Unit-Linked Life Insurance: Cost Drivers, Hidden Payments, and the Tax-Deferral Argument

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Unit-linked life insurance is an effective wealth-planning tool, but managing the participants in the structure and their respective disclosed and undisclosed fees are important to achieving client objectives. A primary benefit of life insurance as a planning tool is tax deferral, but other benefits include asset protection, estate planning, succession planning, avoidance of forced heirship laws, and control over wealth transfer.

I am going to discuss the benefits and advantages of unit-linked life insurance, its various structures, and the relationships between the parties in the structure. I will first look at the benefits of unit-linked life insurance, including the one most often cited—the tax-deferral benefit. Lastly, I will review a few proposals designed to resolve some of the issues within the industry, both at a practice level and at an industrywide level.

One good reason advisers should care about gaining a better understanding of the intricacies of life insurance is fiduciary duty. For example, the Uniform Prudent Investor Act in the United States provides that trustees may only incur costs that are appropriate and reasonable. I would argue that the act in principle also applies to advisers who function in the capacity of a fiduciary and who adopt a fiduciary role in implementing life insurance for their clients. Therefore, to compare costs versus benefits, an adviser has an obligation to know the underlying costs of life insurance.

Benefits of Life Insurance

Life insurance comes in two main forms: deferred variable annuities (DVA) and variable unit linked (VUL). Both are life insurance products with cash values that are dependent on, or linked to, the value of a portfolio of underlying securities, or "wrapped" in the policy. Life insurance is very flexible and can be adapted to a wide range of purposes. It enjoys very favorable tax treatment in most if not all jurisdictions and can be used to preserve and increase wealth and pass it on to the next generation in a tax-efficient manner. Life insurance has become essentially analogous with wealth planning.

Under certain circumstances, life insurance can circumvent forced heirship laws by removing assets from the policyholder's estate and also avoid the estate tax for U.S. citizens and sometimes for Europeans with assets located in the United States. It is possible to wrap almost any bankable asset and a surprising variety of nonbankable assets in a life insurance policy. The assets are usually held in a segregated managed account with the insurance element conferring certain advantages and benefits to the structure. The policyholder typically selects a broad investment strategy and gives the asset manager a discretionary mandate to manage the assets. The asset manager is usually designated by the policyholder but actually hired by the insurance company.

Asset protection, particularly in such litigious jurisdictions as the United States, England, Australia, and South Africa, is a major benefit of life insurance policies. The key is that legal title to, or ownership of, the assets passes from the policyholder to the insurance company. Essentially, the assets underlying a policy cannot be attached by a court of law or accessed by a plaintiff or a creditor in a legal process. A life insurance policy issued in Liechtenstein, Luxembourg, Bermuda, the Cayman Islands, or Singapore will offer a remarkable level of asset protection if it meets certain criteria. For example, the policyholder designates his or her spouse, children, or other descendents as the beneficiary(ies), the beneficiary designation is irrevocable, and it is made more than 12 months prior to setting up the life insurance policy.

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Tax deferral and tax exemption are arguably the most cited and biggest benefits of life insurance structures. Usually, a life insurance policy enjoys full tax deferral during buildup; that is, no taxes on the income or capital gains in the policy portfolio are payable during the accumulation period. In the case of DVA insurance, principal and gains are split at maturity. The principal—which is the basis—is paid tax free at maturity, whereas the capital gains and the income component are taxed at the beneficiary's marginal rate. In the case of VUL insurance, on occurrence of the insured event, the entire death benefit can be paid out tax free as shown in the example in **Exhibit 1**. The example is a U.S.-compliant variable unit-linked life insurance policy that was funded with $100 in 2000. By 2010, it had accumulated $40. The biometric risk component is 5 percent, which amounts to $7 over 10 years. Assuming the insured event occurs, and assuming that the policy was properly set up, the principal, the gain, and the biometric risk component are all paid tax free to the beneficiary(ies). These three components together are termed the "death benefit."

