Asia e-Alert

June 20, 2013

Asia Participating Business Survey

Participating business: Alive and well, but room for strengthened governance

The report of the decline of participating business (par business) was an exaggeration. Faced with persistently low interest rates across many markets in the Asia Pacific, commentators have been predicting a reduced role for par business for some time. In stark contrast to this, volatile securities markets since the global financial crisis and strong demand from distributors and customers have helped par business to cement its position in many markets, and it looks set to regain a place in certain markets, such as India.

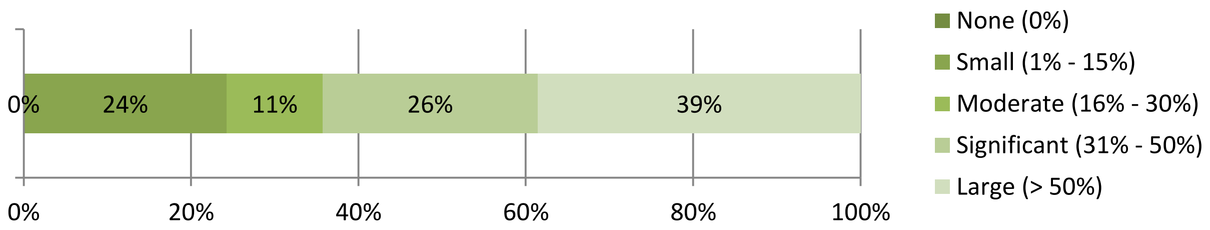
Earlier this month, Milliman carried out a survey of senior life insurance executives to gauge the current views on a number of issues relating to participating business across Asia. The survey covered insurers in all major insurance markets in Asia, excluding Japan and Korea. Thank you to those who participated. We are pleased to present the results of the survey below.

Results

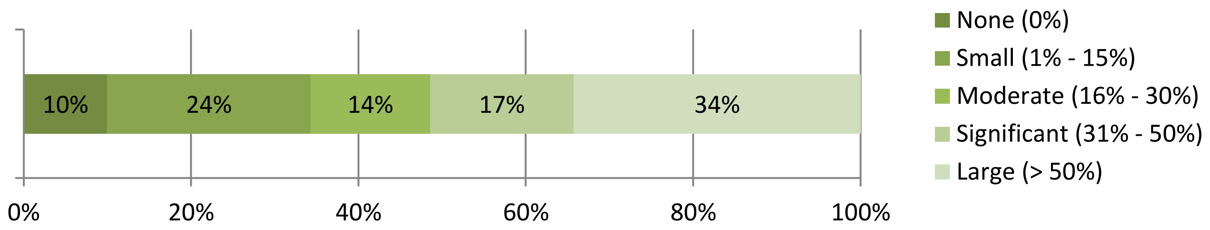
Of the 82 responses received, 10 (12%) indicated they did not have any participating business on their books and had no intention to sell it in the near future.

The following results are from the remaining responses received.

Q1. What proportion of your in-force business (by reserves) is participating?

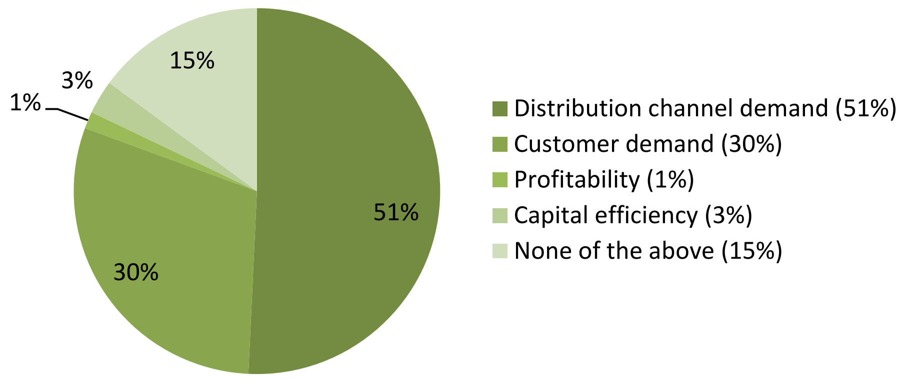


Q2. What proportion of your new business (by new business APE) is participating?



