Ireland as a Hub for Insurance-Based Products for International Investors - A Personal History

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1 Introduction

When I was studying for the actuarial exams – not today or yesterday, as I'm sure you've guessed –a standard exam question was that you were given a statement, supposedly by someone close to the insurance industry. The challenge was to assess the reasonableness or otherwise of the statement.

The key clue as to whether the student should agree or disagree with the statement lay in the person who was supposed to have made it.

- If it was the chief actuary in the company, the statement was definitely true, no matter how stupid it seemed at first sight.
- If the finance director made the comment, it was almost 100% correct, but he (it was invariably a "he" in those days) would have missed some subtle nuance of actuarial science.
- In similar vein, if the comment came from an actuarial student, it was reasonably accurate but naive in that the student, with his head in his books, had no understanding of what happens in the real world.
- Next in the hierarchy was the financial adviser. I hate to disappoint any members of this worthy profession who are here today, but the financial adviser too was deemed by the exam setters to have a less than perfect understanding of the complexities of the life insurance business.
- But the exam setters had no doubt as to who were at the very bottom of the pile in terms of their understanding of the business: non-executive directors and financial journalists. If, as a student, you were told that a non-executive director or a financial journalist had made a particular comment, then you knew that it was complete and utter rubbish!

In the course of my career, I have discharged all of the above roles. I started as an actuarial student, and later in my career I was lucky enough to serve as finance director of an insurance company. I have also acted as chief actuary for a number of life assurance companies in Ireland and the UK and I was a financial adviser for corporate pension sponsors for four years or so. The bad news is that I have now fallen to the bottom of the heap: I am a non-executive director of a number of insurance companies. I am also a keen private investor and I write a monthly column recounting my successes and failures, which qualifies me as a financial journalist of sorts. Therefore, take careful warning from the people who set the actuarial exams all those years ago: whatever I say today is complete and utter rubbish!

2 The Early Days of the IFSC

Now to the serious business. This is a personal - and I stress the qualifier "personal" - history of Ireland's emergence as a major centre for international insurance-based investment products.

I was lucky enough to have been involved more or less from the start. Dublin's International Financial Services Centre (IFSC) was established in 1987 but life insurance did not feature initially. This was because taxation of life assurance in Ireland was based on a system inherited from Britain, dating back to before the Irish Free State was established in 1922. This was the so-called "I-E" system, where "I" stands for investment income and "E" stands for expenses. Companies were taxed on investment income but could claim relief on expenses incurred in writing the business. The tax on investment income was passed on to policyholders so, from the investor's perspective, there was tax on the inside build-up. The rate of tax was 35%. Needless to say, this was a major barrier to life assurance companies establishing in the IFSC.

The tax rules were changed in 1993 for life insurers selling internationally from Ireland. From that date, life insurance policies sold to international investors enjoyed tax-free inside build-up, or what we on this side of the Atlantic call gross roll-up of investment return. There was the added attraction that Ireland has double taxation agreements with a large number of countries around the globe, so a portion of the withholding taxes deducted at source in other jurisdictions could often be reclaimed by the life assurance company.

Between 1993 and 1999, policyholders resident in Ireland were still subject to the old "I-E" regime. From 2000 onwards they too enjoyed gross roll-up of investment return. Irish residents are subject to an exit tax but policyholders who can prove that they are resident outside Ireland are exempt from this tax. They may of course be subject to an exit tax in their own country of residence.

The 1993 change in the tax regime, which increased Ireland's attractiveness for new international life assurance companies, coincided with a major change in my personal circumstances.

I had joined Bank of Ireland Group in 1986 as part of a two-man team charged with spearheading the bank's efforts to establish a new life assurance subsidiary. Both of us were actuaries and both of us came from the insurance industry. We were soon joined by others. The bank got regulatory approval for its proposed new company in 1987 – despite determined opposition from agents, brokers and other life assurance companies. It was the first new life assurance company to be established in Ireland in decades. I was appointed to the position of finance director.

By 1993, six years later, I had enough of the bank – and they had enough of me! I decided to establish a new actuarial consulting practice from scratch. The timing was fortuitous. Within months, I obtained a consulting contract from J Rothschild International, the first life assurance company to establish in Dublin's IFSC, with a brief to provide it with actuarial advice and to discharge the statutory role of appointed actuary.

J Rothschild International was the brainchild of Mark (now Sir Mark) Weinberg, a South African born financier and entrepreneur who achieved legendary status in the life assurance industry for his ability to identify and exploit new product and business opportunities. Subsequently, J Rothschild International changed its name to St James's Place International.