Exhibit 1. Example of the Death Benefit on a Unit-Linked Life Insurance Policy

Policy and biometric risk	105%	biometric risk is 5 percent
Premium (the basis)	$100	paid in at inception in 2000
Current cash value	140	10 years later
Insured person dies: payout	$147	140 × 105%
Payout to beneficiaries		
Return to basis	$100	tax free
Gain on portfolio	40	tax free
Biometric risk component	7	tax free
Death benefit	$147	tax free

Structure of Unit-Linked Life Insurance

Setting up unit-linked life insurance is accomplished in two main ways. The more common way is for a broker to broker the policy. The policy normally involves four main parties: the insurance broker, the insurance carrier, the asset manager, and the custodian bank. The contractual agreements include the asset management agreement plus power of attorney between the asset manager and insurance carrier (who has legal title to the assets), the intermediary agreement between the insurance carrier and the insurance broker, and the custodial agreement between the insurance carrier and the custodian bank.

The second way is for the asset manager (or other intermediary, such as a lawyer or accountant) to mediate the policy directly with the insurance company. The client's asset manager is designated as the asset manager for the assets that will be held in the life insurance policy. Often, not much actually changes from the client's point of view except the structure holding the assets, which now optimizes the client's tax planning, asset protection, and estate and succession planning.

Cost of Unit-Linked Life Insurance

The range of fees and charges that are possible in the insurance policy structure is very wide. Taking a $1 million policy as our example, the insurance company may charge an establishment fee ranging from 0.15 percent to 1.5 percent and an annual administration fee ranging from 0.35 percent to 1.5 percent. The asset manager's fee may range from 0.5 to 2 percent, depending on the underlying strategy, potentially with an additional annual performance fee of up to 20 percent. The custodian bank will likely charge a depot fee of 0.15–0.45 percent and transaction fees on trades of 0.5–2 percent, depending on the product, along with foreign exchange charges, account opening charges, and a spread on financial products. The fund producer is also a source of costs when the asset manager puts mutual funds in the portfolio. The fund producer often charges an up-front fee as well as the usual annual management fee and performance fee. Finally, the insurance broker may charge an up-front commission of up to 5 percent, and in some cases, the insurance company will pay an annual trailer fee to the broker of up to 0.5 percent. The trailer fee comes out of the insurance company's annual administration fee.

Within the insurance structure, there are a wide range of disclosed and undisclosed cash flows. The insurance company receives three main fees: the establishment fee, recovery of the broker's commission if a broker is involved, and an administration fee. All three fees are deducted from the client's account. The insurance broker is paid directly by the insurance company, and the asset manager deducts the asset management fee from the client's account. Generally, the custodian bank receives about 0.25 percent in disclosed fees.

The undisclosed cash flows and payments are more interesting. In Switzerland, it is common practice for asset managers to receive retrocessions, or rebates, on the management of the assets from the custodian bank—for example, on brokerage. Disclosure of retrocessions, in general, has improved a lot in recent years, but still lags in the insurance sector. The asset manager may receive retrocessions or cash rebates from the custodian bank on revenues from brokerage, depot fees, and foreign exchange transactions as well as from the fund producers—investment funds, mutual funds, and structured products—whose funds are being placed in the portfolio. Furthermore, the insurance broker may be paid a kickback of 0.15–0.30 percent by the asset manager for bringing new business to the asset manager. The same holds true for lawyers, other advisers, or whoever brings the business.

Table 1 shows the results of a scenario analysis in which the worst-case and best-case scenarios of costs were calculated for setting up and maintaining a "typical" life insurance structure. The median cost represents what is considered "standard" or common practice in the industry. The range between the worst and best cases is quite wide. **Table 2** shows the resulting costs to the client of the three scenarios over five years. The example uses the following assumptions: a €1 million policy with the €1 million paid in a lump sum at inception; a 6 percent raw annual return on the underlying assets; and a balanced strategy of 40 percent equity, 40 percent bonds, and 20 percent alternatives and other. The cost to the client over the first five years ranges from 40.70 percent of the paid-in premium (€407,000) in the worst case to 8.70 percent of the paid-in premium (€87,000) in the best case. The median costs are 20.14 percent of the paid-in premium (€201,375).

