How the financial crisis and impending accounting changes will change insurance products

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What we'll cover

I. The Background

II. Case Study: Australian experience

III. Products themes for the new world

IV. Annuitization – An opportunity for the global insurance industry

V. Challenges in Japan

VI. Conclusions

I. Background

- Internationalization of the world financial markets and other factors have led to increased volatility
- Current accounting standards in Japan can give results that do not accurately show the underlying risks to which companies are exposed
- Current solvency standards in Japan do not recognize all the risks companies are taking

I. Background

- We don’t know when the accounting and solvency standards will change
- We don’t know exactly how they will change
- It is likely that new accounting standards will be based on market values
- It is also likely that new solvency standards will be economic based

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I. Background

- Shareholders want stable earnings!
  - **Unhedged or unmatched positions in a market value accounting system could cause severe and immediate pain for insurance companies.**
  - **Your cost of your capital could be materially higher then your competitors if your balance sheet is more volatile.**

“When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you’ve got to get up and dance. We’re still dancing,”

"We finished the year, and we reported that we had $17 billion of cash sitting at the bank's parent company as a liquidity cushion. As the year has gone on, that liquidity cushion has been virtually unchanged."

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“Good insurers accept only those risks that they are able to properly evaluate (staying within their circle of competence) and that, after they have evaluated all relevant factors including remote loss scenarios, carry the expectancy of profit. These insurers ignore market-share considerations and are sanguine about losing business to competitors that are offering foolish prices or policy conditions.

They limit the business they accept in a manner that guarantees they will suffer no aggregation of losses from a single event or from related events that will threaten their solvency. They ceaselessly search for possible correlation among seemingly unrelated risks.”

II. Case Study - Australia

- **In the late 80’s and early 90’s- life insurance market was dominated by**
  - Complex products combining investment and insurance components
  - Products with long term guarantees (e.g. Whole Life)
  - Very similar to Japan today
- **Sales of these complex products were decreasing**

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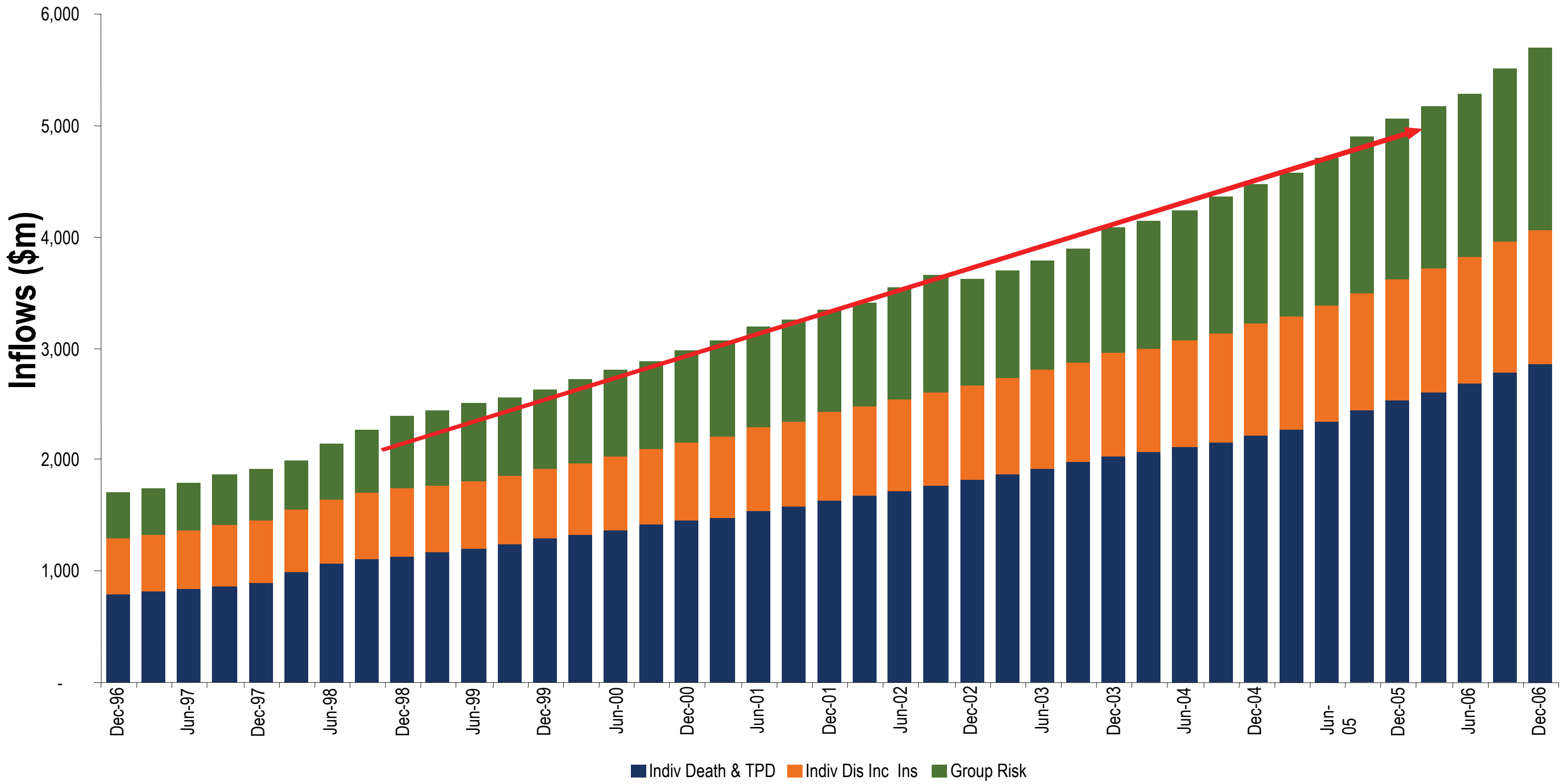
Accounting

