An Introduction to PPLI

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The road private placement life insurance (PPLI) has traveled to Come into its own has been a bumpy one and hardly straight. But what was once a shadowy side business is now a legitimate market, with a foundation solid enough for growth. PPLI is the most recent innovation within the life insurance industry for super-affluent investors (individuals with $10 million or more in liquid net worth). It is a variable universal life (VUL) insurance transaction that occurs within a private placement offering. Private placement adds the flexibility to VUL’s product construction, pricing and asset-management offerings. Because the product is sold through a private placement memorandum (PPM), every transaction can be individually negotiated and custom designed for the investor. The tax benefits it offers to policy owners are available from few other investment vehicles, particularly since they accrue without the need for complex trust structures.

Life Insurance: Where It Starts

Of the two basic types of life insurance available - term and permanent Coverage - term is considered the most cost-effective way to purchase a life insurance death benefit for a relatively short period. But it's the permanent contract that provides buyers with the unique tax benefits that have helped create the PPLI market.

The key distinguishing factor of permanent coverage is that it has a cash value that accumulates on a tax-favored basis inside the product. The policy is funded over one or more years and is intended to last the entire lifetime of the insured. The premiums are typically much higher than they are for a term policy for the same death benefit, but the value of the product is to front load or level the premium amount so that the coverage lasts at least until the insured reaches age 100. This difference is important because it lays the foundation for the tax benefits that come with permanent life insurance products. These benefits help the policy owner grow the cash value that covers the higher costs of insurance charged as an insured ages, without a corresponding increase in premium payments.

The larger early premiums combined with tax-free growth make it possible to pay lower total premiums over the lifetime of the insured. This is especially important considering what cumulative term costs would be over an insured's lifetime. If term were the only option available to buyers, there would be very little coverage purchased that lasts through life expectancy.

Permanent life insurance has a long history in the United States as a tax-advantaged long-term wealth-creation, savings, and investment vehicle. As long as a permanent contract complies with U.S. tax rules, it's entitled to preferential tax treatment. The Internal Revenue Code (IRC) sets forth the testing required for a permanent policy to ensure that it qualifies and remains compliant as a life insurance contract under U.S. tax law.

With a properly designed and legally compliant contract, which is typically assumed as a given when working with the larger, more highly respected U.S. Iife insurance companies, a policy owner can accumulate tax-deferred investments by paying premiums into a policy. The ultimate death benefit on that policy will one day be paid to the beneficiary free of all income taxes. Once the premiums are paid (often referred to as the investment amount in a policy), these investment benefits accrue under decades-old tax laws as follows:

- The cash value of the policy can grow free of current taxation, and investment income credited under a life insurance contract is not subject to current taxation.
- The policy owner retains tax-free access to the cash value through the use of withdrawals up to basis (basis being the amount of paid in premium) and/or low-cost loans from the carrier, which uses the appreciated cash value as collateral. This tax-preferred access to liquidity is available only from a non-modified endowment contract (see chapter 2).

- The death benefit amounts, including any accumulated investment income, received by a beneficiary of a life insurance contract are not subject to income tax.

As a planning tool, life insurance in some states offers an additional benefit in that the cash value (and in some instances, the death benefit) of a life policy is considered an "exempt asset," which means it is statutorily protected in the event of bankruptcy and cannot be claimed by creditors if a judgment is awarded against the owner or beneficiaries (see chapter 4). This unique feature varies by state but is an additional benefit of owning a life insurance policy in about 20 states.

Finally, permanent policies can be written on more than one life, which is the so-called second-to-die or joint-and-survivor contract. With this design, the investment horizon is substantially extended because the contract will not pay a death benefit until the death of the second insured under the contract.