Table 1. Three Cost Scenarios for Setting Up and Maintaining a Life Insurance Structure

	Cost Range over Five Years		
Participant and Cost Type	Worst Case	Best Case	Median
Insurance company			
Establishment fee	1.00%	0.50%	0.75%
Broker's commission	6.00	0.00	2.40
Administration fee	5.00	1.75	3.75
Independent asset manager			
Asset management fee	7.50%	2.50%	5.00%
Custodian bank			
Depot fee	2.25%	0.75%	1.25%
Transaction fees to set up	1.35	0.68	0.90
Transaction fees	2.25	0.38	0.75
Foreign exchange surcharge	0.15	0.00	0.04
Fund producer			
Up-front load (emission fee)	8.00%	0.75%	2.00%
Management fee	7.20	1.40	3.30

Table 2. Example of Total Costs to a Client for Three Cost Scenarios over Five Years

Cost Type	Worst Case	Best Case	Median
Total cost to client			
Establishment & up-front loads	16.35%	1.93%	6.05%
Ongoing fees & charges	24.35	6.78	14.09
Totals	40.70%	8.70%	20.14%
Absolute amounts			
Establishment & up-front loads	€163,500	€19,250	€60,500
Ongoing fees & charges	243,500	67,750	140,875
Totals	€407,000	€87,000	€201,375
Insurance broker commissions			
Up-front fee	5.00%	0.00%	2.00%
Trailer fees	2.50	0.00	1.50
Return (percentage)			
Portfolio return	33.82%	33.82%	33.82%
Less total fees	40.70	8.70	20.14
Net return over five years	–6.88%	25.12%	13.69%
Return (absolute amounts)			
Portfolio return	€338,226	€338,226	€338,226
Less total fees	407,000	87,000	201,375
Net return over five years	–€68,774	€251,226	€136,851

Notes: Figures based on the following assumptions: Premium paid at inception is €1,000,000, raw annual return on the underlying assets is 6 percent, and a balanced strategy is used (i.e., 40 percent equity, 40 percent bonds, and 20 percent alternatives and other).

The bottom line for the worst case is that the client has a negative return of almost 7 percent over the first five years of the policy. In the best case, the client's five-year return is about 25 percent, and the median return is about 13–14 percent. These scenarios are fairly representative of the industry; the worst-case scenario is rare but does happen, and the best case is also quite rare but certainly does happen.

The median represents about a 2–3 percent cumulative annual growth rate (CAGR) over five years. Assuming an average annual inflation rate of about 1–1.5 percent, the client is left with about a 1 percent real annual return remaining of the original 6 percent assumed raw annual return. The party with the most power to influence portfolio return is the asset manager. The asset manager decides the management fee, but more importantly, he or she strongly influences transaction costs, depot costs, and costs associated with investment products. Furthermore, because the mandate is discretionary, the asset manager decides which products to put in the portfolio within the bounds of the agreed-upon investment strategy.

Participants in the Insurance Structure and Their Fees

The first participant in the value chain is the insurance broker. The broker generally receives a sales commission. The sales commission may be up to 5 percent of the paid-in premium. If a broker is not involved, the up-front fee is often waived or very much reduced. The median broker commission for a €1 million policy today is about 2–3 percent. With regard to the trailer fee, the worst-case and median amounts paid to the broker are 2.5 percent and 1.5 percent, respectively. The undisclosed fee, or kickback, to the insurance broker from the asset manager is estimated to range from 2.5 percent to 1.25 percent over five years for the worst and median cases, respectively.

The second party in the insurance transaction is the insurance company. The insurer is the key service provider and the enabler of the insurance strategy. The insurance company is generally very transparent about fees it charges, with a correspondingly narrow range between the worst-case and best-case fees—a spread of about 2.25 percent. The real cost of service of the insurance policy itself can actually be relatively cheap at about 0.5 percent for setup and about 0.5 percent ongoing. The median cost of fees charged by the insurance company is 3.40 percent over five years.

The asset manager is the third party in the insurance structure and is the primary determinant of undisclosed fees imposed on a client. The issue of undisclosed fees is a global problem endemic to the industry. The asset manager charges an asset management fee, plus he or she may receive a wide range of retrocessions and kickbacks. The large number of possible retrocessions received by the asset manager is considered a symptom of the lack of transparency. Because of the lack of transparency, the range of fees possible (disclosed and undisclosed) is very wide. The result is a nearly 15 percent spread in possible outcomes between the worst-case scenario (17.33 percent, which comprises a stated asset management fee of 7.50 percent plus the undisclosed fees) and the best-case scenario (2.5 percent, which comprises only an asset management fee of 2.50 percent over five years and no undisclosed fees).

Keep in mind that this disparity in fees occurs for the same basic policy with the same basic parameters. The median fees paid to the asset manager over five years are around 7 percent. To state the issue clearly, it is the result of either an absence of effective control systems or an overriding of systems by managers to achieve their own interests to the detriment of investors.

