The Insurance Industry and the Implications for Treasury Management

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- To a large extent, the insurance market follows economic and social development trends in Asian economies. Future growth potential remains strong in Asia, particularly in China.
- The challenge for the corporate treasurer lies in how to develop the right treasury management solutions to support the growth of business, so the focus of this article is more on cash and treasury management and the selection of relevant banking products, and less on actuarial issues like asset-liability matching, or investment issues like relative value analysis and asset allocation, although they are equally important.
- Apart from providing insurance coverage and wealth management products, insurance companies as institutional investors benefit in-country from capital formation. Effective treasury management is key but requires the availability of the right banking products and an appropriate regulatory framework.

Asia has gone through tough times, but adjustments have been made and lessons learned. Events that unfolded during the decade between 1994 and 2004 completely changed Asia's economic landscape. Asia entered into a deflationary era after China's "macroeconomic adjustment" policy in 1994 and the Asian financial turmoil in 1997, evidenced by low interest rates and downward adjustments in real-estate prices. This painful experience highlighted the importance of sound liquidity management and risk controls. Devaluation of local currencies and non-performing loans exposed the weaknesses of some local banks and financial institutions in mismatching asset liabilities and foreign currency positions.

However, consolidation in the banking sector has improved capital adequacy and risk management standards. The capital markets have also benefited from the surge in government bond issuance, which has created the yield curve and benchmark effect required for promoting the subsequent growth of the corporate bond market. With that comes the recognition of the role of credit rating agencies in enforcing market discipline. September 11 highlighted the importance of business continuity and crisis management. The Enron event and its consequence – the Sarbanes-Oxley Act, 2002 – set the stage for future corporate governance standards and operational risk management. China survived the Asia financial turmoil and joined the World Trade Organization (WTO) in December 2001. Economic integration between China and the rest of the world has grown, with China now becoming the world's sixth-largest trading nation. China is increasing its importance as a destination for exports from neighbouring Asian countries.

Trend and Potential for Insurance Industry Development in Asia

To a large extent, the insurance market follows economic and social development trends in Asian economies. Rising per capita

income, increased life expectancy and the privatisation of pension and healthcare services have contributed to the growth of insurance products for protection and secured investment purposes. Future growth potential remains strong in Asia, particularly in China. According to Sigma, the research arm of Swiss Re, the per capita figure for life insurance premiums in China was USD25 in 2003, as illustrated in Figure 1, compared with over USD1,500 in the US and over USD3,000 in Japan.