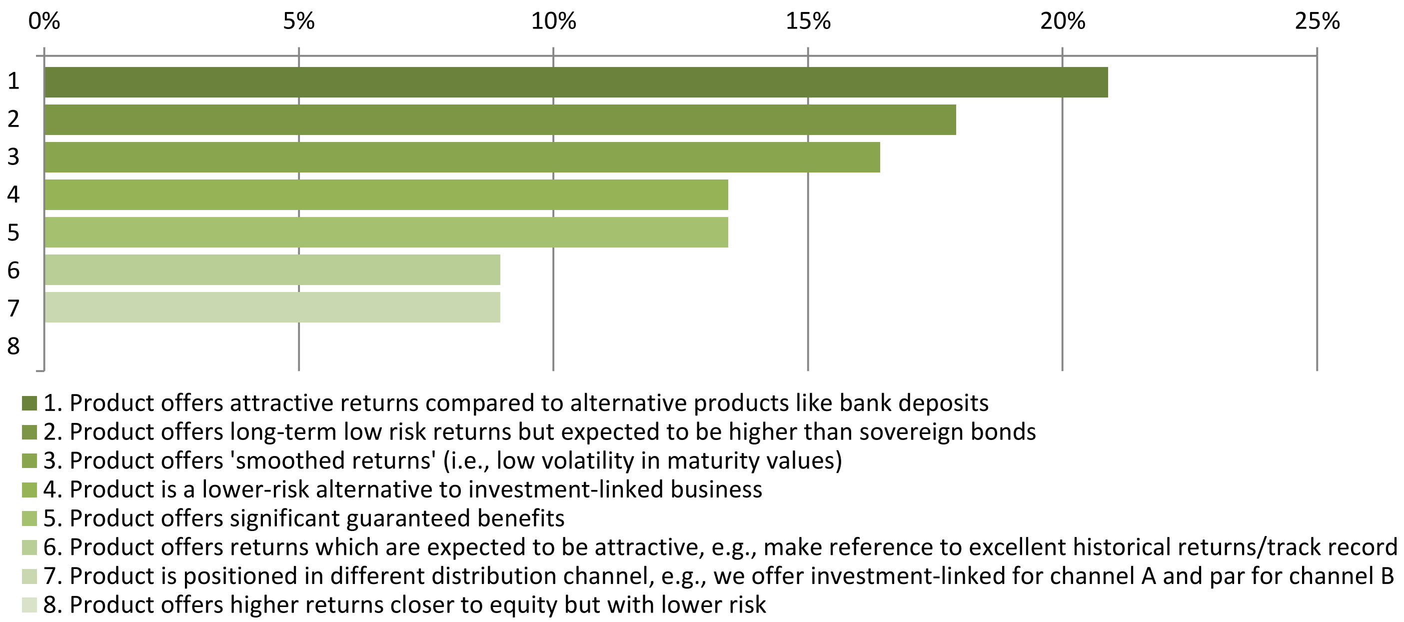
The responses to the first two questions show that participating business makes up a significant proportion of the market. Although the proportion of new business sales is lower than current in-force levels (suggesting a modest move away from par business), it still shows the continued importance of par business across the region.

Q3. What is the most significant factor in why you offer participating business?



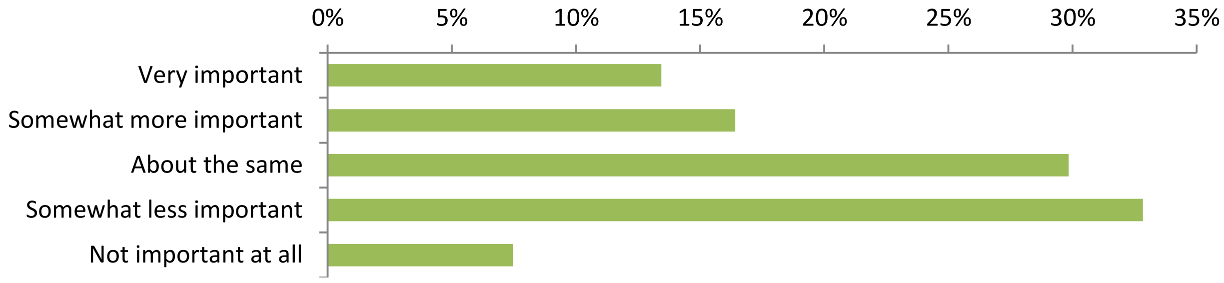
Distribution channel and customer demand are driving the sale of par business. The results suggest that par business might remain an easier proposition for distribution channels than more complex products. In both Singapore and China, the balance between customer demand and channel demand was more even. We also note that in India the product regulation including higher maximum commission rates may encourage par business over unit-linked and universal life business.

Q4. What are the key components of your product positioning?



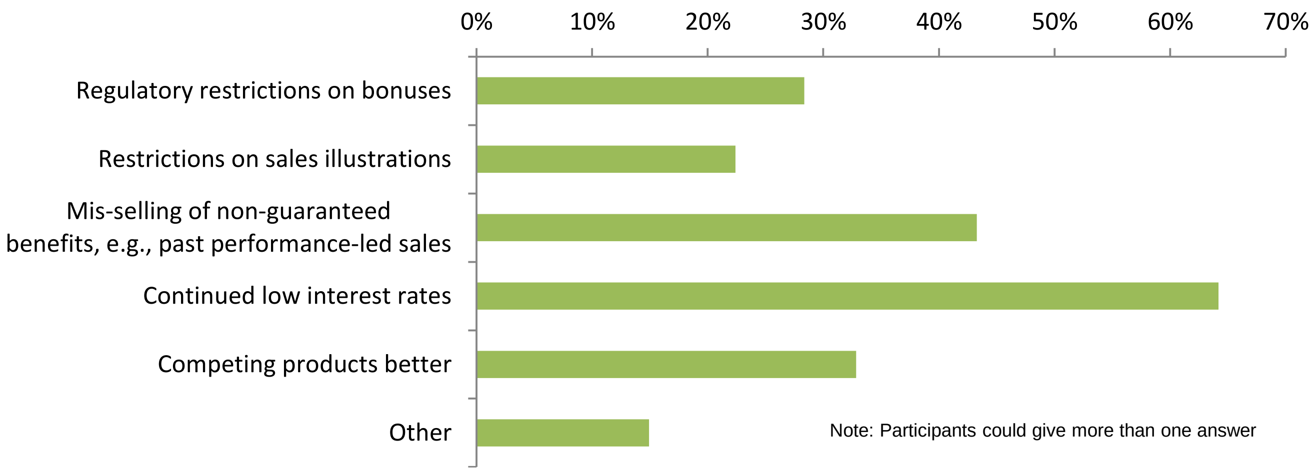
Three of the top four answers to this question suggest that participating business is being positioned as an alternative to bank deposits and sovereign bonds (i.e., the “risk-free plus” proposition) with material guarantees. This view was expressed in every territory. No respondents described the proposition as a higher equity-like return, but with lower risk.

