

INVESTMENT PERFORMANCE OF LIFE INSURERS

Introduction

Life insurance has evolved over many decades from a pure risk insurance to whole life and endowment insurance and more recently a shift to investment-linked insurance where the benefits ultimately paid to policy owners depend directly on the investment performance of the insurer. This has much to do with the growing wealth and financial sophistication of the general public which contributed to the shift in the perception of consumers, towards greater demand for such savings products. With the convergence of the different financial services in the market, life insurance has to compete effectively with other savings instruments like bank deposits, government bonds, unit trusts and mutual funds. With the increasing importance of the savings element in life insurance, investment management has grown into an integral part of life insurance business.

Design and Pricing of Life Insurance Products

Life insurance products are priced based mainly on three elements, namely, the expected

investment returns, mortality experience and management expenses. Although the level of expenses varies amongst individual insurers with differing economies of scale and operational efficiencies, the life industry as a whole experiences a continuous improvement in the operating expenses as shown in **Chart I**. Similarly, the mortality experience of assured lives in Malaysia has also shown a continuous improvement over the years as indicated in **Chart II**.

Besides the expense and mortality factors, investment return has become an increasingly important factor in product pricing due to the higher savings component in life insurance products. However, investment earnings are volatile, very much dependent on the cyclical trend of the financial market. The unprecedented Asian financial crisis which occurred in mid-1997 showed how unpredictable is the investment climate faced by the life insurance industry. To manage the volatility in investment earnings, life insurers have designed life insurance policies with features which entitle the policy owners a share of the surplus. These "With Participation in Profit" products enable the policy owners to share the benefits of higher future investment returns. The initial guaranteed benefits of the product is set at a level which the insurer is

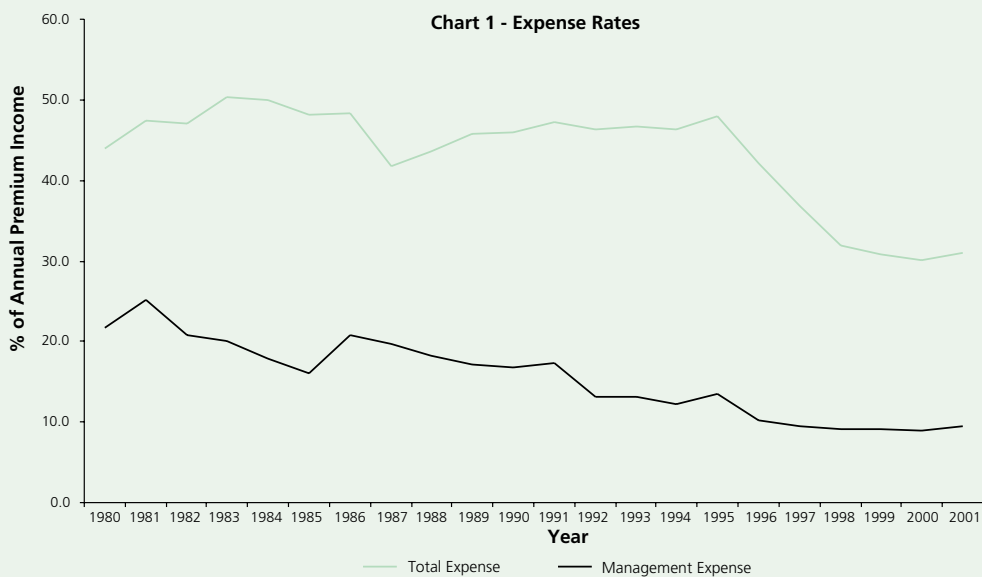
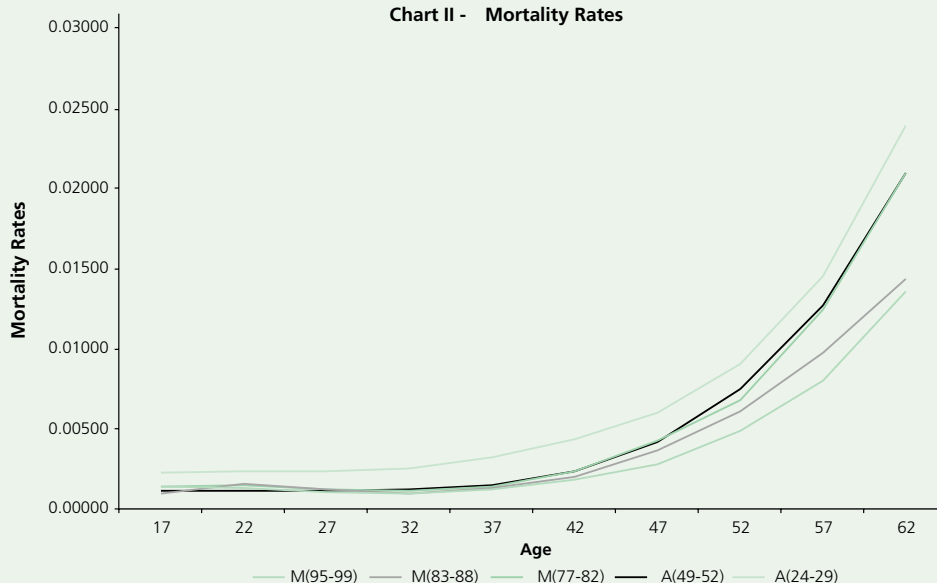


