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The True Cost of Swiss Private Placement Life Insurance and Deferred Variable Annuities

For the client, it is often practically impossible to get a clear picture of the costs associated with "insurance wrapper" products. In this article, we estimate the range of costs clients are paying and weigh them against the tax and non-tax benefits.

Private placement life insurance (PPLI), variable universal life (VUL) insurance, deferred variable annuities (DVAs), and similar products (often collectively called "insurance wrappers") have boomed over the past 10 years—being highly profitable for all providers involved. The benefits and advantages of life insurance as a wealth-planning strategy are well known; less well known are the costs.

For the client, it is often practically impossible to get a clear picture of what a policy actually costs. In this article, we focus on the range of costs clients are paying and the impact on total return—from best case (low impact) to worst case (high impact). We then examine whether the tax deferral holds up. For analysis purposes, we have estimated a set of "standard practice" costs or "median" values based on what we see as the norm or representative values prevalent in the industry because there is so little published data.

BENEFITS OF LIFE INSURANCE SOLUTIONS

Life insurance has become virtually ubiquitous in wealth planning. The main reasons for using life insurance are as follows:

- **Inheritance and succession planning:** Life insurance allows for an effective, low-cost, tax-efficient transfer of wealth from the older generation to the younger without the need for estate executors or probate. It can, under certain circumstances, bypass forced heirship laws by removing the assets from the policyholder's estate (the assets become the property of the insurer). Furthermore, legal disputes are rarer; it is exceedingly difficult to attack a Swiss life insurance policy.
- **Investment tool and control:** The policyholder has a very flexible choice of investments, virtually any bankable asset (and an astonishing range of nonbankable assets) can be "wrapped." The policyholder selects an investment strategy managed by an asset manager who has a discretionary mandate. The asset manager is usually designated by the policyholder but is actually hired by the insurer. In general, the policyholder is prohibited from making any investment decisions himself, although he may define investment strategy.
- **Asset protection:** Because legal title (ownership) to the assets passes from the policyholder to the insurance company, assets underlying the policy cannot be attached or accessed by a creditor or other claimant in a legal process in many cases and in many jurisdictions.

TAX PLANNING AND OPTIMIZATION

In general, a life insurance policy enjoys full tax deferral during buildup—no tax on income or capital gains on the portfolio during the accumulation period. On maturity of the policy, the payout is split in two: principal and gain. The gain is generally taxed at either the beneficiaries' marginal rate or, more often, a reduced rate on payout. In some jurisdictions, if the benefit is paid upon the death of the insured person, the beneficiaries receive the lump sum (principal and gain) tax free.

Under Swiss law, both variable and fixed annuities are treated as life insurance policies and are exempt from Swiss income and asset taxes. Swiss life insurance and annuities are also exempt from the 35 percent federal withholding tax. Furthermore, assets in an insurance policy in Switzerland or Liechtenstein are exempt from the EU withholding tax on EU residents. Generally, this savings alone covers the extra annual costs associated with the policy.

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ACTUAL COST OF AN INSURANCE POLICY

Table 1 sets out the most common fees and charges and the possible ranges.

The broker's up-front commission in **Table 2** is paid indirectly by the client, with the insurance company deducting an amount from the account over a period of years. Nonresidents do not need a broker to set up a Swiss insurance policy; it can be done through a lawyer, asset manager, or other intermediary.

The extraordinary range of fees and the effect on return is obvious. **Table 3** sets out the total cost in both percentage and absolute terms for a policy for the first five years under the following assumptions:

- €1,000,000 premium paid in on inception.
- 6 percent per year raw return on the underlying assets.

The "median" values underlying the calculation are based on what we believe to be standard practice in the industry based on experience and empirical observation. **Table 4** takes our parameters and calculates the effect on net returns over five years.

A median cumulative return of roughly 10–15 percent gross over five years equates to a 2.3 percent cumulative annual growth rate. If we assume inflation to be around 1.5 percent per year, the client is left with less than 1 percent on her nominal 6 percent "raw" return. We believe both worst and best cases do happen and for otherwise identical policies from the same insurer. Note that the asset manager has the most power to influence portfolio return because the manager has control over many of the costs within the policy, both disclosed and nondisclosed.

DOES THE TAX-DEFERRAL ARGUMENT HOLD UP?