Private placement deferred annuities (PPDA) have been more popular than PPLI to date mainly because they are so simple to implement. They typically involve only a one- or two-page application, and no physical or financial underwriting is required. PPDA tax benefits and asset-protection issues are similar to the benefits of life insurance in that the investment amount grows free of current income taxation. At some point, however, assuming the contract has an investment gain, either the annuity contract owner or the beneficiary will be required to pay income taxes on the gain at the short-term capital gains rate. That makes PPDA an attractive mechanism for deferring current taxation, but it does not have the preferred lifetime access to cash value on a tax-deferred basis or an income tax-free death benefit as do life insurance contracts. For this reason, informed investors typically prefer the PPLI transaction when the ultimate goal is current tax deferral with future access to cash value during the investor's lifetime.

Whole Life and Universal Life Insurance

The architecture of a permanent life policy, often referred to as the chassis, typically takes one of two forms. The first is a whole life contract; the second is a universal life contract. The whole life chassis is the older of the two and is somewhat antiquated for today’s market. It has a fixed death benefit, a fixed premium amount that must be paid each year and stated guarantees with respect to the coverage and a portion of the cash value. With whole life, if the stated premium is paid every year, the policy owner is guaranteed to have the stated death benefit to contract maturity (often defined as age 94 to 100).

One problem with whole life coverage is that it is extremely inflexible. But the more important drawback of whole life policies when considered for purchase by sophisticated investors is the lack of disclosure to the buyer of the underlying costs of the policy - a problem often referred to as the "black box." Basically it’s impossible for anyone to break out the costs of the policy making it hard to determine whether the insurance company is pricing the product fairly. The insurance company declares an annual dividend, and the policy performs based on this unilateral declaration by the insurance company. Although whole life does include guarantees that might be important to some buyers, there are newer products that make the whole life chassis obsolete for the affluent buyer (people with a liquid net worth exceeding $5 million).

The second type of permanent contract, universal life (UL), was created to address many of the complaints buyers and insurance agents expressed regarding the black box. UL products were not widely available until it became possible to arm the agent with point-of-sale computing power. Older whole life products were designed so that an agent could simply consult a rate book to determine an annual premium amount. But with UL, which was built to have flexible premium payments and simplified death-benefit changes, premiums could not be illustrated or modeled without the use of a personal computer. This new and updated product provides much more flexibility and allows the purchaser to see the explicit charges in the contract.

This kind of transparency provides the buyer clarity regarding the amount the company is charging, as well as full disclosure regarding the guaranteed maximum the company can charge at any future time. The sophisticated investor gains the ability to analyze all elements in the contract and make informed cost comparisons. Although UL products do offer many levels of guarantees, they are not the rigid guarantees that whole life products provide. Therefore, the product is more flexible and requires more knowledge to understand, transact, and service after the sale. Despite the increased complexity, most clients quickly understand the economics of a UL product, whereas they never understood the black box associated with a whole life policy. The greatest benefit to working with UL products is the flexibility and the transparency of costs associated with the policy.

Most illustrations represented as computer printouts for UL contracts include a ledger of all costs and the assumed earnings on cash value in the contract, typically shown on a year-to-year basis. This makes it easy to explain and illustrate what happens to the money in the contract, and showing how different assumptions affect the performance of the policy over time is a simple matter (see chapter 11). UL performance depends heavily on a factor called the crediting rate, or the earnings rate attributable to the cash value within the product. This rate tends to track long-term corporate bond yields.

Often, when UL contracts are sold, insurance agents illustrate what happens to the contract at the current crediting rate, at the minimum guaranteed rate, and also at a midpoint on the scale. This is done through a sophisticated software program that produces a policy illustration and shows what can happen if certain assumptions occur after the policy is purchased. But there is no way to predict exactly what will happen to interest rates, mortality experience, or carrier profitability after a contract is sold, so the illustration is simply an assumption (see chapter 11).

Within a universal life illustration, it's common to look at different premium streams as well as changes in the death benefit. Premium payments can be increased, decreased, or left unpaid based on the policy owner's discretion with no prior consent from the insurance company. For this reason, a universal life product is often referred to as a flexible premium chassis because it provides the maximum flexibility to investors. The policy owner may determine the frequency and amount of premium payments, subject to minimum policy requirements that there be enough in the cash value account to pay the policy charges and the maximum premium guidelines to keep the contract within the definition of life insurance under IRC § 7702.

