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Opportunities and Challenges in the Korean Insurance Market

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Korea's financial crisis in the late 1990s caused a dramatic shift of wealth from low to high-income earners: the rich got richer and the poor got poorer. These days, young professionals in the wealth-accumulation group are looking for enhanced financial services, and the high- net-worth group that has capitalized greatly on the rebound of the capital and real estate markets is looking for a better way to secure their wealth. People have learned about financial risk the hard way, consequently, protecting their wealth in this volatile market is their major concern.

Due to the greater demand for financial services to focus on wealth accumulation and management, service providers are introducing more innovative and sophisticated services, such as private banking and financial planning tailor-made for specific clients.

Meanwhile, globalization, financial holding-companies, a low-interest-rate environment, and changes in the regulatory environment pose both challenges and opportunities for the Korean economy. While these challenges will in some ways strengthen the fundamentals of the financial market, they will also threaten some companies that are incapable of coping with such forces.

TABLE 1—MAJOR CHALLENGES FOR THE KOREAN FINANCIAL MARKET
• Globalization • Financial holding companies • Low-interest-rate environment • Changes in the regulatory environment

Reforming the Market

About one-third of Korean domestic life insurers declared bankruptcy due to the financial crisis in 1997. While some were successfully merged into or acquired by other insurers, some were eventually merged into a life insurer under the custody of the government. Any joint venture partnerships between failed local companies and foreign insurers were dissolved. They are now under a single ownership or management.

Since the market reshuffle, insurance companies are now classified into three groups: the Big Three, domestic and foreign insurers. Samsung, Kyobo and Korea Life are grouped into the "Big Three." The remaining life insurers under local ownership are grouped as "domestic," while those under foreign ownership are grouped as "foreign." There are no longer any companies in a joint-venture partnership.

As summarized in Table 2, there are currently 23 life insurance companies in Korea. It is worth noticing the strengthened position of the foreign insurers in the market. They will play an important role in future market development, becoming market makers rather than market followers, by introducing advanced and innovative products to the market.

Merger and Acquisition (M&A) Market Prospects

Many of the domestic life insurers are affiliates of group companies; and, while profitability is one of the owners' main interests, it is in fact more important for them to have management control over the insurance companies. Historically, conglomerates established their insurance arms to have easy access to low-cost capital.

TABLE 2—MARKET STATISTICS AS OF 30 SEPTEMBER 2003

	NO. OF COMPANIES	NEW BUSINESS (FA)	TOTAL ASSETS	SURPLUS
BIG THREE	3	79,038	128,396	3
DOMESTIC	10	30,077	18,948	10
FOREIGN	10	29,791	13,483	10
TOTAL	23	138,905	160,827	23

The largest M&A deal in the history of the Korean insurance industry was completed at the end of 2002, when the Hanwha consortium acquired Korea Life. The participating partners in the consortium were the Hanwha group from Korea, Orix from Japan and Macquarie from Australia. It took a long sales process to complete this acquisition.

Daishin Life, which was involved in the public sales process for about two years, was recently acquired by Green Cross, a leading pharmaceutical company in the local market. Hanil Life was reported to be acquired by Kookmin Bank, the largest bank in Korea, for use as their bancassurance business arm.

Financial institutions from other industries are now preparing to provide comprehensive financial services to their customers through bancassurance and wealth management. Domestic insurers are expected to have fewer opportunities in the bancassurance market, as they have less to offer than the Big Three and foreign insurers. One feasible solution for domestic insurers to serve this market would be to merge with other insurers to strengthen their business operations and to improve productivity. Another solution would be to invite foreign capital to strengthen their financial position, but the issue of management control will be a difficult issue.

Table 3 summarizes recent M&A activity in the Korean life insurance market. In addition, both Samsung and Kyobo are in preparation for possible IPOs, but there are some outstanding issues that need to be resolved.

TABLE 3—RECENT M&A ACTIVITIES IN THE MARKET

Korea Life	Acquired by Hanwha consortium
Daishin	Acquired by Green Cross
Hanil	Announced to be acquired by Kookmin Bank
PCA	Prudential UK acquired Youngpoong

Regulatory Issues

Insurance Business Law (IBL)

The IBL was revised in May 2003. One change will allow life insurers to sell insurance in a third area products, such as personal accident, disease and long-term care products, such as indemnity-type insurance. This will enable them to compete with property and casualty (P&C) insurers under the same regulatory conditions. In return, P&C insurers would be allowed to sell their long-term products with an unrestricted insurance period. (Currently, these products are restricted to an insurance period of less than 15 years and coverage up to age 80.) The changes will be effective as of August 2005.

