Tharman Shanmugaratnam: Challenges and opportunities for the insurance industry

Address by Mr Tharman Shanmugaratnam, Chairman of the Monetary Authority of Singapore, at the International Insurance Society Global Insurance Forum, Singapore, 13 June 2016.

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Mr Michael Morrissey, President & CEO, International Insurance Society

Distinguished delegates

1. Let me first say how pleased we at the MAS are that you have chosen to hold your meeting in Singapore. We are especially humbled by your decision to host the meeting in Singapore in rotation with New York and London, henceforth, so that we meet in Asia, in Singapore, once every three years.

2. It's a challenging time for the insurance industry, and more broadly, for everyone involved in the business of providing assurance in retirement. But it's also a time of opportunity, especially in Asia, where the opportunities for insurance are multiplying. I'll talk a little about the challenges the industry faces before highlighting some opportunities.

Ensuring retirement security

3. The challenges come about for reasons that go well beyond the cyclical forces. We are faced with structural trends around the world, that are making the business of insurance and pension funds and everyone concerned with retirement security more difficult.

4. The principle challenge lies in the ***combination of meeting the needs of societies getting older and living for longer and an environment of low interest rates***.

5. We know the current over-reliance on monetary policy to solve the problems arising from the global financial crisis has had downsides for long term finance, particularly pension funds and insurance funds. The costs and benefits of low or negligible interest rates are being debated, but there is no doubt about the increasing burden they pose for pension and insurance funds.

6. But the problem is not merely to do with current monetary policies, and not fundamentally of a cyclical nature. ***Low real interest rates are very likely here to stay, and for reasons that are essentially structural***.

7. There are ***two main forces*** behind this.

8. The first is ***ageing itself, and its implications for savings behaviour, particularly in today's advanced countries***. A baby boom generation is reaching retirement, and they also expect to live significantly longer than their parents did. They will have to save more, for some time to come, in order to sustain themselves through retirement. Higher savings will in turn mean that a ***continuing surplus of savings over investment globally***, a stubborn gap, and it also means that interest rates over the medium to long term, even after the normalisation of monetary policy, will remain low.

9. This is accentuated by shifts in asset allocation, as the baby boom generation is also likely to allocate more funds to bonds and other fixed income instruments, and gradually reduce holdings of equity. This is a normal 'life cycle' allocation of assets, where people entering retirement seek to reduce the risk in their investments, and aim for some stability in income. This coming shift in asset allocation towards bonds over the medium to long term is itself expected to add to the downward pressure on interest rates.

10. And low interest rates are themselves leading to increases in savings rates, particular among older people. It is debated between economists: whether low interest rates lead to

higher or lower savings. But we are seeing how in some countries, older people responding to low interest rates not by going out and spending more, but by saving more so as to be able to assure themselves of a the level of income that they desire in retirement.

11. So we are in a situation where there are self-reinforcing forces. People are getting older, they expect to live for longer, they are saving more and they are allocating more of their funds to bonds. Interest rates remaining low as a result. Older people saving more as a result of low interest rates. The structural gap between savings and investment remains, in turn keeping interest rates low. ***A self-reinforcing cycle*** that we are going to have to live with for some time to come.

12. There is a second major factor that adds to this, which is ***the slowdown in the underlying growth of economies around the world***. This is happening particularly in the advanced world, but even in the emerging world there has been a slowdown in potential growth. No one can say for sure if this is a permanent state of affairs. There is some debate among economists as to whether the productivity slowdown is a short term or long term phenomenon. But certainly the demographics will still be with us, societies will get older and labour force growth weaker, and economic growth is going to be significantly slower in the next 10 to 20 years than it has been in the past. Investment is unlikely to pick up very significantly in this context, and it does mean taken together with the savings trend, a lower long term real rate of interest in the global economy.

13. So putting the two together – trends in ageing and in economic growth, I think we have to ***live with the fact of low real interest rates for many years to come***.

14. It will pose a challenge for retirement security, and especially for pension funds and insurance funds. As you know, it hits you on both your assets and your liabilities. It means a lower return on your assets. And it pushes up the value of liabilities because the discount rates has gone down.

