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"Allfinanz": Between What it Should and What It Is

1. Shotgun Weddings

An unmistakable feature of the Swiss banking and insurance scene is the large number of differently constituted, but in effect identical, joint ventures between life insurance and financial firms. The forms range from banks that have founded subsidiary life insurance companies (like CS Life), to inter-firm direct investment (e.g. the Union Bank of Switzerland's investment in Swiss Life), all the way to simple cooperation. The financial investment and life insurance opportunities offered by these joint ventures are developed and targeted to the market cooperatively. In addition, the life insurance companies are supposed to realize synergy advantages in their own investment practices. As US regulations forbid a joint offering of banking services and life insurance, there is no English translation for this activity. We therefore name it "Allfinanz" and use the German word in analogy to "Kindergarten" or "Blitzkrieg"...

The sheer number and speed of these couplings demand that we pay attention. For the individual investor, the question is, what kind of advantages might be had from the appearance of these joint offerings in the marketplace. For banks that are in the business of providing investment services to private customers, it must be considered whether the traditional (more limited) offering of investment management options is now hopelessly inadequate. Beyond that, and more generally, it is worthwhile to take the opportunity to consider the question of how the individual investor's needs are constituted and through what services those needs can best be met.

2. What is it that the investor should actually want?

The question is intentionally posed in a somewhat inelegant fashion. This is the only way to make explicit the fact that the question is only seldom answered - and then generally only in very theoretical terms. Those who know the investment and life insurance businesses are aware that both investment portfolios and life insurance policies are usually established under fairly chance circumstances.

Generally, at some point there just happen to be some funds available that need to be invested somehow. The interest structure of the investor often is not explicitly developed much beyond the assessment of this initial circumstance. And the likelihood that an investment advisor - perhaps also relatively haphazardly chosen - will do everything necessary to uncover implicit investor needs is severely circumscribed by the advisor's interest in completing the transaction. A real analysis, that takes into consideration all the relevant criteria, quickly becomes extremely complex and time intensive. The conditions of the acquisition process mean that often the real costs of this kind of elaborate analysis cannot be recovered. As a result, in both the life insurance and investment management business, more rudimentary needs assessments are common, while well grounded diagnoses and problem solving are rare.

The simple recognition that some uncommitted resources are waiting to be invested, is tantamount to an accounting practice in which one only looks at a single asset line-item and then completely ignores the liabilities side of the balance-sheet. More often than not, we fail to recognize that, at least implicitly, private parties are just like every other economic entity in that they have a balance sheet with two sides: an asset side, which reflects the sum of a variety of anticipated future revenues, and a liability side that captures the sum of the complete range of future liabilities. An incomplete analysis leads to, among other things, investment decisions by private parties that do not take into account refinancing costs. But above all, the fact is generally ignored that there are risks attached not just to a private party's capital investments but also to the overall structure of his balance-sheet - and the significance of these latter risks can go way beyond the choice of a particular investment medium.

What does that mean? Lets imagine for a moment a person who owns a single family home that he partially financed with a mortgage. He finds he has some amount of uncommitted money that he would like to invest. If his financial advisor looks only at this asset item he may not see that he is about to burden his client's balance-sheet with additional interest rate risk. For example, if the uncommitted funds were invested in bonds, then the client would be negatively impacted on both sides of his balance sheet by any increase in interest rates: The mortgage interest rate climbs, which - from an economic standpoint - amounts to an increase in his debt position. At the same time, on the asset side, the value of the bond investment is reduced. And in the worst case, the market value of his single-family home drops as well, as is entirely possible in times of high interest rates.

These kinds of internal balance-sheet risks can, without question, take on dramatic dimensions. Nonetheless this combination of interest-rate sensitive investments (like bonds or life insurance) with equally interest rate

sensitive mortgages, continues to be a prominent feature of the Swiss investment landscape. As will be shown below, this fact is attributable in part to the Swiss tax structure, but also to the poor quality of financial advising in the "Allfinanz" industry. This is perhaps surprising given that the term "Allfinanz" suggests precisely the kind of advising that is necessary - financial advising based on a careful assessment of a client's total (total!) balance-sheet.