Financial Reinsurance

In 2002, when coinsurance was allowed, financial reinsurance became the immediate solution for financially constrained companies to meet the solvency margin requirement; but, reinsurers have been hesitant to deal with financially insolvent companies. Financial reinsurance may be costly, but it can be utilized in various areas, such as new business growth constraint, asset-liability management and other areas.

Corporate Pension

Last year, the government announced that it would introduce corporate pensions into the market, which would operate concurrently with the existing retirement plan. Employees would be given the option of converting their current defined benefit retirement plan to the corporate pension scheme. Once converted, however, employees would not be able to revert back to their previous plan. The greatest criticism by employees of the current retirement system is its lack of portability between employers. Under the current plan, employees can make partial withdrawals from their plans on an annual basis, and they are required to withdraw the total amount when they resign.

The corporate pension plan under consideration would be similar to the company sponsored 401(k) plan offered in the United States. The current retirement plan could easily be converted to this type of plan, which would be easier to administer, from an employer's perspective. It is also portable from one employer to another.

Managed Care

Together with existing employer-provided benefits, a managed care system, which will supplement the state health system, is expected to be introduced in 2005. The state system is currently the only insurance scheme covering medical expenses. Considering the substantial rise in insurance costs over the last few years, and the fact that a further cost increase would be quite burdensome to consumers, the introduction of an efficient health insurance system is inevitable.

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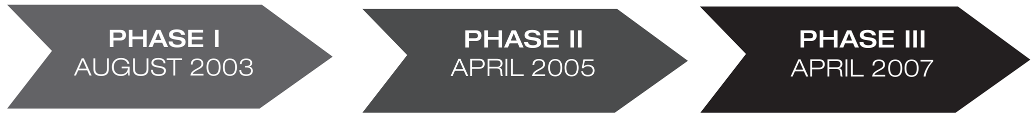
FIGURE 1—EXPANSION OF PERMITTED PRODUCTS



Bancassurance

Considering its strong potential to reform the life insurance industry, bancassurance is currently the most carefully scrutinized activity in the financial industry.

Regulators will introduce bancassurance in three phases. Phase 1 was implemented in August 2003, Phase 2 will begin in April 2005 and Phase 3 is scheduled to begin by April 2007 (see Figure 1). The core issues for bancassurance are its form, product development, and sales processes and approaches. While each of these areas will initially have some restrictions, they will likely be reduced, as the process advances through the phases.

Banks (retail and industrial), mutual savings banks, and securities firms will be allowed to sell insurance-type products through bancassurance. Customer protection is another issue at the top of the regulator's agenda in the implementation process.

Bancassurance Phase-In

In Phase 1, large financial institutions with assets over two trillion won are required to form business alliances with at least three insurance companies, each of which is restricted to having no more than 50 percent of the business sold by their banking partner. In addition, a cross-partnership between a bank with its own insurance arm and the insurance subsidiary of another bank is not permitted, in order to prevent the business from transferring between the two groups.

Development of Bancassurance Products

As illustrated in Table 4, in the first phase, it is likely that credit life and savings-type insurance policies will be allowed to be sold through banks. In the later phases, protection-type insurance policies, including whole life and term life policies, will be allowed.

Sales Processes and Approaches

A branch-based approach to customer service is permitted, and limited use of the non-branch-based approach is also permitted. Use of call centers and outbound marketing is not allowed. Direct mailing and Web site marketing are already being used by banks, therefore, it would be unjustifiable to prohibit the current practice for the introduction of more defined approaches.

This approach was originally intended to give small to medium-sized insurers every opportunity to develop business alliances with banking partners.

However, the banking partners' predominant role and the significant initial investment required by the insurers have restricted those companies hoping to capitalize on the opportunity.

Market Trends

Most Korean life insurers have shifted their leading life products from savings type to protection-type products, as demonstrated in Table 5.

TABLE 4—EXPANSION OF PERMITTED PRODUCTS

PHASE 1	
Life	Individual Savings Insurance and Credit Insurance
P&C	Household Fire and Long-Term Savings Insurance
PHASE 2	
Life	Individual Protection Insurance
P&C	Motor (Personal Use) and Long-Term Protection Insurance
PHASE 3	
Life	Group Insurance
P&C	Motor (Business Use) and Commercial Line Insurance

TABLE 5—BUSINESS VOLUME BY PRODUCT TYPE						
	FACE AMOUNT				PREMIUM INCOME	
	New Business		Existing Business		New Business	
Fiscal Year	Savings	Protection	Savings	Protection	Savings	Protection
1999	30%	70%	35%	65%	73%	27%
2000	34%	66%	32%	68%	29%	71%
2001	14%	86%	25%	75%	55%	45%
2002	15%	85%	22%	78%	49%	51%
2003 (SQ)	12%	88%	20%	80%	46%	54%

