Jacqueline Loh: Re-thinking investment strategies for growth

Keynote address by Ms Jacqueline Loh, Deputy Managing Director of the Monetary Authority of Singapore, at the Asia Investment Management Summit, 25 November 2013.

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Distinguished guests, ladies and gentlemen, a very good morning to all of you.

1. The global economic recovery remains uneven and fragile, five years after Lehman's collapse. While there have been some encouraging signs over the past year, with stronger jobs growth and the housing recovery in the US and the Euro area economies stepping out of the recession zone, there continues to be heavy reliance on extraordinarily loose monetary policy and low interest rates for life support.

2. Lean economic growth since the onset of the Global Financial Crisis, beset by bouts of heightened volatility, present a challenging environment for investment managers. For the insurance industry, higher payouts following natural disasters pose additional difficulties. Five of the ten costliest natural disasters, in terms of money rather than lives, occured in the past five years.[1]

3. As a result of economic, financial and environmental systems coming under stress at the same time, insurance companies are now operating in extremely trying conditions. Specifically, ***insurers' profitability is under pressure simultaneously from all 3 sources***:

a. ***Firstly premium income***, which is correlated to weak economic growth and excess capacity;

b. ***Secondly investment income***, amidst a low yield environment and higher market volatility; and

c. ***And thirdly, claims and expenses***, given increasing claims for natural catastrophes.

4. In light of this unprecedented mix of challenges, the insurance industry is responding as follows:

a. ***Firstly, focusing more on improving underwriting profitability. Against a backdrop of low yields***, insurers can no longer rely on investment income to compensate for poor underwriting results. Insurers now recognize the need to strengthen their underwriting capabilities, in order to improve underwriting profitability. Following the spate of natural catastrophes in Asia-Pacific in 2011 for instance, many insurers have imposed more stringent underwriting and risk controls such as event limits and policy exclusions. Steps have also been taken to close data and risk modelling gaps, which will enable more accurate measurement and in turn, better management of risk exposures.

b. ***Second, optimizing investment and product portfolios***. For in-force businesses for which policy terms cannot be changed, insurers are primarily seeking to optimize their investment and hedging strategies. For new products and policy renewals, insurers are also looking to re-price their policies or adjust guarantee levels.

c. ***And third, enhancing operational efficiency***. Apart from improving premium and investment income, insurance companies are also streamlining processes to lower operational and claims expenses.

[1] Economist, Jan 14, 2012, citing Munich Re's numbers. Adjusted for inflation. RMD adjusted for Hurricane Sandy (Oct 2012) to Munich Re's numbers.

5. Going forward, there is no doubt that ***a longer-term and more sustainable approach is needed to achieve long-term profitability.*** In keeping with the conference theme of "Seeking Better Returns in the Current Volatile Climate" – I would like to ***discuss the investment challenges facing insurers***, as well as ***share my observations on key issues that insurance companies would need to address in this new investment landscape.***

6. This is important because as many of you know, insurers operate in a multi-stakeholder environment. They need to first offer competitive products to policyholders to meet their needs, maintain adequate capital to meet regulatory requirements, as well as provide adequate shareholder returns. The insurance industry's targeted return corridor to policyholders can be at least 3–5%[2] in order to maintain bonus payouts for participating policies; whilst the ROE to shareholders have typically ranged between 10%–15%[3]. In the case of life insurers, in particular, for which investment returns is a key source of income given their focus on long-term and guaranteed savings products, lower returns will strain the ***ability to meet both policyholders' and shareholders' expectations.*** Some insurers have ventured to forecast that a 10% ROE for the industry will be a "best-case scenario", with many more calling for the industry to be more realistic about its return expectations from their investment portfolios.

Challenging investment landscape

7. Let me first discuss the investment headwinds facing insurers. Specifically, there are 3 key challenges that are driving insurers to undergo a fundamental rethink of their investment approach:

a. One, lower returns in the new normal;

b. Two, lack of long duration assets; and

c. Three, regulatory reforms.

Lower returns in the new normal

8. First, lower returns in the new normal. There has been increasing acceptance that the era of low yields is not just a cyclical phenomenon, but is in fact the New Normal. In advanced economies, policymakers are faced with conflicting challenges as they seek to maximise economic growth on the one hand; while having to pursue fiscal consolidation and financial sector reform on the other. Meanwhile, emerging economies will grapple with tighter financial conditions and by implication, slowing growth when unconventional monetary policies are unwound. The outlook is highly uncertain as the normal cyclical recovery template cannot be applied to structural deleveraging episodes such as the one we are currently in. Although bond yields are expected to rise from their current low levels, it is likely that insurers will have to settle for much lower returns from fixed income investing in the years ahead than that achieved in the pre-crisis period. Over the next 20 years, the slowing demographic outlook for the world will also exert pressure on economic growth and lower the expected returns for most asset classes.