The custodian bank is the fourth party in the insurance structure and is understood as the provider of a pure commodity service. There is relatively little differentiation in the services provided by custodian banks, and any differences are reflected in the net fees received by the banks. The worst-case, best-case, and median fees are, on average, 3.68 percent, 1.80 percent, and 2.01 percent, respectively.

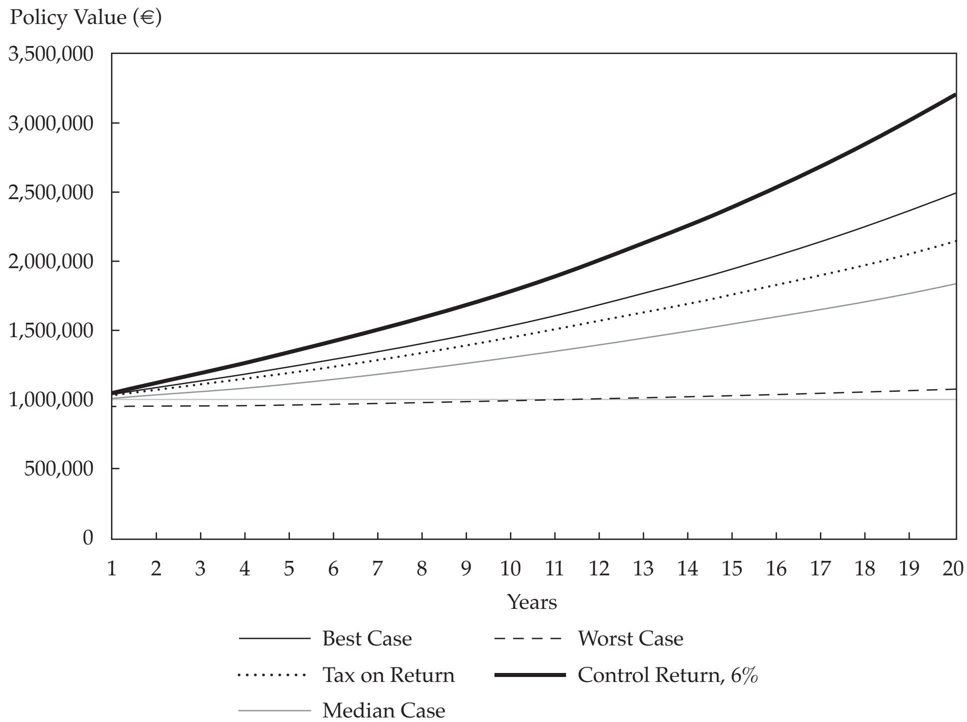
The fund producer is the fifth participant receiving fees. The fund producer is usually unknown to the client. Many investment funds impose an up-front load as well as the annual management fee. In general, a large portion of these fees are passed along to the asset manager as a retrocession. The net fee received by the fund producer ranges from 5.20 percent to 2.15 percent, with a median fee of approximately 3 percent. It may also be that the asset manager is the fund producer, placing his or her own proprietary funds in the portfolios. Given that the asset manager then receives both the asset management fee on the account plus investment fund management fees, this scenario effectively means the manager may be charging fees twice on the same assets.

To understand the effect of transparency levels, consider the three main participants—insurance broker, insurance company, and asset manager—their level of fee transparency, and the spread in costs between the worst and best outcomes. The transparency of the insurance broker is at a medium level, and the spread between worst and best fee scenarios is 10 percent. The insurance company's level of transparency is very high, with the spread on possible costs at about 2.25 percent. At the asset manager level, low transparency and low levels of disclosure lead to a very wide spread in possible outcomes of roughly 15 percent. In my opinion, the spread in practice can be even wider than that.

Extending the analysis over a time horizon of 20 years, **Figure 1** shows a comparison of the control return with the worst-case, best-case, and median possible range of returns, as well as the effect of introducing taxes. In the worst case, the policyholder—the client—could lose nearly all of the return (or 96 percent) over 20 years. In the median case, the costs consume about two-thirds of total return over 20 years, and in the best case, they consume about one-third.

