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Profiting from Financial Turmoil in Asian Insurance Markets

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Summary: While Asian insurance markets continue to offer extraordinary long-term potential, many are experiencing growing pains associated with the rapid development of the past decade. Many markets will see bankruptcies, consolidations, and retrenchment by even the established players.

This session covers the situation in Japan, Korea, and various markets of Southeast Asia. It examines common threads that underlie financial difficulties arising in these diverse markets. In particular, it examines the role played by financial reporting methods, regulator's growth, market share at the expense of solvency, and lack of insurance sector expertise.

While market problems create particular challenges for management of new operations, they also create unique opportunities for players investing for the long term. By the end of the session, attendees will
- *Gain an update on events in the Asian markets.*
- *Learn about the impact of regulatory oversight.*
- *Understand peculiarities of financial reporting in various markets.*

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- *Gain an understanding of risks and rewards that arise because of current market problems.*

Mr. Stephen H. Conwill: I would like to apologize for the title of this session, which is "Profiting from Financial Turmoil in Asian Insurance Markets." The intent was to look at the growing pains in the Asian markets. We believe that we have products and services and professionalism that can be applied there and that western companies can invest in the Asian markets and hopefully achieve an appropriate return on earnings (ROE) for that investment. If you look around Maui or look around the airport in Honolulu, you will notice there are not very many Japanese tourists here. If you've been here before, you'll notice that's quite a change. If you think about that, it may be a leading indicator that the Japanese financial markets have dropped very much as we all expected.

We have three panelists with extensive experience in the Asian markets. The first speaker will be Clark Ramsey. Until very recently, and for three years, he was chief actuary for Allstate International, focusing significantly on Japan and Korea, but his travels would take him to Singapore and across to India, so he has broad experience in the region. Next up will be Dale Kelly. Dale is a consultant with Trowbridge Consulting and heads up the Singapore office. He's been a consultant in Southeast Asia for the past four years, and his travels take him to Singapore, Malaysia, Thailand, the Philippines, Indonesia and Brunei. After Clark talks about primarily Korea and Japan, Dale will give us an overview of some of the Southeast Asian markets. Then we'll end up with Jeff Newnam whose focus will be Indonesia. He's worked for Principal Mutual's operation down there and focuses on employee benefits, pension funds, and group insurance issues, so he'll give us both a prospective on the product side and a real focus on Indonesia.

Let me give you a brief Japan-centric view of the current Asia problems and then turn it over to the panelists, who will have a different view. If you look at a very capsule history of Japan for the last 50 years, we can go back to the period 1945–50. The goal and the primary focus of the government and society of Japan was feeding the people. The material infrastructure was ruined after the war, but they had a very strong intellectual infrastructure, and the goal of that five-year period was just making sure everyone had food. In the early 1950s, in part because of the jump start afforded by the Korean War and Japan's being a large supplier to the U.S. in the war effort, the economy began to pick up. The 1950s, 1960s, and 1970s saw remarkable economic growth. There were some labor unrests as a result of oil crisis, but Japan saw very unprecedented growth from 1950 through the mid-1980s, by which time Japan had become an incredible export engine, and, as you all know, the import sponge was the U.S. There was a lot of concern about the huge trade and cash-flow imbalances that were occurring.

The G5 nations decided in order to correct the trade imbalances to take a currency focus and inflate or increase the value of the yen. Over a very short period of time, the value of the yen more than doubled. In fact they did to some extent slow down this incredible export engine; the exports did slow a little bit. The U.S. trade deficit with Japan did decrease to some extent, but there really was an unanticipated by-product of increasing the value of the yen. It created enormous financial wealth in Japan, and what do you do with financial wealth, you try to recycle it in some way. The Japanese invested heavily in Hawaii, bought properties on the west coast, and in New York—Rockefeller Center—but more to the point of this session, the Japanese domestic industry was having trouble competing on price, so what do you do, you decide to expand your operations overseas. In particular, huge cash flows went from Japan to the Southeast Asian nations to move plant and equipment to those nations and build an export engine focused on production outside of Japan.

At the same time, the opportunities in Japan for investment were somewhat limited, so people focused on financial assets and real estate. From 1985 to 1990, real estate prices went up many multiples, as had the equity markets from about 10,000 to about 40,000. In any case, we had this huge boom created by an export of Japanese capital and a bubble created by what was happening in the internal investments. The boom in Southeast Asia was not just Japanese capital, it was North American, European, and Australian capital following the Japanese money. Good work ethics and reasonably stable governments formed a good environment for creating a boom, but it was an inherently unstable situation, and as you know, the boom has turned rather rapidly into a bust, and it's very hard to know where the bottom will be or what happens next. I'm going to turn this over to the panelists and let them discuss what they've seen and what may be in store for the future.

Mr. Clark A. Ramsey: I'm sure you're all aware that 1998 is the Year of the Tiger in the Chinese calendar. So far it hasn't been a very good year for the tiger. Those of you who remember the Vietnam War probably recall the domino theory that said the U.S. had to be involved in Southeast Asia because if the government of South Vietnam fell to communism, the governments of the other countries would fall like dominos. It turns out the domino theory was basically right. It was off by about 30 years, and instead of falling like dominos, it was really a bonfire of the currencies that swept through the region. It didn't start with the war in Vietnam, it started with botulism in Thailand. And the governments aren't falling to communism, the currencies are falling to currency speculators or market forces or whatever you believe. It wasn't restricted to Southeast Asia but instead spread to Korea, Japan, and Mexico, and if you're surprised at seeing Mexico on the list, I'd ask you to go out and check the foreign exchange listings. The peso has been plunging in the past few weeks, but it hasn't gotten any news, the basic reason being Asia has been monopolizing the news.

