The Next Phase: Long-Term Implications for APAC Insurers from Lower-for-Longer Rates

Impact of Lower Interest Rates Exacerbated by Asset/Liability Duration Mismatches

> "Lower-for-longer interest rates will pressure insurers' credit profiles in the medium to long term, with the impact dependent on existing product mixes and investment portfolios."
>
> Kanishka de Silva, Fitch Ratings

Lower-for-longer interest rates have a number of implications for the financial profiles of Asia-Pacific (APAC) insurers, including for earnings, investments and capital. They may also prompt changes to insurers' business profiles, with the overall impact dependent on existing product mixes and investment portfolios.

Impact Varies by Business Line

Fitch Ratings expects the low-interest-rate environment to have the largest consequences for life insurers with long-term guaranteed business, exacerbated by asset/liability duration mismatches stemming from a lack of long-dated bonds in the APAC region.

Conversely, non-life insurers with short-tail classes, such as motor, are likely to be the least affected. The impact on non-life insurers and reinsurers with long-tailed business will hinge on their ability to reprice over time, subject to competitive pressure. Earnings for all insurers will be affected by a weak investment outlook.

Higher Investment Risk Taking

We believe insurers will take on more investment risk to offset the effect of low rates on returns. Holdings of equities, real estate, lower-quality fixed-income securities and alternative investments may rise. Insurers in some APAC markets, such as Japan and Taiwan, have been coping with low interest rates for some time, and have increased allocations to foreign bonds in search of yield.

Insurers with riskier portfolios, notably in emerging markets, may have little rating headroom to further increase risky investments.

Focus on Underwriting Profitability

We think underwriting profits will become more important across all lines as investment returns dwindle. Insurers will focus on lowering loss ratios through price increases and cutting expense ratios by streamlining operations.

Insurers' ability to achieve meaningful price increases will be subject to competitive pressure. Premium affordability will also be a key consideration, especially in light of the economic weakness brought about by the coronavirus pandemic in some APAC markets.

Products Likely to be Revisited

We believe insurers will shift towards products that are more attractive under a long-term low-interest-rate environment. Life insurers are likely to shift away from products with high guarantees in favour of more profitable protection-type products. Non-life insurers' long-tail business classes are also likely to be repriced to compensate for lower investment returns.

Related Research

The Next Phase: Megatrends and Financial Institutions' Ratings (November 2020)

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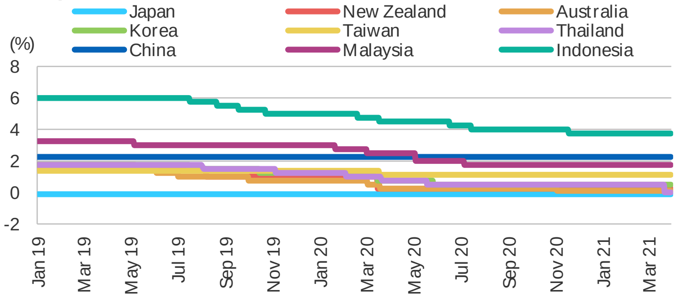
Pandemic Spurs Rate Cuts

The pandemic-driven economic fallout has induced supportive central bank policy in APAC markets. This has caused market rates to fall and has created the expectation that the low market interest-rate environment will be prolonged. Government bond yields have picked up recently, following a rise in US bond yields, although they remain below pre-pandemic levels.

Policy Rates in APAC markets



Source: Fitch Ratings, central banks

Product and Investment Mix Drives Impact

Life insurers in Japan and Korea are exposed to interest-rate risk due to past sales of products with long-term investment guarantees. Some insurers in Japan still have wide asset/liability duration mismatches, while those in Korea have reduced the gap by sufficiently investing in long-dated bonds. We believe further pressure is limited for Japanese insurers, as policy rates have been negative since 2016. The shift towards profitable protection-type business and sustained mortality gains have also offset pressure from low interest rates for insurers in both countries.

Insurers in developed markets, such as Japan, Taiwan and Korea, and emerging markets, such as China and Sri Lanka, have high risky asset exposures. Investment and asset risks carry a moderate- to high-influence in our assessment of most insurer's ratings in these countries, and also have implications on our assessment of capitalisation via the Fitch Prism Model scores. Further material increases in risk taking in search of yield due to the low interest rate environment could pressure their investment risk profiles.