Shortage of long duration assets

9. Next, a shortage of long duration assets. Asia has often been singled out as the bright spot in the global insurance industry, as rising incomes and lower than average

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[2] Allianz Global Investors estimates.

[3] OECD Global Insurance Statistics.

insurance penetration in many markets offer rosy opportunities for growth. However, in terms of seeking investment returns, Asian insurers are operating within similar market trends as their global counterparts. To illustrate, long-term government bond yields in the US and Euro area have declined an average of 200 to 300 bps compared to the 10-year average prevailing before the Global Financial Crisis. In Asia, long-term government bond yields are, on average, 50 to 300bps lower than pre-crisis levels. Asian insurers also have to face increasing costs of capital[4], compounding the pressure to generate higher returns.

10. Addressing the duration mismatch between assets and liabilities has been a persistent challenge for insurers in Asia, due to a shortage of long-dated instruments as well as restrictions on investments in some jurisdictions. A number of governments in Asia, including Korea, Taiwan, China and Singapore, have responded by issuing long-dated bonds; and easing restrictions on specific assets classes that insurers can hold. Notwithstanding this, the supply of high quality government and corporate bonds remains limited relative to the strong demand from a wide spectrum of investors for these "safe haven" assets, such that insurers can be crowded out.

Regulatory reforms

11. Finally, let me touch on the oncoming regulatory reforms, such as Solvency II, which will also play a significant role in shaping insurers' investment strategies. Almost 80% of the respondents to a recent Goldman Sachs survey listed regulatory capital treatment as the predominant non-market related concern.

12. Insurance regulatory reforms are converging towards a principles-based and fair value approach for the total balance sheet. This will enable a more accurate assessment of an insurer's financial and capital strength, even in times of stress. However, this can increase volatility in an insurers' balance sheet, and raise overall risk charges and capital requirements on long-term assets. In order not to disincentivise insurers from investing in longer maturity instruments, it is therefore critical for regulators to continue to calibrate their solvency regimes carefully. We do note however, that some regulators have or are introducing into their capital frameworks, mechanisms to smooth out the effects of market volatility, such as the illiquidity premium in Australia and the matching adjustment & volatility balancer in Europe. These mechanisms recognize the long term and illiquid nature of insurance liabilities, where insurers are able to hold assets to maturity.

Increasing Importance of Risk Management

13. So let me now move on to talk about the increasing importance of risk management in these challenging times. The forces I have mentioned earlier, have triggered an investment mindset shift, particularly in the last 6 to 12 months amongst insurers – from conservative asset allocation strategies and matching of liabilities – to reaching for yield.

14. In their search for returns, many Asian insurers are investing more tactically across asset classes and diversifying their fixed income portfolios. In addition, many are thinking outside the low yield box and considering an extension of the investment universe parameter. This would encompass non-traditional asset classes, such as emerging markets, infrastructure, trade finance, structured credit, and alternatives such as hedge funds, real estate and private equity. In the alternatives space alone, the average allocation by insurance companies, as a percentage of their assets under management, has in fact already increased from 10% to 15% between 2011 and 2013[5].

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4 "Asian Insurers: Adapting Investment Strategies to a Changing World", BlackRock in conjunction with the Economist Intelligence Unit, Sep 2013.

5 Preqin's 2013 Global Alternatives Report.

15. A recent Goldman Sachs Insurance Asset Management survey reports that nearly half of Asian insurers are looking to raise their allocation to higher yielding assets. Like expected returns, risks – market, credit, liquidity, and legal to name a few – from investing in these newer asset classes will also be higher. There is no free lunch. Insurers' risk profiles will be distributed across a wider and more complex spectrum of asset classes. This will call for more sophisticated and robust management of individual investment risks, as well as the correlation between the range of investment risks within a more diversified and complex portfolio.

16. The risk management deficiencies highlighted by the global financial crisis and recent tail events, have raised the bar in all areas of risk management. As a result, risk management has now been elevated from a mere control function under the responsibility of the Chief Risk Officer, to a strategic role that comes under the direct oversight of the insurer's Board and senior management.

17. Similarly, the investment decision is not an isolated one, but one that has to be made in view of the firm's overall business goals, business strategies, capital needs, liabilities structure and risk appetite. Insurers would gain from establishing a robust Enterprise Risk Management (ERM) framework to manage these factors holistically. Good execution on this front will entail close coordination and communication between the investment function and other key functions, including actuarial, risk and finance, to ensure that dynamic trends on both investment assets and insurance liabilities, as well as the resulting impact on earnings and balance sheet volatility, continues to be monitored and managed dynamically.

Asia driving global insurance growth

18. ***The ability to manage investment risks skillfully is even more essential in the Asian context, due to its rapidly growing share of insurance business and attendant risk exposures.***

19. Over the next decade, Asia will continue to rise in importance in the global insurance arena. Munich Re for example, estimates that Asian premiums can register healthy growth of about 8% per annum, and account for almost 40%[6] of global premiums by 2020. This is underpinned by positive structural factors such as a growing middle-class and rising affluence, aging demographics, and the continued industrialisation, trade and infrastructure development in emerging Asia.