I'm going to focus mainly on Korea during this talk, but I'm going to do a lot of comparing of Japan with Korea, because the two are very intimately linked not just by geographical proximity, but also genetically. Apparently the Japanese and the Koreans are more closely related than either group is to any other ethnic group on earth.

The economic system in Japan is dominated by the Keiretsu and in Korea it's dominated by the Chaebol, which are very similar, although not identical, organizations. The Japanese colonial area in the 1920s and 1930s was when the Chaebol were first started up and they were intended by the Japanese to be copies of the Japanese Keiretsu. They were originally set up to make sure that Korea acted as a good feeder of supplies for Japan. With independence after the world war, a lot of things changed there. There are differences between the Chaebol and the Keiretsu model that they're based on, although they are both conglomerates of many companies. The Korean Chaebol actually dominate the economy even more than they do in Japan. I've read that the super C-Chaebol, the top four Chaebol, actually account for about 40-45% of Korea's gross domestic product, which is quite frightening, and it will be even more frightening when we talk about financial state of the Chaebol a little later.

In Japan, the Keiretsu are typically centered on a large financial institution such as Mitsubishi Bank. In Korea they kept the financial institutions separate from the Chaebol organizations, and it did have important implications for capital allocation in Korea. Another distinction is while the Keiretsu tend to be vertically integrated so that, for instance, you can use a Mitsubishi bank loan to buy your Mitsubishi car that includes a Mitsubishi radio, the Chaebol actually spread across many different industries. It appears to me as an outside observer that the Chaebol have made a pretty gallant attempt at being in every business in every country, and in doing so, not only have they failed to achieve economies of scope, but I think they have achieved diseconomies of scale in general. The Keiretsu are far less formal than the Chaebol. The Chaebol actually do have a centralized control and a very formal structure, but it's been said that the Chaebol financial plans always originate in the financial center of the parent of the organization and are disseminated downwards rather than originating in the operating companies themselves.

The final distinction is that the Keiretsu may have been family-based originally, but so much time has passed from their founding that that's no longer the case. The Chaebol, on the other hand, are relatively recent phenomena, and they are still very strongly family based, so that not only the leaders, but also a good percentage of the top management, of the Chaebol are from the same family.

Whereas Japan has the Ministry of Finance, which has been described as the most powerful organization in the world outside of Washington, D.C., Korea decided to do them one better and has the Ministry of Finance and Economics (MOFE). They both play a very active role in their respective economies. With regard to insurance in particular, they actually do the licensing of insurance companies, issue all the regulations, and place restrictions on the businesses that different countries can participate in. For example, the same company cannot be in both life and non-life, and to be in any other business other than, say, your life insurance business would require specific approval from the MOFE. There are a couple of other insurance regulatory bodies in Korea also, for example, there's the Insurance Supervisory Board, which does the more detail-level things, such as auditing companies and managing the very tiny guarantee fund for the protection of policyholders in Korea. It's nowhere near the size of what we're used to in the U.S.

A very important point is that the big three Korean companies also act as shadow regulators, so that in effect they may actually be the ones approving your policies, distribution, etc. I believe this is typical in Japan also with the large companies there.

Historically insurance in Korea has been very tightly regulated with regard to what products you could offer, how you could price those products, extending to even what dividends you'd be paying on those products, how you distribute them, and even asset management, to the extent of what assets you buy, not what class of assets, but perhaps what particular asset you buy, or what particular asset you might sell. As in most of Asia, Korea has had liberal solvency standards, but even those haven't really been enforced. There is a gradual process of liberalization going on. A lot of deadlines have come and gone without the promise of liberalization taking place.

The MOFE has maintained a very tight control, including how you determine gross premiums. This concept is important to grasp, because it will help you understand the level at which most Korean actuaries practice. Gross premiums in Korea are really just a loaded valuation net premium, loaded for acquisition expenses, maintenance, and collection expenses. You don't even have much leeway in the selection of assumptions, because the MOFE actually specifies what interest rate, mortality, or morbidity you will assume, and what acquisition, maintenance, and collection expenses you will assume. It becomes really a life contingencies exercise to calculate premiums and not an exercise in selecting assumptions and profit margins and so on.

My boss at Irish Life in North America is very fond of pointing out that if you put a group of actuaries in a room and ask them to develop a product, they'll come out with a camel. In Korea, if you put a group of actuaries in a room and ask them to develop a product, not only do they come out with a camel, but it's exactly the same camel that every other company has, perhaps with a different color saddle on it.

Three main types of products exist in Korea: savings products, protection products, and endowment products. Probably the most important feature of all of them is that in general they're participating. While I believe there's some lack of complete clarity on exactly what you have to pay out in the form of dividends in general, you can assume that it has very negative implications for the amount of money that's left over for shareholders.

Most of the savings products are interest-sensitive products, with a credited rate that's usually tied to the one-year bank deposit rate. It might involve a spread over the one-year bank deposit rate, say, 100, 200, or 300 basis points above that rate, or it might be a multiple of that rate, for instance, 110% of the bank deposit rate. Some of the products have what we refer to in the U.S. as a two-tier interest rate structure, so a lower interest is used to determine surrender values, compared to the higher interest rate that's used to determine maturity values. In 1998 a new monthly floating-rate product has been introduced in Korea, and I will talk about that in a few minutes. Most of the savings products are very short-term; five years is probably the most common maturity. They also have three-, five-, seven- and 10-year products, and the new floating-rate products are even sometimes shorter.

