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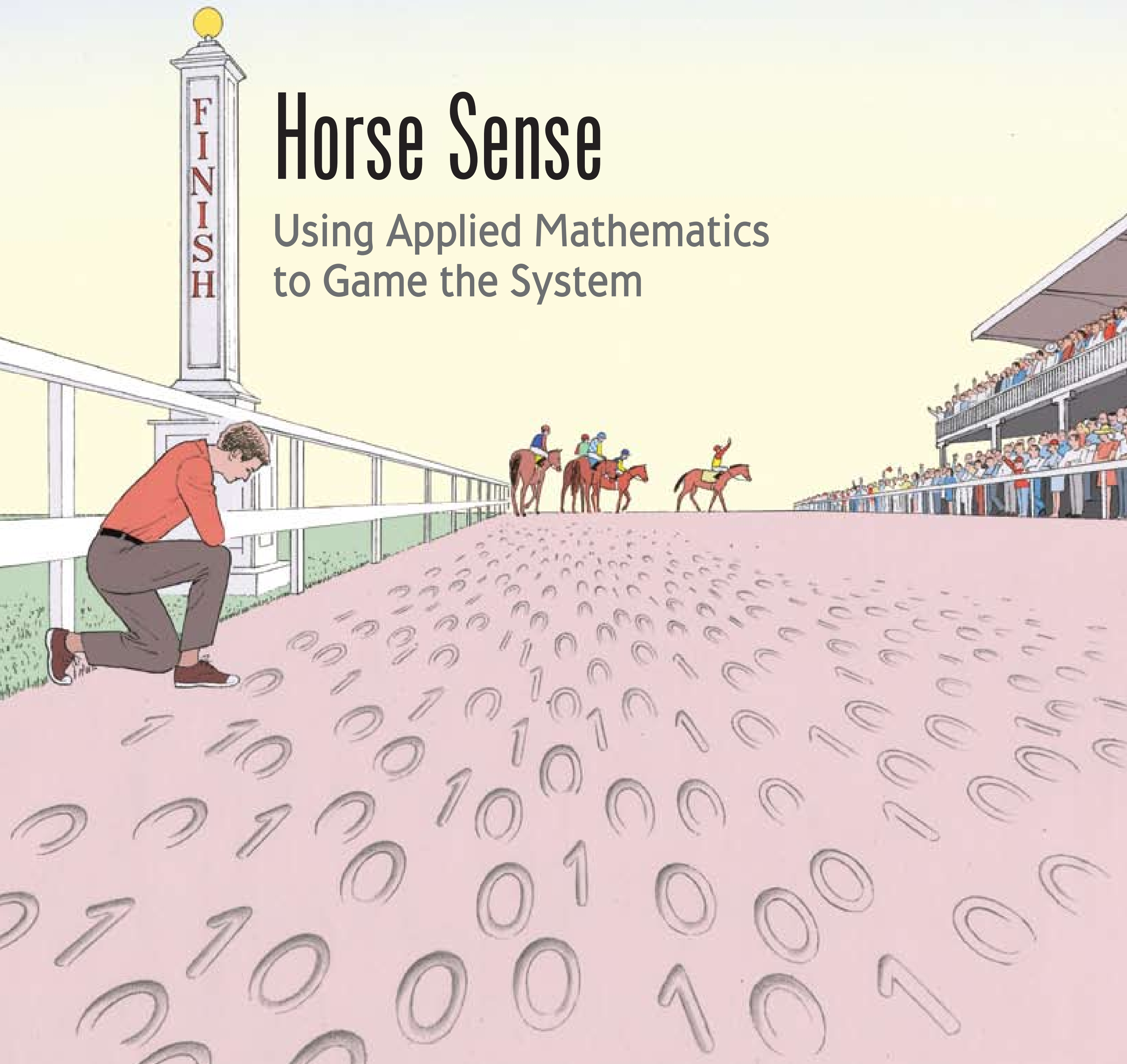
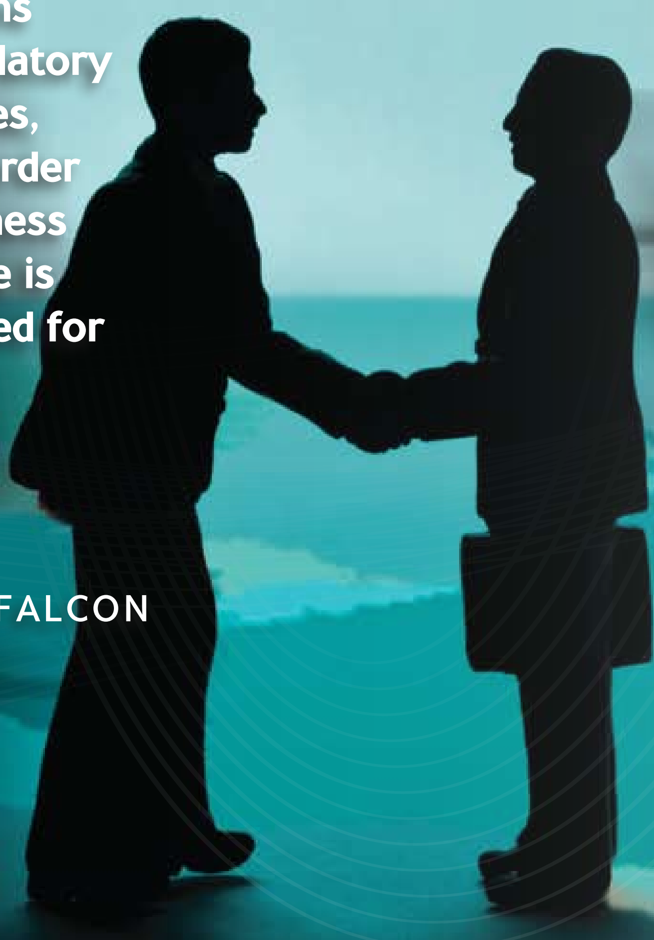