- Accounting framework transitioned from a book value basis to a model similar to IFRS Phase 2.
- Solvency framework transitioned to a model somewhat similar (but not nearly complex) as Solvency 2.
- Did that spell the end of the insurance industry in Australia?

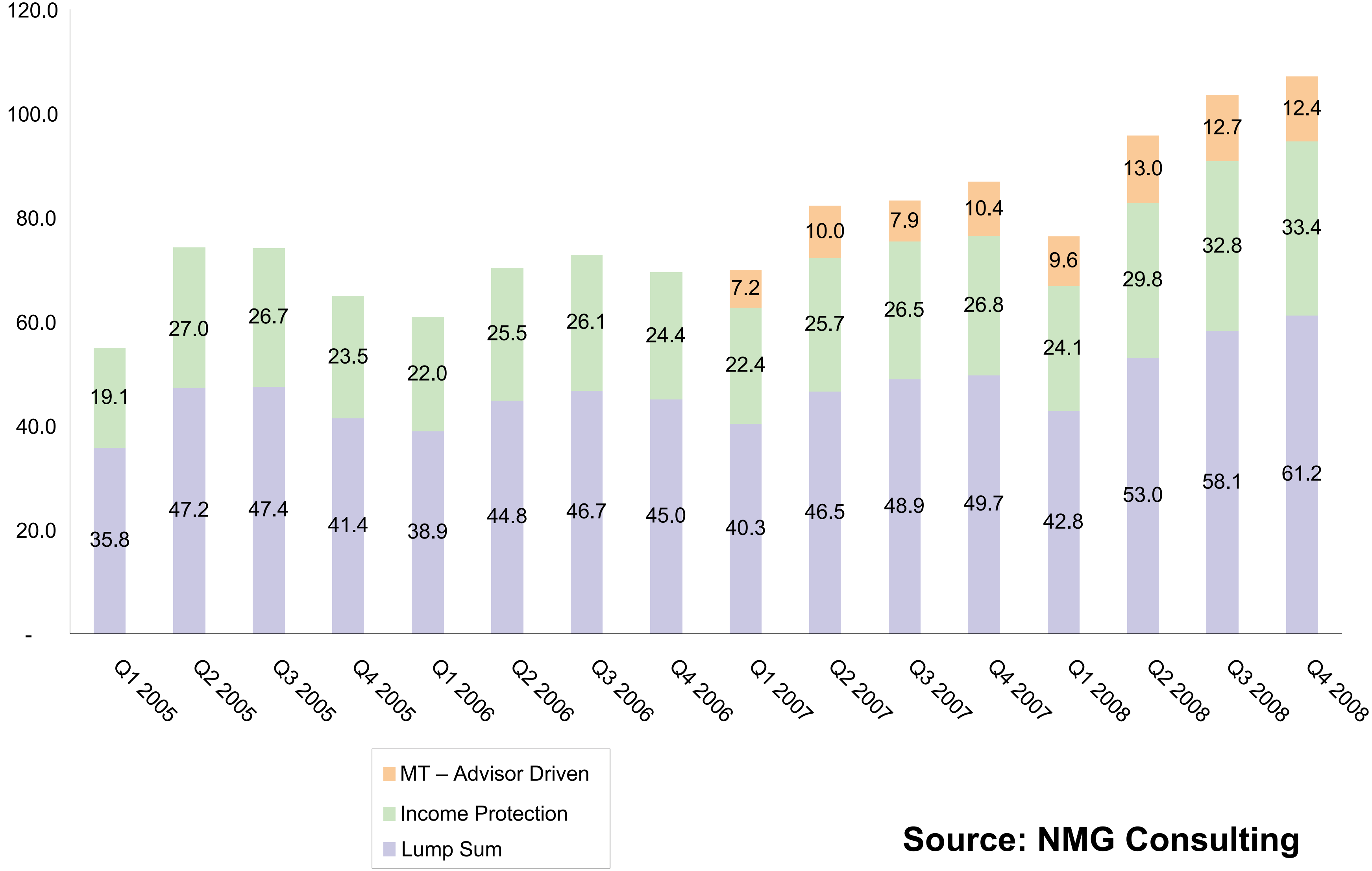
Consistent Growth in Australian Life Market