The maximum premium guidelines are driven by one of two tests under IRC § 7702-either the guideline premium test (GPT) or the cash value accumulation test (CVAT). Under both tests, there is a maximum amount of premium that can be paid into a contract without creating a modified endowment contract (MEC). Although slightly different, both tests are based on factors such as the age, sex, and health status of the insured and the amount of death benefit in the contract.

The transparency inherent in a UL policy requires the insurance company to closely monitor the disclosed charges in order to remain competitive in the marketplace. If a company’s charges become uncompetitive, the policy owner can exchange the policy for a new one with another company using a tax-free exchange under IRC § 1035. (The caveat for a 1035 exchange is that the insured person must remain in good health.) This factor is important in the process of keeping consumers informed and in keeping companies honest about future charges in a contract. Generally, sophisticated life insurance buyers tend to be much more comfortable with a universal life contract rather than a whole life contract.

In both whole life and UL products, the cash values are invested in conservative fixed-income investments within the insurance company's "general account." General accounts of life insurance companies are heavily regulated, which limits the types of investments that can be made within them. In addition to the investment restrictions, a key disadvantage of general-account investments is that the cash values are subject to the company creditors. Essentially the policy owner is a general creditor of the insurance company, and in the event of bankruptcy, the policy owners could lose their cash values to other secured creditors. Therefore, company creditworthiness over a long projected period can be important. For most policy owners, this risk is not a practical concern, but with large' multimillion-dollar contracts, these issues become very important to prospective purchasers.

Variable Life Insurance

In response to the shortcomings of whole and universal life, insurance companies created a new product called a variable universal life contract, or VUL. These variable policies include a unique feature called a separate account, which is an actual account where the cash values are held. The separate account segregates the cash values of the policy from the general account of the insurance company for protection from the company's creditors in the event of insolvency.

State law dictates the separate-account protection applicable to the company's VUL cash values, but most states and many foreign jurisdictions have laws providing statutory protection of the cash values invested in separate accounts. Separate accounts also enable the policy owner to invest the cash values outside the restricted limits of the general account and take on the investment performance risk of the policy.

A separate account can be invested in anything from fixed-income funds to emerging-market funds and everything in between. Potentially higher long-term rates of return from equity investments can directly benefit the policy owner through superior contract performance. Conversely, if the equity investment experience is less than the crediting rates of UL policies, the policy could underperform a similar UL policy with cash values invested in the general account. Although these separate accounts provide an opportunity for quality professional investment management, diversification and investor-control rules for variable policies under IRC § 817 (see chapter 12) must be observed.

The basic cost difference between a variable policy and a UL policy is the added expense of a professional manager who will be responsible for the investments within each separate account. Many sophisticated investors welcome the equity exposure and understand that the purchase of a life insurance policy is a long-term investment that should be appropriately matched with long-term needs and objectives (see chapter 8).

VUL policies typically are registered products and their sale is highly regulated, requiring a prospectus as the offering document with each policy. Agents selling these VUL products are required to be licensed to sell both insurance and securities.

Private Placement Life Insurance

PPLI was first used more than 10 years ago in the U.S. corporate-owned life insurance (COLI) market as a tool to fund deferred-compensation obligations through extremely large institutional transactions (see chapter 7).The original products were essentially primitive versions of registered products with a single purpose: to lower the insurance agent's commission in order to make the product more attractive to the large corporate buyer. Early COLI contracts were geared specifically toward the cost structure of the policy and were not expected to expand investment options for the corporate buyer. The market for individual policies, which got started in the offshore markets less than 10 years ago, took the basic COLI policy structure and kept its cost benefits, but shifted the primary focus to the investment options within the contract. The change of emphasis was an effort to appeal to the super-affluent investor. This new emphasis enabled the use of hedge funds, hedge fund of funds, structured products, private equity and other unique tax-inefficient investments inside the policy, which themselves are typically distributed through private placement offerings. Now, a large investor can access the same type of sophisticated and exclusive investments found in his taxable portfolio, but can do so within the context of a life insurance policy. Super-affluent buyers can grow their tax-inefficient assets tax deferred, gain access to these assets during their lifetime, gain asset protection, and receive an income tax-free death benefit for the estate. The overriding question, of course, is what do these benefits cost? A competitive PPLI policy from a reputable U.S. or offshore insurance company should cost less than 100 basis points of cash value annually once all of the premiums are paid into the policy. All insurance company expenses, structuring, and servicing compensation are included in the 1 percent charge. Such a low fee represents a drastic departure from a typical retail expense-and-compensation structure. The 1 percent does not include the asset-management fee for the selected investment managers; however, the same management fees would be paid whether the investment was held inside or outside an insurance policy.