The protection products in Korea are disarmingly complex. Most of them present a life contingency nightmare. They might offer benefits such as life insurance protection, but there is usually an additional payment for accidental death, and some other additional payment if death occurs because of cancer. Often disability benefits are included in the same policy, where the lump-sum payment can depend on one of seven different degrees of disability. It might be a payment for a traffic accident, which is not a common feature in a life insurance policy, except in Korea. There might be benefits for hospital stays or surgery and usually those are indemnity-type benefits. There might be benefits for cancer, which could be for diagnosis, hospitalization, or death from cancer, as I mentioned before. All of these benefits can be offered in one policy. To make it even worse, they offer these with a wide array of benefit periods and premium periods. You might be able to buy these as a 10-, 20-, or 30-year product or a product to age 65, and then the premiums may or may not be co-term with the benefit period, so it may be a single pay, five pay, 10 pay, 20 pay. You end up with a rate book that's quite voluminous.

I know that at the company we were dealing with at Allstate the factor file had somewhere in the neighborhood of 10 million factors on it and there were about 200,000 policies in force. Not very efficient.

The endowment products in Korea are typically the education endowments that you find in the rest of Asia. One of the benefits is for young children or newborns, and in the case of some policies some are for unborn fetuses. The endowments or coupon benefits are usually tied to school events, which is entering into the next level of school or college, and usually there's some type of protection benefit included also, which may include several benefits we talked about earlier. There are also endowments such at age 65, 20-year endowment, etc.

Continuing in my comparison of Korea and Japan: both countries are characterized by a very undeveloped capital market. This is probably best illustrated if we take a look at the distribution of assets that Korean life insurance companies have. Cash, real estate, stock, and bonds all together account for only about half of the assets. The other half of the assets, 48% or so, is in the form of loans. Actually very little of it is in the form of securities, and that reflects the actual distribution of assets in the Korean capital markets. The equity market itself is small; the bond market itself is very small. The entire market capitalization of the Korean stock market in very rough terms is about one American International Group or two Allstates—something in that range. That reflects not only the effect to which the Korean stock prices have been beaten down so far, and the stock price bubble in the U.S., but also the fact that very little of Korea is actually capitalized via equities. It's mainly capitalized via debt.

The allocation of capital in Korea has been similar to its allocation in Japan, although not identical. It principally has been by government dictate. The government has identified certain industries and certain companies it has wanted to succeed, usually for purposes of leading the economy by the export engine that Steve mentioned. There is also, to a lesser extent, what we might call the crony capitalism, the allocation of capital by personal connections and favors. The very important factor here is that without the functioning of a credit market, like a corporate bond market where you have a lot of underwriters evaluating the credit worthiness of a prospective borrower and the projects and so on, its capital allocation has really been without much regard for the risk of whatever it might be, say, funding or for the potential returns there.

Korea is really a debt-capitalized economy and not an equity-capitalized economy. If you look at the super-Chaebol, the largest Chaebol, the debt ratios at the end of 1997 are quite frightening by western standards, with Hyundai leading the pack at almost six times as much debt as it has in capital, Lucky Gold Star at almost five times, and Samsung at far more modest ratios.

You probably have not seen much the use of promissory notes on the floor. I found this during 1998, and they're presented as really the next debt crisis in the making in Korea. Apparently most intercompany transactions in Korea are not settled via cash but via promissory notes, which typically carry a maturity of three to six months. These notes are completely unsecured, and if you'd rather have cash rather than the promissory note, you have two options. You can wait until it matures, or you can take it to the bank and have it rediscounted. When you rediscount it, you in effect change the guarantor payment from whoever created the promissory note to yourself. Right now there's so much doubt in Korea as to who is able to make good on their promises that the promissory note system is apparently almost paralyzed. It has created a lack of confidence, and, as I said, it is a potential new crisis. The Chaebol themselves apparently have about $5 billion worth of these unsecured promissory notes outstanding right now, which is a material number. This is a debt problem that is in addition to the foreign debt crisis that's being addressed by the International Monetary Fund (IMF) in London. It hasn't been in the news much.

Japan has Zillmer reserves. I should point out that the Japanese insurance system was really modeled after the German system, and I'm sure you guessed that Zillmer was a German name and not a Japanese name. Korea, on the other hand, again did them one better and came up with what I call pseudo-Zillmer reserves. A Zillmer reserve is an actuarial way of amortizing some predefined level of acquisition expenses, usually based on whatever your pricing assumptions were, and we think of it in the U.S. as just a modified premium type of reserve. In Japan they frequently use modified Zillmer reserves to create the net level in, for instance, five or 10 years. Korea decided to simplify things, so they went to what I call the pseudo-Zillmer. They replaced this actuarial amortization with a straight-line amortization, where the amortization follows a 10-year straight line for the first three years of the policy's life. The other three years it jumps to a seven year schedule, so you do get quite a discontinuity. These pseudo-Zillmer reserves also determine the cash surrender values of the policy.

Finally in the comparison, whereas Japan has an undercapitalized life industry, Korea once again did them one better and has a completely insolvent life industry. Steve Conwill has done research that shows the reported capital and surplus over the past five years of the original six Korean companies, which continues to be positive, although given the size of those companies, that's actually a relatively small positive. The new Korean companies are showing a rather healthy negative, in 1996 about 800 billion won in the hole on a reported basis. The JV companies are over 200 billion won in the hole at the end of 1996, and the foreign companies are showing a small positive.

It is important to understand that this is what's reported as capital and surplus and may not have any direct relationship with economic capital and surplus. It's just a brief comparison of Korean GAAP and U.S. GAAP. Whereas under U.S. GAAP we're all familiar with the deferral of acquisition costs over the useful economic lifetime of the block of business, in Korean GAAP start-up costs for the company are deferred, so that a new company takes its start-up costs, which are defined in the accounting literature, for the first five years of its operations and defers them so that it begins amortizing them over the second five years of its operation. Clearly your profitability and your capital and surplus are restated during the first five years and over the first 10 years, and profits are shifted from the second five-year period to the first five-year period. It makes it hard to evaluate some of these companies.