The main argument for using insurance is tax deferral and favorable tax treatment. With a 35 percent marginal tax rate on both income and capital gains, the tax-deferral

Table 1. Main Fees and Charges Paid Directly by the Client for Unit-Linked Life Insurance

Entity	Fee Type	Range	Comments
Insurance company	Establishment fee	0.5–1%	Generally about 1% to set up the policy
	Administration fee	0.5–1.1	Covers the insurer's annual administration costs and broker trailer fee
	Broker up-front commission recouped	0–6	Charged at 0.0–1.2% per year over 5 years
Asset manager	Asset management fee	0.5–2	Wide range and different models common
	Performance fee	0–20	High-water mark common
Custodian bank	Depot fee	0.2–0.5	Custody account administration cost
	Transaction fees (*courtage*) on trades	0.5–2	Varies widely
	Foreign exchange charges	0–1.5	Taken as surcharge (*agio*) on the inter-bank rate
	Account opening charges	0–1	Levied for setting up the account; less common
	Spread on financial products	0.1–5	Wide range possible
Fund producer	Up-front load on investment funds	0–5	Varies widely
	Fund management fee	0.4–2.5	Varies widely
	Performance fee	0–20	Normally on high-water mark

Table 2. Broker Commission

Type	Range	Comments
Broker's up-front commission	0–5%	Paid one-off by insurer
Trailer fee paid by insurance company	0–0.5	Comes out of insurer's administration fee

Table 3. Total Fees Charged to Client over Five Years as Percentage of Paid-In Premium and Absolute Value

Fee Type	Worst Case	Best Case	Median	Comments
Percentage of paid-in premium				
Establishment and up-front loads	16.35%	1.93%	6.75%	Simple addition of one-off fees and charges
Ongoing fees and charges	24.35	8.03	14.59	Simple addition of fees and charges
Total	**40.70%**	**9.95%**	**21.34%**	
Absolute amounts				
Establishment and up-front loads	€163,500	€19,250	€67,500	
Ongoing fees and charges	243,500	80,250	145,875	
Total	**€407,000**	**€99,500**	**€213,375**	

Table 4. Portfolio Return over Five Years

	Worst Case	Best Case	Median	Comments
Portfolio return	33.82%	33.82%	33.82%	Assuming 6% per year return on underlying assets
Less total fees	44.30	9.95	21.60	Total fees over 5 years
Net return over 5 years	–10.48%	**23.87%**	**12.22%**	**Return**
Portfolio return	€338,226	€338,226	€338,226	Absolute return on underlying index/portfolio per year
Less total fees	443,000	99,500	216,000	Total fees over 5 years
Net return over 5 years	–€104,774	**€238,726**	**€122,226**	**Absolute return**

argument is psychologically appealing: The small 0.5 percent, 1 percent, and so on, charges appear insignificant next to 35 percent. The 35 percent, however, is applied to the annual return, whereas the small charges are on total assets invested.

In the real world, most investors in this category have their money managed by a professional money manager. The comparison, therefore, is between the insurance median case and the return on a discretionary managed account taxed at a marginal 35 percent per year. **Figure 1** uses a 20-year horizon and assumes a 1 percent per year asset management fee and 0.5 percent per year bank charges plus brokerage, giving a total net return of 4.5 percent per year. This 4.5 percent is our control case.

Based on these assumptions, there is effectively no difference between holding the median case insurance policy and a discretionary managed account that is declared and taxed at 35 percent. Consider that in many cases, however, the money being managed is not declared to home jurisdiction tax authorities and returns are not taxed. Capital gains in Switzerland are tax free, both on domestic and foreign assets. In addition, Swiss withholding tax is levied only on Swiss quoted (domestic) assets, and nondomiciled investors pay no withholding tax on interest or dividends on foreign assets. In many cases, therefore, wrappers are less attractive.