The European Cross-Border Market: High Worth, Low Visibility

Despite economic downturns and regulatory challenges, cross-border life business in Europe is still poised for growth.



BY ROB FALCON

WITHOUT ATTRACTING MUCH ATTENTION, the European cross-border life insurance market has grown significantly over the past 15 years. Despite a relatively short history and low profile, this segment of the insurance industry is one of the largest in Europe, with potential for future growth.

Operating principally out of Ireland, Luxembourg, and Liechtenstein, cross-border companies in 2007 wrote an estimated €38.5 billion (roughly $57 billion, based on the Dec. 31, 200,7 exchange rate of €1= $1.47) of mostly single-premium unit-linked business for customers in Italy, Germany, the U.K., France, Belgium, and other EU states. When ranked against the markets in individual countries, the aggregate cross-border market is the fifth largest in Europe, having grown to its current size from almost nothing a decade ago and with business increases regularly surpassing 20 percent per annum.

Market Beginnings

The cross-border market was ignited in 1994 by the EU's Third Life Directive, which gave companies domiciled in one EU state the authority to sell life insurance products into another. This enabled companies to sell common propositions to diverse individual markets without the need to conform to a variety of local rules and regulations. With the creation of the single EU market in 1993—and the potential for a pan-European financial market still fresh in the minds of lawmakers—the directive was designed to remove the often artificial barriers caused by the necessity of gaining separate authorizations to sell life insurance products in each EU state and tailoring products to a complex web of local rules.

The Third Life Directive requires cross-border companies to adhere to the consumer standards of the states in which they sell (the so-called general good rules), but it allows them to create and market products for those target states based on the technical requirements of the country in which they are domiciled. This guarantees consumers protection while providing them with access to products from regulatory regimes beyond their country of residence. The results are lower costs for suppliers and increased competition, giving consumers across Europe access to more, better, and often less expensive life products. More recently, the same principle was extended from suppliers to distributors, which may sell financial services in other EU states while being regulated in a home state.

As with many new regulatory regimes, the beginning was plagued by difficulties—mainly host countries seeking to classify their entire local insurance regulation as "general good" under the directive. These discriminatory and protectionist measures have been fought successfully by EU authorities—notably, through the Competition Directorate. Since the beginning of the decade, an almost level playing field has existed between local suppliers and cross-border companies operating into other EU markets.

Although this has begun to change recently, the initial cross-border market developed around products benefiting from economies of scale (e.g., savings and investment management) rather than those likely to involve additional local complications (life cover underwriting, rider benefits, pensions, etc.). The typical product takes the form of a life investment, either a standard unit-linked contract, usually with a wide range of funds, or an investment portfolio wrapped in a life contract, often called a personalized portfolio bond.