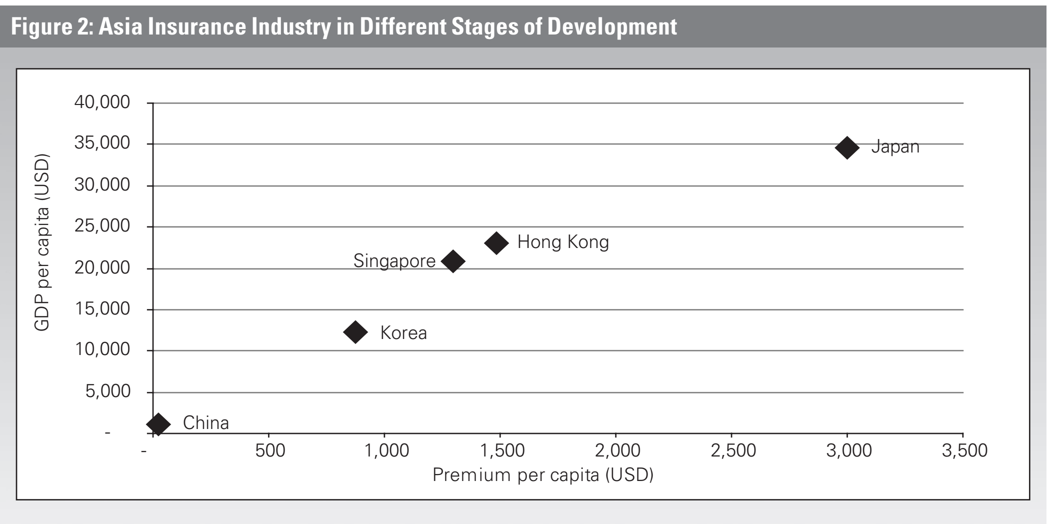
Figure 1: Life Insurance in Asia

Country	Population (millions)	GDP (USDbn)	Standard of living GDP per capita (USD) [A]	Insurance penetration Premiums as % of GDP [B]	Insurance density Premiums per capita (USD) = [A]*[B]
Japan	127.0	4,429	34,900	8.61	3,002.9
Hong Kong	6.8	159	23,300	6.38	1,483.9
Singapore	4.3	91	21,300	6.09	1,300.2
South Korea	48.1	621	12,900	6.77	873.6
Taiwan	22.6	287	12,700	8.28	1,050.1
Malaysia	24.7	105	4,300	3.29	139.8
Thailand	62.0	143	2,300	2.25	52.0
China	1,290.8	1,410	1,100	2.30	25.1
Philippines	81.4	80	990	0.87	8.6
Indonesia	214.5	208	970	0.66	6.4
India	1,056.3	601	570	2.26	12.9
Vietnam	81.5	38	470	0.87	4.1

Source: Swiss Re Sigma No. 3/ 2004

Insurance penetration measured in terms of total premiums expressed as a percentage of gross domestic product (GDP) was only 2.3% in China, compared with 4.38% in the US and 8.6% in Japan. Wealth measured in per capita GDP terms in US dollars (USD) was slightly over USD1,000 for China, compared with over USD30,000 for both the US and Japan. Excluding Japan, most Asian economies are in different stages of development, as shown in Figure 2, and their insurance markets are expected to further grow in depth and breadth. Historically, there is a strong correlation between insurance penetration and the standard of living measured as per capita GDP. If China maintains the current momentum of its economic growth, the future potential for the development of its insurance market is enormous.

Figure 2: Asia Insurance Industry in Different Stages of Development



Implications for Treasury Management

The challenge for the corporate treasurer lies in how to develop the right treasury management solutions to support the growth of business, so the focus of this article is more on cash and treasury management and the selection of relevant banking products, and less on actuarial issues like asset-liability matching, or investment issues like relative value analysis and asset allocation, though they are equally important. Given that Asia represents a continuum of countries in differing stages of economic development, there are opportunities for gap-filling and the adoption of best practices. Implementing the following changes in the insurance industry in Asia will result in a healthy market expansion:

- offering a user-friendly and convenient payment solution to customers;
- developing a bank account and liquidity management strategy that maximises investment return;
- selecting the types of cash management services that the banks can provide to reduce operating costs;
- building up a good line of communication with banks to explore product development efforts and other opportunities for cooperation;
- promoting an "economic profit" culture among operating entities to emphasise the concept of opportunity costs;
- establishing an arrangement for risk controls among operating entities;
- managing currency risks related to foreign investments; and
- developing a more flexible approach towards meeting solvency requirements.

Build in Payment Convenience as a Strategic Advantage

In some countries where cash is a popular means of premium payment, multiple collection points can be used including convenience stores, department stores and post offices – in addition to bank counters. In fact, banks are shifting their retail banking focus towards wealth management, and there are fewer counters available for making payments. The challenge to insurance companies is matching the payment amount against the policy number. This is not going to be straightforward until the banks or the collecting agents put together a robust IT system such as bar-code scanner or check digit control that can reduce unmatched errors.

In China, some major domestic banks have already introduced a "bank-insurance link", which can transmit policy numbers and payment amounts online to insurance companies. The paper cheque is gradually being substituted for by other forms of electronic payment – such as mobile banking, Internet banking and automated teller machine (ATM) banking. Furthermore, the advantages of keeping a float for facilitating deposits against cheque payments are reduced when interest rates are at low level. Direct debiting, or the use of autopay against a bank account, credit or debit card are popular for collecting renewal premiums that are repetitive in nature. Once payment information is captured, the next step is to transmit the data to an insurer's host system in a timely manner so as to synchronise with the customer's record. The success of such a connection will not only improve customer service but will also reduce operational risks.