Note that the benefit reserves in the U.S. GAAP are net-level premium, or for 1997 products they're based on account value. In Korea, they are the pseudo-Zillmer reserves or sometimes net-level premium reserves. It's probably important to note that to pay shareholder dividends out of the company, I believe you have to be at a net-level premium basis, and most of the newer companies are not. The benefit reserves in Korea are sometimes based on this maturity rate for the two-tier products, but sometimes they're based on the lower surrender rate for the two-tier products, so again there's probably an understatement of reserves there.

Finally, there is bad debt allowance, which is not something that actuaries focus on very often. In the U.S. it's based on a realistic assessment of probability of collecting. In Korea it's just based on a formula percentage. Perhaps by pointing this out to you I'm suggesting that bad debts are typically understated. If we remove the effect of those deferred assets from the reported capital and surplus from the Korean life companies and restate them, we see a far worse picture than we saw before. The original big six companies, of course, do not have any deferred assets. They've been in existence for a lot longer than ten years. The new Korean companies should be shown at about negative 800 billion won before restating for the deferred assets and about negative 1.3 trillion after restating. Similarly, the JV companies are in the negative 400 million won range, and the foreign companies are still showing a very small positive. When you add these up, you do get an insolvent life insurance industry on a restated basis.

One thing that Korea has that Japan clearly does is interest rates. Korea has a lot of interest rates. The three-year bond is the long-term bond in Korea. Some very high rates occurred in late 1997, but they fell to a 29% rate by the end of 1997. That spike in rates that occurred in 1997, of course, has had some rather predictable impacts. As policyholders seek higher returns and possibly safer institutions also, persistency has been bad, and disintermediation has been very high. I don't think this has been an issue yet, but in the very near future the liquidation of assets in order to pay those departing policyholders may be a challenge, to say the least, for some of these companies. Loans are not quite as easy to liquidate as corporate bonds are. We may see some cash-flow insolvencies.

There has been a tendency in the past few years for Korean companies to tend to claim that they're solvent as long as they have enough cash flow to meet their obligations, so it was irrelevant whatever the recorded capital and surplus was. Even under that very liberal standard of insolvency, I think some companies are probably about to go under.

I mentioned earlier that a new product was introduced to deal with this new volatile interest rate environment. It is a floating-rate savings vehicle, and not to be outdone by the protection products in Korea, they decided to design it in a rather complex way. They use a moving weighted average of three items: the policy loan rate, bank deposit rate, and the three-year corporate bond rate.

Challenges in the life insurance industry are: profit margins that are lower and negative, and the very serious perception that selling insurance lacks prestige. Agent productivity is poor, and retention of agents is poor. Policies have been missold, there is recognition of the need for more efficient distribution, products that are complex and misunderstood by our consumers, and product shelf lives are shrinking. The life insurance industry in the U.S. has a lot of challenges, and in Korea it's even worse. Not only all this, but very severe problems with distribution also exist.

The Korean model of distribution has been based on housewives selling part-time, typically poorly educated and inadequately trained. They typically sell to a close network of family, friends, and other associates like that. As a result, retention of those solicitors has been very poor. I've seen numbers of something like 40% of solicitors still remaining after one year, and policy persistency has been equally bad, with some companies showing lapse rates in the neighborhood of 60% or 65% in the first year. Part of the reason is that the compensation system is not necessarily clear, that is what it is they're being paid for. There's a combination of salary and commission. When there are incentives with it, it's not even clear that it's designed to align their interest with the company's, so that persistency, for instance, is not very well rewarded. It's a very complex formula and hard to understand, and when something is hard to understand, it's hard to base your actions on that formula.

There are some companies that are succeeding with professional agents, Prudential and, I believe, the ING Company in Korea. They are showing persistency rates and agent retention rates that are well in excess of industry norms, and probably at sufficient levels to be profitable.

Let me give some recent developments in Korea. The financial supervisory commission has identified 15 life insurance firms out of a total of 33 that suffer what they call payment capability problems. Apparently 10 of them were bad enough that they've been ordered to submit rehabilitation plans by June 20, so there should be movement in relatively short order. If those companies fail to implement their rehabilitation plan three options have been noted. They will be forced to merge, they could see a forced takeover by a third party, or they could have their business license revoked, which doesn't sound like a good way of protecting the policyholders involved here.

Met Life has been very active recently in Korea. They've had a joint venture with Cologne Met Life for quite some time, and in April or May Met Life bought out their joint venture partners, so that now or soon will be a 100% owned company. Met Life has also entered into $1 billion deal with Korea Life, which is one of the good-sized companies in Korea and, from what I've seen, probably one of the better-run companies in Korea. There is at least one company that is making a fairly significant bet on Korea right now.

Would you want your company to do that? There's been a lot of talk about purchasing companies or other assets that wouldn't affect your fire-sale prices, and I think we've all heard that GE Capital has quite a contingent scouring Asia; rumor had it about 75 people full-time in Asia are looking for things to buy, and I guess they have made some purchases. Citicorp has chartered 747s to take due diligence teams to the area to look at companies that they're interested in. American International Group is rumored to be on the ground looking at quite a few things.

The one thing to keep in mind in Korea is that gaining control of the company is likely to be an issue. I'm not talking about majority ownership. Even with majority ownership, you may find that you don't have control of the company, that it's still a Korean company, and as non-Koreans you may not be listened to as much as you thought you would be via ownership. You'd also find that financial statements of the company are going to need very careful review. Due diligence should be a major task. I've indicated that there are some areas to be concerned with already. There's a lot more. When you get right down to it, what are you buying? It could be an insolvent company with a broken distribution system. There may be reasons why it's at a fire-sale price.