The company's initial business plan was to sell gross roll-up investment policies from Ireland to high net worth investors in the UK. These policies were quite tax-efficient for an important and affluent customer segment. The company prospered. I am pleased to say that St James's Place International, as the company is known today, is still very successful and, to the best of my knowledge, its success is still based on a variation of the initial product design and target market.

Other companies – mainly subsidiaries of UK financial services groups - soon followed suit and products aimed at high net worth UK customers accounted for a high proportion of total life assurance business written from the IFSC in the early years.

3. The Italian Period

In the mid-1990s, J Rothschild International took a number of initiatives to expand beyond its core UK market. One of the markets it looked at was Italy. It established a distribution relationship in that country and I got to understand some of the special features of the Italian life insurance market.

That introduction to the Italian market formed the backdrop to my next lucky break. In 1997, Barry O'Leary, who was then European Director of Ireland's Industrial Development Agency (IDA), the state body charged with attracting multinationals to Ireland, asked me to accompany him and some of his colleagues on a promotional trip to Italy. In the space of four days in the June heat of an Italian summer, we called on ten life assurance companies and banks, in Rome, Milan, Verona, and Turin. The visit was a phenomenal success. Either directly or indirectly as a result of that visit, we managed to persuade over a dozen Italian financial services groups to establish life assurance subsidiaries in Ireland. I understand that that particular promotional visit to Italy ranks as one of the most successful marketing trips ever in the history of the IDA. No wonder Barry O'Leary was subsequently promoted to chief executive of the organisation!

Why did so many Italian financial services groups decide to establish life insurance subsidiaries in Ireland? There were a number of reasons:

- The European single market in financial services – which allowed financial institutions based in one EU member state to sell products into another member state – was established a few years previously but, as is usual with major international initiatives of this nature, the pace of progress towards implementing the single market varied across the different countries. In life assurance, Italy had further to go than some other countries. The Italian life assurance market was dominated by traditional participating (or what we call with profits) recurring premium endowment assurance contracts. The typical annual premium was quite modest. At the time we visited in 1997, unit linked policies and single premium investment bonds were relatively new.
- In contrast, the Irish life assurance market was probably the most advanced in Europe at the time. The first unit linked policy was sold in Ireland in 1964 and the first single premium investment bond, which was linked to the performance of a fund invested in real estate, was introduced in 1969. As an aside, what I call unit linked would be more familiar to some of you as separate account business, although there are some important differences between unit linked and separate account, some of them favourable to the investor and others unfavourable. I leave it to my legal colleagues to explain the differences to anyone who's interested.

As early as 1975, unit linked policies accounted for more than 50% of life assurance policies sold in Ireland and unit-linked investment bonds were the leading vehicles for lump sum investment, to such an extent that mutual funds or what we call unit trusts never really took off in Ireland for retail investors. They were squeezed out by life insurance-based investment bonds.

There were a couple of reasons for the relative sophistication of the Irish market. One was that we inherited the UK system of regulation when this country gained its independence in 1922. The UK's regulatory regime for life assurance allowed companies considerable freedom in terms of product design, pricing, and where the underlying assets could be invested. It also involved minimal regulatory intervention. But why were Irish life insurers more advanced than their UK counterparts? They say that necessity is the mother of invention and that definitely was the case here. The Irish domestic market was much smaller than the UK, so Irish-based insurers were at a competitive disadvantage to their UK counterparts in the main product areas, particularly with profits endowments, which accounted for the bulk of sales up to mid-1960s. Irish insurance companies had to come up with something different if they wanted to compete. The new product they came up with was a life insurance based investment bond, where the underlying premiums were invested in real estate. The first of these products, which was introduced in 1969 by Ireland's leading domestic insurer, Irish Life, was called the property modules bond. It tapped into the Irish love of land and property and was a phenomenal success.

- Another reason for Ireland's attractiveness as a base for new life assurance companies was that, at the time of our marketing trip to Italy in 1997, the government department responsible for supervising life insurance in Ireland was also responsible for promoting foreign direct investment into the country. One consequence is that new applicants for life assurance licences were favourably received by the regulator - provided they were from outside the country, Now, in the post Lehman world, this dual responsibility, with its obvious conflict of interest, seems ridiculous, but the system actually worked as far as life assurance was concerned. In our conversations with insurance executives in Italy and elsewhere, we were able proudly to say that not a single life insurance company supervised from Ireland had gone bankrupt since the landmark 1936 Insurance Act, which was the first substantive insurance legislation enacted since the foundation of the state.
- In contrast, the Italian insurance supervisor (ISVAP) took a very intrusive approach to regulation of the industry. Despite the fact that prior regulatory approval of product designs and prices was supposed to have gone by the wayside following the establishment of the single European market earlier in the 1990's, the Italian regulator insisted on micromanaging as many aspects of life insurers' operations as it could. The Italian regulator also insisted on higher capital requirements than were strictly required under European regulations. Furthermore, there was a suspicion in some quarters that ISVAP was in cahoots with the leading established Italian life insurers in order to maintain a cosy cartel and prevent recent entrants to the market, particularly banks, from succeeding. This was something I could relate to from my experience with Bank of Ireland in 1986/87.