Enhancing Investment Return Through Reducing "Cash Drag"

Life insurance companies require a good cash forecasting system to synchronise investment plans with operating cash flows in order to minimise short-term cash balances. Domestic cash concentration techniques are employed to sweep the premiums received nationwide into a master account. Insurance companies sometimes have to manage multiple bank relationships for a variety of business reasons. This gives rise to the need for multi-banking solutions, which is a type of banking product that is very popular in Europe. As more local banks become SWIFT-enabled, the scope for such applications is now wider and more meaningful.

Most jurisdictions restrict insurance companies from borrowing. However, an efficient cash minimisation programme requires some form of contingent liquidity measures, including the use of overdraft for working-capital management purposes. Regulators may consider a more flexible approach, such as to allow the use of overdraft facilities (both intra-day and overnight). For example, a company may outsource cheque production to a bank. Instead of funding that current account on a daily basis, with an amount which may not be fully

drawn, the "deficit" in the current account balance can be offset by the positive balance in another account which is used to clear collected premium cheques. This arrangement will reduce the overall idle cash level and economise on the use of banking facilities which can then be redeployed elsewhere.

Contingent liquidity achieved through bond repurchasing is now possible in many Asian economies. However, some tax-related regulatory issues need to be resolved in a number of countries to make bond repo cost-effective. The adoption of International Securities Market Association (ISMA) documentation as the standard is rapidly becoming universal. The most recent item of this documentation, TBMA/ISMA Global Master Repurchase Agreement (GMRA), was released in 2000 [TBMA stands for The Bond Market Association]. The local-currency repo market is also rapidly expanding in Asia and banks are setting up new bank lines for such purposes.

Managing Growth With a Flexible Cost Structure

The product development and servicing capability of cash management banks has made a quantum leap forward in Asia during the past decade. Some banks have chosen to develop an indigenous product – from concept to design to implementation – solely within Asia, thus, shortening the turnaround time and taking full advantage of local language flexibility. Staff are localised and trained so they are fully qualified to spend time with customers to tailor-make a solution that works, and to supervise the implementation from "change management" or role-mapping, to user-acceptance testing (UAT).

From an insurer's point of view, the challenge is to do more with less. The rapid growth of business has created the opportunity for banks to perform collections (e.g. retail lockbox cheque-processing and post-dated cheque inventory management) and payment outsourcing for the insurance companies. However this also creates the need for banks to put into place a robust business continuity environment and backup arrangements as well as user-friendly service level agreements.

Bank Relationships

Increasing compliance costs, new Bank for International Settlement rules on capital charges and the spectre of eroding lending margins have driven banks to increase their fee-based businesses and reconsider their strategies with regard to customer selection. Traditionally bank branches were benchmarked in terms of their deposit-taking abilities. This trend has changed as branches are connected in a single IT platform. The role of branch banking is shifting; branches are now seen as being sales outlets rather than as stand-alone loan and deposit profit centres. In geographically large markets like China and India, banks' headquarters begin to perform an expanded role both in product development and in coordinating a seamless delivery of services to key clients.

Paradigm Shift

A high quality cash forecast can only be achieved if the grass-roots level believes in the benefits of reducing cash flow mismatches in the form of either shortages, which will result in unnecessary borrowing costs, or excessive idle cash. However in some jurisdictions, the "no borrowing" restriction is narrowly defined as "no negative book or general ledger balance". In a current account, it is possible to have a negative book balance even when the bank balance is positive due to the existence of unpresented cheques. This will result in an inefficient use of funds, which is an economic loss or opportunity cost incurred.

Operational Risks are Hidden Costs

Investment assets represent a major component of the balance sheet of an insurance company. A good custodian banking arrangement is essential to ensuring its investment is protected in a segregated portfolio. It would be a welcome move indeed, if some jurisdictional regulations were to be modified to provide an insurer with the flexibility to make the choice of custodian bank based on its credit rating, pricing, system and service. The capability of the custodian bank in enforcing operational risk controls should be an important criterion in that selection decision.