15. It is not a temporary challenge but a long term challenge. As life expectancy goes up, liabilities will be pushed out further, and the gap in maturity between your liabilities and your assets is likely to grow. This mismatch in durations, together with low interest rates, means we have a growing problem.

16. We cannot address this fundamentally through changes in asset allocation strategy among insurance and pension funds, taken as a whole. There have been recent shifts towards alternative assets. There has been a search for yield, and some funds have seen improvement in their return on their assets. But we have to bear in mind that ***globally, there is a limited supply of quality alternative assets***. Funds are moving into private equity, real estate and some other alternative assets but more money going into these assets doesn't raise yields. It can only mean a lower return on these assets over time. ***The search for yield doesn't raise yields overall, it just redistributes yields among different players***. So there are limits to this strategy for the pension and insurance fund industry as a whole.

17. I should note that the challenge we are talking about in retirement security is not a problem only for the advanced economies. Several emerging economies too are entering a phase where their societies are ageing, and some are quite unprepared for it.

18. Brazil is the most pronounced case, where the unsustainability of its social security system is reaching crisis proportions. Past promises have not been funded, are soon going to have to be funded, and they are not going to be able to fund it. China has also begun ageing. It has a complex system of retirement security, with multiple pension schemes in different provinces and for different groups. But China is in the process of reforms, integrating its systems and seeking to provide adequate coverage for all workers, and I think they will be getting there.

19. Even in ASEAN, Thailand is going to begin ageing before long. And the Asian countries that grew quickly a few decades ago are also entering the ageing phase – societies like Japan, Singapore, Korea, Taiwan and Hong Kong. We don't face quite the same problems as the rest of the world in Singapore – we have a defined contribution pension scheme which doesn't have

the same problems of sustainability. But this is a global challenge. Low interest rates and societies that are ageing and fortunately living longer will pose challenges to retirement security everywhere.

20. Globally, therefore, we need fundamental reforms. We can't fix the problem through investment strategies, certainly can't fix it by monetary policies. It needs fundamental reforms.

21. First, we have to enable people to work for long than they used to, in virtually every society that's getting older, and ***make it attractive for older people to work***. Fortunately, each new generation of people entering their senior years is also healthier. But in a situation where we are going to have much longer lives, it is critical that we have the ability to earn a living and to save money over more years, so as to provide security and assurance through our retirement years.

22. It's true everywhere in the world. Some countries have already recognised it through legislation. Denmark is a good example, of having linked their retirement age and pension age to life expectancy. Sweden intends to follow. Several other countries are considering the same thing.

23. But it is ***not just about pushing back the retirement age or pension age. It is critical that we make it attractive for older citizens to work***. That means not just providing jobs but rearranging the work place so that it becomes part of the culture to have older persons, experienced persons, in the team, in the work place. The ***culture of the work place*** has to change and the culture of the consumers has to change in a whole range of industries so as to accept and celebrate the presence of older persons at work.

24. So that's one important reform over the next 10 to 15 years – enabling older persons to work for longer, it may be ***full time or part time***, but make it attractive to work.

25. The second important reform concerns the financial industry. We have to ***reduce the costs that ordinary savers face in saving for the retirement***.

26. There has over the last 30 years been a shift in the pensions industry towards defined contribution schemes – away from defined benefit schemes, because of the latter's unsustainability. But this shift towards defined contribution schemes has also led to a fragmented market place in many countries, and one where responsibility is placed on the individual to manage his or her funds and take on the risks. It is also by and large a landscape of funds that actively manage investments, rather than passively. So it's a ***fragmented marketplace, people have to choose between different funds to invest in and take their own risks, and the funds are largely actively managed***. It's the case in the US, several countries in Europe, and in the UK and Australia, for example. That combination of factors, particularly the fragmentation of the pensions market and active management, ***has meant higher costs*** than are sustainable in the long term.