In Figure 1, the dotted line shows the effect of introducing taxation to the analysis. Assuming that the 6 percent control return is taxed at a marginal rate of 35 percent, the investor is still better off paying taxes rather than taking out an insurance policy based on the median assumptions. Of course, if the investor is actually making 6 percent, an insurance policy makes no sense at all. The

Figure 1. Five Scenarios of the Effect of Insurance Costs on Total Return over 20 Years



Notes: Control return assumes a 6 percent compounding return. Taxation scenario assumes a 35 percent tax rate on the control return.

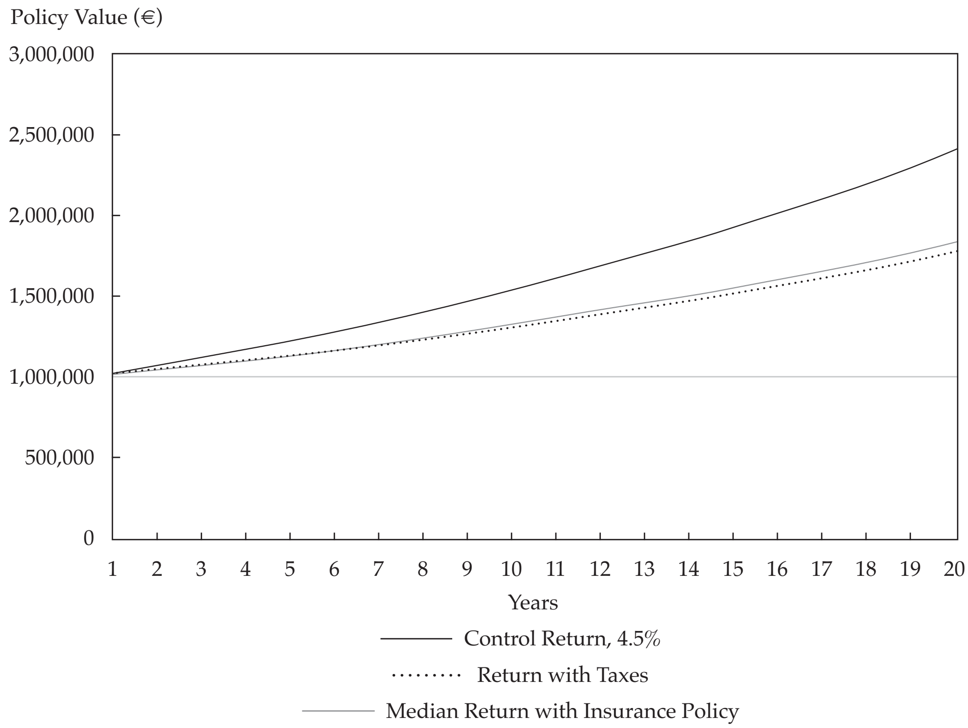
question is, what is driving the industry? A substantial driver is the move from noncompliant, nondisclosed assets to compliant, disclosed assets as investors seek tax-optimized solutions.

Taking the analysis one step further into a real-world situation, **Figure 2** shows, for a 20-year horizon, the value of a discretionary managed account earning 4.5 percent a year versus the same account taxed at 35 percent versus the same account with the median-case insurance policy. Consider that in the real world, most clients who would benefit from this type of wealth-planning tool already have their money managed by a professional money manager with the assets held at a custodian bank. The fees the client pays to the asset manager and to the custodian bank—for example, 1 percent and 0.5 percent, respectively—would reduce the control return of 6 percent a year to 4.5 percent a year. When that 4.5 percent annual return is disclosed and taxed, the cost of the life insurance, assuming the median-case parameters, is actually equal to the value of the tax deferral.

When I started the original scenarios analysis, I was not expecting this outcome. It is fascinating that despite the lack of transparency that is characteristic of this branch of the insurance industry, investors on the whole appear to have correctly priced the service they are receiving. This outcome would be expected in an efficient market according to the no-arbitrage pricing model. Up until today, however, the industry has been rather inefficient. In a more transparent world where assets are declared and costs are more transparent, there may well be effectively no difference between the loss as a result of taxation at the marginal rate and the cost of the insurance policy.

The median insurance structure costs can be viewed as the benchmark set of cost values for other insurance structures because they equal the value of the tax deferral. When the actual policy value beats the benchmark policy value, as shown in Figure 2, the insurance structure is adding value for the client through tax savings. It is then a tax-optimization strategy. The adviser's goal then is to beat this benchmark. In fact, even when the dollar cost of the insurance policy is equal to the dollar value of tax savings, insurance can add real value because the other benefits of life insurance—asset protection, succession planning, investor control, privacy, flexibility—become effectively free.