Source: Merill Lynch, Plan for Life

New Sales through Australian IFA Channel (A$ million)

<January 2005 to December 2008>



Source: NMG Consulting

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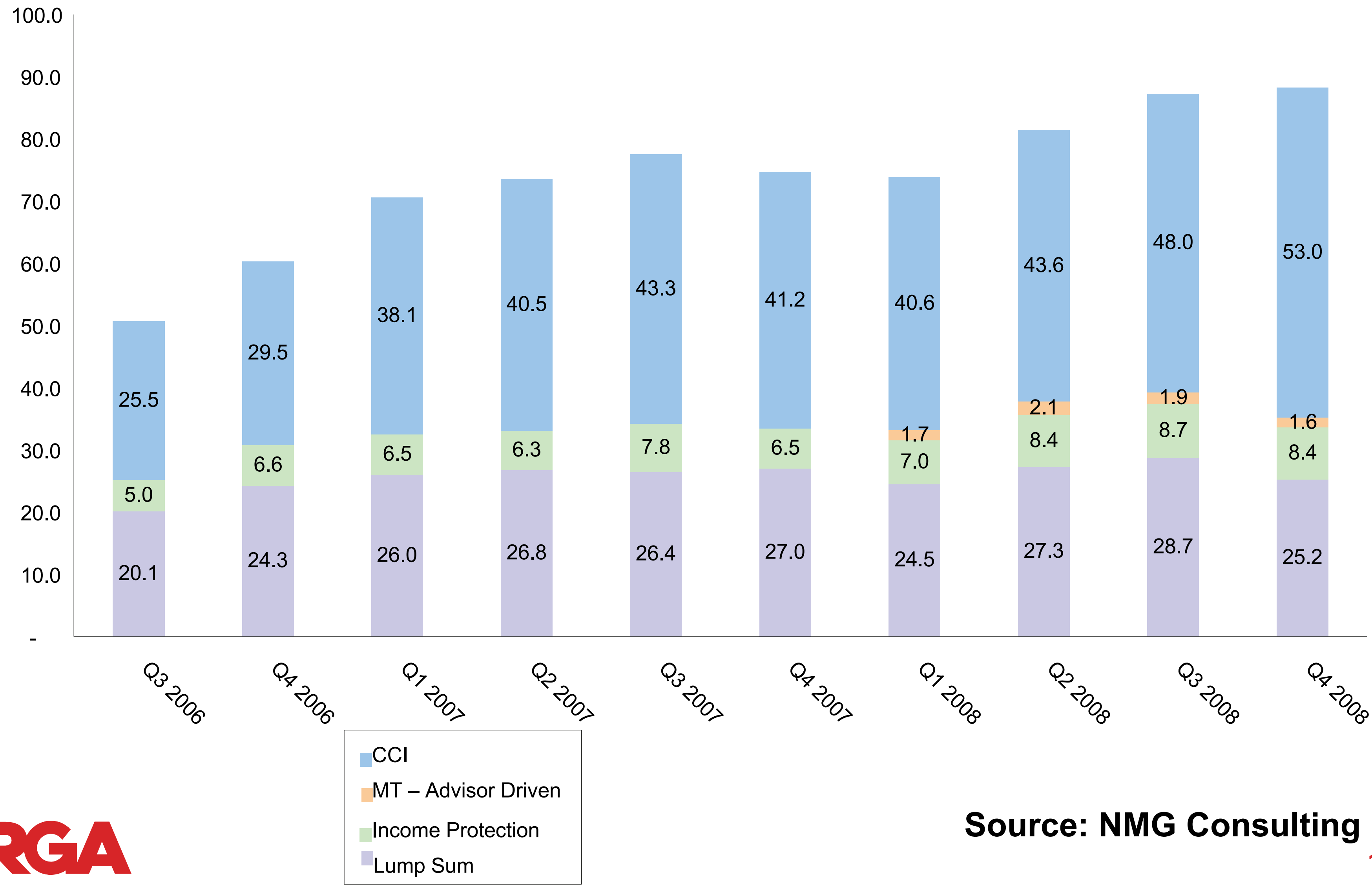
New Sales through Australian Bank Channel (A$ million)`

