

Life Insurers: Strategies in a Low Interest Rate Environment

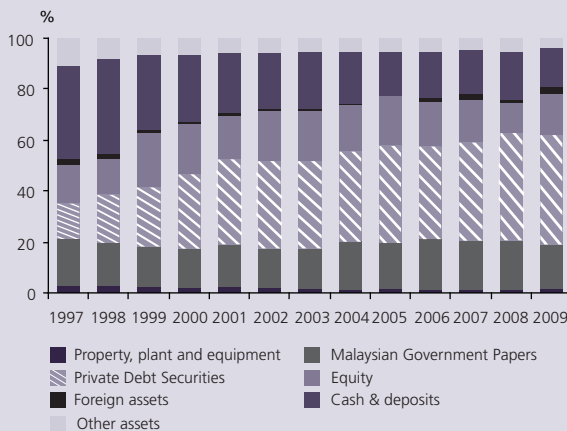
The long-term nature of the life insurance and family takaful business necessitates a long-term view on investment strategy. The apparent mismatch between the long-tailed insurance liabilities and obligations as opposed to the shorter tenures of the insurance fund assets presents an inherent challenge for players in the industry. Specifically, a long period of low interest rates in an environment of weak and bearish equity market will have medium-term implications on performance and capital accumulation of life insurers and family takaful operators (subsequent reference to life insurers include family takaful operators). Such an environment is challenging to life insurers in managing the assets and liabilities. These issues are exacerbated by policy holders' expectations on minimum returns on insurance and takaful policies. This article examines the responses of the life insurers in managing the challenges that surfaced during the low interest rate environment experienced in this recent decade, and in managing the expectations of the policy holders.

Sustaining returns through responsive investment strategy

An active portfolio rebalancing accords insurers with greater flexibility to re-strategise and reallocate assets in response to changes in the market environment. The dynamics of this process enhance the value of the insurance fund assets and returns on the investment portfolio, hence benefiting the policy holders. While investment in debt securities has consistently dominated the asset portfolio given the nature of the insurance obligations, insurers have continuously re-balanced the composition of the fund assets over the recent 10 years in order to maintain the total returns on investments and thus the ability to meet the expectations of policy holders.

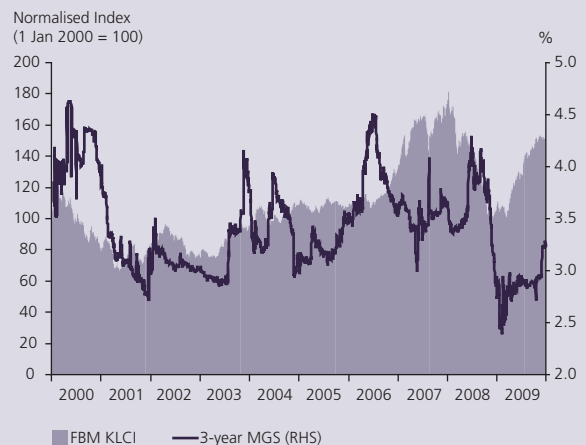
The Overnight Policy Rate was maintained at 3.5% since 1998 to support the recovery and subsequently sustaining the growth of the domestic economy. The rally in the equity market during this period nonetheless provided some cushion to the low returns from investment in bonds. In particular, improved investment conditions between the period of 2003 and 2007 resulted in the domestic equity market to rebound and bond yields to trend upwards. There were nonetheless a few exceptions, i.e. the period following the technology bubble bust earlier in the decade and in 2008 following the global financial crisis, which caused equity prices and bond yields to decline. Investment in equities during these periods were reduced, with higher allocation towards fixed income investments.

Chart 1
Life Insurers' Asset Allocation from 1997-2009



Source: Bank Negara Malaysia

Chart 2
Trends in FBM KLCI and MGS Yield



Source: Bloomberg

Managing duration mismatch through product and pricing strategy

The generally long-term nature of insurance liabilities vis-à-vis the available range of assets and investments raises the issue of negative duration mismatch. The effect of asset-liability duration mismatch is amplified when interest rates are low, as the value of liabilities increases more than the value of the fund assets. This affects life insurers in varying degrees and substantial impact will be experienced by those with larger duration gaps between assets and liabilities. Those with a higher composition of traditional life products, such as 20- to 30-year whole life products, are likely to experience greater pressures in managing the duration mismatch. As at end-2009, the amount of

insurance liabilities of life insurers stood at RM120.3 billion. Of this amount, more than 70% of the insurance liabilities have maturities beyond 10 years. In terms of the asset portfolio, only 12% are in the form of debt securities with maturities exceeding 10 years. The large gap in the duration of assets and liabilities partly reflects the limited availability of long-term assets with reasonable returns which is further exacerbated by the intense competition for these assets from other institutional investors. The difficulty in obtaining assets with similar profiles that match the liability cash flows also exposes life insurers to reinvestment risk in an environment of declining interest rates and a bearish equity market. These challenges have heightened the criticality for a more responsive management of the duration gap by life insurers.

Shifts in product strategy can alter the magnitude of the duration mismatch and facilitate better management of the duration gap. Growing demands for wealth management products with protection elements and increasing concerns over health issues by the general public have provided the natural transition towards product rebalancing strategy by insurers.