If you plan to start a new company, considerable patience is going to be required if you're looking for a quick profit. I don't think Korea is going to be the place for you. You're likely to make quite a sizeable investment over a period of years before you do see any profits. As I mentioned before, there are some successful models there. Prudential and ING, which I believe are both structured as foreign companies, are showing quite a bit of success, so there are possibilities.

I would like to leave you with a couple of final thoughts. The Korean people have made it through crises much worse than this, and they'll survive this one too. This is a very hard-working nation. Despite everything I said, I do have a lot of confidence in their making it out of this crisis and hopefully making a far more flexible economy that's better positioned for the twenty-first century. Here's a final thought: North Korea is still heavily armed, it's still very close to South Korea. The two countries are still technically in a state of war and even though it may be very weakened by the famine that it's been undergoing for the past couple of years, North Korea is still capable of inflicting a lot of damage on South Korea. That tends to be something that's overlooked quite often.

Mr. Dale R. Kelly: Before we leave Japan and Korea, let me tell you that somebody recently mentioned to me that if you take the insurance markets in Asia, Japan is as large as the rest of Asia put together. If you split Japan, Korea is then as large as the rest of Asia put together. If you exclude Japan and Korea, Taiwan is then as large as the rest of Asia put together. If you exclude all three of them, the rest is really quite small. I'm going to try to cover four countries, so I won't be covering them in the same level of depth as Clark did. Singapore, Malaysia, Thailand, and Philippines. This is a little bit like listing the U.S., Canada, U.K. and Australia. They are very different markets. The financial influences from each of them are very much the same. I'll be aiming to cover those similarities.

If you look at a brief comparison of those four markets, first on the population side, it should strike you that Singapore is very small and Thailand and Philippines significantly larger (Table 1). If you look at the number of life insurance companies, Singapore and Malaysia have more life insurance companies than do Thailand and Philippines. It's worth noting at this point, and I'll be going into it later, that Thailand has increased that number with 12 life insurance companies very recently. Philippines has issued 15 new licenses in the last couple of years. Looking at Southeast Asia as a whole, Thailand was the largest economy there until recently, which is quite remarkable considering that Indonesia has 200 million people.

TABLE 1
BRIEF COMPARISON OF MARKETS

Country	Population Millions	Number of Life Insurance Companies	GDP Per Capita PPP U.S. $	Insurance Penetration (% pop.)
Singapore	3.1	12	$22,770	70%
Malaysia	21.2	18	9,020	20
Thailand	60.8	24	7,540	10
Philippines	71.5	35	2,850	18

It's often said that Singapore is saturated, with 70% of the population having life insurance. That's true on the surface. The reality is that many of the policies in Asia are endowment savings types, and I would say that the number of people in Singapore who are actually adequately insured would be significantly lower than 70%, but it's commonly said that Singapore is saturated. I don't believe that. I think there's a lot of insurance to be sold there. Looking at Malaysia with 27%, they have a lot of growth potential. Thailand at 10% is a very young market, and Philippines is at 18%. It's also worth mentioning that in countries like the Philippines, maybe 50% or 60% of the population is living more or less at the poverty level, so that wouldn't really form the market for insurance.

Looking at the snapshot of the financial crisis, I'm really not dwelling on any of those numbers, but I think the number and size of these negatives drive home the point (Table 2). These numbers are three weeks old, and some of them are a lot bigger even as of yesterday. There are some hidden numbers as well. Singapore's currency against the U.S. dollars has gone down 15%, but what that doesn't tell you is that Singapore's currency actually depreciated against Australia’s by that 10%. Those countries are also being hit very hard. I've included Indonesia just because the size of the numbers are quite interesting. The stock market's falling quite a bit more.

TABLE 2
SNAPSHOT OF EFFECTS OF ASIAN FINANCIAL CRISIS:
PERCENT DECLINES

Country	Currency (Against U.S.$)	Real Estate	Stock Market
Singapore	15%	25%	48%
Malaysia	35	30	55
Indonesia	80	60	41
Thailand	35	50	75
Philippines	35	20	38

If you look at the effects of this on the life insurance industry, the regulators over the last couple of years have been increasing capital requirements, and there's a new focus on insolvency. Many of the local companies in Asia are very poorly run. The effects of the crisis are that you have high policy lapses and fewer policy sales, really all the effects you would expect, and many local owners are beginning to question the value of their stakes in life insurance companies. With increasing capitalization, a number of these owners are being asked to put in more money. Some are unwilling to put in more money because they're not getting the returns on their existing investments, and some quite frankly are just unable to because they don't have the cash.

There's also a perception that was voiced to me recently that foreigners, because the local currencies have devalued, have more money to spend. Now, in local currencies that may be true, but some of the local companies have actually raised the price of their companies which doesn't quite make sense. You also have the conspiracy theory, which is probably being most voiced in Malaysia by the prime minister Dr. Mahathiro.

You also have a problem that independent valuations aren't really accepted. There's a local perception that independent assumptions aren't appropriate. The local parties that once used earned assumptions tend to be more aggressive than a foreign partner. You tend to get a bit of a problem in valuation. The concept of independent advice is also not fully established. The Asian way of doing business is via networks, and they don't fully appreciate that we're not all in one big network and supporting each other. There's also political resistance in giving up ownership to foreigners and some of the regulators would prefer local consolidation rather than foreign intervention. There are also cultural differences, which differ from region to region.

If you concentrate on the markets, just looking at Singapore, it's the most developed market and its limited size with only three million people has resulted in little interest in foreign companies in the past few years; there was only one takeover recently. Consolidation of banks may result in like companies being consolidated. There is a lot of pressure on the banks to consolidate and strengthen, and Singapore hasn't escaped that pressure. Five out of seven local companies are under bank owners, and it's quite likely that if there is a bank consolidation, then the companies will be consolidated also. It's unlikely that Singapore would allow a foreign company to come in and take over one of its life insurance companies. In summary, there's really little opportunity in Singapore.