<July 2006 to December 2008>



Source: NMG Consulting

How did the market thrive

- **Guarantees dramatically curtailed**
- **Products were simplified**
- **Regulatory focus on quality of advice**
  - Greater training of agents
  - Larger sum insured’s sold to meet clients need
- **Industry focus on underinsurance**

How did the market thrive

- **Focus on new distribution of risk products**
  - Independent agents, Bancassurance, Internet
- **Focus on making insurance sales easier for agents**
  - E-Underwriting, instant issue with no wet signature, etc…
- **Vibrant group market developed**
  - All players in a given industry will have insurance cover

Is the Australian model applicable to Japan?

- **In some ways yes**
- **In other ways no**
  - Guarantees do not have to be removed completely. There is a desire and need on the part of the public for some guarantees.
  - However, companies should limit volatile risks you can not hedge externally or internally (i.e. diversify away)

Traditional Product Shift?

Allianz — …*The deteriorating market conditions also made the sale of investment oriented products difficult — particularly through the banking channel. By contrast, business with traditional life insurance products remained stable.*

Source: Annual General Meeting of Allianz SE on April 29, 2009. Report by the Chairman of the Board of Management, Michael Diekmann of the development of the business

Aviva — The company's Annual Report for 2008 reported that growth in life and pension sales was offset by a fall in the sales of investment products.

ING — …*the crisis has created a shift in customer demand towards products that offer wealth-protection and risk reduction.*

Source: ING Group, Annual Report 2008

Zurich — Zurich Financial Services Group, in its Annual Report for 2008, reported an increased demand for protection products in its Global Life segment towards the end of 2008.

AEGON — AEGON reports that their strategy in the United Kingdom is to move more of the business to higher-margin areas, such as annuities and protection products.

III. Product themes for the new world

- **Theme #1 – Link unhedgable portion of benefits to external indices**
- **Theme #2 – Extreme tail risk remains with the policyholder**
- **Theme #3 – Allow flexibility within product structure to manage tail events**

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Theme #1 – Index unhedgable benefits

- **Whole life policies are unhedgable in Japan (liabilities longer than assets)**
  - Rather than guaranteeing premium rates for life, only guarantee for 20 years, then reset future premiums to swap yields at year 20
  - Policyholder retains upside if interest rates increase. This would likely illustrate very well in today's interest rate environment
  - Insurer retains a smooth earnings profile (with all associated benefits)

Theme #2 - PH keeps tail risk

- Vanguard issues a lifetime annuity in the US where payments increase with inflation, up to a cap
- New York Life sells a term to age 90 policy where the rates are only guaranteed for a certain number of years

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Theme #3 – Product Flexibility

- Some charges for optional benefits (GMxB) in the US can be changed up to a maximum amount
- The crediting rate on many fixed annuities or UL products in the US can be adjusted annually down to a minimum level

IV. Annuitization – An opportunity for the global insurance industry

- **Globally there will be many people that are at a high risk of outliving their income**
- **Japan is in better shape then some countries due to the National Pension and Employee's Pension**
- **However**
  - National Pension is very small
  - Employee's Pension doesn't cover all workers
  - Will the pension schemes survive as the population declines?