Regulatory and tax arbitrage have been principal drivers behind the growth of the cross-border market, and these factors tend to have a far greater impact on wealth-management propositions than other life business. As a consequence, cross-border opportunities are being exploited by companies offering savings and investment products aimed at affluent or high net-worth clients. These companies are usually high-level private "bancassurance" (banks selling insurance products), or independent financial advisers. High net-worth and ultra-high net-worth customers benefit particularly from a range of tailored solutions that are often developed on a bespoke basis by the cross-border industry in a way that's impossible to replicate in domestic EU mass markets. It's estimated that 65 percent of cross-border production is from the high net-worth/ultra-high net-worth segment.

Market Emergence

Three countries have emerged as the primary financial centers for offering cross-border contracts: Ireland, Luxembourg, and, most recently, Liechtenstein (although a limited amount of cross-border business is being conducted into the U.K. and a few other markets from the Isle of Man and other island jurisdictions).

These three centers have proved attractive to cross-border companies because of their focus on the cross-border opportunity, long-standing involvement in wealth management, regulatory flexibility, and sometimes favorable tax conditions. Specific attractions of each jurisdiction include the following:

IRELAND: Low corporate tax; a base that includes Great Britain, Ireland, Canada, and the U.S., including a principles-based regulatory scheme; outsourcing facilities; and initially low costs.

LUXEMBOURG: Already established as a major financial center for investment and banking; centrally located; multiple language skills; and a legislative environment that is friendly to cross-border companies.

LIECHTENSTEIN: Lightly regulated; a low corporate-tax rate; proximity and links to Swiss financial markets.

The growth of the cross-border unit-linked market is such that it has become a major component in certain target markets and a locally recognized proposition in its own right. Figure 1 (see Page 46) indicates estimates of the proportion of certain local unit-linked markets taken by cross-border suppliers.

Despite its aggregate size and importance, the cross-border market has largely prospered under the radar because its impact on each local market is, with some exceptions, relatively small. More important, many of its customers are well-

FIGURE 1. Cross-Border and Unit-Linked Business Within Selected Target Markets

Target Market	Domestic Unit-Linked Market[1] (€ billion) 2007	Cross-Border Market[2] (€ billion)	Cross-Border Proportion of Total UL Market
Belgium	4.0	2.7	40%
Germany[3]	1.6	8.3	85%
Italy	17.9	10.7	35%
Spain	3.7	1.2	24%
U.K.	54.4	5.5	9%

Sources: National industry associations and Milliman analysis

Notes

1. Data based on new business, where available, or adjusted premium-income data, and representing comparable market sectors.
2. Estimated from individual cross-border center data and assuming almost entirely single premium.
3. Figure for single-premium business only. Substantial regular-premium universal life (UL) business is written in Germany, and it is estimated that around 30 percent is cross-border.

FIGURE 2. Summary of Cross-Border Jurisdictions (Estimated 2007)

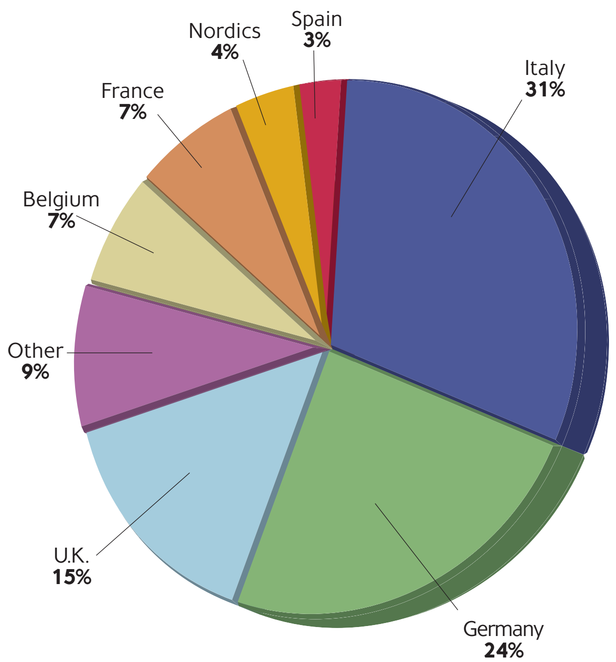
Center	Estimated SP 2007 (€ billion)	Estimated SP 2007 HNW (€ billion)	Estimated U/HNW Proportion	Principal Target Markets
Ireland	18.5	7.4	40%	Italy, U.K., Germany
Liechtenstein	6.6	5.7	85%	Italy, Germany, Austria, Switzerland, Sweden
Luxembourg	10.5	8.4	80%	Belgium, Germany, France, Italy, Spain
Other[1]	3.0	0.8	25%	U.K., Sweden
Total	38.6	22.3	60%	

Note

1. Including an assortment of smaller cross-border businesses from the U.K. or Germany into Germany, Austria, France, Spain, etc.