Life Insurers Look to More Profitable Products

We believe life insurers with large long-term investment guarantees, which are mostly found in legacy products, will be the most challenged by the low interest rates. These insurers face substantial re-investment risk, as the average yield on investments will fall faster than the average guarantee on liabilities due to existing asset/liability duration mismatches. Overall profitability is likely to be supressed by higher reserving and lower investment returns.

In response, life insurers in some markets have been moving away from products with high guarantees to more profitable protection or capital-light unit-linked products. We think this will support insurers' business profiles in the medium to long term.

Japan's life insurance industry has experienced a negative spread burden for some time, but has enjoyed a positive spread since 2016 as the average guaranteed yield has kept falling. However, several Japanese life insurers still face a negative spread burden.

Japanese life insurers have stayed away from Japanese-yen denominated saving-type products due to the ultra-low interest rates and have moved towards US-dollar and Australian-dollar denominated products. However, these products have also fallen out of favour due to declining foreign-bond yields. Japanese insurers are now focusing on more profitable, shorter-duration protection-type products, which are relatively capital efficient.

Major life insurers in Korea are facing a negative spread burden as investment yields trend down due to legacy products; these were mainly sold in the 1990's and have high guarantee rates of more than 6%. Korean insurers are also shifting to products with higher value-of-new-business margins, such as protection-type products.

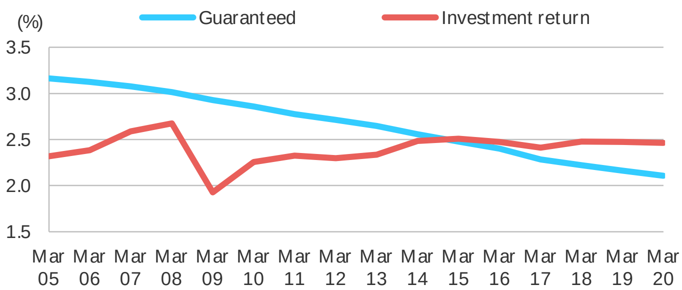
The China Banking and Insurance Regulatory Commission caps the maximum guarantee Chinese life insurers can provide on participating and universal life products to 2.5%-3.0%. The 10-year government bond yield has remained above 3.0%, but most Chinese insurers are subject to asset/liability duration mismatch risk, because of the lack of supply of long-dated bonds.

Unlike health insurance policies in many developed markets, Chinese policies mostly carry saving features, which are sensitive to interest rates. Some major insurers are developing pure protection-type long-term medical insurance products to meet rising demand while reducing exposure to interest-rate risk.

Australia's life insurance industry has avoided the problems associated with high guarantees and negative spreads, as the investment component is unbundled from the insurance component within Australian superannuation products. The investment business is mostly unit-linked, with the risk largely transferred to policyholders, and is typically less capital intensive. Unit-linked business is also popular in Indonesia and has been rising in Taiwan amid the low-interest-rate environment.

However, the share of unit-linked business in most major APAC markets has generally been low due to weak demand, thin margins for insurers and regulatory reasons. Under these structures insurers earn a fee based on the funds under management, and fund flows can be volatile, depending on financial market performance.

Japan - Gap Between Guaranteed Interest and Investment Return



Source: Fitch Ratings, Companies

Reserve Strengthening; Better Underwriting Discipline

Lower-for-longer interest rates are likely to lead non-life insurers with long-tailed business classes to strengthen reserves, as investment income will be insufficient to fund future claim payments. Insurers typically invest in long-dated bonds to back long-tail insurance liabilities. However, inappropriate reserve releases to boost short-term performance amid falling investment income remains a risk. Ensuring premiums are sufficient to meet future claims is key to maintaining profitability.

We expect non-life insurers to focus on underwriting profitability to compensate for the weaker investment outlook. Insurers are likely to take advantage of the hardening insurance market and increase premiums to improve loss ratios. However, this will be subject to competitive pressure.

The ability to meaningfully pass on rate hikes will also be subject to premium affordability, especially in personal-line businesses, where claim inflation has been picking up. Soft economic activity in some APAC markets compared with pre-pandemic levels is likely to have weakened consumer affordability.

We also believe the weak investment outlook will hasten insurers' efforts to cut operational costs. APAC insurers have been adopting digital distribution channels and automating claim handling processes to lower costs. These initiatives will also help sustain competitiveness.

Investment Shift Towards Riskier Assets

We think insurers may increase their holdings of risker assets, such as equities, real estate, below-investment-grade fixed-income securities and alternative investments, to compensate for lower investment income. However, those with already-high risky asset exposures, especially in emerging markets where the supply of high-quality fixed-income securities is limited, will have limited rating headroom to further increase risky-asset exposure.