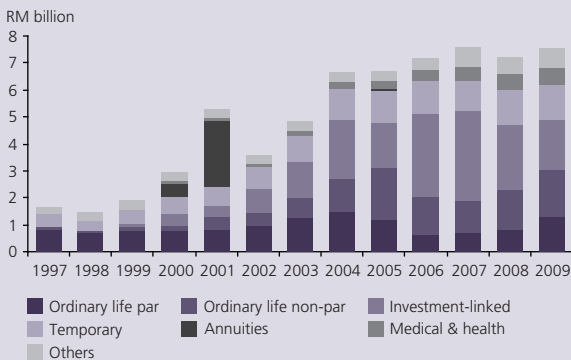
The recent decade has also witnessed the shift from participating life products (where surpluses are distributable to policy holders in the form of pre-specified bonus or dividend payments) to non-participating products. In addition, underwriting of shorter-term investment-linked products with a bank or a third party capital guarantee that capitalised on the strong equity performance during this period also gained momentum since 1999 and, in the more recent period, the growth in medical and health products. Nevertheless, life insurers need to strive to have a fair mix of traditional and investment-linked products in their portfolios in order to provide the flexibility to suit different macroeconomic conditions. From a survey conducted on a sample of life insurers, changes in the product composition have resulted in a more balanced product mix as the size of the duration gap for ordinary non-participating products is 6.6 years while the duration gap for ordinary participating product is 6.8 years.

Chart 3
Example of Life Insurers' Asset & Liability Cash Flow Projection



Source: Eckler Partners Ltd.

Chart 4
Distribution of New Business Premiums for Direct Insurers



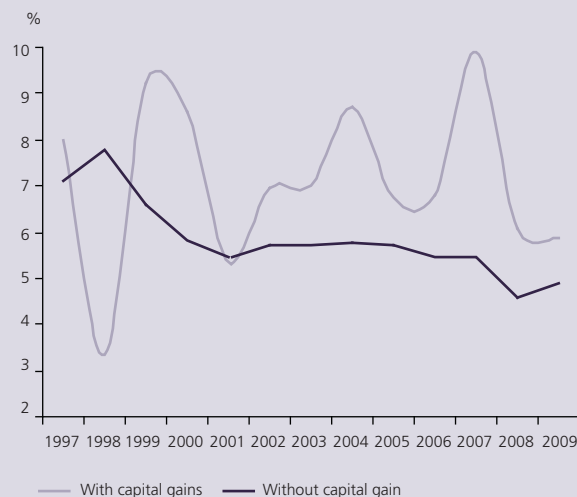
Source: Bank Negara Malaysia

At the same time, these developments have paved the way for new business opportunities for the life insurance industry. Changes in the product mix strategy were also complemented with revision to the pricing structure to better reflect expectations on the future risks and returns, taking into account the structural, financial and demographic changes going forward.

Managing policy holders' expectations

The lower returns on fund assets than that expected by the policy holders present another key challenge for the life insurance industry, particularly for participating products. While the bonus payments or dividend level is not guaranteed, managing the expectations of policy holders is imperative. A well-balanced and appropriately formulated communication strategy that aims to create a better understanding and awareness among the policy holders will avert unnecessary adverse perception on the credibility and resiliency of the insurance players. Managing these expectations is more demanding for participating products underwritten at times when financial market conditions were indeed very favourable and economic growth was strong. The lower total returns experienced during certain periods over the recent decade, and particularly in the recent years, have constrained the ability of a small number of life insurers to maintain the expected bonus rates to policy holders, resulting in the reduction of bonus payments. Mindful of the expectations, the Bank has put in place minimum requirements that must be observed before bonus cuts can be made. This includes a rigorous evaluation by the Appointed Actuary that a bonus cut is an appropriate strategy to preserve the stability of the institution. In addition, detailed assessment on the marketing literature and sales methods will be performed to ensure that the institution has a valid legal basis to undertake the bonus cut i.e. the projected cash bonuses contained in the sales illustration do not tantamount to a contractual obligation on the part of the institution. Reduction in bonuses will also be conducted over a period of time to avoid a sudden and substantial decline in returns to policy holders. Reduction in the bonus payments is also communicated early to the policy holders to provide lead time for the policy holders to make preparations or adjustments to the policies owned. Early notice will enable policy holders to understand the effect of premature termination of policies should they choose to do so and thus allow policy holders to make informed decisions.

Chart 5
Life Insurers: Investment Yield



Source: Bank Negara Malaysia

Conclusion

Life insurers have performed considerably well in managing and responding to the challenges of the low interest rate environment. Progress in risk management infrastructure and capability has been fundamental in building the capacity in managing the structural challenges and vulnerabilities facing the industry. It is envisaged that efforts would continue to be devoted towards further strengthening the risk management and investment capability of the industry with specific emphasis on the management of assets and liabilities. The industry is expected to continuously evolve to remain adaptable and responsive to the business and operational challenges faced in different environments and business cycles. As the industry fulfills the needs of the general public, insurance products such as shorter-term endowment, investment and wealth management, as well as medical and health products, are likely to gain greater prominence without crowding out the traditional products, going forward. This direction has the twin benefits of narrowing the duration gap whilst increasing the level of insurance penetration in the country. The use of hedging solutions such as derivative instruments will also contribute towards the improved management of the duration gap either by lengthening the duration of the assets or shortening the duration of the liabilities.

In addition to strengthening the risk management capability, greater expectations will continue to be accorded to the capacity of life insurers in managing financial shocks. These include prudent management of surpluses, accumulation of financial buffers and availability of liquidity to meet unexpected increase in obligations arising from policy surrenders and benefit payments.