Preparing for change in the Hong Kong life insurance market

Innovative savings and protection product developments in response to changing RBC/regulatory regimes

Appointed Actuaries Symposium

Michael Thomas, RGA, Executive Director, Global Financial Solutions (Asia)
Simon Pang, RGA, Head of Business Development, Hong Kong Market

8 November 2016
- I’d build a stronger RBC for a new day

- Because it is time for a better bargain

- To make RBC go away, I’d just change my hairstyle

- I’d build a great RBC – and nobody builds RBC’s better than me – and I’ll build it very inexpensively

- It’s freezing and snowing in New York – we need global warming and we need RBC

- You know, it really doesn’t matter what RBC looks like so long as you’ve got a young beautiful piece of ***
Agenda

1. Introduction to Risk-Based Capital
2. Overview of the Hong Kong Life Insurance Market
3. Experience from Other Markets
4. How to Prepare for a Good Outcome
5. Product Ideas and Innovations from around the Region
Introduction to Risk-Based Capital
Introduction to Risk-Based Capital

Background – Global Supervisory Trend

• The Insurance Authority (IA) of Hong Kong SAR is a member of the International Association of Insurance Supervisors (IAIS), committed to adopting of the Insurance Core Principles (ICPs)

• ICP’s (updated November 2015) cover a wide range of supervisory activities – not just reserving / capital but also ranging from supervision powers, governance, sales practices, controls, conduct, disclosure, financial crime, etc

• RBC is one of the limbs of the framework promulgated by IAIS

• Hong Kong supervision is currently in transition from the Office of the Commissioner of Insurance (OCI) to the Insurance Authority

• While handover is occurring, timing of implementation remains uncertain
Introduction to Risk-Based Capital

What Does the Framework Look Like?

**Pillar 1 (Quantitative)**

**Capital adequacy – Total Balance Sheet**
- Thresholds – Prescribed Level / Minimum Level
- Standardised Approach (initially)
- Risk categories – underwriting, credit, market, operational, liquidity
- Capital tiering

**Valuation of Assets / Liabilities**
- GAAP recognition / derecognition principles
- Consistent valuation of Assets / Liabilities
- Economic approach (other than Class G)
- Market Consistent or Amortised Cost Approach to Assets
- Market based discounting (allowance for anomalous conditions)
- Not reflect own credit standing, include margin for risk, and allow for time value of money and embedded options / guarantees

**Pillar 2 (Qualitative)**

**Corporate Governance**
**ERM / ORSA – feedback loop into management process**
**Investment Policy / ALM**
**Ability to Apply Capital Add-Ons**

**Pillar 3 (Disclosure)**

**Public Reporting**
**Content**
**Frequency**

Local entity requirements to apply consistently to branches
Forms part of a Broader Scale of Change for Industry

Changing Regulation Across the Region

China
- CROSS implemented in 2016
- CIRC giving active guidance to change local product design / increase duration of business / control outwards capital & investment flows

HK
- RBC - Timing still to be confirmed
- GN16 – Par & UL regulation

Bermuda ISF
- Implemented in 2016
- Directly affects HK branches

IFRS 9 & IFRS 4 (Phase 2)
- Numerous countries committed to IFRS alignment
- Interaction with local statutory frameworks in numerous jurisdictions

External Influences
- May be through parent / group exposure or third party relationships
- Solvency II
- IAIS / ICP’s
- Basel III (bancassurance groups)

RBC Development in Other Markets
- Singapore RBC2 - Expected implementation in [2017-2018]
- Philippines RBC – Expected implementation in [2016-2017]
- Thailand RBC – [Under consultation]

How much added value does a new solus RBC regime generate?
Pros / Cons of RBC

- Regime which rewards better behavior and risk management / competitive advantage
- More responsive supervisory mechanism
- Opportunity to address gaps in existing framework
- Policyholder security?