27. The solution has to be ***greater pooling of funds and a greater reliance on passive investment management***. Active management is not all it has been cracked up to be: it has not proven its worth for most ordinary savers preparing for their retirement. We do have to move towards a system, in a whole range of countries, of helping people save for the long term through passive investment funds, and pool savings to avoid fragmentation and excessive marketing costs. The savings in fees and charges matters:

- If we can take one percentage point out of the fees and charges that ordinary savers pay in many market-based pension schemes, that one percentage point makes a large difference in retirement savings. Taken over a lifetime of work, that one percentage point will mean at least a 25% improvement in retirement savings.
- In a whole range of countries, the experience has been that it has been difficult for people to manage their own funds. They don't make the right investment decisions. We have to think hard about the reforms that pool and collectivise savings, to reduce the costs for ordinary savers.

28. A third challenge has to do with ***reforming healthcare systems***. The advances in healthcare have been remarkable and that's largely why people are able to live for much longer than we used to. We are living healthier lives. But by and large, in a whole range of countries, we have extremely inefficient healthcare systems. Too much treatment takes place in hospitals rather than in primary care or in the community. And it is also a system where subsidies have been dispensed on an untargeted basis in many countries. The system is not sustainable and is going to take up a lot of resources in the future: both private and public resources that could otherwise be used to strengthen retirement adequacy and incomes. This is an important challenge, not just for sake of healthcare, but for the sake of retirement security. ***We need to move towards a fair, progressive and sustainable healthcare financing systems. If we don't, then our ability to afford decent retirement for all our citizens, in a whole range of countries, is going to be severely compromised.***

Emerging opportunities for insurance

29. Let me move now to some of the emerging opportunities in the insurance industry. It is a difficult environment in many respects – I've spoken about low interest rates, here to stay for the long term. It's also a crowded market in traditional insurable risks. You know that better than me. Too much capital is chasing after the same risks in traditional insurance lines (property and casualty for instance), and that doesn't help returns.

30. But there are still many viable options for growth, and here in emerging Asia especially, there are major new underwriting opportunities.

- The insurance market in emerging Asia is projected to grow by 9% per year over the next 10 years, which is substantially above the global growth of the insurance industry.
- By 2020, Asia is expected to account for 40% of the insurance business.

31. There are three major opportunities that I will highlight briefly, besides traditional underwriting opportunities.

Infrastructure financing

32. First, infrastructure financing. It is a huge opportunity in Asia. Whichever infrastructure you look at – transportation, communication and power links, water and environmental sustainability – in every area the needs are growing, the need to remove bottlenecks to economic growth and social development are growing.

33. Traditionally, it has been a sector that has been financed by governments and banks. Governments will be constrained in the future, across the region. Although banks currently have ample liquidity, they too will over time become more constrained. So that combination of governments and banks isn't going to be able to cope with the rapid growth in financing for infrastructure in the future.

- This is why institutional investors – insurers, pension funds and other long term investors – have become very important. For insurers, infrastructure is an attractive asset class. It is attractive as a potential diversifier of assets, and has the potential to provide reliable inflation-linked returns over time, and with low correlation to other conventional assets.

34. But we need quality data for infrastructure to take off as an asset class for long term investors. We need quality data for reliable performance benchmarks to be constructed, and to allow long term investors to perform asset allocation on a reasonably reliable basis. That quality data doesn't yet exist but it is being put together by the EDHEC Infrastructure Institute in Singapore. By the end of this year they expect to have usable performance benchmarks, including for unlisted infrastructure debt and equity. The data has not been transparent, especially for privately-held investments, it has not been put together, and this is what EDHEC

is doing. So that’s one dimension of it. Getting the data together to allow institutional investors to allocate a desired portion of funds to infrastructure as an asset class.

35. Second, the ***regulatory treatment for insurers has to evolve so as to make possible long term investments, including infrastructure investment***. Some rethinking is already underway globally on the design of capital frameworks for insurers. It has to be aimed first of all at ensuring that individual insurers are on a sound prudential footing, not just for the short term but for the long term. It should also support efforts to ensure that our economies are able to grow and to remain healthy, which is also in the interests of every player. This means we have to support long term investment.