Q5. For the future, how important do you consider participating business to be to your future sales plans compared with the present?



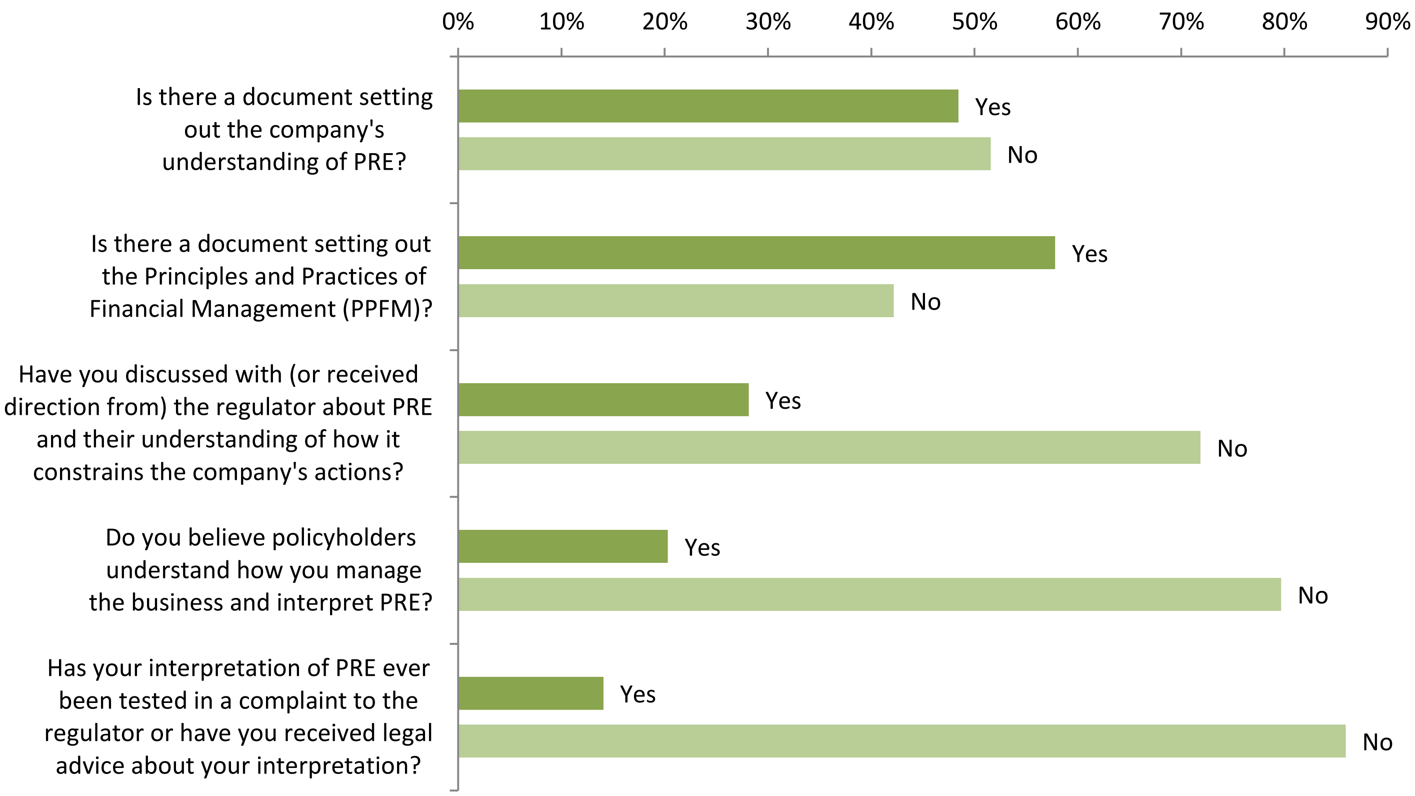
Mirroring the answers seen for questions 1 and 2, there seems to be at most modest overall reduction in the focus on participating business for future new business plans, especially in Hong Kong, Malaysia and Singapore. This may reflect ongoing concerns about the level of interest rates in these markets. The greatest increases in importance were seen in the nascent par market of Indonesia and the re-emerging market of India. Par business clearly will remain an important component in many companies' marketing plans for the foreseeable future.

Q6. What is the biggest risk to successful participating product offering?



