive to the domestic investor who wants to invest offshore. Large average investments, sophisticated products and low numbers of cases demand a certain structure of company and allow a specific pricing basis; and, to a large extent, price competition is not a particularly strong feature of the market.

I define 'international' as the market described in ¶¶4.1.3 to 4.1.5, where the tax treatment may be secondary to the issues of hard currency, political stability and, again, confidentiality. The true international market makes significant demands on a company's ability to cross cultural boundaries, and complexity picks up several gears when we start to move into these markets. Again, the market is a little less price competitive, and, as a result, the margins tend to be a little more generous for the company.

The cross-border market, on the other hand, describes to me a market where the competitive advantage is driven by an ability to offer a product more competitively than a domestic competitor, either because of product design, investment expertise or price. So, the difficulties in marketing across international boundaries are added to a requirement to be at least as cost effective and service competitive as the domestic players in that market. Here is where the recent overseas life business tax

https://doi.org/10.1017/S1357321700001197 Published online by Cambridge University Press

changes may well prove relevant eventually. In fact, many companies currently describing themselves as cross-border insurers are, by my definition, offshore companies.

The decision as to where to locate your offshore or international or cross-border company, relies on your understanding clearly which of the three types of company you are setting out to be. I think Mr Morris's contribution was a good indication of the fact that there is quite a broad range of views on that subject, as with most issues in this market.

The offshore market depends mainly on tax considerations and confidentiality; and where the tax regime of your chosen market is under review — and this is a point which has been made many times in this discussion — it is clearly more challenging to plan accurately how your business is going to develop or, more importantly, how the assumptions which underlie your product pricing will turn out in reality. Persistency is the parameter which I find the hardest to predict. Changing marketing rules can also throw the best laid plans off the rails. The authors refer to the high charges associated with offshore products. It remains to be seen what effect disclosure will have on sales of offshore products in the U.K., as these higher charges are exposed more clearly for all to see.

The personalised bond is a product which is covered in the paper in some depth, but has not been raised at all in the discussion. This product is almost worthy of a paper in its own right. To offer what is effectively a portfolio management service within a life product, at charges which may be high by insurance bond levels, but are actually very, very low by private banking levels, is a very strong marketing proposition; but we have to ask just how profitable this business is.

Distribution is covered relatively briefly in the paper, and it is an area fraught with danger. We have had some discussion on this. The master agent approach removes much control from the life company, which carries enormous risks when the manufacturing base and the distribution base may be thousands of miles apart. I remain unconvinced that a direct sales force will be any more successful in the international sector than it is proving in the U.K. in some instances, other than where very specific and favourable circumstances apply.

That brings me to my main concern about the future development of this industry internationally, and that is one of financial viability — a point which was raised by the opener and has been returned to by several contributors. My own experience suggests that distribution costs are extremely high, and getting higher, as many new entrants choose to buy their way into the marketplace. Historically, persistency was very high in the expatriate market; expatriates tended to invest with you and stay with you as they moved from one expatriate contract to another. Things are unproven in indigenous markets, and we will have to wait and see.

Salary inflation in the offshore centres is high. You may argue about whether that in Guernsey is higher than that in the Isle of Man or than that in Luxembourg. The fact is that costs are very high; and, as the market expands and more entrants move in, we have to expect that the inflation rates that apply to salary costs will continue to push upwards. I have a concern about whether some of these rising costs have been masked, up to now, by the outstanding results achieved in terms of sales growth by this market. I find it hard to believe that these growth rates can continue to be maintained at their current levels; and just how robust the industry will be to a flattening in growth rates, or even a decline, remains an unanswered question.

One aspect of this business is that things happen very quickly. Mr Iqbal mentioned the Big Bang risks. He is quite right; and it challenges the actuarial profession to respond commercially. No one is suggesting that someone would knowingly under-reserve for future contingencies, but it is not always obvious what is reasonable in the sort of market that we have been talking about.

There is a point there on the calculation of appraisal values too. There is a temptation, in some quarters, to become over-scientific about the few issues where we do have some experience, at the expense, perhaps, of some of the bigger issues where we have little experience and which can have a far greater effect on the eventual outcome. Further work in this area, in financial modelling of the way the offshore industry or international industry may develop and the pressures on the companies involved in it, may be useful.