History of the Market

Today a number of companies, both onshore and offshore, offer PPLI contracts. Until a few years ago, there was substantially more activity in offshore jurisdictions than within the United States. The profusion of offshore activity resulted directly from regulatory pressure and undue bureaucracy. Within the United States, we've elected to regulate insurance products state by state. There are 50 regulatory bodies and 50 different sets of laws. As one might imagine, it's difficult for a U.S. carrier to provide cutting-edge innovation and achieve multistate distribution in a short period. It's also very expensive and time consuming for insurance companies to introduce and sell products nationwide.

This regulatory albatross gave the offshore market a definite advantage because the laws and regulations of insurance in many offshore jurisdictions such as Bermuda, Cayman Islands, Ireland, and Liechtenstein are clear and straightforward. This clarity provided the ultimate flexibility for insurance companies domiciled in these jurisdictions, but it also meant the buyer had to be wary. Most of these jurisdictions have few consumer protection mechanisms outside of a brilliant bankruptcy process. Therefore, many companies reaped the benefit of moving offshore by teaming up with or creating insurance companies domiciled in these business friendly non-U.S. jurisdictions. Interestingly, these companies achieve no tax benefits by being offshore when their focus is on the U.S. customer; the only real advantage is the absence of bureaucratic regulations and, some would say excessive consumer protections that are not aimed to protect super-affluent buyers. Again, these jurisdictions assume the buyers are sophisticated and able to negotiate their own transactions with the help of educated and experienced legal, tax, and insurance advisers.

Offshore PPLI

The offshore PPLI market is split into two distinct categories. The history of the market explains why this bifurcation exists. The first segment of the market is the oldest group. It started when a few creative tax advisers came up with the idea to push the envelope defining life insurance and created products and companies that participated in questionable transactions for U.S. tax avoidance. Many of these transactions and the offering companies that issued policies incorporating them are in danger of collapsing because of their alleged lack of compliance with U.S. tax law.

The envelope pushing and consequent U.S. and offshore regulatory scrutiny have cast a dark shadow on PPLI's legitimate use, which frankly has slowed the market acceptance to date. But these aggressive companies will likely disappear quietly into the night as regulators continue to tighten the noose on their activities and their clients. The real question is what will happen to the U.S. investors, who entered into these transactions, Investors who anticipated a very different tax benefit than they're going to enjoy. PPLI professionals must be prepared to address the fallout by understanding and pointing out the fringe nature of these rogue offshore PPLI transactions.

The newer group of players that moved into the offshore market included legitimate insurance companies looking to take advantage of the reduced regulatory oversight in order to offer unique products to South Americans, Asians, and Europeans. Most of these companies, assumed that foreigners would break down their doors to acquire a tax-preferred product denominated in U.S. dollars since life insurance is a tax-favored investment vehicle in many countries, even at a premium when compared to U.S.-domiciled products. Although these companies proceeded to build such a product, the non-U.S. customers didn’t come. The companies involved were eventually left with three choices for their offshore entities: close down or sell their offshore operations altogether, join the first group of pioneers and enter into the questionable side of the market through the use of potentially noncompliant U.S. transactions, or change their focus and concentrate on appealing to super-affluent U.S. taxpayers seeking to ease the overall tax burden on tax-inefficient investments and improve estate planning through the use of products that comply with U.S. insurance regulations. Because of seemingly insurmountable obstacles for entering the legitimate market, most of the companies took one of the first two paths. Now that truly viable and compliant U.S. and offshore markets are developing, those decisions have damaged reputations and prevented some companies from re-entering a legitimate business. Given the gross malfeasance that has occurred in the investment research, mutual fund, and hedge fund industries, informed advisers would not want any client to risk entanglement with these aggressive companies.