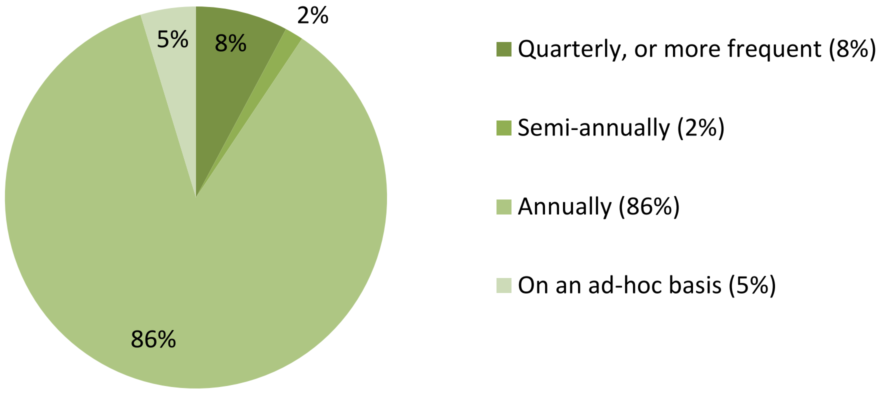
Low interest rates are a concern for nearly two-thirds of respondents. Mis-selling of non-guaranteed benefits was a concern with many respondents, which ties in with the concerns over low nominal future investment returns, as these will limit the size of bonuses and dividends that can be afforded. We have seen some proactive risk management in this regard, with the recent review of par illustrations in Singapore where the gross future investment return assumption has recently been reduced to 4.75% (from 5.25% previously). Correspondingly, only 29% of respondents from Singapore perceived mis-selling as a major risk.

Qs 7 to 11. Policyholders' reasonable expectations



The majority of respondents' companies have had no discussions with, or direction from, the regulator about interpreting policyholders' reasonable expectations (PRE), and only 15% have ever had their interpretation of PRE tested in a complaint case or received legal advice about their interpretation. Many, but not all, respondents have good internal documentation about PRE and current practices, but 80% believed policyholders did not understand how discretion is exercised by companies in interpreting PRE (Singapore is the outlier with 71% believing policyholders have an understanding of PRE). This suggests that greater focus might be needed in explaining to policyholders how companies exercise discretion in practice.

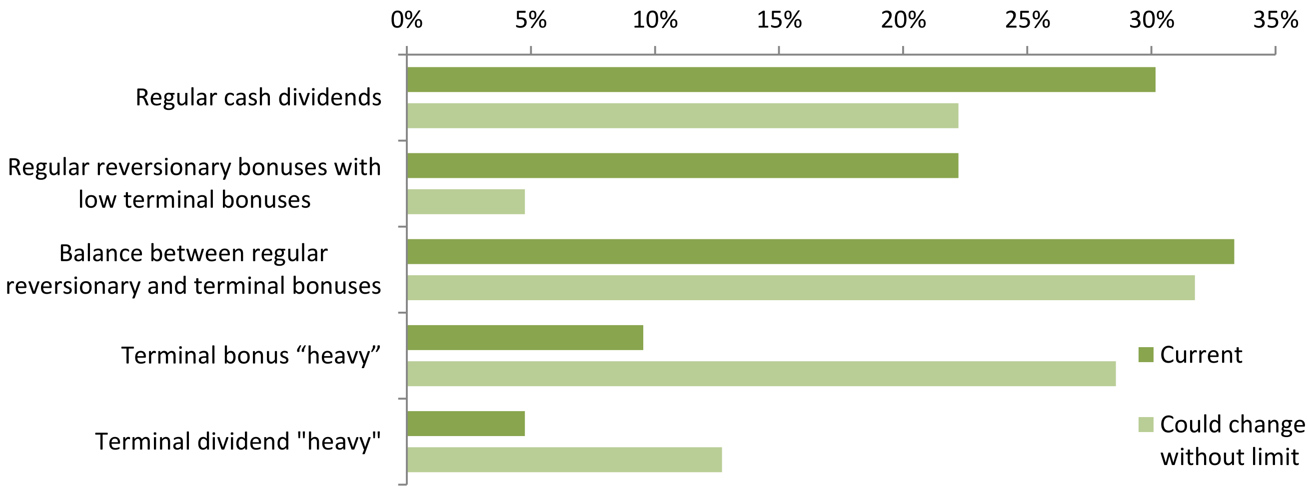
Q12. How frequently do you send out policyholder communications?



Communication frequency with policyholders is good, with 95% of respondents saying they communicate at least once a year, which seems to be the standard. More frequent communication may not be cost-effective, although additional ad-hoc communications may be required in the event of changes that affect policies. Arguably more important, but difficult to measure, is the quality of the communication that is given, since this is the companies' best opportunity to shape their view of PRE.

