Zeti Akhtar Aziz: Transforming the East Asian insurers – time for action now

Keynote speech by Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia, at the 26th East Asian Insurance Congress "Transforming the East Asian insurers – time for action now", Kuala Lumpur, 30 October 2012.

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It is my great pleasure to join you this morning at this 26th East Asian Insurance Congress. It was almost 24 years ago in 1988 that Malaysia hosted this event. Since that time, the global and regional financial and economic landscape has been dramatically transformed. During this period the world has also experienced more than a hundred financial crises, with the recent global financial crisis being the most severe. This has prompted wide ranging financial reforms by the international community to strengthen the resilience of the financial sector. The enhancements to the regulatory and supervisory frameworks have also had a far reaching and fundamental impact on how insurers manage risks in their businesses. In this highly dynamic and more challenging global environment, the insurance industry has continued to evolve and develop with the broadening of the product range and greater diversification of the distribution system.

In Malaysia, the insurance industry, including the Takaful sector has also progressed significantly during this period, both in terms of growth and development. In this more recent decade, the penetration rate, as measured by the number of life policies to total population, increased significantly to 55 percent, from 31 percent in 2000. Total premiums to GDP increased from 4.1 percent to 4.5 percent over the same period. Structural reforms undertaken has also transitioned the industry towards more market-based pricing mechanisms in key market segments, improved efficiencies in the insurance eco-system, and a strengthened framework for consumer protection. These trends have also been reinforced by liberalisation measures which aim to support and catalyse the further development of the industry. A proposed new legislation for our financial sector is also now well advanced and will provide a solid foundation for the insurance industry going forward.

This event is taking place at a time of significant change and in a period of transition into a new era for the financial services industry. We can reflect on these developments in the industry and take the opportunity to learn from the different experiences in the region. While we face different challenges and priorities, the insurance industry in the East Asian economies share three important common goals – sustaining growth and performance under more challenging economic and financial conditions, strengthening the capacity to support and drive economic transformation, and building resilience to withstand future shocks and economic cycles. As we turn our minds to these goals, the question before us is: how should the insurance industry in East Asia, in the period ahead, respond to these demands?

In envisioning the future direction of the industry in our own region, it would be constructive for us to reflect on the evolution of the modern insurance industry and contextualise it to our own prevailing and prospective environment. The modern insurance industry came with the maritime expansion which accompanied cross-border trade activity, and the rapid urbanisation which saw significant human and economic losses experienced during the Great Fire of London. This led to the establishment of the first fire insurance company and the invention of the building blocks for life insurance as we know it today. Then, as societies became more affluent, endowment and with-profit policies grew in significance as instruments for savings. As industrialisation and urbanization intensified, the break down of traditional systems of social protection prompted the expansion of insurance products that covered retirement, accident, medical care and unemployment.

Throughout the 20th century, business models have continued to evolve in tandem with the higher levels of financial literacy, rising consumer expectations and advancements in technology. As competition compressed margins, there was a migration beyond tied-agency and commission-based distribution models to include fee-based financial advisors and direct marketing. Bancassurance and the participation of retailers in insurance distribution have also allowed insurers to significantly expand their reach with lower cost structures, while specialisation along the value-chain enabled even greater efficiencies. This more diverse landscape has enabled a much wider and deeper penetration of insurance in the advanced economies.

While these trends are shaping the evolution of the East Asian insurance industry today, several other factors also need to be taken into account. First is the much faster pace at which these forces of change are taking place in East Asia. Second is the significantly more demanding regulatory environment in which insurers now operate. And third is the impact of climate change. This thus calls for a greater urgency in responding to these developments. Allow me to elaborate on these factors given their potential to have an important bearing on the industry's focus and priorities in navigating its future growth path in the region.

On the first point, the growth trajectory for the demand for insurance products and services in East Asia over the medium term will be much higher than the path that history implies. The global volume of cross-border trade has almost tripled since 2000. In addition, intra-regional trade within Asia is projected to account for an increasingly larger share of this expanding world trade. Further liberalisation and greater regional economic and financial integration in Asia will reinforce this trend. This presents substantial opportunities for East Asian insurers to support the growing trade activities. After decades of strong growth, the Asian region is also now the home to a middle income population of 500 million. This number is projected to increase by more than six-fold to 3 billion by 2030. The OECD also projects that by 2020, Asian consumers will account for 40 percent of global consumption.

Within Asia, structural reforms have also increased the importance of domestic sources of growth. Asia's rising domestic demand needs to be supported by the development of a much broader range of financing options for healthcare, education and retirement. This will result in the reduced need for high levels of precautionary savings, which in turn will contribute towards strengthening domestic demand. In addition, with rapid industrialisation, Asia is also experiencing an unprecedented rate of urbanisation. Between 1990 and 2010, Asia-Pacific's urban population increased from 29 percent to 43 percent. It is projected that another 1.1 billion people will be living in cities over the next 20 years, increasing the urban population to 55 percent by 2030.

The region will also be faced with an ageing population in the years ahead, with Asia accounting for 62 percent of the global elderly population by 2050. This transition is already experienced in countries like Japan, South Korea and Hong Kong. But other countries in the region are also converging at a fast rate. Fundamental reforms in social and economic policies are now being pursued by most governments in the region to avert the risk that Asia's population will "grow old before growing rich". Such reforms seek to achieve higher levels of income needed to sustain adequate provisions for welfare as the effects of ageing on the workforce and as rising healthcare and pension costs begin to set in.