- Increased administration / compliance / cost
- May make certain types of business unfeasible
- RBC may increase cyclical & systemic risk ("good behavior" at the wrong time, i.e. sell-low and buy-high)
- Regime which is poorly conceived could upset balance amongst the diverse range of providers
Overview of the Hong Kong Life Insurance Market
Overview of the Hong Kong Life Insurance Market

Based on Top 20 Largest Direct Life Insurers

<table>
<thead>
<tr>
<th>Group Setup</th>
<th>Solvency II (or Equivalent) Group</th>
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<th>C-ROSS Group</th>
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<td>Providers fall under Solvency II or equivalent group capital standards</td>
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<td>Providers fall under C-ROSS group capital standards</td>
<td>Providers subject to Basel III capital treatment (although no specific supervision)</td>
<td>Providers fall under Hong Kong group standards (currently limited mandatory capital standard or supervision)</td>
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<td>HK Incorporated</td>
<td>Provider subject to Hong Kong statutory regime</td>
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<tr>
<td>Bermuda Incorporated</td>
<td>Provider subject to Bermuda statutory (Solvency II equivalent)</td>
</tr>
<tr>
<td>Other Incorporated</td>
<td>Provider subject to home country regime requirements</td>
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<td>HK Incorporated</td>
<td>Prudential</td>
<td>Aviva</td>
<td>Massmutual</td>
<td>Hang Seng</td>
<td>BOC</td>
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<td>Generali</td>
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<td>MetLife</td>
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<td>Transamerica</td>
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<td>Sunlife</td>
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<tr>
<td>Other Incorporated</td>
<td>Zurich</td>
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* Source: Based on new business API (2015) as per OCI Statistics, and public disclosure / financial statements
Overview of the Hong Kong Life Insurance Market

Based on Top 20 Largest Direct Life Insurers

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Overview of the Hong Kong Life Insurance Market

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**Subset C – No RBC & Basel III Consolidators**
- Impacts potentially significant if group makes deduction under Basel III
- Mutual recognition across to Basel III and recognition of parental support as important as RBC itself

**Subset B – Not RBC Groups but solus Bermuda operating entities**
- Impacts for these providers muted by Bermuda capital requirements (Solvency II equivalent)
- Potential upside if mutual recognition with Bermuda (or exclusion from Bermuda stat) can be achieved

**Subset D – Hong Kong domicile group and operating entity**
- RBC most significant impact although only a small percentage of the overall market
- However application to groups only headquartered in HK arguably more important – e.g. China Taiping & potentially Anbang(?)

**Subset A – Already consolidating into an RBC based group**
- Impacts for these providers dependent on which regime HK RBC aligns with
- Solvency II would be a worst case scenario for US, Canadian or Chinese consolidators (most onerous treatment of long term discount rates, credit spread, and equity risk)
- Localisation rules arguably more important for these players

* Source: Based on new business API (2015) as per OCI Statistics, and public disclosure / financial statements
Case Studies from Other Markets
Case Studies from Other Markets

United Kingdom Participating Business – From Thriving to Bust!

Participating Business (% of Market)

Investment Mix

New API
Total API
Single Premiums

Other
Fixed Income
Property
Equities
Case Studies from Other Markets

United Kingdom Participating Business – From Thriving to Bust!

Steady decline in share of market from around one half to one fiftieth

Steady decline in equity / property backing ratio from nearly 80% to less than 40%
Case Studies from Other Markets

United Kingdom Participating Business – From Thriving to Bust!

1980’s
Thriving market – large numbers of new entrants
High competition (Top 20 providers only 60-70% of APE)

1990’s
Consolidation on back of growth in 80’s
Top 20 capturing over 90% of APE

2000 - 2003
Significant equity market stress eroding capital buffers

2003 - 2005
- Inevitable regulatory reaction
- Strengthen capital standards (ICA / RBC)
- Independent governance (WPC, WPA)
- Disclosure / transparency

2007 – 2012++
- Even though market is dormant, the debate continues…
- FSA / FCA targeting firms use of inherited estates

Conclusion
- Poor value for money / performance
- Lack of transparency
- Poor expense / cost control
- Significant conflicts of interest exist
- Distort competition

1980
1990
2000
2010
Case Studies from Other Markets

Solvency II – Directly influencing products / behaviors

- Illustrative situation for Annuity product with lifetime longevity risk at point of sale
- Solvency II significantly heavier capital for longevity risk and credit risk
- Significant reductions possible through Internal Model

Treatment of Longevity Risk

- Illustrative situation for Type 2 Securitisation position – 4Y duration
- Also possible to reduce through Internal Model

Treatment of Asset Risk (Type 2 ABS, RMBS, CMBS, etc)
Case Studies from Other Markets

Solvency II Approach – What if we apply to a typical Hong Kong product?

Example - Limited Pay WOL Product with Guaranteed Cash Value

- Illustrative situation for a 10Y limited pay WOL product with Guaranteed Cash Values
- Assume market risks (interest rate / reinvestment) fully hedged

- Projected Reserves and Capital significantly increased
- Additional drag on RoE ~ 10% p.a. to < 5% p.a.
- Additional extension in payback period by 10+ years
Case Studies from Other Markets

What about Other Regimes?