TABLE 6—BUSINESS VOLUME BY TYPE OF BUSINESS								
	FACE AMOUNT				PREMIUM INCOME			
	New Business		Existing Business		New Business		Exisiting Business	
Fiscal Year	Individual	Group	Individual	Group	Individual	Group	Individual	Group
1999	88%	12%	91%	95%	70%	30%	82%	18%
2000	93%	7%	94%	6%	82%	18%	90%	10%
2001	95%	5%	95%	5%	84%	16%	96%	4%
2002	95%	5%	96%	5%	94%	6%	96%	4%
2003 (SQ)	95%	5%	96%	4%	96%	4%	96%	4%

Among the protection-type products, a significant increase in sales is due to whole life policies. The proven success of whole life policies sold by foreign insurers has motivated domestic insurers to sell the policies through their female tied-agency forces and newly established professional sales forces. Some companies market their products through independent agency forces.

Introduction of the corporate pension and employee benefits, such as cafeteria plans, would signify growth in the group insurance market. The size of group insurance is negligible when compared with individual insurance. The statistics shown in Table 6 indicate that the market has significantly downsized over the last few years.

Also, cafeteria plans can be expected to capture a small market share in the early stage of the plan introduction. For cafeteria plans to grow substantially, it will be necessary to include medical expense coverage in the plan.

Market Share

Table 7 illustrates the trend in market share development. The major change seen here is the shift of the market share from domestic and Big Three insurers to foreign insurers. If the market share of Allianz, which represents about 4 percent of the total market, is excluded from the foreign insurers, as Allianz represents an ownership transfer to foreign from a former domestic insurer, the market share advancement of foreign insurers is even more remarkable.

The success of foreign insurers can be explained by the fact that they have targeted high-net-worth and affluent markets with a simple whole life product through a professional sales force. As the high-net-worth market becomes saturated, they will expand their target market to the upper-middle-class market and will also strive for territorial expansion. Some foreign insurers have also deployed aggressive business expansion strategies through alternative distribution channels. With a better reputation and better brand recognition supporting their aggressive business expansion, these foreign insurers will be equally competitive with the Big Three in new and underserved markets.

Although small changes are observed in Table 7 for the Big Three insurers, those companies have gone through total restructuring, including a significant downsizing in their female sales forces and the establishment of professional sales forces. Although the restructuring had a negative effect on business growth, their profitability improved greatly.

New Business

Similar to the trend observed in premium income, new business for the Big Three and domestic insurers has decreased over the

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TABLE 7—BUSINESS VOLUME BY PRODUCT TYPE

	Big Three		Domestic		Foreign		Total	
Fiscal Year	Premium	M/S	Premium	M/S	Premium	M/S	Premium	M/S
1999	32,249	77%	7,307	18%	2,139	5%	41,695	100%
2000	37,784	81%	5,987	13%	2,900	6%	46,671	100%
2001	32,202	77%	5,638	14%	3,744	9%	41,584	100%
2002	33,061	75%	5,974	14%	5,056	12%	44,091	100%
2003 (SQ)	15,647	72%	3,127	14%	2,943	14%	21,718	100%

Unit: billions of won

TABLE 8—MARKET SHARE BY NEW BUSINESS PREMIUM*

	Big Three		Domestic		Foreign		Total	
Fiscal Year	Premium	M/S	Premium	M/S	Premium	M/S	Premium	M/S
1999	15,770	75%	4,214	20%	1,044	5%	21,028	100%
2000	20,828	82%	3,041	12%	1,544	6%	25,413	100%
2001	12,549	75%	2,237	13%	1,925	12%	16,711	100%
2002	10,093	70%	2,035	14%	2,324	16%	14,452	100%
2003 (SQ)	4,014	63%	1,154	18%	1,206	19%	6,374	100%

Unit: billions of won **The new business premium includes single payment policies.*

years, while an opposite trend is observed for foreign insurers. In fact, foreign insurers overtook domestic insurers in new business by the end of 2002 (See Table 8).

Two companies worth observing are ING and AIG Life. Between fiscal years 1999 and 2002, ING's total premium has grown almost sevenfold to 779 billion won. It is now Korea's fifth largest insurer by new business premium and, by taking business growth into account, it is also the fifth largest insurer by total premium. ING's good product mix is considered to be one of its success factors.

Like ING, AIG Life has experienced a 10-fold growth in its total premium with 288 billion won. AIG Life was able to achieve this growth in such a short timeframe due to its multi-channel strategy. It may now have the most diversified channels in the Korean insurance market.

Profitability

As seen in Table 9, which summarizes the reported profit of the industry, business results are improving at a remarkable rate. Almost all companies experienced improved profitability, and many made positive profits in FY2001 and FY2002. Two main reasons for the positive profits in FY2001 and FY2002 are the partial recovery of the financial losses due to the economic crisis in 1997 and the contribution by sales of the whole life policies. Under the current reserving method, huge profits are expected in the first two years, typically followed by five years of losses from the sales of whole life policies.