Mr L. S. Tyrer, F.F.A. (replying): The opener commented on profitability. I agree that the paper does not cover this issue, and it is a very difficult point to cover. There are no published accounts for

https://doi.org/10.1017/S1357321700001197 Published online by Cambridge University Press

most offshore insurers, consequently it is an extremely difficult item to look into. My own view is that, provided the businesses have solid business focus in the main offshore markets, such as Hong Kong and the Middle East, then we are seeing substantial profits starting to emerge. Many companies are expanding at a fast rate, and, therefore, the business development costs will delay emergence of profits. These are difficult issues to investigate and comment upon without being the actuary of the company. The opener also mentioned court decisions, and, in particular, one in a South Pacific country where the decision did not accord with U.K. practice. Offshore insurers operate in some very diverse parts of the world, and the courts in these areas can give what appear to us to be very odd decisions.

Mr Morris spoke about Guernsey. Mention was made of the use of trusts, and the fact that a lot of offshore insurers use Guernsey and Jersey as a base. This is not necessary, but it can help to protect the arm's length nature of any transaction. So, if the insurer is an Isle of Man company, it is a further safeguard to have a Channel Island trustee. Also, with regard to the reasonable expectations of policyholders with personal portfolio bonds; there are significant profits to be earned on currency exchange deals and on the interest margins where cash is held in the bond. Provided that the basis of such transactions is clearly stated in policy documentation and in brochures, these are bona fide profits of the life company. They are akin to profits you would expect a bank to make operating a multi-currency deposit base.

Mr Taylor mentioned the dangers of building a business on a tax advantage, such as arises with portfolio bonds or investment bonds written on the lives of U.K. residents. For a number of companies it is a profitable market; it does carry the risk of disappearing and, therefore, if that was the only market one was aiming for in establishing offshore, I think it could be unwise. Most companies in the offshore market have a very good spread of business and, therefore, while they would be affected if this market disappears, I do not think it would be disastrous.

Mr Iqbal mentioned the valuation standards in offshore jurisdictions. My view here is that, certainly in the Isle of Man, there is a great deal of freedom for the actuary; and here I think it is essential that the actuary has wide experience and takes responsibility, not only for the standard of the valuation bases, but also exercises a high degree of influence over the financial controls that surround the business in terms of distribution, underwriting, and claims management.

Reference was made to a case where £20m of policyholder money was moved without the life company being aware. Where there is external investment management of policyholder funds, the actuary and the directors have to make absolutely sure that these areas are well controlled and that proper safeguards exist.

Mr Whitaker mentioned one of the advantages of an overseas branch over a subsidiary as being financial strength. In offshore subsidiaries the level of shareholder funds is determined by the parent company, having regard to how it wishes to use its capital. Supervisors would recognise that the share capital of certain subsidiaries could be improved upon, but reliance, correctly or otherwise, may be made on the substantial and well-respected U.K. parent. I fully agree with Mr Whitaker on the points he makes about the trading practices of the offshore companies and how they have to be closely monitored and controlled. I would also agree that extreme care has to be taken when appointing distributors in certain parts of the world.

Mr Grace mentioned the threat of offshore life business to U.K. business as perceived by the ABI and the Government. I believe that there is a degree of paranoia here. The banking systems in the U.K. and the offshore centres are closely connected, with transactions being clearly detectable. In addition, the money laundering regulations, which are applied with considerable force, make it relatively easy to police offshore policies. If you examine offshore business, you will find very little that is of a type where the investor is going to shield his investment from U.K. tax. I think, from an onshore perspective, that many people believe this business to be considerable. However, in reality, it is not.

I would like to reply to the point that Mr Kennedy made about local management and control, and Main Board responsibility. The offshore subsidiary cannot operate with full autonomy. Although management and control has to be on the Islands or in the other centres, the Main Board does have responsibility. It has responsibility for the strategic decisions that the offshore subsidiary will make

https://doi.org/10.1017/S1357321700001197 Published online by Cambridge University Press

and it also has responsibility for major capital outlay. I believe such issues have Main Board involvement, where the board in the U.K. can have a genuine involvement without compromising the position.