Figure 2. Effect of Taxation and Median Cost of Insurance on the Value of a Discretionary Managed Account



Notes: Managed account assumes a 4.5 percent compounding return. Tax rate is 35 percent.

Until now, I have used the example of a €1 million insurance policy. **Figure 3** illustrates the benefit of size. If I move up the policy size scale, then in general the larger the policy, the better value it represents to the client because of the lower overall cost of ownership. As the policy value increases, the costs diminish on a sliding scale. From a policy size of €1.5 million to €2 million, implementing an insurance policy strategy becomes an obvious choice. In fact, looking at an estate plan for a client with an estate of more than €10 million to €15 million, I would question the absence of insurance in the plan rather than the presence of it. In my opinion, for large estates and larger policies, insurance as a component of an integrated wealth-planning strategy becomes an easy decision. In most large estate cases, it just makes sense because it is efficient and cost effective.

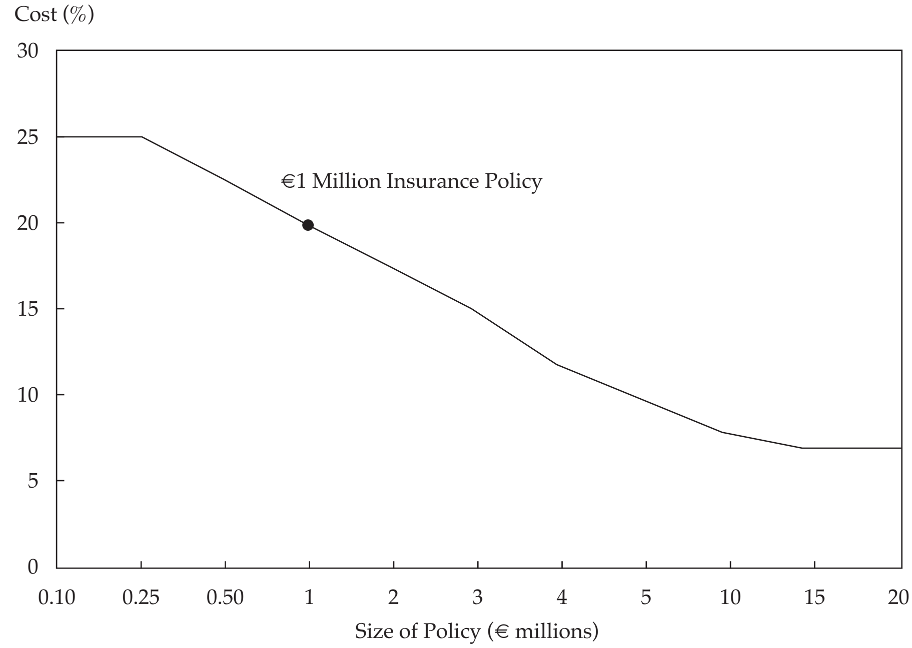
For an estate of less than about €500,000, however, the situation I see is one of caveat emptor (i.e., let the buyer beware); the insurance strategy may make sense, but it is unlikely to be for the tax-deferral benefit. The key message is to be very clear about the objectives and why insurance is being used as a planning strategy.

Possible Solution at the Practice Level—Three Layer Cake Approach

A practical approach to controlling the costs of an insurance structure is to benchmark the costs by participant and separate setup and ongoing costs. Think of this approach as a three layer cake. Using a €1 million policy as an example, estimate the costs for the three main participants. The setup costs for the insurance company may be between 50 and 100 bps of the paid-in premium, with ongoing annual fees of about 50 bps. The asset manager's fee may be between 80 and 100 bps of assets under management. The setup costs at the custodian bank should be roughly 100 bps, which are transaction costs, assuming that cash is paid in for the policy, and ongoing fees should be about 40–45 bps a year.

The total setup costs may be between 1.5 percent and 2 percent, and total ongoing costs may also be about 1.5–2 percent a year. It is critical to understand how each participant is being compensated. I also recommend getting a written estimate from the asset manager regarding the cost of the structure over time and holding the manager to it. Again, transparency is critical to making the structure work for the client.

Figure 3. Median Cost of Insurance Compared with Size of Policy



Note: Cost is estimated over five years.