So what should the investor want? He should demand that his entire financial situation be subjected to a thorough economic analysis. And above all, he should insure that all investment decisions are based not on single asset or liability items, but on the full scope of items on his balance-sheet.

3. A Theoretical Excursus on Options as they Pertain to Life Insurance

One of the investment media that is of particular interest in conjunction with "Allfinanz" is life insurance. Thanks to a tax induced incentive, a currently much loved enstantiation of this medium is the "One-Time Premium Deposit." This "One-Time Premium Deposit" is a species of life insurance that is available on the market in a number of often very customer-specific forms.

From the economic perspective, life insurance is a complex financial instrument comprised, first, of an option that is defined according to certain criteria and, second, a monetary investment. The option establishes the holder's right to a monetary payment of a particular sum should an event that is covered in the insurance contract occur - typically the death or severe disablement of the policy holder. In other words, we are dealing with an option on the life expectation of the insured. The longer this expectation is assessed, the higher the price of the option.

An essentially mirror image manifestation of the basic life insurance model is the life annuity. In this model, the insurance holder is granted a certain payment as long as he remains alive. In other words, the smaller life expectation the deeper the value of the life insurance.

The other economic aspect of life insurance is the monetary investment. This is essentially the investor's claim upon the life insurance company to participate in its investment business. The claim is in principle the same as the claim that investors have on an investment fund. However, in practice the claims differ significantly, because the rules governing investment through life insurance (like the rules for paying out settlements) are determined by strict guidelines set out in insurance law. In insurance investing, a distinction is made between a minimum "guaranteed" return, and a claim upon "excess" investment returns. The investor's guaranteed claim is to the sum of the premium he paid in plus a minimal interest rate. His

claim on excess returns arises when the ratio of the insurance company's investment earnings to damage claims paid out is sufficiently positive. But for the lay person, it is typically difficult to establish how his claim on excess returns is calculated and whether or not it is fair.

It is also important to note that the life insurance company investments - in contrast to investment fund transactions, or any other capital investment - are characterized by a fixed time constraint; i.e. there is no market price for early disinvestment.

From an economic perspective, the option aspect of life insurance (that is, the actual insurance itself) and the monetary investment aspect clearly have nothing to do with each other. Both pieces could, in principle, be sold separately on the market and, in fact, to a limited extent they are. In the case of risk insurance, the monetary investment aspect is completely absent. The strict regulatory structure under which monetary investments are made, allow one to suspect that their performance is unlikely to be stellar. Collective investment media are significantly restricted with respect to risk taking: Life insurance companies invest predominantly in government bonds and in real estate. This produces, in addition to generally moderate performance, the previously discussed interest rate sensitivity of life insurance. In other words, there are few reasons why an investor would be interested in a complete life insurance package, were it not for...

4. ... the big tax advantage.

In the eyes of legislators and the treasury, life insurance is a support-worthy instrument for improving the personal provision of citizens. As a result, tax law has been written to provide this investment medium with several weighty advantages. In Switzerland, we distinguish between the so called "linked" and the "voluntary" forms of insurance provision. In the linked version, premium payments made while one is employed are tax free, and the capital payment made at the expiration of the policy is also partially shielded from taxation. In the case of voluntary provision, which is also available after retirement, only very limited premium write-offs are allowed, but the insurance pay-out, including investment returns, are completely tax free.