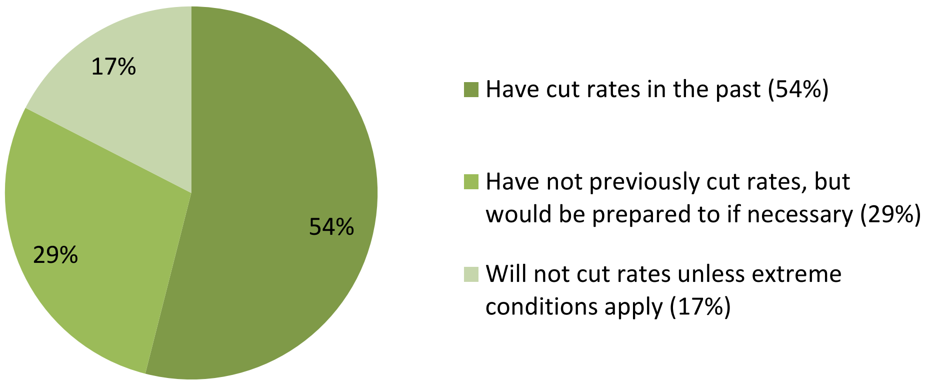
Q13. How would you describe your current shape of bonuses? and

Q14. What shape of bonuses would you like to have if you could change them without limit?



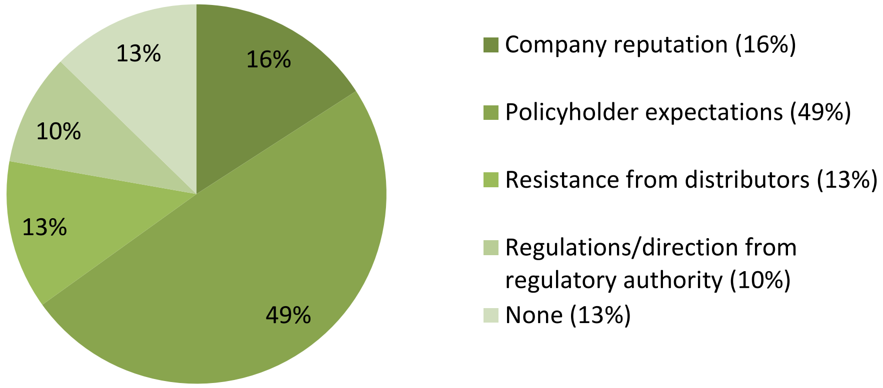
The current shape of bonuses in the region seems to be weighted more towards regular dividends and bonuses (over 50% of responses described their current shape as either "regular cash dividends" or "regular reversionary bonuses with low terminal bonuses"). However, when asked what shape they would like if they could change it without limit, the responses shift to being more terminal bonus or terminal dividend "heavy" (41% combined). This is likely to be a result of the extra reserving and RBC capital requirements and higher guarantee costs associated with regular bonuses and dividends.

Q15. What is your view on cutting future bonus rates?



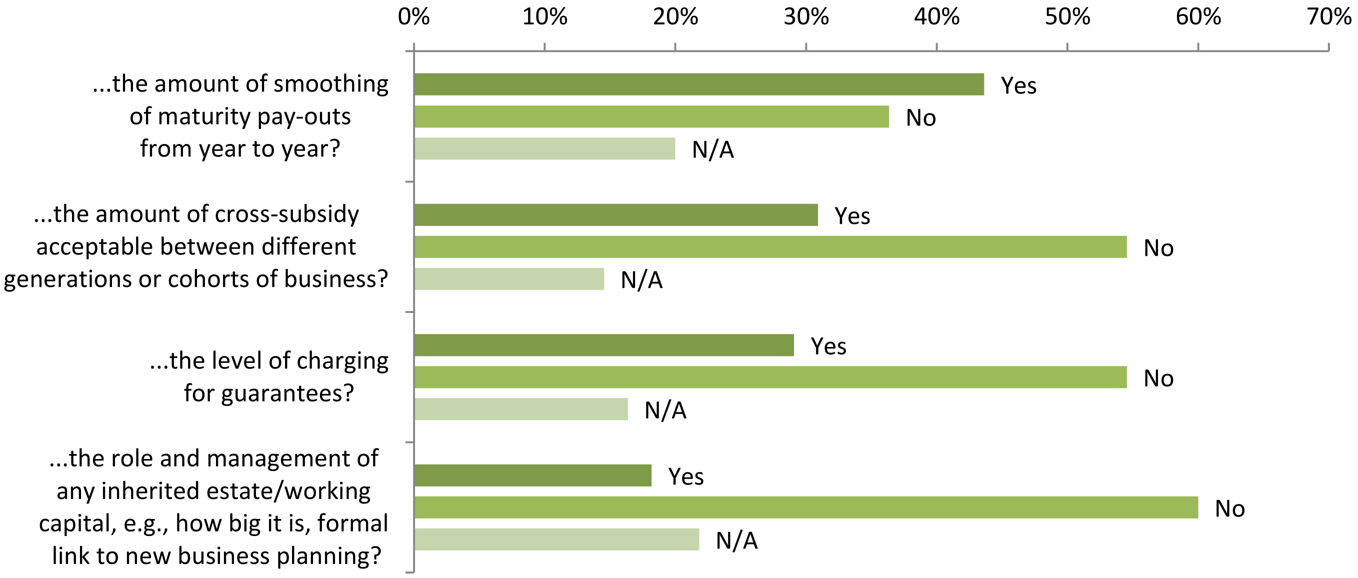
The majority of respondents (83%) have either already cut bonus rates in the past or would be prepared to do so in the future if it was necessary. For companies that have yet to cut bonus rates, the issue remains whether this is in accordance with PRE, which could affect their ability to do this in practice.