Chart II - Mortality Rates



likely to be able to achieve. Policy owners will then share with the insurer the additional profits generated by the insurer in the form of bonuses or cash dividends. The Insurance Act 1996 explicitly governs how the profits should be shared between the two parties to ensure that the interests of policy owners are protected.

In declaring bonuses and cash dividends, the insurer may “smooth out” the profit or surplus arising in a particular year to ensure that the returns to policy owners are more stable and, to a certain extent, shielded from the vagaries and volatility of the financial markets. For example, in a very good year where investment returns are much higher than expected, the insurer may not distribute all the profits generated. In a bad year where investment returns are poor, the insurer may utilise the undistributed profits to enhance the returns to policy owners. This smoothing process is one of the most important features of a “With Participation in Profit” product design.

Importance of Investment Performance

With the trend towards higher savings component in life insurance products, the investment performance of life insurance funds

is the critical success factor for life insurance business. A superior investment performance allows a life insurer to market competitive products that can provide a higher rate of return to its policy owners. In a competitive financial sector, customers are likely to compare products of different life insurance providers. The intensity of competition is further heightened by the increasing blurring of the distinction between financial products like unit trusts, bank deposits and investment-linked insurance. Consequently, not only do life insurance products have to compete within the insurance sector but also with products of other financial institutions for public savings. An investment-linked policy, for example, competes directly with a unit trust product as an asset accumulation tool.

The importance of investment performance in life insurance business extends beyond the ability to design competitive products. Good investment performance assists the insurer in generating a higher actuarial surplus to contribute to insurer’s profitability, and generate further free assets beyond the liabilities of the insurance funds. Adequate free assets allow insurers to write higher volumes of new business by providing the capital necessary to set up the required reserves

to finance new business strain. These free assets provide a cushion to smoothen out the fluctuation in investment returns caused by cyclical movements in the economic environment. With adequate free assets, life insurers are able to invest more freely and take advantage of the investment opportunities. Thus, insurers will be able to achieve higher investment returns that will give better benefits to their policy owners, thus enhancing their competitive position vis-à-vis other savings-type financial products.

It is therefore imperative that life insurers build up the essential investment management expertise to manage their life insurance funds. Of foremost importance is the ability of insurers to earn the expected returns to enable them to fulfil policy owners' reasonable expectations of the illustrated insurance benefits. Under the Code of Good Practice for Life Insurance Business issued in 1997, life insurers are generally allowed to adopt a maximum investment return of 8.5% for the purpose of benefit illustration to the policy owners. Hence, the actual investment earnings must be equal or higher than the rate assumed in the profit test in order to meet the benefit illustration.