As real-time gross settlement (RTGS) is available in most markets in Asia, the adoption of "payment versus payment" (PVP) for foreign exchange settlement and "delivery versus payment" (DVP) for securities settlement is moving fast. For example, in April 2004, the China Government Securities Depository Trust & Clearing Co Ltd (CDC) agreed with the Hong Kong Monetary Authority (HKMA) to establish a linkage from CDC's Government Securities Book-Entry System (GSBS) to the Central Moneymarkets Unit (CMU) in Hong Kong. Taking advantage of the CMU's interface with the Hong Kong dollar (HKD) and USD and euro (EUR) clearing systems in Hong Kong, the GSBS-CMU link will enable mainland Chinese financial institutions authorised to deal in foreign exchange transactions to hold and settle debt securities in Hong Kong. Mainland investors will be able to settle HKD, USD and EUR-denominated debt securities lodged with the CMU on a DVP basis. This will reduce any settlement risk arising from cross-border trades or time-zone differences. The CDC is empowered by the Chinese Ministry of Finance to operate a nationwide government securities registration and settlement system, a system designated by the People's Bank of China for the interbank debt securities market. It provides interest and principal collection, registration, custodian and settlement services for government debt securities and financial debt securities as well as other debt instruments.

Growing Needs for Foreign Exchange Hedging Products

Insurance companies invest a portion of their portfolio offshore for diversification benefits and yield enhancement. Some local capital markets have yet to develop to the level that provides the breadth (choices of credit, duration and sector) and depth (retail and institutional investors, size of secondary market and repo market) of market similar to those available in developed markets. Offshore investment restrictions are gradually being relaxed. The ceiling can be measured in terms of maximum percentage of assets or a solvency margin. For investment-linked funds, it can be a percentage of net asset value (NAV). Such reform opens up opportunities for further developing the onshore foreign exchange market.

Cross-currency swaps are a common form of hedge. The duration tends to vary greatly from over 10 years in Singapore to around a year in Taiwan. As the underlying investments, say in USD, EUR or Australian dollars, are likely to be sovereign or corporate bonds with a long duration (10 years is common), the risk of a mismatch in hedge duration has to be managed.

The HKMA has taken the initiative, forming the Treasury Markets Forum of Hong Kong (*www.tmf.org.hk*) in March 2004. Chaired by the deputy chief executive of the HKMA, the TMF aims to bring together market participants, including banking professionals and corporate treasurers, to promote market and product development as well as appropriate codes and standards for the treasury markets. For example, the adoption of the International Swaps and Derivatives Association (ISDA) documentation is key to establishing foreign exchange counterparty relationships. The potential in some major markets like China is immense but the challenges, including different languages and banking practices, have to be overcome. Success in developing the appropriate hedging products will also be positive for the growth of the qualified foreign institutional investors (QFII) programme and the future qualified domestic institutional investors (QDII) programme.

Use of Standby Letters of Credit for Margin Solvency Purposes

Traditionally, local regulators require insurance companies to place deposits at banks to meet margin solvency requirements. In some jurisdictions like Hong Kong, the requirements have become more flexible. Insurance companies can choose to arrange a standby letter of credit to be issued by a panel of banks with the Insurance Authority as the beneficiary. The letter of credit can either be "clean" or supported by a portion of the bond portfolio as collateral through the signing of a pledging agreement. As a result the funds locked in low-yield bank deposits can now be invested to achieve a much higher return. For a variety of reasons, liquidity levels in the Asian banking system are extremely high and loan-to-deposit ratios remain low. Gone are the days when banks rely upon deposit-taking as their sole *raison d'être*, and banks now prefer the fees they earn from the issuance of letters of credit. Therefore a more flexible approach is worth consideration by regulators in other jurisdictions.

Conclusion – Doing Right Things Right

Apart from providing insurance coverage (protection) and wealth management (investment) products, insurance companies as institutional investors perform an important role in the capital formation process of an economy. Effective treasury management addresses the priorities of a company for growth, liquidity, investment return and risk controls; the success of which requires the availability of the right banking products and an appropriate regulatory framework. In turn, a healthy development of the insurance sector provides the impetus for sustainable growth and the further development of the economy. ◆