FIGURE 3. Current Business Mix by Target Market

The allocation of business to the primary target markets from the primary EU centers is illustrated below, along with estimated 2007 cross-border premiums by target country.



Source: Milliman analysis based on data from three cross-border centers

to-do clients looking for personalized wrapper products tailored to their individual needs. These consumers form a niche market, but the large amounts of capital that they hold available for investment amplifies the size and impact of the cross-border segment across Europe.

As it has nearly all financial and investment products, recent turmoil in the financial markets has negatively affected cross-border business. There have also been regulatory or fiscal changes in Germany and elsewhere that could have a negative impact on the business. But this industry has a history of recovering from setbacks, both financial and regulatory. It has managed to be resilient and creative in adapting to new challenges, reinventing itself in the face of tax changes or rebounding quickly when investment markets begin to revive.

The Market in 2007

Figure 2 (see above) provides an estimate of the cross-border business written in each of the three main centers in 2007, the latest year for which comparable figures are available. The proportion of high net-worth/ultra-high net-worth contracts is defined as more than €500,000 ($735,000). Luxembourg and Liechtenstein specialize in this type of business—mostly personalized portfolio bonds—while Ireland retains a large middle-market business writing Italian bancassurance savings policies and credit life in the U.K. (Some limited cross-border activity done from the major countries into other EU states—

FIGURE 4. Estimated Premium Income by Country

Country	Estimated Premium Income 2007 (€ billion)
Belgium	2.7
France	2.6
Germany	8.3
Italy	10.7
Nordics	1.4
Spain	1.2
U.K.	5.5
Other	3.3
Total EU cross-border[1]	35.6[2]

Source: Milliman analysis based on data from three cross-border centers
1. Major centers only
2. Excluding rounding

FIGURE 5. Breakdown for Major Markets

Market	Approximate Mix
Italy	36%
U.K.	27%
Germany	24%
Nordics (principally Sweden)	4%
Other	9%

including credit-card loan protection from the U.K. and general savings business from Germany—isn't included in this review.)

Italy is the largest market overall, with an estimated nearly €11 billion ($15 billion) in revenues and more than 30 percent of the total business. Companies from all three of the main centers do business in Italy. Substantial business is also being done in Germany by companies from all three jurisdictions, with the U.K. an important market for Ireland (less so for other jurisdictions). Luxembourg does major volumes in France and Belgium, while Liechtenstein has the largest proportion of business from outside the EU-particularly Asia.

Cross-Border Activity for the Big Three

This analysis is based on the latest available data from 2007, but the picture is unlikely to have changed substantially for 2008.

Ireland

Cross-border life insurance sector sales in 2007 from Ireland were approximately €18.5 billion ($27 billion), up around 20 percent from the year before. Sales in Ireland have grown every year since the market's inception in 1994, and they grew more than 20 percent every year between 2003 and 2007. The market was initially based primarily on the success of Italian bancassurers with middle-market unit-linked products and, to a lesser extent, U.K. independent financial adviser business with U.K. firms. More recently, Ireland has diversified both in product and target-market terms.

New business growth in Ireland has come both from established players enjoying continued expansion through product innovation and more players entering the market. Over the past three years, Hartford, MetLife, Standard Life, and AXA Life Europe have begun writing business from Ireland. Nevertheless, many companies write business in only one country and are yet to be much diversified.

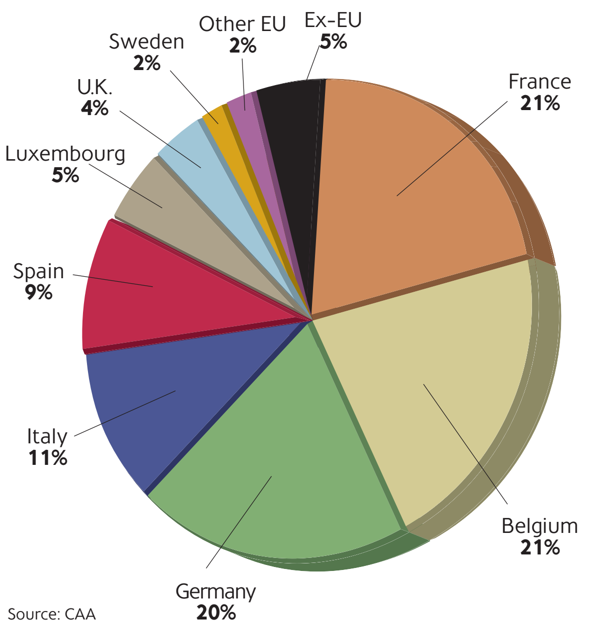
No official statistics are available on the country of origin of Irish cross-border business. However, a review of some third-party estimates suggests a breakdown for major markets (see Figure 5).