Q16. What is the main obstacle to cutting bonus rates?



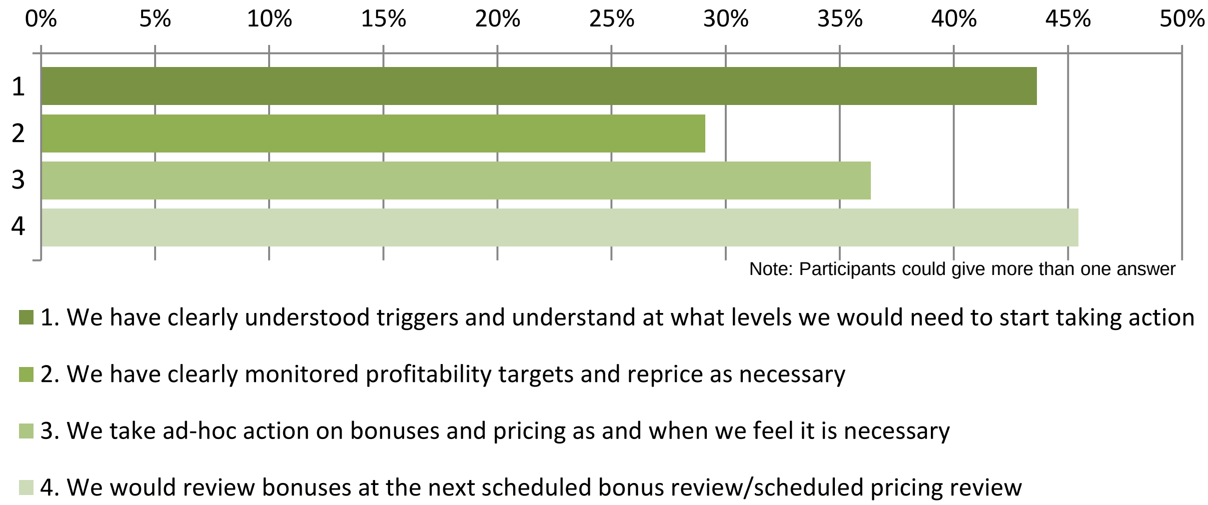
The answer to this question highlights the importance of setting expectations with policyholders if companies are to cut bonus rates, should the financial condition suggest this is needed.

Qs 17 to 20. Do you have a clear policy/practices relating to…



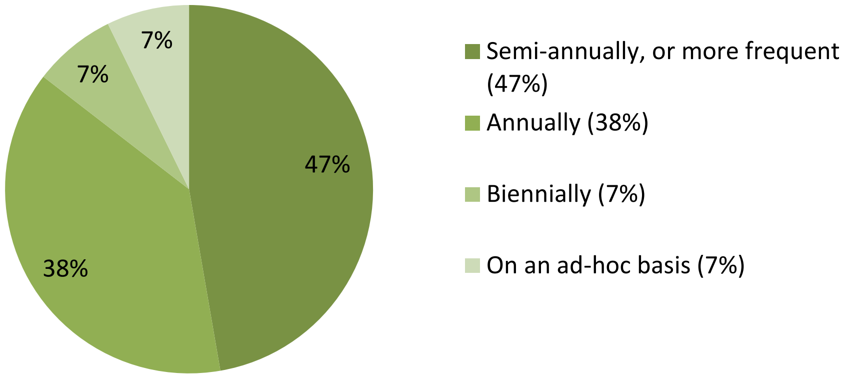
The answers to these questions highlight that, in general across the region, there is a lack of clear policy in some of the key areas of how discretion is applied in the management of par business. The response to question 4 indicated that smoothing was an important feature in the participation business proposition, but 36% don't have a clear policy on how this is applied. Only 18% of respondents have clear policies/practices for the role and management of any inherited estate/working capital, which can be a valuable resource for aiding the efficiency of par business. Similar results were reported for all territories, with the exception of Singapore, which showed more developed practices for smoothing and cross-subsidies (71%) but less developed practice (in line with other territories) for charging for guarantees and the management of the working capital (29%).

Q21. If fixed-interest yields dropped sharply and this coincided with mark to market losses in credit securities and equities, do you know how you would reflect this in your bonus actions?



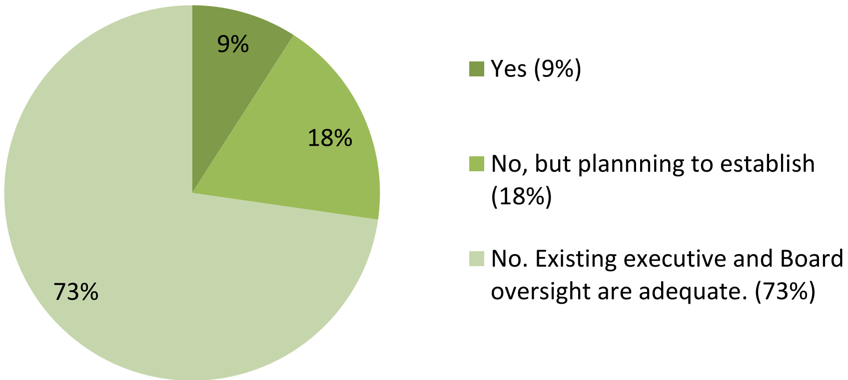
Forty-five percent of respondents said they would wait until the next scheduled bonus or pricing review before acting on significant market movement. Cash surrender values are not large in many instances, which is helpful to protect companies, who might otherwise need to apply a market value adjustment to surrender values.