The Case for Compliance

The third choice of creating a more traditional and compliant transaction brought with it tremendous hurdles and hardships for large U.S. carriers. The greatest barrier - trying to sell a non-admitted product (a product not available for purchase in a U.S. state jurisdiction) to U.S. taxpayers - seemed almost impossible to overcome. After all, only products that are admitted can be sold and discussed with potential policy owners while the agent or the prospective purchaser is within the state.

Realistically, how would a U.S. investor learn about a company's product when, as a non-admitted product, it could be sold, underwritten, and serviced only in the offshore jurisdiction? Who was capable of introducing such a complex financial tool to these target customers? And most important, what were the rules and regulations, related to providing these products to U.S. taxpayers? After all, a broker that sells this type of investment to U.S. super-affluent individuals should be a licensed broker in an offshore jurisdiction, have a real operation in that offshore jurisdiction, and be well informed of the potential pitfalls of the market.

The insurance companies knew they couldn't sell, solicit, or negotiate these transactions while any party was still in the United States. Doing so would violate insurance laws in most U.S. states. Therefore, the brokers and the companies themselves needed to tap into third party legal advisors who had access to super-affluent clients, the expertise to understand the offshore PPLI products and their potential applications, the legal right and/or obligation to inform their clients about offshore life insurance, and the ability to convince their clients to go outside the United States to procure such a product.

To further complicate matters, most of these sophisticated tax and legal advisers were not comfortable working directly with an insurance Carrier because the carrier's interests might conflict with the client's, especially in a lightly regulated market, where pitfalls were surely present but seldom known. In addition, purchasers of life insurance generally prefer to work with an independent and experienced third-party broker who is paid to protect their interests during the acquisition process and who will provide continuing advice and support during the life of the insurance contract. For their part, the life insurance companies were not accustomed to direct marketing and sales of their products; nor did they have a reputation for understanding the unique needs and goals of the super-affluent client.

What's more, executing an offshore PPLI policy is not a simple matter. To do so, an interested investor must complete the following steps:

- Travel to the offshore marketplace.
- Undergo a physical examination offshore.
- Complete all required paperwork offshore.
- Set up a non-U.S. entity to own the offshore contract.
- Have the non-U.S. entity pay the premiums to the insurance company.
- Interact with the broker in follow-up service issues.
- Take receipt of the policy outside the United States.

Clearly, only the most motivated and sophisticated investors were willing to move forward and establish PPLI's viability. As a result, very few carriers were willing to move forward with them. But there were insurance companies willing to face the opposition and change an entire marketplace by creating a U.S. tax-compliant product that was more flexible than anything available within the United States. Some companies recognized the unique opportunity and knew that the challenge was to appeal to the upper echelon legal, tax, estate, financial, insurance, and asset-management professionals in the United States. That's what it would take to successfully enter the otherwise untapped market of super-affluent U.S. investors in search of tax-advantaged investments that were safe, secure, and protected from creditors.

Clearly, such a marketplace did not exist, but a few forward-thinking insurance executives were willing to risk their own reputations and company brands to enter this untapped field. Mindful of U.S. rules related to life insurance policies for super-affluent American citizens, these carriers obtained the appropriate talent, built an infrastructure, and initiated the necessary marketing programs. Fortunately, these pioneering companies had sound motives, strong compliance standards, and a clear vision of PPLI's strength. Industry leadership, market knowledge, and a large deal flow were the rewards for taking early risks.

Trudging Through the Early Days

Just before the offshore insurance companies needed to select their preferred business course, my firm, WaxmanCavnerLawson, was investigating whether a foreign asset-protection trust could invest in a U.S. life insurance policy for income tax benefits. We also had a few prospects looking for offshore solutions involving the use of life insurance, and we had U.S. lawyers asking about life insurance on behalf of a number of super-affluent clients seeking asset protection offshore.

