Milliman Fulfillment Ratio Index

Reporting year 2020 – how did insurers fare during the COVID-19 pandemic?

Understanding fulfillment ratio

Life insurance companies in Hong Kong are required by the Insurance Authority to publish fulfillment ratios for their participating ("par") products on an annual basis starting from January 2017 in compliance with the Guideline on Underwriting Long Term Insurance Business (Other than Class C Business) (commonly referred to as "GL16").

Fulfillment ratio =

Actual aggregate non-guaranteed benefits*

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Aggregate non-guaranteed benefits illustrated when customers purchased the policy

* Either aggregate accumulated bonuses (for annual dividends and reversionary bonuses) or aggregate payout (for terminal dividends).

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Types of non-guaranteed benefits typically offered by par products in Hong Kong

Annual dividends

Declared and paid out as cash at the end of each year. Policyholders can typically choose to leave these on deposit with the company to earn interest. The actual interest credited will also affect the fulfillment ratio.

Reversionary bonuses

Bonuses declared as a permanent addition to the basic sum assured of the insurance policy, which cannot be taken away once declared.

Terminal bonuses or dividends

Typically paid at maturity, on death and surrender of the policy through a lump sum. It is sometimes referred to as the "final bonus".

The Milliman Fulfillment Ratio Index ("Index") – Introduction*

Calculated annually by Milliman, the Index covers Hong Kong life insurance companies representing a significant market share, as measured by in-force premiums (>85% in 2020).

The top 10 life insurance companies in Hong Kong are included based on in-force premiums. The companies included are reviewed annually.

Six material par products offered by each of the selected companies are analysed. Product types include savings, critical illness, annuity and endowment, with a balance between active and "shelved" products.

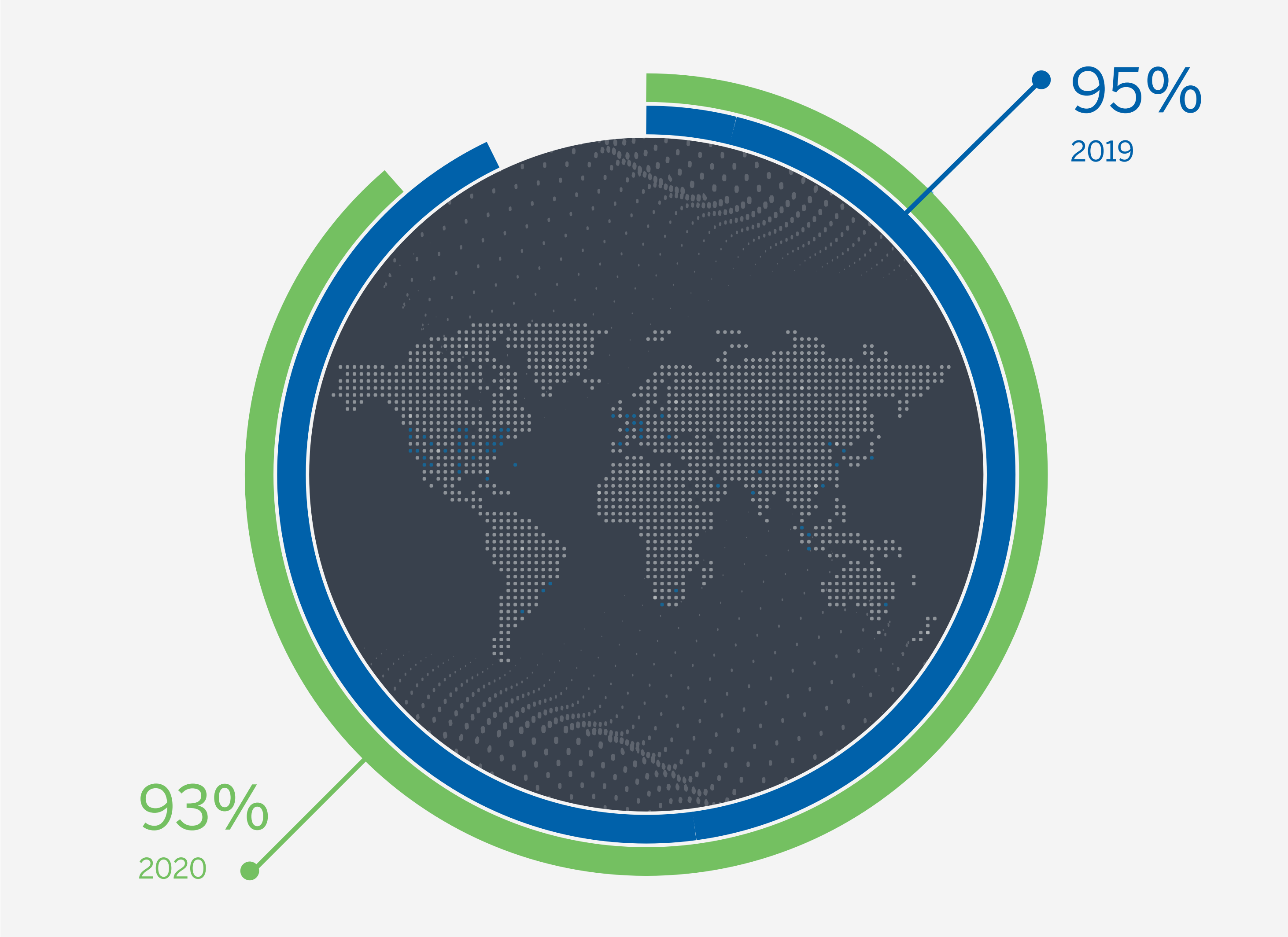
All policy years are considered to better reflect the condition of different cohorts. A simple average is taken across the fulfillment ratios of all policy years available.