In Malaysia it's a little bit more active, and you have nine of 18 companies locally owned, and the regulator is pushing for consolidation. I heard this morning that the Malaysian regulator is stepping up pressure on the companies to consolidate quite significantly and by the end of this month there will be a paper issued that will dictate to them. I believe they're being asked to give a plan to the regulator on exactly how they will be tackling the financial problems in the next 12 months, and if they can't demonstrate adequate profitability and solvency, then they will be forced to consolidate.

The regulator may allow one or two local companies to sell to foreign parties. Some of the local companies for political reasons are really off limits. Some of the companies are actually looking for foreign suitors, but there is the price problem. That’s likely to persist for the near-term future, and I think when the pressure is felt, then the prices will come down, and you will get some reasonable trades. At the moment, many talks are going on, but nothing is really happening. In summary, there are limited opportunities in Malaysia.

Looking at Thailand, because of the issue of new licenses, you have two categories. Two-thirds of the established companies are locally owned, and two-thirds of the new companies are locally owned. First, looking at the established local companies, many are badly in need of foreign expertise and capital, and some companies may slip into insolvency. That's maybe an understatement, because some of them are already insolvent. Some are open for discussion with potential foreign partners, but there is, especially in Thailand, fierce resistance to “economic colonization,” as they put it.

Let me summarize some of the problems in Thailand. With due diligence, the process is very tricky. Some of the record keeping in companies is not the best and at times you can end up picking up liabilities that you didn't plan on that hadn't been adequately documented. Cultural integration in Thailand is probably the hardest of anywhere in Southeast Asia. I've heard that Korea is quite difficult, but in Southeast Asia, Thailand has that reputation. Language difficulties do form a big part of that. But also, Thailand has never been colonized.

If you look at the new local companies, they're just formed, so they have little or no business as yet. There's been a perception that the licenses have a sale price, and a lot of the local companies applied for the licenses in the view that they will obtain them and then sell them to the local suitor. The foreign companies so far disagree with the valuations, especially recently, because the licenses were obtained before the crisis. The Thais really do resist foreigners picking up assets at fire-sale prices. There's a lot of pride in being Thai, and they resist foreigners quite a lot, although they do need the expertise and the capital.

One interesting issue is that some of the banks and finance companies who own shares of the new companies have actually been pushed into liquidation by the government. There's a question about what's going to happen to those assets. They're technically owned by the central bank right now, but by the end of the day they have to be auctioned off, and there's a question of whether foreigners will be able to bid. In summary, there are potential opportunities in Thailand.

The Philippines is quite different from the other countries. Twenty to 35 companies are locally owned, and many of the local companies are open to discussions with foreign companies. One of the unique things about the Philippines is that 100% foreign ownership is allowed. In Malaysia until recently the limit was 30% and in Thailand also. This has attracted many foreign companies. There's little resistance from the regulator in talking to foreign partners and coming to agreements. The problem is that the market's very competitive now, and allowing new licenses and allowing 100% ownership attracted a lot of companies. With the new entries, you now have 15 foreign companies. They're all vying for the same human resources. There is a limit in the Philippines. In summary, there aren't many opportunities, but it's now competitive.

Looking at an overall summary, in all the markets you have increasing possibility for foreign companies as a result of the turmoil. In Singapore specifically, you probably have better opportunities. In Malaysia one or two local companies are known to be available. That's likely to become more of a reality in the short-term future. In Thailand both established and new companies are available but only for the patient; there will be a long negotiation process there. In the Philippines there are many opportunities, new licenses, and existing companies, but it's increasingly competitive. Finally, opportunities are being generated from the turmoil and significant opportunities are possible, but Asia is going to remain competitive, and it's going to continue to be a challenging place to do business. In summary, only the best managed companies are going to meet their profit objectives. Many foreign companies will not.

Mr. Jeffrey P. Newnam: I'd like to point out that there are many similarities between all of the Asian markets. One of the things that strikes me after listening to Clark's presentation on Korea is how all of Asia has really followed the Japanese model of financial markets, and these models do not depend on the capital markets. All the countries have very small, almost nonexistent bond markets. The stock markets are thinly traded and subject to manipulation by insiders. Many companies do not float all of their stock; they will float only maybe 40% of it on the market, and they continue to control 60%. So shareholders really have no rights. I think this is similar in all of the markets.

I had great difficulty with this topic when it was presented to me, because I had to think about a lot two months ago when I started preparing this presentation. Indonesia really went through a meltdown. In the first quarter they reported that economic growth declined 8.5%. I started writing this presentation the end of

April. Then I had a couple weeks off to reflect as the country burned, and I would say that in the month of May there was probably another 8.5% decline and that we're looking at a 20% decline in gross domestic product (GDP) from 1997 to 1998. I've read that they're estimating it will take five years for the GDP to reach the 1997 level. This is a country with severe problems. I'm going to try to outline what the problems are, because they really do affect the insurance industry and the opportunities that are available.

Twelve months ago I was on vacation in the Philippines and completely out of touch with what was going on. When I left in July, we were investing primarily in banks because there are no bonds that you can purchase. We were investing in three month time deposits with banks. We were getting annual percentage (APR) rate of 14-16% from these banks. We were using 20 Indonesian private banks that we consider to be the best quality ones in the market. The exchange rate was 2,350 rupiah to a dollar. Three weeks ago interest rates were 55-65% for one-month instruments. The local treasury rates were 58% for one month. Based on our analysis, we believe that although many banks continue to operate, five are solvent, and they're probably going to remain solvent throughout the crisis and are survivors. The last I heard, exchange rates were roughly 13,000 rupiah to the dollar, which makes it a lot cheaper to play golf now, but it's quite a hardship on most of the population.