At the same time, insurers' investment decisions are likely to be influenced by internal risk-appetite frameworks and regulatory-capital requirements, especially if these are strict. For example, Australian insurers tend to have conservative portfolios, partly due to higher capital requirements for riskier investments and greater availability of high-quality fixed-income securities.

Some regulators in APAC have recently loosened investment restrictions. For example, the Thai regulator has amended certain investment rules to allow higher investment yields and to diversify investment risk. The changes, made in January 2020, include a higher allowable allocation to foreign assets and property funds as well as relaxed hedging requirements for capital considerations.

Taiwan's regulator now permits insurers to invest in unlisted or over-the-counter international bonds that are privately placed by foreign-listed companies and in sukuk certificates issued by foreign issuers that are sold exclusively to professional investors. At the same time, risk management has been strengthened by requiring insurers to manage their fixed-income investments based on the credit ratings on the issue, rather than the issuer, which aligns with international practice.

The China Banking and Insurance Regulatory Commission also eased restrictions on Chinese insurers' equity-type investments in 2020, encouraging a higher allocation to equities, depending on insurers' solvency and asset-liability management capabilities. We think life insurers in China are likely to increase their equity investments, including in hybrid funds and equity-type non-standard assets, which generate higher dividend returns than bond yields.

However, a higher allocation to equities and real estate is not likely to help insurers bridge asset/liability duration mismatches, as such assets are difficult to match against longer-term interest-sensitive liabilities compared with traditional fixed-income assets.

At the same time, the volatility in equity markets in 2020 and recent corporate-bond defaults in China, including two bonds issues by state-owned enterprises, underscore the risks that such investments pose to insurers.

Low Rates Prompt Overseas Investment

Insurers in certain APAC markets have been diversifying their investment portfolio due to low interest rates that have prevailed long before the pandemic. They have looked to investments in overseas markets in search of yield and to better match the duration of assets and liabilities. However, this has exposed the insurers to currency risk and has made adequate hedging and associated costs a key consideration.

Japanese life insurers maintain a large allocation to foreign bonds; we expect this allocation to remain steady in the near-term due to currency-hedging costs, which have recently fallen. Some life insurers are increasing credit risks, as sovereign bonds, which traditionally have been a favoured investment, are less attractive due to the low interest rates.

Korean insurers are attracted to long-term foreign bonds to better match their asset/liability durations and have also increased their allocation to overseas alternative investments in search of yield.

Life insurers in Taiwan have increased the portion of foreign investments to more than 60% since 2016, from 30% in 2008, as foreign fixed-income securities have offered higher yield pick-ups, despite the currency mismatch.

Increased Regulatory Scrutiny

The low-interest-rate environment has implications for insurers' regulatory capital positions, a risk that is exacerbated by existing asset/liability mismatches. We expect liability valuations to increase due to lower discount rates and believe regulators are likely to ramp up supervision to ensure insurers have adequate governance practices amid the low-rate conditions.

We believe Japanese life insurers will continue to strengthen capital in preparation for new standards that come in 2025. These will have a greater impact on their operations than on non-life insurers, as life insurers have limited options to improve the duration mismatch between assets and liabilities under the low-interest-rate environment.

Korea's regulator has strengthened the country's risk-based capital framework to reduce the impact of the new solvency regime, K-ICS, to be introduced in 2023. Changes include the full recognition of credit and market risk charges for guaranteed retirement pensions and a higher capital requirement to be held against interest-rate risk arising from variable-rate products that provide minimum guaranteed returns to policyholders.

At the same time, the recent introduction of 'coinsurance' in Korea offers the possibility of reducing interest-rate risk in the regulatory capital requirement. Coinsurance allows an insurer to transfer an entire block of risk to reinsures, as opposed to transferring only insurance risk under traditional reinsurance.

The Reserve Bank of New Zealand has imposed additional licensing conditions on some life insurers that are exposed to falling interest rates, requiring them to hold extra capital buffers.

Taiwan's regulator, since late 2018, has required declared rates on variable-rate policies to reference the monthly average investment return in the past two years before the month of declaration, as opposed to the past one year previously. This is to bring more stability to declared rates in light of the higher volatility of investment returns after the adoption of IFRS 9.

Meanwhile, Hong Kong's insurance regulator now permits insurers to use a variable discount rate that is weighted more on the historical average to calculate the required margin in the regulatory solvency calculation.

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