The President (Mr G. M. Murray, C.B.E., F.F.A.): The cycles that industries go through are interesting. The Scottish offices, having in their early development had an international stance, in due course began to draw in their horns and focused back into the domestic market. However, the international aspect has become much more important again and we are seeing significant developments. They might prove to be a fashion and a following of the herd, and there could be a number of painful experiences. I hope not, as the global financial sector has to be a potentially huge market. I hope that our domestic companies are successful.

I am sure all companies are looking closely at what is happening and giving consideration to the possibility of operating abroad.

I should like to thank all of those who participated in the discussion for their contributions, particularly the opener and closer; but obviously we would not have had a meeting without the paper, and so I ask you all to show your appreciation to Mr Boal and Mr Tyrer for giving us the opportunity to have such a useful discussion on a very important and interesting topic.

WRITTEN CONTRIBUTION

The authors subsequently wrote: Several speakers have raised issues in relation to the relative merits of branch or subsidiary status, most particularly the positive aspects of transacting business through the branch route in terms of capital efficiency and financial strength. These factors have, indeed, been put to advantage by a number of insurers, for example, utilising branches located in the Isle of Man or Guernsey for specialist lines of business (e.g. with-profits or deposit administration) or for particular tax reasons. We do, nonetheless, maintain that the route of an offshore branch as a sole strategic option is a questionable long-term strategy. As the opener mentioned, it takes only a sleight-of-hand to alter the taxation status of a policy. Similar action could be applied to an offshore branch. Indeed, very often branches get caught in legislation which was not intended. The advantages of conducting business within a specialist subsidiary are generally overwhelming when compared to the branch route, particularly when access to the U.K. resident market is considered.

Mr Morris and other speakers commented upon some of the locations discussed in this paper. We wholeheartedly agree that each centre has a role to play in this industry, the choice amongst them, in any particular case, being dependent on distribution strategy and products. Dublin and Luxembourg, in particular, are at least as effective as the Isle of Man in terms of possible locations for a subsidiary. However, we stand fully behind our comments in respect of Guernsey.

It is also important to appreciate that the ability to offer gross roll-up products in Europe is no longer dependent on establishing an overseas branch or a Dublin or Luxembourg subsidiary; the recent Finance Bill proposals now substantially affect this issue.

Some of the speakers mentioned profitability and the fact that, whilst there are opportunities, there are clearly major risks to be controlled. The costs of managing these risks, because of the international nature of the business, can be high. Mr Taylor asked how these risks might be factored into profitability calculations, and considered two possible options — a higher risk discount rate, or simply a higher target profitability. We think both have merits, but, perhaps, a higher target profitability is the better. Different products issued by an offshore insurer carry differing degrees of risk, and products issued on a Latin American life rather than a U.K. life (for example) can be judged so significantly different as to warrant a higher risk reward ratio. By adopting different profit standards by contract and by geographical area, an office has the advantage of setting consistent assumptions. It may, in this respect, find it a more useful informative approach than varying the discount rate.

Mr Morris raised a very important question in relation to the efficacy of policyholder

https://doi.org/10.1017/S1357321700001197 Published online by Cambridge University Press

protection schemes in the context of a small base of insurers. We share his concerns. We do, however, consider erroneous his reference to trusts having to be written in a jurisdiction other than that of the Isle of Man. Equally, we do not agree with his comment about policyholders' reasonable expectations *vis-à-vis* efficient treasury management, particularly if (as is the case in our experience) the basis of the policy and of interest/currency transactions is fully and reasonably explained.

Finally, two speakers commented upon reserving standards within the industry, questioning how prudent these could/should be in the light of a relatively unregulated market. Anecdotal evidence suggests that the prudence of U.K. reserving standards is generally fully carried over to the offshore industry, at least as far as the Isle of Man and Guernsey are concerned (Dublin companies are, of course, already subject to the full weight of the normal Irish valuation regulations). The same, however, does not hold for Luxembourg, where no formal Appointed Actuary system exists. In our opinion, further professional guidance specific to offshore companies, in the form of expansion of GN5, would be beneficial to the industry and to the profession.

https://doi.org/10.1017/S1357321700001197 Published online by Cambridge University Press