The Index reflects actual dividends and bonuses aggregated up to, or paid out in, a calendar year. Some dividend/bonus adjustment decisions made in the same calendar year may not be reflected until the year that the annual dividends/bonuses or terminal dividends are actually paid out.

Many companies are seen to implement bonus and dividend cuts for older products rather than for their key products currently being sold. The Index is calculated by considering both key new products and older products in order to capture any material changes, based on the fulfillment ratios published by the companies.

Note *
The Index covers par products only and does not consider universal life products

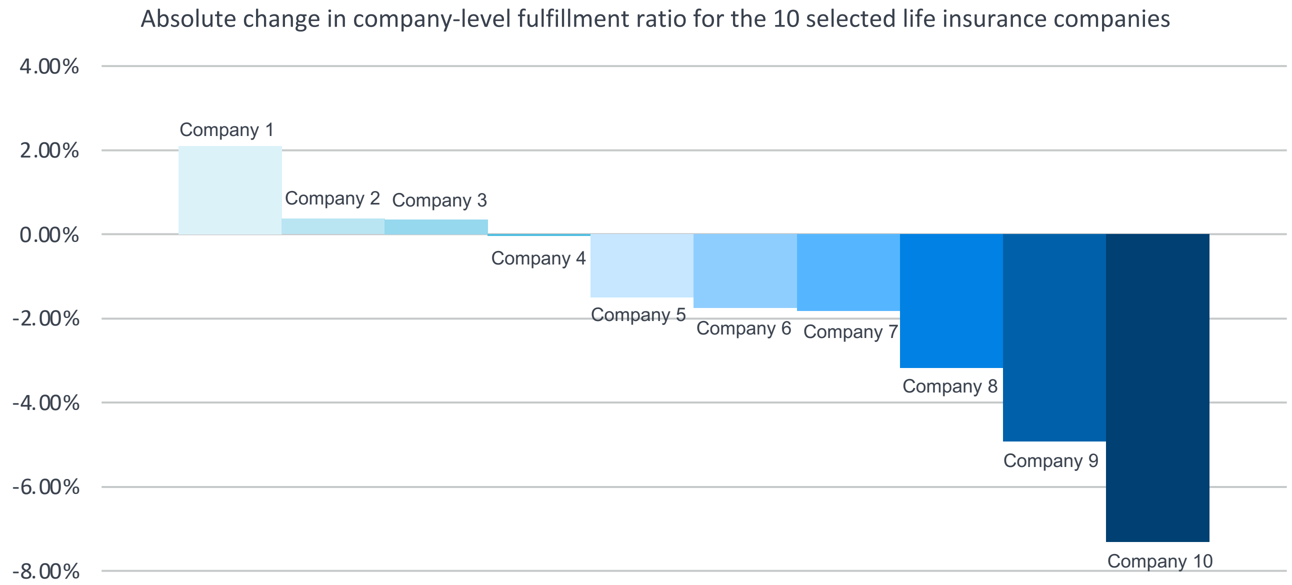
The Milliman Fulfillment Ratio Index in reporting year 2020 and comparison with reporting year 2019