Analysis of Investment Performance of Life Industry

Life insurance products as distinct from other financial products have long-term policy durations. This distinctive characteristic allows investment management of life insurance business to smoothen out the short-term volatility to deliver long-term investment returns. Past investment performance is often used as an indication to measure an insurer's ability to meet its long-term financial commitments as well as the policy owners' reasonable expectations.

While the country's overall economic climate is important for the investment performance of the industry, the impact of such economic factors would possibly depend on the ability of an insurer to take advantage of the economic scenario to best manage the asset mix of its life insurance fund. This asset mix is subject to the admitted assets requirements that sets prudential limits on insurer's exposure to equities, bonds, loans and properties. Given the spread of the investment portfolio in various categories of assets, the life insurance industry had experienced stable investment result over the past ten years as shown in Table 1.

In terms of investment performance, the compounded average rate of return, excluding capital gains, earned by life insurers over the 10-year period from 1992-2001, was 6.85%, while the yield, including realised capital gains was 9.07%. The rates of return, excluding capital gains, were relatively stable over the period under review with a standard deviation of only 0.81% over the average rate. On the other hand, the rates of return, taking into account capital gains were more volatile, exhibiting a standard deviation of 4.07% across the average rate.

The investment performance of the life insurance industry was markedly better during the first 5-year period from 1992 to 1996 as compared with the later 5-year period from 1997 to 2001. Including capital gains, the compounded average rate of return was 11.76% for the first 5-year period while the second 5-year period was 5.38 percentage points lower, at 6.38%. A high rate of return of 16.55% was recorded in 1993, due to the higher stock prices on the Kuala Lumpur Stock Exchange (KLSE) as against a low return of 3.84% recorded in 1998 following the onset of

Table 1
Life Industry's Rate of Investment Returns

Yield\Year	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001 ¹
Excluding Capital Gain	7.97	7.80	6.54	6.46	6.70	7.23	7.76	6.55	5.83	5.70
Including Capital Gain	9.70	16.55	15.25	7.92	9.41	6.99	3.84	8.95	7.30	4.83

¹ Based on calendar year

the regional economic turmoil. It was also observed that the return including capital gains during the 10-year period was invariably higher than the one without capital gains with the exception for the years 1997, 1998 and 2001. The analysis revealed that even in a lower interest rate environment, investment in equities, although entailed higher risks, still brought in an element of capital gains and increased the potential for higher investment returns.

Despite the lower interest rate environment, insurers managed to sustain a yield (excluding capital gain) during the past 3-year period of between 5.5% and 7% as compared with the prevailing market interest rates of between 3% and 4%. Further analysis of the investment returns by type of investible assets during this period revealed that loans and Malaysian Government papers and guaranteed loans, which constituted more than 30% of the policyholders' funds, contributed a return ranging from 6% to 8% while the rate of return for other type of assets was around 5%. This analysis confirmed that the insurance industry was more resilient in the depressing market with a diversified long-term portfolio of funds.

Comparison with Other Financial Markets

The economic slowdown experienced since the onset of the Asian financial turmoil in 1997 had a profound effect on the overall investment performance of the life industry. The industry registered a decline in investment earnings, from 7.76% in 1998 to only 5.70% in 2001. However, compared to the other financial markets, the rates were still higher than the 12-month interbank rate and the yield for the 10-year to maturity Malaysian Government Securities (MGS), as shown in **Chart III**. The compounded average return earned by life funds, including realised capital gains during the period from 1992-2001, was 9.07% as against the market indicative yield of 7.50%¹ for investment in MSG in 1992 with 10-year to maturity. In comparison, the average increase in the KLSE composite index for the same period was only 0.7%.

Nevertheless, the persistent decline in yield, as indicated by five and three year moving averages (shown in **Chart IV**) of the life

¹ The market indicative yield indicates yield to maturity. It is given as an indicated yield due to the lack of market liquidity.