As a firm, we decided to take on the opportunity presented to tap the super-affluent marketplace with a unique life insurance product. In the process, we learned from attorneys in the asset-protection field that repatriating assets already moved offshore for foreign investment and asset protection was to be avoided. Repatriation would occur as soon as premium payments were sent back to U.S. life insurance companies as premium payments. Our firm embarked on a journey in 1998 that educated us on this otherwise untapped market of offshore life insurance companies.

We determined very early that many pricing changes, contract provisions, controls, and other protections would need to be put in place to protect the policy owners from poorly constructed and unilaterally written contracts that could exploit foreigners looking for U.S. dollar-denominated contracts. These contracts were obviously never intended to appeal to nor had any foresight built in for the preferences of the super-affluent U.S. buyer. This lack was made more problematic given that super-affluent U.S. taxpayers generally avoided life insurance as a planning tool mainly because of the perceived overpricing in the industry.

If these super-affluent individuals could, see the real benefits of PPLI and gain a measure of comfort with the protections within the contract provided by the offshore jurisdiction, then a real market would emerge. As a broker with potential deal flow, our firm brought life insurance expertise to the process, but we were prohibited from soliciting buyers while they were in the United States. Therefore, the process of attracting clients turned our efforts to educating legal advisers on the benefits of offshore PPLI transactions. These marketing efforts were directed to legal advisers who weren’t selling the product but who were seeking solutions to clients' needs that PPLI could easily satisfy'. Despite PPLI’s obvious benefits, we still had to satisfy the lawyers' concern that any perceived risk to the client relationship would be managed through a well-executed transaction. The key was to establish relationships with highly capable and solid insurance companies while building a library of sales materials for the legal community to use in educating clients.

At the outset, we thought the sales process would be the most difficult. We quickly learned that the insurance companies, despite their tremendous investment in the marketplace, represented a much greater hurdle because of their complete lack of practical experience and a general uneasiness regarding new business ventures. We had raw material but no design for product creation, management, and delivery. The good news was that we became central to the policy-design process in building a suitable market. It was tough going, but it became a wonderful opportunity to shape a market to meet the needs of a highly attractive prospect base. We all knew the process would be long but the end result could be a tremendous success if the interests of each of the parties remained priorities throughout the design process.

We moved from creation to application by bringing live opportunities to the insurance companies. Fortunately, we had the foresight to work with advisers and clients who knew the market was immature but who were willing to suffer bumps in the road. Our first client came in early 1999 - a 40-year-old male looking to invest approximately $5 million per year over a five-year period. He was patient, extremely intelligent, wealthy, had good legal counsel, an actuarial consultant, and most-important, a tolerance for being a guinea pig. What followed was surprising to even the most seasoned and pessimistic insurance professional.

I met with the client in Bermuda to provide a complete explanation of the costs, benefits, and steps involved in the transaction. We took the client to the King Edward VII Memorial Hospital for the physical exam. The problems started there and didn't end for more than six months. Local hospital rules compelled us to check the client into the hospital for the routine medical exam. We met with three insurance companies and signed applications for each company since this was the only time the insured would be offshore to complete his paperwork. Although no implicit commitment was made in taking the medical exam or signing applications, the client was prepared to go forward with the transaction. Our brokerage firm paid for the medical examinations in an effort to keep the three companies at arm's length until a final decision was reached about where to go in the reinsurance market to have the case underwritten.

As underwriting got under way, all three companies admitted that they were unable to put the product or risk together for this case. Each company gave a very different reason for backing out. One said its corporate counsel was uncomfortable with a U.S. citizen as the insured, a detail that was quite obvious when we introduced the case to their representatives and counsel. Another said it was unable to set up a new investment account that would appeal to the needs of the client. A third simply gave up three months later, after failing to secure $115 million of death benefit coverage from its carrier's reinsurers. The reinsurance snafu was extremely puzzling at the time, but the size of this first transaction proved to be such that the reinsurers balked at an exposure that was new to them, hard to quantify, and fit into none of the traditional boxes. Despite the client's excellent health, the reinsurers hadn't contemplated these types of cases offshore and eventually admitted they were uncomfortable with so many unknowns. Neither the insurance companies nor the reinsurers were ready for the types of clients that would want to purchase PPLI offshore.