Q22. How frequently do you review the investment strategy for the assets backing your with-profits/par business?



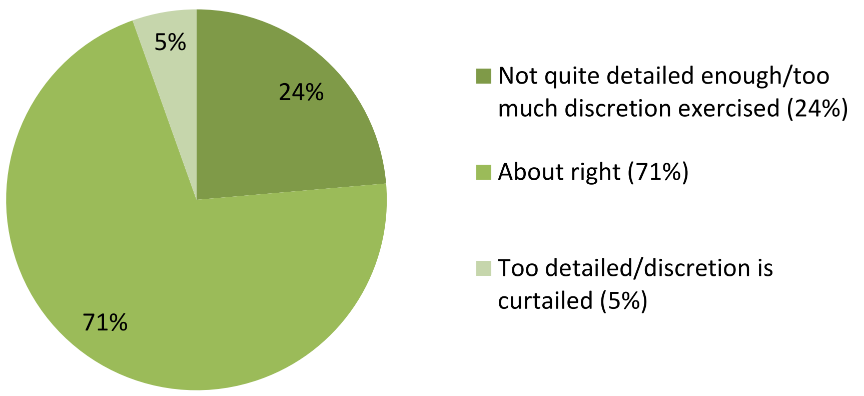
The vast majority of respondents' companies are regularly reviewing their investment strategy for participating business, at least annually.

Q23. Do you have a "with-profits committee" or "participating business committee" whose term of reference is to review the exercise of discretion in relation to such things as bonus rates, investment policy and management of the working capital/inherited estate?



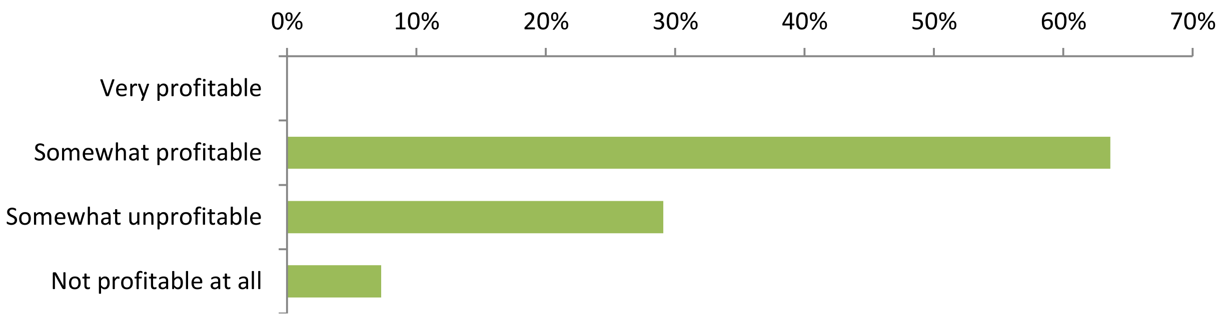
Given the possible conflict of interest between shareholders and policyholders, some companies set up a separate "with-profits committee" or "participating business committee" to oversee management from the policyholder's perspective. However, the survey results suggest that around three-quarters of respondents do not see a need for this, as they see existing executive and Board oversight to be adequate. The major outlier is India, where new regulation requires a with-profits committee to be established, and hence companies either have or are planning to establish such a committee.

Q24. Do you think your internal governance is…?



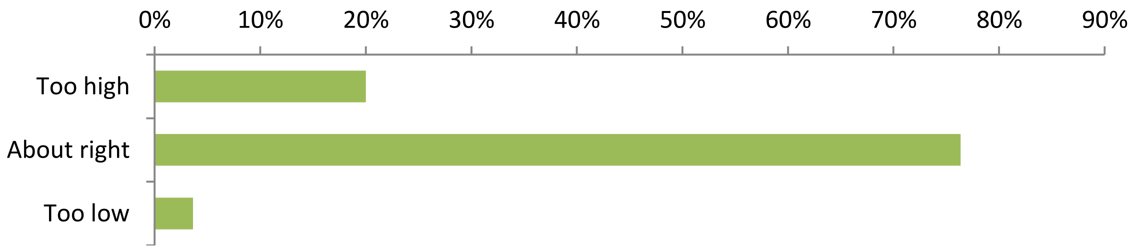
The general view (71%) is that the level of internal governance is about right, but of those where this is not the case, the majority felt that governance was not quite detailed enough or that too much discretion is exercised.

Q25. How do you view participating business profitability?