Within weeks of that June 1997 visit, one of the leading Italian banks decided to set up a new life assurance company in Ireland, with the aim of selling back into Italy. It was one of the smoothest projects I have ever been involved in. From a standing start in September 1997, the company was able to open its doors for business within 12 months, having secured all the necessary regulatory approvals, completed all the necessary legal work, having designed and priced the entire product range, and with the necessary staff and the required financial and administrative support systems in place.

In the early years, this company's sales into Italy consisted almost entirely of lump sum investment products sold to individual customers of the bank, mainly mass affluent and high net worth individuals. The core product was a plain vanilla mutual fund type investment bond with minimal additional life insurance cover, just enough for the policy to qualify as life insurance, but not a cent more.

That initial entrant enjoyed phenomenal success, both top-line and bottom-line. Other companies soon moved to replicate it success and, as I said earlier, more than a dozen Italian financial institutions followed the same successful path. That success has continued to this day. Looking at sales figures for 2013 (the latest year for which industry-wide figures are available), the top five companies selling internationally from Ireland were all targeted primarily or exclusively at Italy and total sales in 2013 for those five companies exceeded €10 billion. To give an indication of the importance of the Italian market, sales for these five companies were more than 2 ½ times the corresponding sales figures for the top five companies transacting domestic business in Ireland.

I have already outlined some of the advantages to the insurer of selling from Ireland into Italy at that time: a less intrusive regulator, greater pricing flexibility, lower capital requirements. Other advantages included Ireland's low corporation tax rate (10% at the time, now increased to 12½%), more flexible asset admissibility rules and more sophisticated policy administration systems, which were a consequence of Ireland's experience of administering unit linked business since 1964. As an aside, it is worth noting that Ireland's low corporation tax rate, which is much touted as the main reason for foreign investors deciding to locate here, was not the primary reason for Italian institutions setting up life insurance subsidiaries in this country.

From the investor's perspective, policies offered from Ireland enjoyed similar tax advantages to those offered by domestic Italian insurers. Traditionally, life insurance enjoyed favourable tax treatment in Italy, because in Italy life insurance was primarily for what Leona Helmsley called the "little people" and typically involved small regular savings, accumulated over many years in endowment policies. This made the product relatively safe from the prying eyes of the taxman. The advent of lump sum investment products, aimed at high net worth individuals, changed completely the nature of the game but it took some time for the tax authorities to recognise the new realities.

Ireland offered other, more subtle, attractions for high net worth investors. To take one example: as the name implies, unit linked policies require the underlying premiums to be invested in a unit linked fund. Normally, the underlying fund was a mutual fund, but internal unit linked funds created by the life insurance companies were quite popular in Ireland. As indicated earlier, from as far back as the late 1960s Irish internal unit linked funds included real estate. Generally, such real estate funds comprised a portfolio of offices, shops, warehouses, et cetera, all pooled into a single fund in order to give investors some diversification benefits. But for some investors it was advantageous to ask the insurance company to establish an internal fund consisting of a single asset, for instance a valuable property, which might be owned by the investor or his/her family. In some circumstances, there were distinct capital and inheritance tax advantages in transferring legal ownership of the property to an insurance company, which then wrapped it into an internal unit linked fund. The former owner of the property could then buy a unit-linked policy where the underlying asset consisted entirely of units in the fund containing that specific property. This is just one example of the tax planning opportunities for high net worth investors.

For many of the same reasons, Ireland proved attractive as a base for selling into other countries, besides the UK and Italy. Countries that come to mind from my consulting days include Sweden, Finland, France, Belgium, Germany and Spain.