Not surprisingly, this kind fiscal incentive is met with enthusiastic demand from the general public. And it cannot be denied that under the circumstances the investment advisor has a difficult task finding arguments in favor of direct investments in securities. Take for example a life insurance policy that, over the length of its term, "only" yields say 4 or 5 percent per year. It will very probably outperform a pure bond portfolio that is subject to, for example, a 30% tax rate. Even in a case where a portfolio manager smartly concentrated on low interest yield coupons,

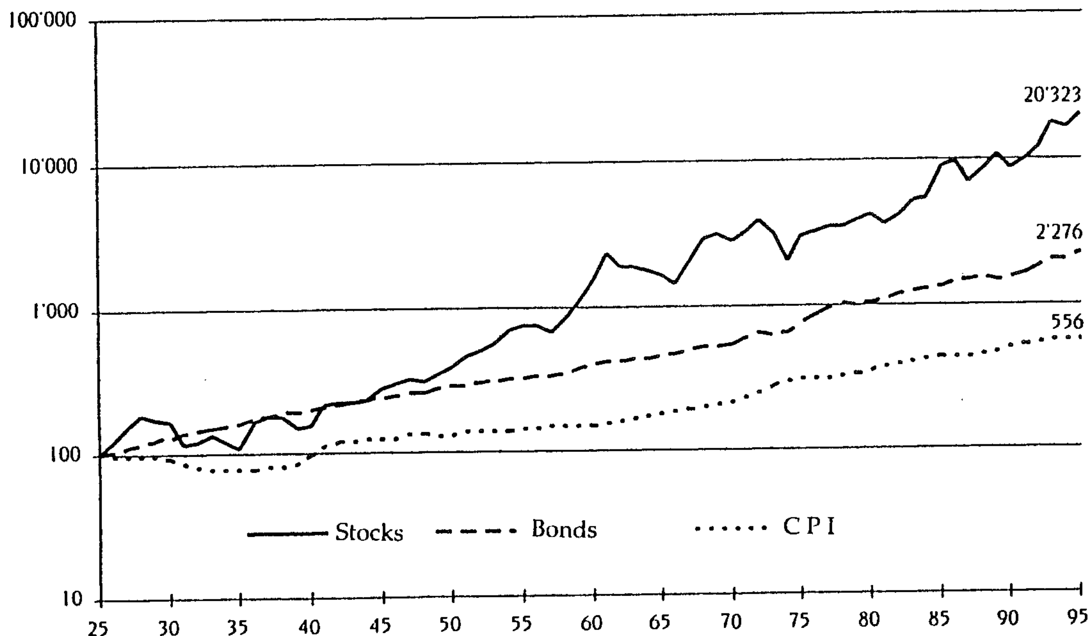
thereby minimizing the directly taxable earnings, it would be difficult to produce a similar after-tax yield.

Nonetheless, there is a lack of flexibility in life insurance investments that must be taken seriously. Furthermore, one must always consider the risk concentration that accompanies the investment of all funds with a single debtor. At a minimum, these qualifications should forewarn the investor against staking everything on a single investment medium.

5. Stocks as the only truly valid argument.

The superior yield of life insurance compared to direct investment in securities melts away like snow in the sun if we include stock investments in the equation. The average yield of Swiss stocks, viewed over a the very long-term 20 to 50 years - is about 8 to 10 percent per year. If one takes the reasonable position that a conscientious investor can occasionally identify at least a couple of future strong-growth firms, then over time this average yield should be significantly higher. Of course, one must take into consideration the fact that stock yields will vary much more dramatically than will yields in the bond markets. A person who invests in stock has to be prepared to grit his teeth every few years. During these periods he has to keep sight of the fact that over time, for fundamental reasons, equity capital has to have a higher yield than providing loan capital. If he hangs on, he will soon be rewarded with the return of his above average yields.

The following graphs chart the very long-term yield pattern for the Swiss capital market. Anyone with time can invest in stock.



Source: Wydler/Ruhoff: The Performance of Equities and Bonds in Switzerland since 1925, Pictet & Cie, 1995

In comparing stocks to life insurance, there is another consideration beyond their relative yields. A life insurance policy is, as we have said, a collective investment vehicle. Between the investors (the policy holders) and their investment there exists an extensive employment system: the insurance agent, the general agent, the insurance company with its management, and those that actually make the investments. For the investor, this is an expensive layer of organization, given that he can participate directly in the capital market. But of even greater importance is the fact that this organization develops its own incentive system. As we pointed out earlier, their investment strategy is presumably completely geared toward mistake-avoidance and risk-aversion. Lawmakers want it this way, since they are more concerned with having insurance services provided than with maximizing performance.