Singapore

- Collaborative approach with industry
- More accommodative than Solvency II on discount rate setting:
  - Wider product eligibility for matching adjustment
  - Similar asset eligibility
- Consulting on special provisions for universal life business to take account of industry concerns
- Allowance for management actions on non-guaranteed benefits (removal of 50% cap)

Canada

- Collaborative approach with industry
- More accommodative than Solvency II on discount rate setting:
  - Retention of an asset based yield for insurance contract valuation
  - Wider range of asset eligibility (bonds, equities, etc)
  - Fixed discount rate for liability / demographic stresses (i.e. not sensitive to market yields)
How to Prepare for a Good Outcome
How to Prepare for a Good Outcome

Focus on closing Gaps in existing framework

Quantitative

• Developing a “Group” Capital standard – focus on aggregate capital requirements and quality of capital

• Par business – making provision for discretionary benefits, and also management actions

• Risk based capital charges – but avoiding systemic risk or forcing players out of the market

• Non-insurance activities, e.g. stock-lending

Qualitative

• ERM / ALM / Governance

• Most providers should already be doing these

Disclosure

• Public reporting
## How to Prepare for a Good Outcome

### Identifying key arguments

<table>
<thead>
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<th>Quantitative</th>
<th>Qualitative</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Setting discount yields – avoiding risk-free discounting (widest product &amp; asset eligibility)</td>
<td>• Mutual inwards recognition with other regimes</td>
</tr>
<tr>
<td>• Avoiding complete ring-fencing of par business</td>
<td>• Multiple reporting bases and multiple layers of supervision will only make cost of doing business prohibitive</td>
</tr>
<tr>
<td>• Alignment with accounting regime and Hold-To-Maturity / Amortised Cost approach? (Key for universal life business)</td>
<td>• Consider impact of cumulative changes – not just RBC in isolation</td>
</tr>
<tr>
<td>• Avoiding stringent localization (“onshore fund”) requirements</td>
<td>• Keeping a level playing field</td>
</tr>
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Product Ideas and Innovations from around the Region
Product Challenges

Back to Basics

- Investment Product Undesirable
- Focus on Protection
- Stronger Guarantees on Morbidity
- Higher Pricing & Investment Risks
- Higher Capital Charges

What can we do?
What Can We Do?
Ways we believe can work

Reduce Investment Guarantees
- Re-pricing of products focus on Terminal Bonus or reduce GCV
- Diversify portfolio from heavy investment products

Focus on Protection
- Growth of protection products
- Educate distributors the importance of protection in financial planning
- Add protection elements in heavy savings products

Customer Engagement
- Insurance is not just for savings
- Engage customers using third parties
- Positive branding, growth of wellness and other well-being programs & services
- Manage inforce block & lapse risks
Japan’s Story

A long history of low interest rate environment

Regulator
- Allow conservative pricing
- Add pads
- Ignore improving trends for morbidity and mortality risks

Insurance Companies
- Focus on protection
- Low or no CSV products
# Japanese Companies’ Source of Profits

## Nippon Life and Aflac

<table>
<thead>
<tr>
<th></th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
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<tbody>
<tr>
<td><strong>Nippon Life</strong></td>
<td></td>
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<tr>
<td>Profit in total</td>
<td>544 billion</td>
<td>547 billion</td>
<td>592 billion</td>
<td>679 billion</td>
</tr>
<tr>
<td>Interest margin</td>
<td>32 billion</td>
<td>32 billion</td>
<td>115 billion</td>
<td>191 billion</td>
</tr>
<tr>
<td>Mortality/morbidity margins</td>
<td>451 billion</td>
<td>448 billion</td>
<td>405 billion</td>
<td>409 billion</td>
</tr>
<tr>
<td>Expense margin</td>
<td>62 billion</td>
<td>67 billion</td>
<td>73 billion</td>
<td>80 billion</td>
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<td><strong>Aflac</strong></td>
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<tr>
<td>Profit in total</td>
<td>203 billion</td>
<td>162 billion</td>
<td>325 billion</td>
<td>453 billion</td>
</tr>
<tr>
<td>Interest margin</td>
<td>3 billion</td>
<td>-9 billion</td>
<td>26 billion</td>
<td>44 billion</td>
</tr>
<tr>
<td>Mortality/morbidity margins</td>
<td>186 billion</td>
<td>155 billion</td>
<td>266 billion</td>
<td>362 billion</td>
</tr>
<tr>
<td>Expense margin</td>
<td>14 billion</td>
<td>16 billion</td>
<td>33 billion</td>
<td>48 billion</td>
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(JPY)
Japanese Insurance Market

New Products Overview in 2015

- Some new features such as:
  - 3CI multi-payment
  - Extended maximum issue age
  - Mental coverage
  - Simplified Issue
  - Reimbursement benefit etc.