- The European regulators are already in close consultation with the industry, on providing some measure of capital relief for long term investments. Globally too we have to do this. We need ***lower risk charges for equity held by insurers for the long term, including infrastructure***. I hope globally regulators will arrive at an understanding that makes this possible.
- Here in Singapore, MAS is engaging closely with the industry in this regard. We will be having another round of ***public consultation at the end of this month*** on our risk-based capital framework for insurers (or “RBC 2”). The aim is to finalise our proposals for providing capital relief for long-term assets which match the cash flows of the liabilities. We will also be raising questions, as part of this review, on the merit of having a different set of risk charges for infrastructure in particular.

Catastrophe insurance

36. The second major opportunity is in catastrophe insurance. The economic cost of natural disasters is growing. It’s certainly growing here in Asia, a consequence partly of economic growth itself, a consequence of urbanisation and the growing concentration of wealth in cities in Asia, and a consequence of a higher incidence of natural disasters.

- Lloyd’s has estimated that even a modest an increase in penetration rates for catastrophe will allow for a large reduction in the economic costs that are being borne by governments and local communities in Asia.

37. So far the take-up of catastrophe insurance in Asia has been woefully low. Part of the reason has to do with a lack of insurance awareness among businesses around the region. But it also has to do with data gaps – the industry needs good data on the frequency, location and economic impact of natural disasters, so that insurers and reinsurers can price risks adequately. So we have had a limited supply of insurance coverage, that has itself led to higher cost of protection, which in turn discourages demand for insurance against catastrophe risks.

38. But we can solve this problem. We can overcome the fragmentation of data in Asia, pool data so as to facilitate more efficient underwriting of catastrophe risks. Here too, we have an initiative in Singapore called the Natural Catastrophe Data Analytics Exchange (Nat Cat DAX).

- Nat Cat DAX is a public-private partnership, involving several leading global insurers, the public sector and our research institutes;
- It is using high resolution data obtained through remote sensing technologies – from satellites, drones and UAVs – and combining that with industry data to much richer database on natural disasters;
- We welcome more in the industry to join the founding members in this initiative.

Cyber insurance

39. The third major, emerging opportunity is in cyber insurance. The good news is that Asia is the most rapidly growing digital market globally. But it also means increasing costs of cyber attacks. This is a global problem, and we face it here in Asia. The frequency, sophistication

and the sheer audacity of cyber-attacks is growing. It will pose huge costs to our economies, and to corporate and personal privacy.

40. The demand for protection will grow, not just the need to insure against losses but also the demand from businesses who wish to strengthen their resilience and to recover more quickly from security breaches.

41. But the market needs development. It's still in its infancy. We have to increase awareness of the importance of insurance in dealing with cyber risk. Again, however, the data needed for efficient underwriting of risk is weak. We need to ***strengthen collaboration between the industry, government and academia*** to build reliable databases and analytical tools to enable the efficient underwriting of cyber risk.

- We have set up the Cyber Risk Management Project in Singapore. It was launched recently, involving the Nanyang Technological University's (NTU)'s Insurance Risk and Finance Research Centre (NTU-IRFRC), and supported by leading industry players and the Cyber Security Agency (CSA) in Singapore.

Conclusion

42. It is, to conclude, a difficult and challenging environment for insurers globally. We have to live with a low interest rate environment for a long time to come, even as our societies are getting older. It's a challenge for everyone in the retirement business, including insurers. We have to find ways to make savings for affordable for ordinary savers as they prepare for their retirement.

43. But we also have to meet new opportunities in the insurance industry. Asia is growing in every segment of the insurance business, but I want to highlight the importance of infrastructure financing as an opportunity for insurers, as a way in which you can play a useful role in the economic growth of the region. I also want to highlight the criticality of catastrophe insurance and cyber insurance. Public-private collaboration is the way to go in all these areas and I'm glad we are off to a good footing in our relationship with industry leaders, and in tying together collaborations with the academia and research institutions. When we next meet three years from now in Singapore, we should be in a slightly better place.