Luxembourg

Luxembourg had €11 billion in total life sales in 2007 ($16 billion), 95 percent of them cross-border (unchanged from 2006). Lately, the market has developed more slowly than in Ireland. Few new companies have set up, and as a result of a new premium tax and approaching saturation, the major target market of Belgium has gone into reverse.

However, Luxembourg business now comes from a very wide spread of target markets, with most of the larger companies operating in several of them. As the importance of Belgium has decreased in recent years, French banks operating in France, plus a number of companies operating in Germany, Italy, and Spain, have increased the importance of these new markets.

FIGURE 6. Breakdown of Luxembourg Premiums by Target Market (2007)



Source: CAA

Liechtenstein

Although not a member of the EU, Liechtenstein has taken advantage of the Third Life Directive through the mutual recognition of that legislation by the European Economic Area group of countries, of which Liechtenstein is one. With the arrival of Swiss, Austrian, and German companies, mostly from large groups such as Swiss Life, the small alpine state has become an established center for cross-border life activity. Products tend to be personalized portfolio bonds, similar to those available in Luxembourg, marketed through private banks and wealth managers in the neighboring countries of Germany, Austria, Italy, and Switzerland. Liechtenstein's 2007 cross-border life premiums, broken down by country of origin, are shown in Figure 7.

Of particular interest is the dominance of Italian business when compared with the small proportion of business from neighboring countries Switzerland and Austria. Over the past two to three years, new sources of business from the Far East and Middle East have emerged, and these now form more than 10 percent of the total. Liechtenstein has suffered some reputational problems stemming from a German tax-avoidance issue in 2007, but the impact of the controversy appears to have been less than expected.

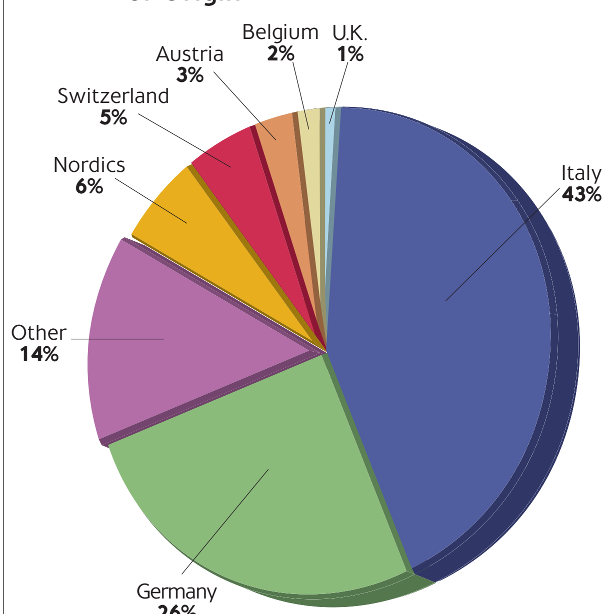
Market Benefits

Cross-border business varies in product terms and by target market. However, a major part of the market is unit-linked business based on a wide diversity of collective funds—often, many hundreds being available on the product—or on a personalized investment portfolio wrapped in a cross-border life assurance contract (the aforementioned personalized portfolio bonds). These sophisticated investment solutions, targeted to the high net-worth segment and presented inside life contracts, distinguish the business from domestic life companies in the target markets.