The Index dropped slightly, from 95% in 2019 to 93% in 2020. Despite the impacts of the COVID-19 pandemic in 2020, including continued low interest rates, depressed equity returns, and more volatile policy surrenders, it is observed that:

- The insurers covered under the Index have either reduced dividend levels for selected products or kept dividend levels unchanged. In particular, there is one large company covered in the Index with its first dividend cut captured within the reported fulfillment ratios.
- The dividend cuts that were made are likely to have been triggered by the low interest rate environment, as some insurers have lowered their reserving/pricing/financial reporting interest rates. Insurers may be able to justify the dividend cuts as a result of the COVID-19 pandemic impacting the whole market, hence managing their policyholders' reasonable expectations in line with their peers.
- Some companies reduced non-guaranteed crediting rates for dividends left on deposit, which has been a material component of the benefits illustrated to policyholders. This will have a negative impact on fulfillment ratios over time when the policyholders' accounts are credited at a lower rate.
- The reduction of the Index has been mitigated by the following two factors:
  (i) Some products with historical reduction in annual dividend/reversionary bonus have fulfillment ratios on terminal dividends reported for the first time. These terminal dividends have not been reduced and, therefore, have a fulfillment ratio of 100%; and
  (ii) Dividend cuts have been applied to some older products but, since there has been no new business for more than five years, they are no longer reported, and have been replaced by other products in the Index.

Changes in company-level fulfillment ratios



The above chart shows the absolute change in the company-level fulfilment ratio for the 10 selected life insurance companies, determined using the six material par products offered by each company. Some key observations are set out below:

More than half of the companies covered have reduced bonuses and dividends for the selected products

- Following bonus and dividend adjustments in 2020, seven companies saw a drop in company-level fulfillment ratio, with the decrease in the range 0% – 7%.
- The difference in magnitude of the dividend adjustments among insurers is attributable to a number of factors including primarily:
  - (i) the smoothing mechanism and tolerance level defined by each company's internal dividend declaration policy;
  - (ii) the change in long-term economic assumptions assumed by the company (in particular, some insurers have reduced their long-term expected return on fixed income assets in 2020); and
  - (iii) the actual experience of the par portfolio, in particular the investment experience.
- When looking at the change in fulfillment ratio by benefit type, products with reversionary bonuses have generally experienced larger falls in fulfillment ratio than those with annual and terminal dividends. This can be explained in part by the fact that, unlike annual and terminal dividends, reversionary bonuses become guaranteed once declared. This increases the level of guaranteed benefits which cannot be reduced in the future under adverse scenarios. On the other hand, some companies may also have reduced their terminal bonus for some future policy years. These reductions are yet to be captured by the fulfillment ratio, which only captures actual terminal dividends already paid out.