50 Products Launched, of which…
Nippon Life (April, 2016)

Semi-tontine Annuity (“Gran Age”)

Standard Annuity

Total Premium

Premium Period

Age 50

Death Benefit (CSV)

Benefit Period

Annuity

Age 70

Semi-tontine Annuity

Total Premium

Premium Period

Age 50

Death Benefit (CSV)

Benefit Period

Annuity

Age 70

Age 80

Defer

Three Options:
- 5-yr certain WoL
- 10-yr certain
- Lump sum
Singapore’s Story

Focus on Protection, Enhancing margins in bancassurance

- Several insurers in Singapore have launched *guarantee issue protection riders* on heavy savings products e.g. endowments with reducing NAR over time
- Risk managed by having reasonable sum assured caps and longer waiting periods.

“*Allow higher profit margins in the products through adding protection elements*

*Reduce focus on pure return competition*”
Singapore’s Story

Examples of Guarantee Issue Riders

Aviva SG
MySavingsPlan + GIO Riders

Manu SG – RetireReady

Pru SG – PRULifetime Income
Singapore’s HNW Market

A shift towards Single Premium Whole Life

- When SPWL product was launched in late 2013, it quickly becomes a hot seller for this company.
- SPWL has little investment upside and more protection focus – general case sizes are smaller but they are ideal for real legacy planning purpose.
What About Us?

Movements and Trends in Hong Kong

<table>
<thead>
<tr>
<th>RB / TB Plans</th>
<th>Protection Focus</th>
<th>Wellness &amp; Well-Being</th>
</tr>
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</table>
| New participating products focus on offering terminal bonuses or revisionary bonuses with lower CSV scales. | Critical Illness products  
  - Single Disease products  
  - Old Age Pure Protection products  
  - Segment-Focused Protection products e.g. retirement  
  - Medical products | Wellness Programs  
  - Disease Management Programs  
  - DNA Programs  
  - Case Management Programs  
  - Third Party Partnerships |
| Re-pricing of WoL plan |  |  |
| Reduce investment guarantees risks |  |  |
Recent Breakthrough

Some of the New Developments in Hong Kong between 2015-2016

**Partnership / Wellness:**
Critical illness product with a diabetic disease management program

**Focus on Protection:**
Extend single disease reimbursement product to cover more diseases

**Wellness & Customer Engagement:**
Wellness programs making use of wearable technology and increase contact with customer through positive health & imaging programs

**Reduce Guarantee Investment Risk & Focus on Protection:**
Develop RB / TB plans with retirement protection options on GIO basis

**Well-Being:**
DNA solution helping customers knowing better about themselves

**Focus on Protection & Partnership:**
Comprehensive protection coverage plus new concierge / care management services

*Just some examples with many more…*
Protection Solution for Retirement Needs

Guarantee Issue Rider for Heavy Savings Products

**Distribution**
- Guarantee Issue
- Capture Untapped Market
- Ideal for Bancassurance / Heavy Savings Products

**Customer Value**
- Whole of Life Coverage
- Benefit of Choice upon Retirement
- Combines Wealth Accumulation & Protection

**How Does It Work?**

**Premium Contribution**
- Wealth Accumulation

**Stage 1 Protection**
- Reduce Investment Guarantees

**Stage 2 Protection**
- Worry-Free Protection @ Retirement
- Shift to Protection
- Wellness / Positive Branding
Holistic Considerations

What needs to be considered?

- **Inforce Portfolio Management**
  - How do we cope with raising interest rate? Lapse?
  - Reserve rising, High capital requirements

- **Company Strategy**
  - Best investment return wins?
  - Comprehensive protection coverage?
  - Innovative products and all-rounded “customer solution”?
  - Distribution strategy and training?

- **Reinsurance**
  - New Product Ideas?
  - Solutions which can combine transfer of investment and lapse risks with guarantees, lowering reserve or capital needs?
Thank you for your attention.