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Using Insurance to Hedge Asia's Future

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As the demographic profile and economic structure of Asia changes, with some countries aging rapidly, it is important to shift the funding model away from short-term credit and banking towards long-term investments that sustain Asian growth and efficiency, whilst reinforcing social and financial system stability. As long-term institutional investors, the insurance and reinsurance industries are essential for the real economy as providers of social security and risk capital and as stabilizers and shock absorbers for the financial markets[1]. Regulations, by not differentiating between banks and non-banks in their different capital and liquidity needs, are preventing long-term investors, such as insurance companies and pension funds, from participating in long-term project financing of infrastructure, energy and green technology. Policymakers and regulators need to re-focus on strengthening the Asian insurance industry to support Asia's long-term development agenda by working together with industry to:

- Promote the capacity and capabilities of the insurance industry in infrastructure financing as this remains key to increasing efficiency and productivity over the long term in Asia.
- Examine the long-term challenges of population aging: to support pension and healthcare reform, incentivize voluntary private savings schemes and develop market solutions to manage longevity risks.
- Strengthen the capacity of the insurance sector to improve institutional investing in the capital markets by removing portfolio restrictions that constrain effective asset diversification, risk-taking capacity and ability of insurance companies to become stabilizers and shock absorbers in financial markets.
- Consider tax benefits to promote savings via insurance schemes and to introduce greater competition and innovation in the insurance industry.

[1] *Institute of International Finance, Strengthening the role of long-term investors, Swiss Re, Zurich, 2013.*

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INTRODUCTION

The largest insurance markets are in the United States, Japan and Europe. In 2011, the United States and Japan alone accounted for 50 per cent of the US$4.6 trillion in global insurance premiums[2], while the United Kingdom, France and Germany accounted for another 19 per cent.

In comparison, Asia (excluding Japan) is grossly underinsured, accounting for only about 15 per cent of global insurance premiums in 2011, although it has 60 per cent of the world population.

The ratio of insurance assets to GDP for Asia (ex-Japan) was 16.3 per cent in 2012, compared to over 70 per cent in developed economies[3]. However, between 2010 and 2012, the Asian insurance industry was growing faster than the U.S. and European markets with premiums growing at an average annual rate of 5.5 per cent, benefiting from urbanization, a growing middle class and an aging population. These trends generate greater demand for insurance products that help manage risks for a more affluent and sophisticated society, and promote long-term savings, healthcare provision and annuities.

Table 1: World Insurance Markers

2011	Gross insurance premiums of which (%)					
	Total US$ billion	Life	Non Life	% Share of world	Insurance density (US$)	Insurance penetration (US$)
U.S.	1,205	45	55	*27*	3,846	8.1
Japan	655	80	20	*13*	5,169	11.0
U.K.	320	66	34	*7*	4,535	11.8
France	273	64	36	*6*	4,041	9.5
Germany	245	47	53	*6*	2,967	6.8
PR China	222	61	39	*3*	163	3.0
Italy	161	65	35	*8*	2,530	7.0
Other	1,514	54	46	*25*	---	---
World	4,595	57	43	*100*	661	6.6

[1]Premium paid per head; [2]premium as a % of GDP
Source: SwissRe

In the interest of making the financial system as a whole more resilient and balanced, the macro-prudential and regulatory environment should be directed to strengthening long-term funding and investment. Five global and regional megatrends will influence the future supply of (and demand for) long-term finance in Asia:

- Financial repression[4] and a protracted period of low interest rates will affect returns on investment and the asset allocation models of long-term investors. Low bond yields can lead to a convergence in global asset allocation, including causing a shift from equity investments to "safer" fixed income securities or alternative asset classes that may be less transparent and less regulated;

- Ongoing regulatory reforms such as Basel III and Solvency II may have unintended consequences in raising capital costs for long-term institutional investors. This would disrupt their intermediation function in providing risk capital to the economy at large and their role in stabilizing markets during crises by remaining invested with a long-term horizon;

- Demographic factors arising from population aging and higher demands for retirement and healthcare insurance will influence asset allocation in most Asian countries in the coming decades;

- Urbanization creates long-term funding needs for infrastructure and green technology while a rising middle class will increase demand for healthcare and wealth management products; and

- Other segments of the population, namely the lower-income groups and Asia's large Muslim population, will need innovations in micro and Takaful (Islamic) insurance products.

[2] The CityUK, Insurance Briefing, January 2013.
[3] Estimation based on data of eight Asian economies from Global Wealth Report 2013 by Allianz, namely, China, Taiwan, South Korea, India, Singapore, Malaysia, Thailand, and Indonesia.

[4] Financial repression refers to interest rates being held at levels below the inflation rate so that borrowers benefit at the expense of savers. Since governments tend to be large borrowers, financial repression policies in effect subsidize government debt.