Possible Solution at the Industry Level—New Role for Professional Trustees

A familiar insurance structure for estate planning is trust-owned life insurance, including a trustee, a trust, and sometimes a holding company. Latest figures for the United States indicate that about $1 trillion to $1.5 trillion of life insurance is owned by trusts, and that figure is expected to increase. In Europe, insurance companies are beginning to work more closely with trust companies, and trust companies are increasingly helping clients set up insurance policies.

My view is that a tremendous opportunity exists for trust companies to get more involved in the unit-linked life insurance business and to take a greater fiduciary role. One of the problems, if not the biggest problem, facing the insurance industry is that often no party to the insurance structure expressly takes on the fiduciary duty. The question is, who owes the fiduciary duty to the client? Arguably, it is the insurance company because the insurer is the party that has the contract with the client. The insurance company, however, generally claims that it just supplies the product and that it has very limited fiduciary duty or responsibility toward the underlying investments and implementation of investment strategy.

In essence, the insurance company may disavow fiduciary duty to the client. It does make sense that insurance companies, both large and small, arguably do not really have the in-house skills or capabilities to effectively monitor asset managers; it is not their core business anyway. As a result, an opportunity is open for trust companies to partner with insurance companies to take on a monitoring and evaluation role of the asset manager and to be compensated for taking on the fiduciary role (and associated risk) in the insurance structure.

The process is very similar to the way a trust works. Many international trust companies already have the in-house skills necessary to take on this extended role. Trust law has been on the books for about 800 years; it is tried and tested, the checks and balances are established and understood. Life insurance in the unit-linked form has been around now for about 25 or 30 years. It is still developing and maturing. Incorporating some of what works in trust law may facilitate the adoption of life insurance as an even more widely accepted wealth-planning tool.

Risks Associated with Unit-Linked Life Insurance

Unit-linked life insurance is on an insurance company's balance sheet under the general category of nontraditional insurance. Simply put, nontraditional insurance means nontraditional risks. Considered another way, it means that often it is basically not insurance in substance. Most of these policies carry between 1 and 5 percent biometric risk. These life insurance policies are essentially wealth-planning, wealth management strategy tools. An insurance company's core competency is in the management, pooling, and pricing of actuarial risk. These products, however, carry investment risk and even, potentially, fraud risk; asset managers may misrepresent their track record, qualifications, and even the assets under management.

Operational risk is also very present in the life insurance structure. Deficiencies in procedures, infrastructure, technology, resources, supervision, and security valuations may exist. Seen this way, the insurance companies—the life insurers—have moved from an area that they understand very well and where they are able to effectively price the risks they are taking into an area where they are less able to effectively manage and control the risks present in the product being offered. Insurance companies are also taking the additional legal risk of potentially being held accountable for the actions of the asset manager. Adding a trust company to the life insurance structure would help manage, control, and minimize the risks that a life insurance company is arguably not equipped to handle.

Some insurance companies have recognized the problem and are beginning to hire independent auditors to audit the asset manager and the assets under management underlying the policy. It seems to be mostly the smaller boutique providers—the smaller insurance companies in Liechtenstein, Bermuda, or the Cayman Islands—that are moving in this direction. Larger companies, however, still do not seem to be addressing the issue effectively. I personally think more providers will move toward having auditors audit the asset manager, but I see the problem as one of fiduciary duty. I have my doubts that an audit company is the answer. The long-term solution to managing fiduciary risk is an institutionalized solution, with a provider who understands fiduciary duty, risks, and issues, such as a professional trustee. I believe understanding the issues involved in long-term wealth planning is critical in properly managing the risks associated with the structures.

Conclusion

When setting up life insurance structures, it is critical to know who you are dealing with and to understand the cost base. Demand full transparency in how each participant in the structure is compensated. Be aware that in substance, these life insurance products often have nothing to do with insurance but are wealth-planning strategies.

Advisers need to ensure that the strategy is inline with the client's objectives, that execution is airtight, and that costs are fully transparent. The services being provided are wealth-planning services. They need to be clearly defined, and the fees charged should reflect the services being provided.

This article qualifies for 0.5 CE credits.

Question and Answer Session

Martin Straub

Question: Can a broker-free life insurance policy be set up in Canada with a limited fee structure and chosen asset manager?