TRUE COST OF SERVICE

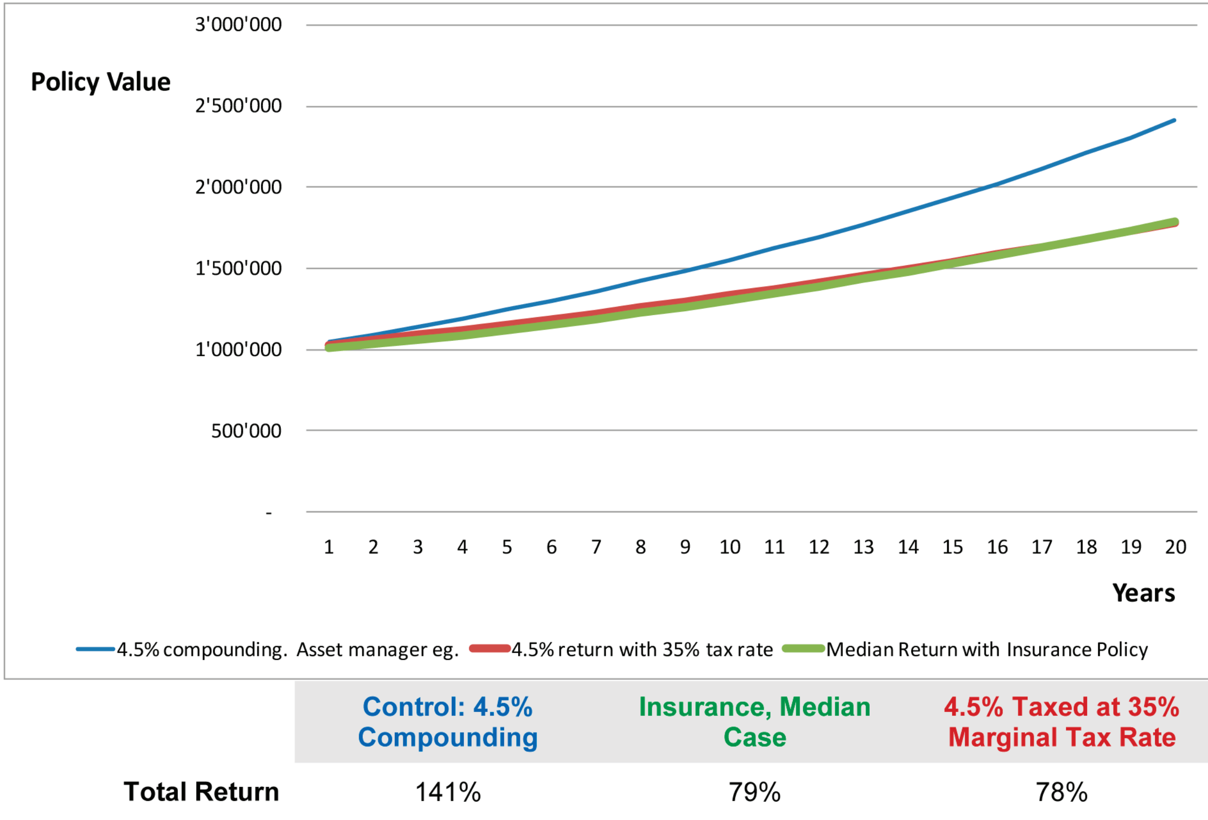
In equilibrium, the effective cost of the service provided is the value of the tax savings over 20 years. If we assume investors are concerned primarily with tax optimization:

> $Price of a life insurance policy =
> $Value of tax savings with that policy.

Despite the opacity, inefficiency, and occasional downright weirdness of the insurance wrapper market, investors on the whole appear to have correctly priced the service they are receiving. In cases where assets are declared, there is effectively no difference between the loss resulting from taxation at the marginal rate and the cost of the insurance policy. Consequently, the true cost of unit-linked life insurance appears to be the value of the projected tax savings.

We would expect this result in a perfectly efficient market according to the no-arbitrage pricing model. In our more transparent, compliant world, the money is declared

Figure 1. Discretionary Managed Account Returning 4.5 Percent vs. Account Taxed at 35 Percent vs. Median Case Insurance Policy



	Control: 4.5% Compounding	Insurance, Median Case	4.5% Taxed at 35% Marginal Tax Rate
Total Return	141%	79%	78%

and taxed, and the nontax benefits of life insurance are effectively free, making even the median case attractive. This can explain its popularity. For the price of the tax the investor now has to pay anyway, he gets the asset protection, estate planning, and other benefits for nothing.

Information exchange agreements between governments, freer information flows, increasing reporting requirements, and improved technological capabilities—all combine to improve governments' capability to enforce ever more invasive legislation and increase cross-border transparency. The old model of simply parking cash and not declaring it is on the way out. Money is moving from non-declared to declared as investors are forced to play by the set of rules dictated by their home tax authorities.

TAKE-AWAYS FOR THE PRACTICE

If you or your clients have Swiss annuities or life insurance, you may be losing a large part of total returns to unnecessarily high fees and costs. But these costs can be about equal to the tax advantages, making the nontax advantage "free." Increased transparency, however, makes this balance of considerations even more relevant. Also, because of the increasing domestic requirements to disclose formerly hidden payments, costs can often be negotiated downward by a considerable margin.

For more detailed information, see more comprehensive white paper from which this article is derived.

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