A number of US life insurers also chose Ireland as their headquarters for expanding into Europe. Unfortunately, their timing was not ideal. Hartford Life of Connecticut comes to mind particularly in this regard. Hartford Life established its European headquarters in Ireland and opened for business in 2005, selling variable annuity products into the UK market initially. The main product offered was a unitised lump sum investment bond, with downside protection either in the form of a guaranteed minimum death benefit, a guaranteed minimum regular withdrawal benefit or a guaranteed minimum maturity benefit. Offering downside protection on an equity-based investment product at the height of the bull market is not the best way to make money, particularly if you don't hedge your risks. When the market crashed in 2008/2009, Hartford Life took a bath, but the company remained solvent and met its obligations to customers.

4. The Crash of 2008 and its Consequences.

We now fast forward to 2008. As I'm sure you know, Ireland suffered badly when the market crashed. A number of the country's banks effectively went bust, not as a consequence of the Lehman Brothers collapse but for the good old-fashioned reason of having lent imprudently to the property sector. Government intervention saved deposit holders, but domestic taxpayers ended up carrying the can. Thankfully, the country has finally clawed its way out of the hole it fell into at that time and the outlook is positive.

The life insurance industry escaped relatively unscathed from the crash. To the best of my knowledge, not a single life assurance company authorised from Ireland failed to meet its obligations to customers. Some of the industry's customers weren't so lucky though.

As mentioned at the start, I am a keen private investor. Warren Buffett is my hero. He also had some pithy sayings. The great man once said that it is only when the tide goes out that you discover who has been swimming without trunks. When the tide went out in 2008/9, we discovered that many holders of real estate based life insurance policies had been swimming without trunks. Those investors – mostly resident in Ireland – had invested in highly leveraged real estate funds at the height of the boom. When the crash came, they were wiped out. The insurance companies sponsoring the funds remained solvent: it was the investors who bore the brunt of the carnage. In that, I am reminded of a comment by a former colleague a number of years ago: he compared modern life insurance policies to neutron bombs: neutron bombs can kill people but leave the infrastructure intact. Modern life insurance policies can kill people's investments but leave the insurance company intact.

Even where investors weren't completely wiped out, their liquidity was severely constrained. Insurance companies invoked clauses in the contracts that allowed them to defer liquidation for months, or even years in some cases.

In the wake of the financial meltdown, the Central Bank took over responsibility for supervising the entire financial services industry. The life assurance industry's excellent solvency record was to no avail as the regulatory noose was drawn ever tighter. Regulations were strengthened and, for a time, the Central Bank's approach to supervision moved closer to the micromanaging model that applied in Italy when I visited that country back in 1997 with the IDA.

Thankfully, a saner approach is now in evidence and there is a healthy relationship between the Central Bank and the institutions it regulates, though it goes nowhere near the cosy relationship that existed pre-2000, when the life insurance industry was supervised by the same government department as was responsible for attracting foreign capital into Ireland. That is of course as it should be. The old regime was indefensible. Challenging but fair is how I would best describe the current relationship with the Central Bank.

One particular consequence of the change in the regulatory landscape has been a much stricter approach to leveraged real estate funds. Liquidity has come much more centre stage than was the case previously.

The Central Bank's new approach is in tune with wider European moves towards greater harmonisation of regulations. Solvency II, which comes into effect for insurance and reinsurance companies across the European Union from January 1 next, puts considerable emphasis on the need for insurers to be able to realise investments at short notice. My understanding is that it can be difficult for leveraged real estate funds to meet those requirements although, for reasons set out below, I am no longer in the front line for discussions of this nature. I'm sure that some of my fellow speakers will be far more familiar with the current state of play.

The year 2008 was not only a landmark year for the industry; it was also a landmark year for me personally: I retired from full-time consulting work. I should add that my retirement was completely unrelated to the crash; in fact I retired in April when everything still looked OK.

Following my retirement, I was offered positions as independent non-executive director with a number of insurance and reinsurance companies. This has given me a different perspective.

My transition from consultant to non-Executive Director coincided with a fundamental change in the way non-executive directors, particularly so-called independent non-executive directors, of which I am one, were viewed by the regulator. I presume you've heard the joke:
Question: what's the difference between a non-executive director and a supermarket trolley?
Answer: actually, there are two differences: firstly, the supermarket trolley has a limited capacity for food and drink and secondly, a supermarket trolley has a mind of its own.

That's how non-executive directors were viewed in the past. Things are very different today. Directors, executive and non-executive alike, are held to account for what happens in their organisations. The high levels of responsibility that go with the role mean that it is not too far off full-time employment in terms of the required time commitment. Nevertheless, I enjoy the variety of the role in the different companies, and I look forward to a few more years of this before I am left with just one job, the one that the people who set the actuarial exams so many years ago considered to be at the very bottom of the pile: that of a financial journalist.

Thank you for your attention.