Chart III - Comparison of Rate of Return for Life Industry, Interbank Money Market and MGS

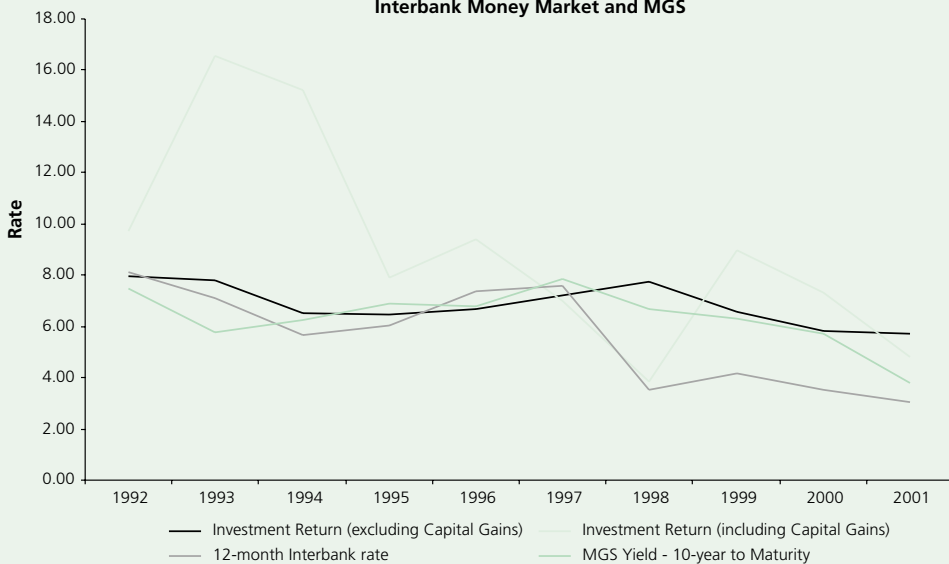
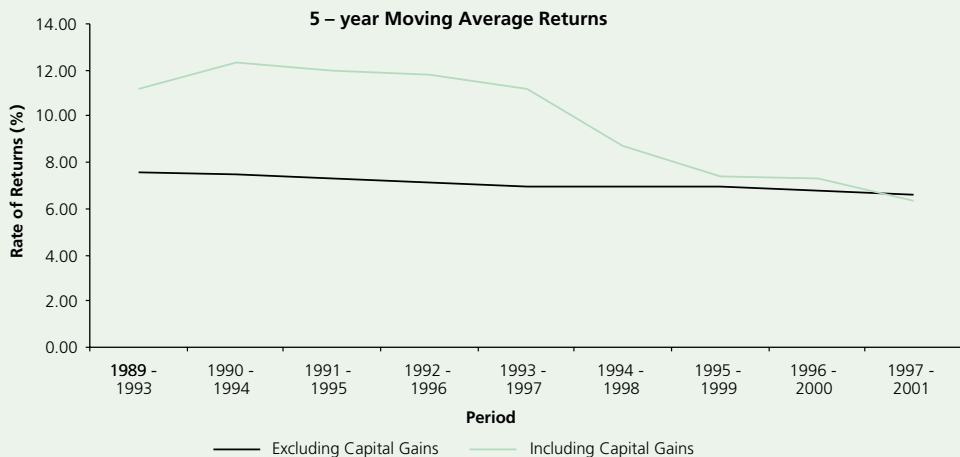
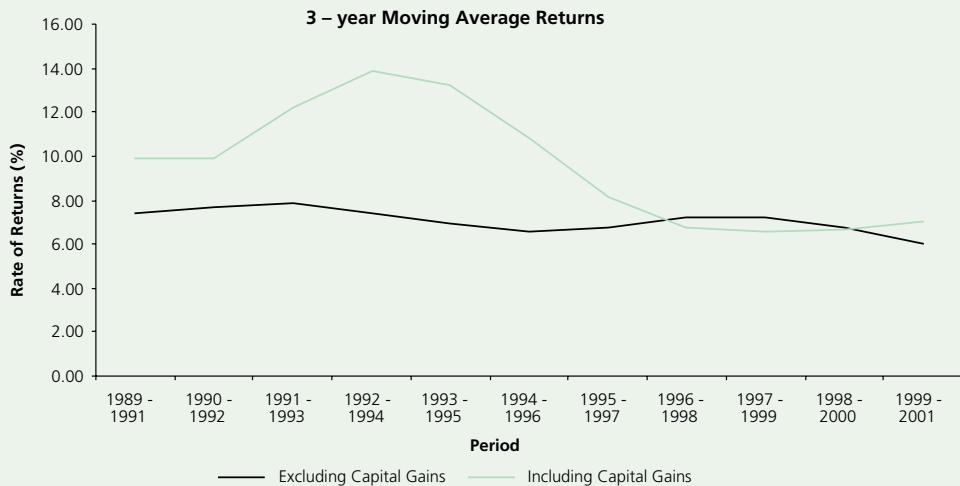