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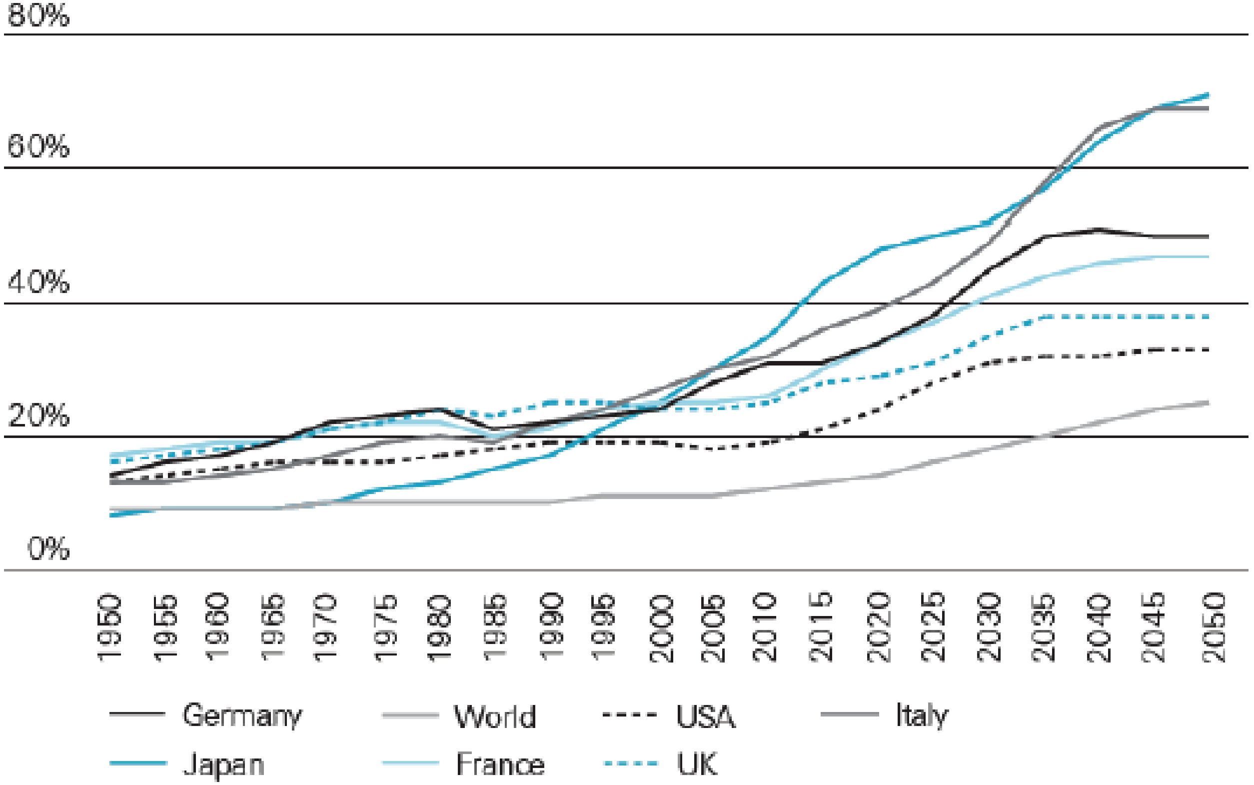
Old-age dependency ratio in selected countries



Source: United Nations, World Population Prospects, 2004 Revision

* Ratio of the population aged 65+ to the population aged 15-64.

Problems with Lifetime annuities

- **Customers don't like them**
  - Worried about illiquidity
  - Don't understand longevity
- **Sales agents don't like them**
  - Once money is locked up in a lifetime annuity, they can no longer provide advice on the funds under managment
- **Insurers don't like them**
  - Not enough experience in older age mortality
  - Anti-selection currently exists when only healthiest of lives are purchacing

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Why we need lifetime annuities

- **Customer**
  - Only privately sold product that will guarantee income for life
- **Government**
  - Eases pressure to provide for people that outlive their income
- **Insurers**
  - Only insurers can sell this product
  - Diversifies existing book (very important under Solvency II)

Action needed

- **Insurance industry must lobby the government**
  - Focus argument on preventing the population from outliving assets
- **Goal is**
  - Simple tax benefits for purchase of annuities or;
  - Mandatory purchase requirements from DC plans

Remember Theme #2 – Policyholder keeps the tail risk

- Perhaps cap annuity payments at age 100?

In 2000, there were 70,000 people in the US that were aged 100 or greater. In 2050, this could figure could be as high as 2.4 million (1% of US population).

Source: Society of Actuaries, Living to 100 and Beyond: Implications for Retirement RECORD, Volume 28, No. 3

Remember Theme #1 – Index unhedgable benefits

- **Perhaps link the payments to industry wide mortality improvement**
  - If population mortality improvement is above some level, then payouts are reduced past some age (e.g. 90)

V. Challenges in Japan

- Product approval process can be long
- New product ideas aren’t easily approved
- The current approval process seems to favor guaranteed elements
- Difficult to facilitate change in large companies

VI. Conclusions

- Companies that prepare for the upcoming accounting changes will have huge competitive advantages
- The time to prepare is now
- Product development and delivery strategies are part of this preparation
- Lifetime annuities are needed, do not let this opportunity pass you by