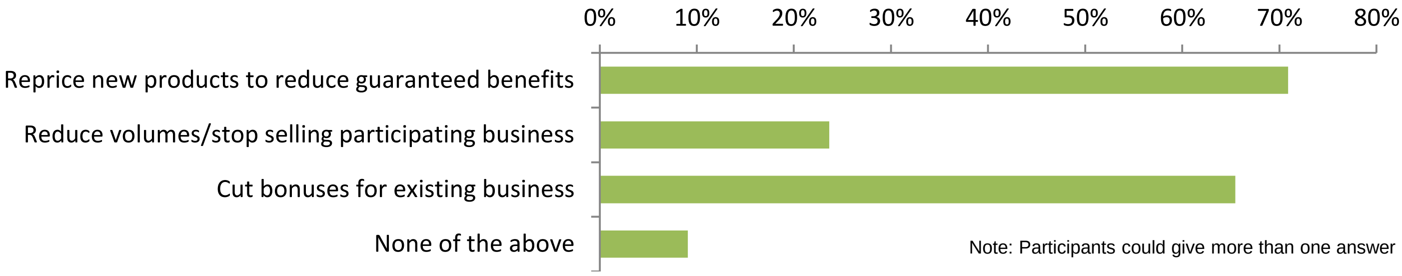
Although the majority (62%) see participating business as somewhat profitable, no one views it as very profitable, and 36% view it as unprofitable. This is consistent with the answers to question 3.

Q26. Do you think guaranteed benefits are…?



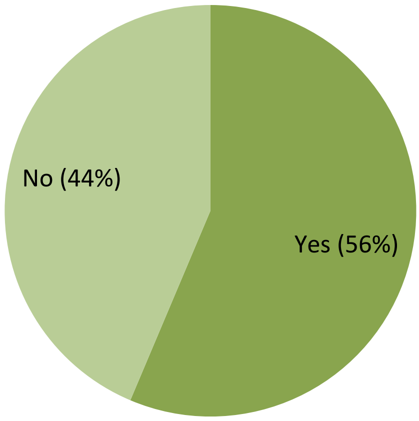
Nearly 80% of responses see the guaranteed benefits as about right, with 20% thinking they are too high. Hong Kong respondents were the most concerned about guarantee levels (43%), perhaps reflecting the very low bond yields at this time.

Q27. If your company believed that interest rates were expected to remain at a low level for the foreseeable future (more than three years) would you expect to…?



Despite the strong view from the previous question that guaranteed benefits are about right, if interest rates were expected to remain at a low level for a prolonged period, then our results suggest that the majority of respondents' companies (71%) would re-price to reduce guaranteed benefits. Reducing bonus rates is also something that most companies (65%) would do in this situation, but far fewer (only 24%) would reduce or stop selling par business. Once again, the extent to which bonus rates can be cut for existing business will be limited by PRE.

Q28. Do you consider stochastic concepts like the time value of options and guarantees in pricing or risk management of your participating business?



Market-consistent valuation methods for embedded guarantees and options in insurance products are becoming more and more common, but 44% of participants surveyed are not considering such concepts for their pricing or risk management of participating business. It is common in Singapore (86%), Hong Kong (86%) and to a lesser extent Malaysia (45%).

Conclusions

Overall importance of par business to remain high – Respondents from the traditional major par markets of Singapore, Hong Kong and Malaysia believe par business will remain important. Respondents from India and China see a growing demand for par business, presumably in response to product and distribution regulations, which have helped to make par business more attractive in these markets (e-Alert: New life insurance regulations in India; e-Alert: Further regulations and risk controls for bancassurance business in China).

Diverse product offering – We saw a wide variety of product propositions in many territories, ranging from "risk-free plus" (either deposit rates or sovereign bond yields) up to a smoothed equity-linked return benefiting from guarantees.

Pricing and profitability robust – Respondents believe par business offers reasonable (affordable) levels of guarantees and reasonable levels of profitability to insurance companies. Hong Kong showed the greatest concerns about guarantees, possibly reflecting the very low interest rates in that market.

Governance varies widely – As expected, respondents from Singapore, Hong Kong and Malaysia viewed governance as strong, but we saw the expectation of increased governance in India, again in response to the recent product regulations. Controls were generally strongest for setting bonus rates each year and weakest for longer-term issues such as equity between generations of policyholders and managing the working capital of the participating fund, even in Singapore, where the regulators have encouraged the strongest governance in the region.

Key risks to continued success are low interest rates and product illustrations - Most respondents recognise that persistent low interest rates would present a significant challenge, but they believe this risk could be managed through re-pricing and cutting bonuses. In China and Malaysia there is a strong reluctance to re-price/cut bonuses, which is a reflection of the historic practices in these participating markets. Notably, 40% of respondents viewed mis-selling as a material risk, while another significant minority were concerned about future restrictions on illustrations.

PRE is poorly understood by policyholders – Most respondents felt that even if methods for determining PRE are well documented internally, how they actually exercise their discretion in interpreting PRE is not particularly well understood by policyholders. This is particularly important given the key risks identified above. Would policyholders understand why bonus rates were being cut in an era of lower nominal investment returns?

The overall prognosis is positive – Participating business is alive and well in the region, but its successful growth will in part rely on enhanced communication with policyholders and strengthened governance.

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