Straub: Yes, you can set it up in Canada, but I am not sure of the exact structure that must be used. The uncertainty about which structure to use in which country is what makes the life insurance business so interesting and why there is so much misunderstanding. Every jurisdiction has its own standards and ideas. Canada is highly complex in that what is considered "exempt" life insurance is governed by a complex set of rules.

The United States, however, is relatively simple. For a U.S.-compliant policy, the IRS and the Treasury do not care where the policy is issued as long as it meets certain criteria. But in Australia, for example, deferred variable annuities and variable unit-linked life insurance policies are not recognized at all for tax deferral.

Question: Do you think it is ethical to sell life insurance through retail banks?

Straub: My experience with the retail banks in Switzerland is that they do not tend to sell this type of life insurance directly. In Switzerland, this type of life insurance is a wealth-planning tool introduced at the private banking level. The private bank may promote the life insurance to the client but use a trusted insurance broker because the typical private banker/relationship manager does not understand the life insurance structure any more than the client does.

The broker's fee can be high, but in some cases the broker is worth his or her weight in gold, particularly if it is a complex case or the client's objectives or the jurisdiction are a bit special. The broker may bring jurisdiction-specific knowledge to the table and may well add considerable value—well worth the amount of the commission. If it is a plain vanilla structure, however, with a production line process, quite often the broker's value added can be negative.

Back to the question of ethics—it all depends. In practice, most of what occurs is ethical. But the banks use an insurance broker, and the broker is external to the bank, which can and does open the door to certain questionable practices.

Question: If part of an adviser's fiduciary duty is to evaluate costs, does that mean advisers have an obligation to minimize the cost to the client?

Straub: Remember that you get what you pay for. If the goal is solely to minimize costs in a life insurance structure, an adviser may end up with a substandard solution or a solution that is not adaptable to the possible changing needs of the client. I think advisers have a duty to first understand client objectives and then how much the client is paying for the service and then to match the complexity of that service and the amount of effort involved to the cost of what is being provided to the client.

Just pursuing cost minimization for its own sake is a short-sighted mistake. It can lead to policies that after five years no longer fulfill the client's objectives and have to be surrendered or restructured at considerable expense.

Question: From Europe's perspective, how are these products being affected by Solvency II, MiFID (Markets in Financial Instruments Directive), and other regulation seeking to bring transparency to the market?

Straub: Not as much as you might think. Remember that MiFID and UCITS (Undertakings for Collective Investment in Transferable Securities) are concerned primarily with transactions in financial instruments. Life insurance products are being more affected by tax exchange information agreements, double-tax agreements, mutual-tax disclosure agreements, tax amnesties, and general information exchange than by MiFID and similar agreements. Also, at the client level, transparency has dramatically improved in such jurisdictions as Switzerland and Liechtenstein.

For example, a landmark court case in Switzerland in March 2006 ruled for the first time that retrocession payments (rebates and other kickbacks) belong to the client and must be disclosed to the client. Disclosure has been improving since then. But for insurance structures, the insurance carrier is the legal owner of the assets, which makes the insurance carrier the client. Often the asset management agreement between insurer and asset manager contains a waiver to the retrocessions and rebates. Technically, the insurance company is responsible, but in practice, disclosure often does not flow through to the client.

Over the next 10 years, I believe this structure will change, with greater transparency to the client in insurance structures, and then such agreements as MiFID will start to have more effect.

For U.S. citizens holding offshore life insurance, the Foreign Account Tax Compliance Act and the Dodd–Frank Wall Street Reform and Consumer Protection Act are already having an impact because going forward, variable annuities, variable unit-linked life insurance, and other forms of offshore life insurance with a cash value will have to be reported. Better transparency will come with this reporting.

Question: You mentioned that life insurance is a good tool to avoid forced heirship rules. Can you explain what forced heirship is?

Straub: In civil law jurisdictions, forced heirship means that a certain portion of the estate must be paid to the decedent's heirs, regardless of their circumstances and ability to deal with the inheritance. Life insurance in Europe is often used in a similar way to a spendthrift trust in the United States—that is, to ensure that the estate is distributed in a way that makes the most sense in the context of the specific beneficiaries of the estate.

Question: Would the trustee solution you proposed add another layer of fees?

Straub: Yes, however, it arguably makes a lot of sense to add an extra 15–20 bps onto the annual cost if you are saving about 100–150 bps by having somebody monitor the asset manager to ensure that the portfolio is not being filled with investment funds and structured products charging 5 percent or more in upfront loads and other charges.