ASIA'S LONG-TERM INVESTMENT OPPORTUNITIES

By 2050, the Asian Development Bank estimates that Asia may account for 50 per cent of global GDP, with a per capita income of US$40,800 – similar to current levels in Europe. Its urban population will double to three billion and Asia will be home to half of the world's middle class population[5]. By 2030, at least 18 per cent of Asia's total population, or 860 million retirees over the age of 65, will need security for retirement and healthcare.

In 2010, most Asian governments were bearing over 40 per cent of the total healthcare expenditure in their countries. By 2020, healthcare costs in Asia-Pacific will more than double to US$2.7 trillion, with a potential shortfall in healthcare financing of US$197 billion[6]. This will require either additional fiscal spending or higher out-of-pocket funding by individuals. Given existing fiscal constraints, further increases in government healthcare spending is unsustainable. The answer, therefore, lies in private insurance plans, which can help individuals to better manage their future healthcare financing needs. However, private prepaid plans contributed less than 10 per cent of the total healthcare expenditure for most Asian markets[7].

In addition to the healthcare funding gap, Asia also faces a huge financing gap for long-term infrastructure development. Between 2010 and 2020, Asia will need US$8 trillion in investments to meet the region's rising demand for safe water, electricity, housing and other infrastructure projects[8]. As Asia is grossly underinsured, the industry may not be able to satisfy these new demands. Currently, assets of the Asian insurance industry constitute only 23 per cent of total assets in the Asian financial system, or less than half of the share of the banking industry (58 per cent)[9].

In order to address the current short-termism and maturity mismatch of the bank-dominated financial sector, development of long-term institutional investors, including the insurance industry, should be given policy priority.

Regulators and policymakers should foster the developmental role of insurance, realign and balance insurance regulations to remove barriers to the insurance industry as long-term institutional investors, and work together to:

- Address the shortfalls in long-term funding, and create a business environment that is supportive of long-term investment and asset allocation.
- Promote the capacity and capabilities of the insurance industry to invest in infrastructure as this remains key to increasing efficiency and productivity over the long term in Asia.
- Examine jointly with industry the long-term challenges and risks of population aging and the contingent liabilities of longevity, including: how to balance the fiscal needs of pension requirements as the population ages, incentivize voluntary private savings schemes and help industry develop market solutions to manage longevity risks.
- Consider tax benefits for savings via insurance schemes, and introduce greater competition and innovation in the insurance industry.

The industry should strengthen professionalism in its underwriting, pricing practices and its code of conduct with customers. In addition, it should raise capitalization in compliance with regulations and deepen product innovation that is aligned to local

[5] *Asia 2050: Realizing the Asian Century, Asian Development Bank, 2011.*
[6] *Swiss Re (2012). Mortality and morbidity gaps, ageing society and implications on product development.*
[7] *Swiss Re (2012). News Release.*
[8] *ADB and ADBI. (2009). Infrastructure for a seamless Asia.*
[9] *Global Wealth Report 2012. Economic Research & Corporate Development*

market characteristics. Technology is also opening up new channels of distribution and marketing. Finally, there should be closer regional cooperation and greater promotion of domestic-foreign partnerships to help structure long-term insurance, re-insurance and financing capacity to facilitate risk assessment and management.

The regulatory response to some of the issues faced by the insurance industry is encouraging. On 2 October 2013, the European Commission published a legislative proposal for changing the application date of Solvency II insurance rules to 1 January 2016. The deadline for transposing the rules into national law has been shifted to 31 January 2015. The International Association of Insurance Supervisors (IAIS) announced in 2013 its commitment to develop the first risk-based global insurance capital standard (ICS) by 2016. Implementation will begin in 2019 after two years of testing and refinement with supervisors and global insurance groups. In 2014, the IAIS will also develop straightforward backstop capital requirements (BCRs), which are planned to be finalised and ready for implementation by global systemically important insurers (G-SIIs) in late-2014.

Given the major ongoing regulatory reforms, there are various recommendations such as those by the Group of Thirty (G30)[10] offering guidance to ensure that the regulatory framework will support innovation and competition in the Asian insurance industry. Similarly, the Institute of International Finance (IIF) and Swiss Re[11] have published a report to reinforce the call for strengthening the role of long-term investors.

There is scope for more regional cooperation in increasing the capacity building of insurance supervisors, mutual recognition of regulatory standards and practices.

Regulators also need to work with the industry to strengthen insurance capacity and ability to meet the policy objectives of improving social security, capital market deepening and long-term funding of infrastructure and system risk absorption capacity.

[10] *Group of 30, Working Group on Long-term Finance, Long-term Finance and Economic Growth, Washington D.C., 2013.*
[11] *IIF, Swiss Re. Strengthening the Role of Long-term Investors. Zurich. 2013.*

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