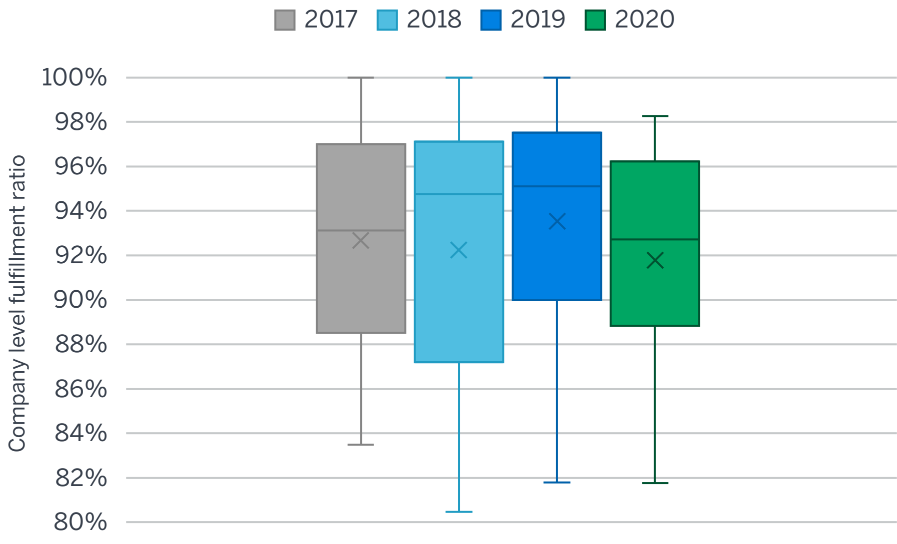
There are some insurers with positive changes in fulfillment ratio

- There are three companies showing small increases in company-level fulfillment ratio. The increase is explained by the combined effect of: (i) no further cuts in declared bonuses and dividends based on the fulfillment ratio observed in 2020; and (ii) the inclusion of new cohorts of terminal bonuses without adjustment.
- As the interest rate environment and equity market showed signs of recovery towards the end of 2020, it appears that some of these companies have successfully deferred the decision to reduce the non-guaranteed benefits through applying smoothing mechanisms.

A closer look at the historical distribution of company-level fulfillment ratios

The box plot shows the minimum / 25th / 50th / 75th / maximum company-level fulfillment ratio of the 10 companies covered under the Index.

In 2020, the entire distribution has been shifted downwards compared to 2019. The 2020 distribution is also more condensed than in the past.



What is next for fulfillment ratios?

- Reporting year 2020 has been challenging for fulfillment ratio disclosures as there has not been such adverse and volatile market conditions since the disclosures became mandatory in 2017. Market observers might have expected the fulfillment ratios to fall further in 2020 given the market challenges. However, the Index does not show a material drop. This is primarily because many insurers have put in place effective smoothing mechanisms to dampen the market volatility, and also because a material proportion of products are still to pay an increasing proportion of terminal dividends that are not fully reflected in 2020 fulfilment ratios.
- It is also key to consider the limitations in the way fulfillment ratios are disclosed, where older cohorts can eventually be dropped from the disclosure, which may include some cohorts with dividend cuts. The fact that the fulfillment ratio is relative to the benefit level illustrated at the point of sale rather than when the product was first launched also provides some drawbacks to the use of fulfillment ratios.
- An important point to note is that most of the popular par products with high equity backing ratios are at a relatively early stage of their policy term. Hence, the current fulfilment ratios do not yet adequately reflect the increasing non-guaranteed element that is planned to be paid to policyholders in the future. A difficult 2020 may have presented an opportunity for companies to reduce the level of benefits gradually without "surprising" policyholders given the expectation of poor market performance.
- The future trend of the Index will largely depend on the actual dividend declaration of insurers, especially when terminal dividends/bonuses become material as some policies reach later policy years if interest rate levels do not catch up with the long-term investment return assumptions used by some insurance companies when pricing these products. It will also be subject to how these actual dividend/bonus adjustments are captured and disclosed under the published fulfillment ratios given the limitations in disclosures.

About Milliman

Milliman is a leading consultant to the insurance industry, advising most of the world's largest insurers.

We combine more than 70 years of risk expertise with advanced data analytics and market-leading technology solutions to help our clients:

- navigate increasingly volatile markets;
- drive product innovation and efficiency;
- protect assets from complex and interconnected risks;
- create groundbreaking solutions to some of society's greatest challenges.

With offices across the globe, we have in-depth knowledge of the local regulations in every market we serve, and we actively invest in research to keep our clients one step ahead in a rapidly changing world.

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