The wrapped investment portfolios may be identical to those currently managed by private banks, discretionary fund managers, stock brokers, and other investment professionals for their clients. But once placed within a life policy, they have five distinct possible advantages:

- **Regulatory**—An investment portfolio wrapped in a life contract is subject to a different regulatory regime, which may permit (or prohibit) the use of certain types of management or assets.
- **Legal protections**—The investment portfolio may gain important legal and/or regulatory protections by being structured as a life policy. Policyholder protections in Luxembourg, for example, are robust. This constitutes a major advantage for this jurisdiction over other markets in general and, to a certain extent, over its cross-border competitors. Another potentially important structural advantage is protection from creditors. Normally, life policies are protected from creditors in the event of policyholder bankruptcy, although this can vary based on the domicile of the policyholder.
- **Inheritance**—An investment portfolio wrapped in a life policy may gain advantages based on how inheritance law varies in different countries. In some countries, an estate may not be distributed to others without first providing adequately for blood relatives. A life contract allows the policyholder to determine the beneficiary for the assets it contains.
- **Administrative advantages**—Although there may be no fundamental difference in the administration of the portfolio when wrapped in a life contract, in some circumstances the policyholder or distributor may simplify the administration of individual asset portfolios by passing them to a life contract. In many cases, the reporting burden is transferred from the owner to the life company.

FIGURE 7. Breakdown of Liechtenstein 2007 Cross-Border Premiums by Country of Origin



Source: FMA

- **Tax**—When it's wrapped, an investment portfolio is treated as a life policy for tax purposes. This can have certain advantages (although there are moves toward a level playing field for all investment vehicles), including tax deferral, different treatments for gains, netting off gains and losses, or even a completely different tax basis (as exists, for example, in Sweden). Additionally, tax treatment on inheritance or wealth taxes is often more favorable for life contracts.

These advantages are rarely found together, but life assurance contracts in most target markets still benefit from a combination of several of the opportunities listed.

Challenges Going Forward

Given the state of the investment environment, the cross-border industry is facing a less vibrant market today. Growth slowed during the latter half of 2008, and new business volumes may sag throughout 2009 and 2010.

While these are challenges for the short term, in the longer term, the view is more positive. It's clear that cross-border operations offer important advantages for anyone thinking about doing business in the EU. Despite current economic conditions, there are still many high net-worth and ultra-high net-worth individuals who are seeking to maximize their portfolios through the kind of tax, retirement, and inheritance benefits that characterize the unit-linked cross-border life industry. These clients will continue to seek out the cross-border industry, looking to capitalize on its ability to offer investment solutions that are more sophisticated and more tailored to their needs.

However, both new and existing companies are going to have to be more imaginative with their products to compete effectively. For example, by introducing variable annuity guarantees, which are still rare in Europe, American companies with more experience in these products could gain a competitive advantage. And it makes more sense to set up in one country where regulators are already familiar with these kinds of unique products than it does to seek appropriate authorizations in a dozen or more different European states. The majority of variable annuity products launched so far are domiciled in one of the three main cross-border centers.

At the same time, capital and market pressure on existing large financial groups may well cause them to revisit centralizing life assurance operations and customer propositions on a Europe-wide basis. We have already seen AXA, ING, Swiss Life, and Allianz launch similar propositions in several countries from cross-border jurisdictions, and this process may accelerate. Since cross-border companies invariably offer attractive propositions and versatility in investment administration, they may well benefit significantly from this trend.

Going forward, there will be regulatory and fiscal changes that might make it more difficult to develop business, especially in Germany, where new fiscal laws took effect in January that penalize personalized investment solutions and have a dampening effect on personalized portfolio bond businesses domiciled in Luxembourg or Liechtenstein. There are signs of this approach being adopted elsewhere in the EU and a more general trend toward the equalization of tax treatments for investments EU-wide.

Also on the negative side, there's the possibility of commoditization of the life insurance wrapper service and consequent reductions in margins, along with the rotation of desirable private banking or wealth manager partners. External threats in the form of an extension to the EU savings tax, or a spreading of Liechtenstein's reputational problems to other financial centers, could also have an impact on the market. Although it's possible that banking secrecy may be compromised in Luxembourg and that Ireland may be affected by solvency problems, these events are likely to have only second-order impacts on the long-term prospects of the financial centers.

There's far greater potential for the positive side of the equation. A strong trend toward wealth accumulation remains in most countries, providing an expanding market for these services. Wealth managers will continue to seek sophisticated investment propositions (including alternative, absolute return, or index-linked funds), product differentiation, greater margins, and products more tailored to their clients' needs.

If the past is any guide, Europe's cross-border sector will continue to innovate. And the attraction of using one of the established cross-border centers as a base for the entire European market (and beyond) should entice more start-ups, further driving product and market innovation in the future. □

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