Now one should consider that with obligatory employment related insurance provision on the one hand, and voluntary, tax-protected life insurance on the other, a major portion of our domestic economic savings potential is flowing into organizations that quasi by nature have to be risk-averse. It is difficult to completely ignore the thought that a substantial ongoing mis-allocation of domestic capital has thus been institutionalized. Or to be more specific: Too much money is flowing into (mostly state) bonds and real estate and too little is being invested in that part of the economy that provides growth. Stock capital as risk-encumbered equity capital: There is not enough of it under the current system.

6. Real "Allfinanz" poses the greatest challenge.

In summary, if we acknowledge that the various investment vehicles - bonds, life insurance, stocks, real estate, etc. - all have unique characteristics and, above all, risk structures, and we recognize that how these various media are distributed on an investor's balance-sheet is of utmost importance, then we can clearly conclude that the type and quality of investment advising private parties need will never be available from a teller window.

The problem is further complicated when one considers that over time the structure of both the asset and liability sides of clients' balance-sheets change significantly. Even if a client has substantial income at 40, but has to amortise the mortgage on his home and maybe finance a multi-person family, by 50 he should be over the hump with respect to liability concerns. His biggest worry should be his tax burden. At 60 he has to consider his retirement and needs to focus on securing a regular income stream. By the time he is 70, at the latest, he has to confront the question of whether he expects to leave behind an inheritance. If so, then he is dealing with a liability term, for which the appropriate answer is to be found on the asset side. At 80, larger expenditures on old age or medical care may be necessary.

"Life-cycle-investment" is anything but trivial. It requires considering when to take on risk and when not to. Scenarios have to be played out in thought and in calculations. The costs and benefits of various investment vehicles have to be weighed carefully. We seriously doubt that the "Total Finance" salesmen, that are now poised to flood the Swiss market, will provide the necessary carefully considered advice that these complex and crucial questions require. At least at this point, it appears that their primary goal is to better utilize existing sales capacities, such that bank tellers will offer life insurance policies and insurance agents can propose investment funds to their clients. Of course this has its economic attraction: The additional sales efforts will only produce marginal costs. Beyond that, this merger will help the banks overcome their well known weaknesses in conducting outreach.

The typical product that is marketed under the title "real innovation" is generally of lamentable quality. When, for example, a bank group decides to link an investment fund with life insurance, it replaces one of the major advantages of funds, namely their tradability (e.g. they offer repurchase privilege without time constraint), with the most important shortcoming of life insurance investing, the fact that the length of investment is fixed. Imagine if at the end of the tenure of a life insurance policy some market condition has driven the value of the linked fund to a low-point. What then?

7. The Private Bank's Response

Given what we have said, "Allfinanz," as it is emerging in the Swiss investment marketplace, is hardly a threat to the investment management business. However, the investment manager is well advised to cultivate his analytic capabilities, so that the is capable of providing meaningful answers to questions pertaining to the balance-sheets of private clients. This does not require the ability to employ sophisticated scientific models. Clients will benefit substantially just from avoiding unnecessary internal balance-sheet risks.

Beyond that, it will be important to have available someone with skills in providing advice on insurance questions. Without the benefit of a joint venture with a major life insurance company, the private banker must exploit the advantage he gains from the joint venture firms as they compete with one another. Insurance brokers are now likely to become more active in the life insurance market and they would make ideal advising partners for the independent investment advisors. Client specific needs could be optimally served through a mix of securities investments and insurance.

One last thing. Real wealth formation will always be tied to the risk taking associated with the provision of equity capital. There is no substitute for stock investments. We are convinced that the non-collective direct investment

approach is, over time, superior to the use of practically state-like organized investment. To be honest, we much prefer a population of investors to a population of life-insured retirement benefit recipients. As a result, our efforts are fully concentrated, now as always, on providing the best possible advice to our clients on direct investments. Finance to all, not "Allfinanz" is the motto.

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