20. In particular, I would like to focus now on how insurers can play a long-term role in Asian society and economies in two pertinent areas: one, financing Asia's retirement funding gap; and two, financing Asia's long-term investment needs.

Financing Asia's retirement funding gap

21. Firstly, financing Asia's retirement funding gap. Asia is experiencing declining fertility rates, increasing life expectancy, and a rapidly aging population. Between 2011 and 2030, Asia's share of population aged 60 and above will increase from 40% to almost 50%, compared to the global average of 20%[7]. At the same time, public retirement and pension systems remain inadequate, and the retirement funding gap is estimated to be up to 13 years of retirement savings[8]. Insurers can play a pivotal role in financing individuals' retirement security through pension, annuity and saving products, complementing public pensions.

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6 Source: Munich Re Study on Asia-Pacific Insurance Market 2020 (March 2012).

7 "Financing Social Protection in Developing Asia: Now and In the Future", NUS, 27 May 2013.

8 2013 Manulife Investor Sentiment Survey.

22. Insurers in Asia stand to benefit from robust premium growth on the one hand; but will also be subject to greater volatility from fluctuations in the economic and financial market cycles on the other. The low-interest rate environment is likely to magnify the present value of future increases in longevity, which will in turn, affect the solvency position of annuity providers and pension funds. While this can have unintended consequences on insurers' role in supporting retirement adequacy, it can provide the impetus for product innovation and alignment with the new investment and regulatory climate. Indeed, insurers have begun to redesign their products such that interest rate risks remain manageable; while offering guarantees that are valuable to policyholders at the same time.

Financing Asia's long-term growth

23. Next, financing Asia's long-term growth. Insurers are one of the world's largest institutional investors, managing almost $25 trillion or a third of the world's professionally managed assets[9]. Due to the nature of their liabilities, insurers are an ideal source of long-term funding to finance economic growth. They have the ability to invest in long-term and less liquid assets, such as infrastructure investments and clean energy. This role has never been more critical; at a time when banking regulatory reforms have crimped banks' appetite and ability to play a long-term financing role. We are already seeing encouraging signs of insurers collaborating with banks to provide debt financing for infrastructure projects together. Allianz, Ageas and Swiss Re are just a few examples of insurance companies which have explored such moves. Zurich Insurance Group also recently made its single largest investment in green bonds, which fund projects that help mitigate climate change in local communities.

Singapore – a key hub to capture Asian premiums and intermediate global-Asia investments

24. Singapore is now recognized as the leading insurance hub in Asia-Pacific. We are home to many top global insurance players, and an ecosystem comprising a strong brokers' cluster, the largest captive community in Asia Pacific, a growing cluster of specialty players and the largest grouping of Lloyd's syndicates outside of London. This ecosystem is self-reinforcing, creating a strong "clustering" effect that has been a key growth driver for Singapore's insurance market.

25. As Singapore continues to develop itself as a global insurance market with the ability to write not just Asian risks but global risks, many insurers are also making plans to set-up their fund management arms to manage their growing investment portfolios in the region. In addition to honing investment skills, there is also a general consensus on the need to strengthen internal risk management expertise, as well as deepen data and modeling capabilities, so as to attain a strong understanding of local market risks. To better manage the risks of more complex products, as well as aggregate portfolio risks, many are also increasingly leveraging on the external expertise of the sell-side bank and capital market players, as well as fund managers in Singapore.

26. Singapore is also highly committed to research and development, and is establishing itself as an innovation centre of excellence. To respond to the challenges of an ageing Asia, it is imperative for Singapore to be at the forefront and lead the development of retirement financing solutions for individuals, businesses and governments in Asia. Research is an upstream activity preceding product development. To differentiate yourselves through innovation, we would strongly encourage the industry to continue to conduct Asian-focused retirement security research in collaboration with research institutes in Singapore, such as

[9] 2009 OECD and IMF estimates.

the SMU Centre for Silver Security and EDHEC Risk Institute-Asia. The SMU Centre for Silver Security for instance, is conducting applied research on financial products and markets for the silver industry, which would allow insurers to develop and commercialise products for the at-retirement market.

Conclusion

27. Let me conclude. The insurance industry will encounter significant headwinds in the years ahead. I understand that the conference speakers will be touching on many pertinent topics, including the macroeconomic outlook and investment implications, asset allocation strategies in a world of low bond yields, and whether there is a right level of asset risks that insurers should assume.

28. The inaugural Asia Investment Management Summit for insurers, organized by Asia Insurance Review here in Singapore, is very timely. It will be an extremely useful platform for all stakeholders to engage in constructive dialogue on how we can navigate the current environment successfully. On this note, I wish all of you a rewarding and fruitful conference. Thank you.