I'm going to talk primarily about the roots of the economic crisis which I think are fairly similar for most of the countries in the region. Then I'm going to talk about the political changes, because they are going to have a big impact on business in the future in this market, and the impact is much more significant than any of the other countries have undergone. Then I'm going to touch briefly on what types of opportunities are available.

Indonesia is a place where buyer beware. There are a lot of problems, and you really have to dig to find the problems. I think if you spend the money and buy something or form a joint venture, you won't find the extent of the problems until two or three years down the road. Things just get buried there, and it's very difficult to uncover them.

The roots of the crisis really started with Thailand and Malaysia. Both countries had very overvalued currencies relative to the U.S. dollar and probably to the yen and very large current account deficits. In Indonesia initially the crisis was caused by economic factors. Most corporations were borrowing off-shore short term in the U.S. dollars, because the interest differential was around 10%. You could borrow at 7% or 8% off-shore, and then local Indonesian interest rates were about 20%, so they had a very big advantage in borrowing dollars. Most of this debt, though, was very short-term, and it was not hedged. One of the worst things was that much of the dollar borrowing was used for projects that generated a rupiah return. The prior policy was a managed depreciation of the currency. The currency was devalued roughly 5% per year for competitive reasons. This worked quite well and was quite predictable, and it was easy to borrow in dollars. Once the economic crisis happened, companies began scrambling to buy dollars, and it just led to a spiral. The more dollars you tried to buy, the worse the exchange rate got, and just day by day it worsened. Eventually, though, the government called in the IMF and they quickly adopted a rescue package; I think the figure was $43 billion that has been pledged to the country. In return for this, there was a very strict regimen imposed upon the government, and many infrastructure projects were cancelled.

Twelve months ago in Indonesia, there were a lot of power projects and road building, ports, airports, and most of these were canceled. Then a couple weeks later, we saw projects beginning to be reinstated. Most of these projects made no economic sense, but the people who were able to get them reinstated were children of the president, friends of the president, and politically connected individuals, and it just led to no confidence in the government; they're not going to say what they do. It really turned into a political problem.

The crisis deepened at the start of the year, and exchange rates went crazy. I think at one point they were spot trading at 17,000 rupiah to the dollar. The effects on business are very severe right now. It's impossible to get working capital loans for businesses. Trade credits for export industries are impossible to get. No economic activity per se is going on. Unemployment is increasing. I've heard reports that 10 million people are out of work, and they expect another 20 million to be unemployed by the end of the year, so we're talking 30 million people out of a population of 200 million unemployed. I would say the country is in a major recession, or depression might be a better word for it.

Throughout the region you're seeing signs of barter trading where commodities are being exchanged; palm oil for petroleum oil or a number of different commodities. The effects on banks are very severe. There are liquidity problems and an overbuilt property sector. Loans were used for noneconomic purposes. There are too many golf courses, too many malls—that type of thing—that were built with U.S. dollars. The high interest rate environment is leading to a negative spread for the banks. They have to pay out a higher rate on their savings products than what they can earn, and it's causing severe problems. The banking sector is inadequately capitalized. I don't know where they're going to get the capital to make it healthy. The central bank is supporting all the banks at this point and guaranteeing deposits everywhere. Banks are coming under supervision and banks are being liquidated or frozen. It's not a good situation at all.

Insurance companies are hit as badly as the banks are, but it's not being publicized. The capital requirement for an insurance company is 4.5 billion rupiah which used to be roughly $2 million, but now it's $200-300,000. It's not nearly adequate enough. Solvency margins are 1% of your premium reserves. Most of the companies focus on the upper-income markets which attract U.S. dollar-oriented products, and they're heavy savings products. When the exchange rate increases, it gets to the point where people can no longer afford the premiums. Also, the cash values, since they're in dollars, are that much more valuable, and it leads to very high lapses and surrenders. Many companies also did not adequately invest the funds. Many of them said, "Why should I invest this in a U.S. dollar asset and earn 6% on it, when I can invest this in a rupiah asset and earn 15% or 16% on it?" There was a currency mismatch, which leads to solvency problems. I would say most of the domestic companies are technically insolvent. It's not being publicized. The Ministry of Finance is taking some steps to paper over the problems and keep the sector limping along.

The bank deposits are a primary vehicle for most of the insurance companies. If you have a problem with the banking industry, it's directly transmitted into the insurance industry. It's not a really attractive situation to be in. The outlook for employee benefits, I would say, is a little better than for insurance. There are 200 million people in Indonesia, but the educated sector of the economy is very small. It's very difficult to find capable, qualified technical staff, and I think employee benefits are one way to help attract and retain these employees. We have found that it could be difficult to sell pension plans. That's our primary focus. The reason for that is I think that employers would rather increase salaries than set up a pension plan and salaries have taken a big hit. On average, salaries have increased 15%, whereas inflation is probably running at 50-60%, so there's a huge loss of purchasing power.

The political change has been quite interesting to look at. It started out as student protests, and these protests were confined to the campus areas. They were very peaceful and really led to an increase in freedom of speech. Indonesia has been a very controlled country for a long time, and political dissent of any kind has not been tolerated. They have internal security laws that really clamp down on any opposition. The student protests were an opening up of the political process. The protests were getting much more frequent. Essentially those universities were shut down by the students, and all they were doing was protesting. On May 12, a faction of the military shot and killed four students on campus. The funerals occurred the next day and the day after the funerals there were massive riots. These riots were race riots; it was the Indonesian indigenous population against the Chinese. Chinese businesses were destroyed, burned, and looted. There were many violent acts against individual Chinese people. During the riots, the military and the police did nothing. There was quite a bit of conflict within the military. The day after the riots, the military was bussed or came in to the capital en masse. We saw many tanks in the streets, a lot of heavy military presence, and they restored order. It was shortly after this that President Suharto resigned, and a new government has taken over.