These were tough lessons, but they've served us well as knowledgeable and experienced advisers.

Finally, we approached a large U.S. company with a Bermuda subsidiary. The company was honest about its capabilities, saying it would not be a good candidate to underwrite the case. However, with more structure, understanding, and realistic expectations in place, the company became willing to move forward and redesign its product in an attempt to attract super-affluent U.S. taxpayers. Indeed, the relationship with this carrier quickly solidified, and we were once again ready to have our first client travel offshore, this time to the Bahamas, to execute documents. Despite the winding process, the client's patience paid off; and he maintains to this day that this was one of the best financial investment he has made.

We continued to work with our new lead carrier to cut a clear path for the underwriting process and to determine the policy elements necessary to make the chassis attractive to the super-affluent market looking for offshore life insurance solutions. As the typical offshore transaction evolved, it had these components:

- Average total premiums of $20 million, usually paid over a four- or five-year period
- Multiple investment accounts
- Flexibility for adding future managers
- Separate-account protection for the accumulation of policy values
- Segregated premium receptacle and reinsurance receipt accounts (something we were unable to provide in the United States)
- A non-MEC structure permitting full access to cash values through the withdrawal of basis and access to appreciation through low- or no-cost policy loans

The offshore PPLI industry has made tremendous progress since 1999, and many investors benefit from the early hard work and expertise developed during that period. And although I believe the market will stay strong, it isn't for everybody. Who is the best prospect for an offshore PPLI policy? A super-affluent individual who will pay total premium of $20 million or more. At these premium levels, the benefits of an offshore policy are very difficult to replicate with one executed onshore. However, the process is complex and expensive to implement, and many people simply aren't comfortable going offshore for their business transactions.

Onshore Migration

Our offshore successes made us true believers in PPLI and the many ways it assists the super-affluent in meeting investment objectives. But as U.S. - based life insurance advisers we saw two major hurdles in limiting our activities to the sole use of offshore companies. First, because an adviser is not allowed to solicit or sell an offshore product within the United States, our success in getting the transaction in front of potential buyers is completely dependent on the work of legal advisers.

Second, the offshore market carries a stigma that’s often hard to overcome. Over the years, we’ve learned that for, every one transaction that ends up offshore, a number of investors would have completed a similar transaction if it were available onshore. So using the lesson we learned offshore, we initiated a U.S.-based strategy and pushed onshore U.S. life insurance companies to create products that would appeal to the super-affluent market. Our proven track record offshore helped persuade U.S. carriers to embark on efforts to bring large pools of assets to the life insurance industry. Again, these pools are from people who otherwise would never consider participating in a traditional life insurance transaction.

Since 2002, the domestic market of PPLI offerings from U.S.-domiciled life insurance companies has grown and matured dramatically. Six years ago, the market amounted to one small entrepreneurial company that was quietly building a book of PPLI and PPDA transactions. By 2002, only a dozen or so companies had PPLI products to offer the super-affluent market, but most of them were still confused and stagnant in the face of regulatory issues. Recent IRS rulings, proposed regulations, and significant changes in the law in a few states looking to attract PPLI business have finally cleared a path for these products (see chapter 12). Today, most of the major U.S. life insurance companies are either in the PPLI market or contemplating new PPLI product offerings.