During this recent two decades, there has also been a discernible shift towards voluntary private provision for healthcare and retirement, including defined contribution pension schemes, given the rapid increase in life expectancy and medical care costs. This trend will become more pronounced as the need to broaden the coverage of welfare is taking place in an environment in which fiscal consolidation is being pursued. As of 2009, the value of private pension funds in 19 OECD countries was almost 50 percent of aggregate national income. Despite this, the IMF estimates that global pension liabilities could be underestimated by up to 50 percent of 2010 GDP. Efforts to close this gap will need to include measures that result in greater risk sharing between governments, pension providers and individuals, the development of capital markets to better support the increasing longevity, and extending the retirement age to be in tandem with the longer life span. While these trends present enormous opportunities for the insurance industry, it also presents the important challenge of building the capacity to support new, larger, more complex and more concentrated risks within a much more compressed timeframe. Risk management, product development and underwriting capabilities will be particularly important at the institutional level while at the system-wide level, closer attention will be needed to enhance the financial safety nets for the protection of policyholders and to avoid economic and social dislocations in the event of large-scale insurance failures. In the advanced economies, the insurance industry built such capacity over four centuries. Asia will have a much shorter time to achieve the same, in order and to ensure that the growth does not outstrip the industry's capacity to manage the associated risks.

This brings me to the second point which relates to the impact that the global financial crisis and the ensuing international regulatory reforms are having on the insurance industry. While insurance companies have generally held up well through the crisis, the industry now finds itself at the intersection of major regulatory developments. The crisis has also delivered a major blow to confidence in financial institutions. This needs to be regained. Both these factors will have an important influence on the way in which the industry responds to new insurance and asset accumulation opportunities in Asia. We can expect that the characteristics of growth in the industry going forward will therefore differ in some respects from the historical experience.

The changes in the capital rules and related accounting standards aim to achieve a more risk-based and market consistent valuations of insurance assets and liabilities. While this should improve understanding and accounting for the risks inherent in insurance business, it will also require insurers to more carefully manage risk and capital, while recognizing the prospect for increased short-term volatility. Going forward, innovations in insurance solutions will also need to take into account the higher regulatory expectations for more transparency, stronger financial buffers against unexpected losses and the requirements to do more to ensure that products offered are suitable to the different customer segments. Regulators will also be applying a much higher level of scrutiny on complex insurance products that increase risks to financial stability. Simplifying insurance products and institutional structures, and creating a strong risk culture in which managing risks is a shared responsibility within institutions, will be important goals to ensure that the risks facing an insurer are well understood and effectively managed.

The third point concerns the far reaching implications of climate change for the insurance industry. This also calls for the industry to pursue a different path from what history has shown in determining the growth strategies for the future. Climate change has been described as one of the biggest risks to the insurance industry. The cost of climate change, without action, is estimated to be at least 5% of global GDP each year, not to mention its significant impact on human society. Some of the effects of climate change are already being felt in increased frequency and severity of weather related natural disasters, water scarcity and crop failures. Asia's exposure to climate change effects is also anticipated to increase. In 2011, Asian countries accounted for 70 percent of 380 billion US dollars in economic losses from natural disasters, however only a quarter of that was insured. The recent floods in Thailand in 2011, was one of the costliest catastrophes in history. As insurance penetration rises across Asia, property insurers will face greater concentration of exposures to natural disasters. Life insurers will also be impacted in other ways, including higher incidences of diseases while also experiencing pressures on long term returns on investment.

The insurance industry therefore needs to be able to manage such exposures as well as act as a catalyst for societies to adapt to such climate change. Risk management systems in particular, needs to be able to capture and aggregate exposures to such event risks in a timely manner. Also important is to incentivise efficient energy use through innovative product design and pricing. In addition, the industry needs to come together to seek out opportunities to partner with government and non-governmental organisations to facilitate improvements in urban planning, infrastructure design and building codes.

The integration of environmental and social considerations in insurers' corporate strategies and operations will clearly become increasingly important to long-term sustainability. This must also include a sustained focus on financial inclusion to achieve balanced and equitable growth. Important is to ensure that all households continue to have meaningful access to financial products and services and that even for those that currently have financial access that they do not become financially excluded especially in an environment where financial products and services are becoming increasingly unaffordable or complex.

It is estimated that up to 4 billion people worldwide require low-cost insurance protection. The low-income population in the Asia-Pacific accounts for about 70% of the global low income population. The need for protection from illnesses, natural disasters and other perils is more acute for this vulnerable segment. Although Asia now accounts for most of the global microinsurance market, covering between 350 to 400 million people the overall participation rate is still low due to liquidity constraints in this segment of households, low financial literacy and business models that are not inclined towards such low-income segments. Innovative solutions and continued efforts to improve financial education will be needed to achieve greater inroads in this area.

The trends that are shaping the socio-economic landscape in East Asia suggest continued positive growth prospects for the insurance industry. This is despite a more modest outlook for the global economy. Indeed, the insurance industry will assume a much larger role in providing the essential financial underpinnings for economic activity and social development in Asia by addressing the wide range of risks that businesses and individuals face in this new and more challenging environment. While historical experience in the development of modern insurance presents a path for the future growth of the insurance industry in East Asia, there are also other important ingredients for sustainable growth going forward. The ability of insurers to internalize the new realities of the business and to execute strategies that are aligned with these realities will provide the strongest assurance for growth with stability as the industry looks ahead to the future. With a clear view of the important role that insurers have in serving and supporting the economy, there is every potential for this to be realised.