Political reform is probably the agenda for the next 18 months. I think what they are going to attempt to do is set up several political parties and hold elections and really move toward more of a democracy. Also, a lot of economic reform is going to occur, and I see one of the things that they're trying to eliminate is corruption, cronyism, and nepotism. You're going to begin to see greater disclosure and transparency in the system. I think that there's going to be a lessening of the dependence on political connections for economic activities. There's going to be more competition promoted, and most of the monopolies are going to be eliminated.

Financial opportunities for us are several. Assets can be purchased right now quite cheaply in U.S. dollar terms. A problem that you have to look out for is, first, lack of transparency. There are a lot of problems hidden in the balance sheet. The balance sheets for most financial statements are very Spartan. There's not a lot of information there, and you really have to dig to find what you're looking for. Most of the potential partners lack capital. Most of the companies in Indonesia are technically bankrupt. Current partners of many companies do not have the ability to contribute additional capital to expanding a business, so that's also a problem.

I think any movement in this market requires a well-defined strategic plan. You can't just say, "This is a big market; I have to be here." You really have to figure out what it is that you want from this market and how you're going to go about getting it. Many companies there now rushed in because it was a big market and because the economy was growing quite rapidly for such a long period of time, and they have problems.

The insurance industry has a lot of problems because of its association with the banking industry. The capital markets have a long ways to go to develop, and that's going to create significant problems going forward I believe. The investment market has completely crashed. Many of the foreign brokerage houses have closed up shop and left. There's a very good supply of investment people right now in the market, who can be acquired at a fairly reasonable cost. I can't really paint a very good picture of this market. There are opportunities, but I'm not quite sure where they are.

Mr. Conwill: Let me give you one truly remarkable statistic from the Japanese market that will give you an indication that there really are potential opportunities for foreign companies. In 1979 Sony and Prudential formed a joint venture in Japan. At the time there was not a lot of interest in Japan. It's a very difficult market to enter; the culture is difficult for an outsider to understand. The large domestic companies were completely entrenched, and people really shied away from Japan. About 20 years later—fiscal 1997—Sony and Prudential have split up their operations, and they're now operating quite successfully as independent companies. These two companies had the largest increase in insurance in force in fiscal 1997.

From the Floor: My question is it looks like many of these economies are basically leaning now on their central banks or their own currencies. How good are these currencies? How good are these central banks? If you were doing a rating, where do they come out?

Mr. Kelly: The quality of the banks varies by country. Singapore is pretty good, Malaysia is quite good, and from there it goes downhill. Thailand: again quality slips quite a bit, but Thailand is quite good. Compared to the U.S. and European banks, I'd say a lot weaker. Central banks do have some strength in Southeast Asia. In some countries they may be marginal.

Mr. Newnam: Indonesia has a bond listed on the New York Stock Exchange, I believe, and I think it is junk right now, but at one point it was priced at about 50 basis points above U.S. treasuries. They have severe problems, because they have decided that they are going to keep the banking system from completely collapsing. They're going to be needing an extremely large amount of funds probably in the next year or two to stabilize the banking industry. I don't think the IMF is really comfortable with their independence prior to the political change, but I think steps are being taken to make the central bank independent from the government, which is a very positive move.

Mr. Craig M. Reynolds: There's a session tomorrow morning on the difficulty of setting a lapse assumption because there are no real data in the U.S. To what extent do any of these currency-wild, interest-rate-wild countries offer some experience that might be useful in setting our own U.S.-based intermediation lapse assumptions, or are they even relevant?

Mr. Ramsey: Do I think the experience in Korea would be relevant if you could quantify it and try to relate it to the U.S.? I think it would, but I don't think that you're going to find the data available. I wish you could. Again the problem goes back to the whole process of premium formulation, where the tracking of experience in order to make assumptions about the future is not an exercise that is well understood in Korea, and so I think the difficulty would be in finding the experience.

Mr. Kelly: I find it difficult to see how the data could be relevant to the U.S.

Mr. Reynolds: Interest rates.

Mr. Kelly: I find it difficult to see any comparison.

Mr. Newnam: I don't believe so in Indonesia, because as insurance agents go out and sell, they sell the biggest policy they possibly can, and if it's U.S.-dollar based, when it comes time to pay a premium, policyholders let it lapse not because the interest rates have changed, but because they can no longer afford to make the payment, and that's why you see the lapses. I don't think it's a function of interest rates.

Mr. Kelly: In Indonesia, I understand, there was a lot of lapsation—people cashing in U.S.-dollar policies—because of the high interest rates.

From the Floor: How do they manage their currencies?

Mr. Newnam: Very poorly. I think most of the joint venture companies actually invest in U.S. dollars, and it's U.S. dollar linked. The insurance law says that you can have a currencies mismatch of 10% at most, but you have very poor regulation in Indonesia, and people do pretty much what they want to do, and not much is said. Insurance audits are rarely done, so there's no enforcement of a lot of these things. Many of the domestic companies have severe problems now because they were currency mismatched.

Mr. Kelly: Only the Philippines has a lot of U.S.-dollar policies, and that's been only recently. There hasn't been a problem except for in Indonesia. A lot of the local companies decided that their U.S.-dollar policies were in fact U.S.-dollar-linked policies, and they set the link at 5,000 rupiah. The foreign companies did resist that, and the debate continues. It's quite an interesting debate.

Mr. Ramsey: In Korea and Japan this hasn't been an issue. They haven't used U.S.-dollar-denominated policies, but they've created an issue out of it by investing some of their assets in U.S.-dollar-denominated securities anyway, despite the fact that they don't have the dollar-denominated liabilities.