Chart IV : Moving Average Returns For Life Industry

industry's investment return following the 1997 financial crisis, would pose a challenge to the industry as low yields from the new investments may eventually result in lower policy owners' benefits. Therefore, it is imperative for the insurers to review its investment strategy as well as the design of its long-term insurance products to ensure that the shortfall in yield expectation would not affect its financial strength as well as policy owners' benefits. Also, the profit test of life insurance products will have to be revised to reflect more realistic investment earnings and the non-guaranteed illustration be less optimistic in order to minimise the risk of not fulfilling the illustrated benefits.

Adjustments in a Lower Interest Rate Environment

The current sluggish global economic environment poses a serious challenge to all life insurers worldwide. A "negative spread" will occur when the rate of investment return that can be achieved by investing in the financial markets is less than the rate assumed in the pricing of life insurance products that is required for life insurers to meet their obligations to policy owners. In other words, the amount that the life insurers can earn from their investments is less than the amount required for them to pay out the benefits to policy owners. A persistent negative spread has

the potential to deplete the reserves of a life insurer, affecting its profitability and ultimately undermining its financial strength.

Domestically, due to the current expansionary monetary policy, domestic interest rates have fallen progressively since the last quarter of 1998. The 3-month weighted average interbank rate has fallen progressively from a high of 11.3% in July 1998 in the midst of the Asian financial crisis to 3.3% in December 2001. Medium-term and long-term interest rates have also fallen in tandem with the decline in money market rates as indicated by the yields of 5-year and 10-year to maturity MGS which have fallen from 6.66% and 6.70% in 1998 to only 3.18% and 3.81% respectively in December 2001.

Although the industry as a whole has performed satisfactorily in the past decade, the investment return of the life business is expected to dampen in the immediate future years. The trend of lower investment returns can be seen from the industry's 3-year moving average investment returns (including capital gains) which declined from 8.11% for the period 1995-1997 to 7.03% for the period from 1999 to 2001.

Given the sluggish investment environment, the potential deleterious effects of a persistent negative spread should be recognised. Life insurers should therefore be prepared to undertake the necessary precautionary measures to preserve their financial capacity as well as their ability to meet the obligations to

policy owners. These measures may range from a revision in pricing assumptions, reduction in bonus declarations, increase in premium rates or as a last resort, withdrawal of the affected plans from the market. In this regard, the industry has already taken steps to revise the interest earnings for its participating plans from a maximum of 8.5% to 7.5% with effect from 1 February 2002. The impact of the revision would be a lower but more realistic bonus illustration to the policy owners. Alternatively, some insurers may maintain the current bonus rates with higher loadings on the premium. However, as required under the Insurance Act 1996, if the financial markets improve in the future, the increase in life fund surplus due to good performance would have to be shared with the participating policy owners. The revision will however only affect new policies purchased after the effective date and hence not affecting the existing policies in force.

Conclusion

The effective management of life insurance funds is critical in ensuring an insurer's long-term financial strength as well as its ability to meet the policy owners' expectations of future bonuses. In view of the difficult economic scenario, care must be taken by insurers to ensure prudent pricing exercise as well as proper investment strategies to match the long-term financial commitments of the life insurance industry. Prudent product pricing coupled with sound investment performance would enhance the growth of the life insurance industry.