The Future of PPLI

The U.S. PPLI market is now mature enough to earn the confidence of buyers, insurance companies, regulators, brokers, and the asset-management community. But a number of issues will likely continue to thwart the full potential of PPLI over the next few years:

- PPLI does not offer insurance agents the traditional upfront commissions they’ve come to expect. Agents in this market are compensated through asset-based fees, which are not a good fit for many high-end producers, whose practices need large cash inflows from every transaction. Moreover, a PPLI transaction may seem like a more traditional investment transaction, but a number of emotional issues are involved in the sale of a life insurance policy and they are not well understood in the investment community. When an insurance professional starts asking an investor not only for financial information but also for a full review of his medical history and avocations, the sale becomes one that only a handful can negotiate. The successful distribution channels will likely be a limited number of insurance professionals who can afford to change the economics of their practice and work in tandem with investment, tax, and legal advisers.
- The PPLI product will become more like a commodity, putting tremendous pressure on insurance carrier margins. The good news is that current market pricing provides only minimal return on earnings for insurers, making this a wonderful screen to bar all but the most serious players from the market.
- The life insurance industry as a whole will undergo new pricing algorithms based on new mortality tables reflecting American’s increasingly longer life spans. These tables, to be adopted by insurance companies sometime in the next few years, will set new guaranteed mortality ceilings within the contracts and will dampen the overall economics of a PPLI policy. A policy owner will have to purchase more death benefit for every dollar of premium invested, without a corresponding decrease in the actual cost of the risk within the policy. A general consensus is that the new mortality tables will drop the maximum amount of premium that can go into a PPLI transaction by as much as 20 percent, with no corresponding drop in costs.

- Revenue sharing between the asset managers and the insurance companies in the U.S. market could taint the product by making it seem to the super-affluent buyer more like a retail product. This is a common technique used by life insurance companies in the registered marketplace. They do it to supplement their so-called illustration competitiveness by lowering the charges reflected on the illustration printout. The end result is that the insurance company is able to move charges off the insurance illustration and onto the investment's separate account, where they aren't apparent to the buyer, improving the insurance company's perceived competitive edge. For example, if life insurance company A requires a 25-basis-point revenue-sharing amount and life insurance company B does not, company A could reduce the fees shown in its illustration by 25 basis points and still have the same perceived level of profitability as company B, thus distorting the comparison. But super-affluent buyers demand full transparency and this form of revenue sharing will likely be viewed as an under-the-table pricing scheme used to shield costs.

  More important, if a PPLI carrier depends on revenue sharing from each of its underlying insurance-dedicated funds, and a certain fund is unwilling to pay such a fee, that fund will find itself excluded from the carrier's platform. Although not terribly negative for the insurance company, this will come as a shock to existing policy owners when they discover that the number of investment choices has been reduced. If this practice were to take hold in the PPLI marketplace, super-affluent investors would not receive it well. Fortunately, the insurance advisers successfully serving this market are on the side of the investor and will put carriers hiding such fees on notice that the practice won't be tolerated.
- Because the U.S. life insurance industry made the mistake of attempting to sell PPLI before it was ready for the marketplace, many super-affluent buyers remain confused. The process of educating these buyers is critical. Delivering solid information on what can and can't be done within these contracts is of critical importance for credibility within the industry.
- Because the average death benefit amounts associated with PPLI transactions are so large, the shrinking reinsurance market, particularly since 9/11, imposes an effective cap of $125 million on the death benefit. For the many super-affluent families for which this cap will be limiting, advisers must employ creative planning ideas, issuing policies on multiple family members.

The U.S.-domiciled PPLI market is poised for tremendous growth and acceptance as a mainstream transaction for both affluent and super-affluent U.S. investors. The reasons are straightforward:

- Product, administrative, and service structures are now in place.
- IRS rulings provide clear guidance on acceptable transactions.
- Market expertise exists to effectively place large PPLI transactions.
- A number of satisfied buyers are now on the books.
- Life insurance companies are getting comfortable with the PPLI concept and its marketing challenges.
- Fund managers have begun allocating resources to the PPLI market, in which more than 80 insurance-dedicated funds now exist.

The entire private placement global market is estimated at about $4 billion of total cash values in both PPLI and PPDA products. I would be surprised - and disappointed - if that number is less than $10 billion by 2008 and if PPLI is not a $100 billion industry by 2015.

John B Lawson, "An Introduction to PPLI," in *The PPLI Solution*,
ed. Kirk Loury (Bloomberg Press, 2005), 3-19.