Lapse/Surrender

The market is experiencing a significant improvement in lapse and surrender rates. Two main reasons for the improvement are effective sales management and sales of whole life policies. Many companies have strengthened their sales monitoring system by introducing programs for the branch or sales managers that provide an incentive for improved policy persistency and a penalty for low policy persistency.

At the same time, greater effort is being given to training sales agents to identify potential customers and to serve customers effectively. While the persistency of policies sold by traditional female agents has improved significantly, policies sold by professional agents generally have better persistency.

Alternative Distribution Channels (Including Bancassurance, Direct Marketing and Telemarketing)

While the tied agency system, from female agents to professional sales force, is well established in the market, insurance companies have made a limited commitment to developing alternative distribution channels.

TABLE 9—REPORTED PROFIT OF THE LIFE INSURANCE INDUSTRY				
Fiscal Year	Big Three	Domestic	Foreign	Total
1999	-645	-348	12	-981
2000	-306	-239	-64	-609
2001	1,628	75	20	1,723
2002	2,303	247	277	2,827
2003 (SQ)	1,422	182	203	1,807

Unit: billions of won

Currently, available distribution channels and channels in development are listed in Table 10, along with the leading companies in each channel.

According to market observation, only a few companies are actively developing new channels. Most small to medium-sized domestic companies are currently focusing instead on developing professional sales forces. Alternative distribution channels would most effectively be used for simple protection-type products.

TABLE 10—LEADING LIFE INSURERS IN EACH ALTERNATIVE DISTRIBUTION CHANNEL	
Distribution Channel	Leading Companies
Independent brokerage	Kyobo, PCA
Independent financial adviser	Samsung
Direct marketing (DM)	AIG
Telemarketing (TM)	LINA, AIG, Shinhan, MetLife, PCA
Cyber marketing (CM)	All companies lead generation
Worksite/affinity marketing	Samsung, Kyobo
Bancassurance	AIG, ING, Tongyang, Shinhan, Kyobo, Samsung, PCA

Product Development

In April 2000, assumed interest rates in pricing were liberalized. The regulator, the Financial Supervisory Service (FSS) prescribed an interest rate ceiling for the calculation of policy reserves, to prevent inappropriate assumptions. The ceiling was set at 6.5 percent for participating products and 7.5 percent for non-participating products. Those rates were reduced to 5.5 percent and 6.5 percent, respectively, in 2001, and further reduced to 4.5 percent and 5.0 percent, respectively, in 2002.

In early 2002, FSS announced that companies would be given product protection rights similar to copyrights for six months on newly introduced products, if they were considered innovative. Samsung, Kyobo and several others obtained six month/three month protection rights for the development of new products.

Two major revisions on pricing assumptions were announced recently by the regulator, which effectively undermined the profitability in mortality and expenses. As of December 2002, the pricing assumption and reserve calculation uses the fourth EMT (Experience Mortality Tables). The new mortality tables are lowered by about 30 percent on average from the previous tables. This applies only to new business.

The prescribed acquisition expense loading for calculation of the minimum nonforfeiture value was also lowered. Consequently, domestic insurers—most of

TABLE 11—PRODUCT DEVELOPMENT		
Line of Business	Product	Year of Launch
Individual Business	Preferred life	2000
	Variable life	2001
	Variable annuity	2002
	Accelerating critical illness	2002-2004
	Variable universal life	2003
	Long-term care	2003-2004
	Credit life	2004-2005
	Individual health policies	2005
	Corporate pension	Under discussion
	Group health policies	Under discussion

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TABLE 12—KOREAN INTEREST RATES					
Rate	31 Mar. 03	31 Dec. 02	31 Dec. 01	31 Dec. 00	31 Dec. 99
3 Month CD	4.70%	4.90%	4.86%	6.87%	7.3%
1 Year Treasury	4.60%	4.98%	5.34%	6.69%	N/A
3 Year Treasury	4.62%	5.11%	5.91%	6.70%	9.03%
5 Year Treasury	4.77%	5.34%	6.73%	6.91%	10.05%
10 Year Treasury	5.04%	5.63%	7.02%	7.21%	N/A
3 Year Corporate Bond (AA-)	5.38%	5.68%	7.04%	8.13%	N/A

whom have enjoyed relatively large profits on the expense loading—face a significant reduction in profits. Foreign insurers, most of whom generally use up the available expense loading, may need to reduce their sales commission level to prevent negative profit on the expense loading.

A few companies have introduced variable products to reduce their investment risk. Since the financial market is bearish at the moment, those products are not so popular. Variable life and variable annuities need a guaranteed minimum death benefit (GMDB) and a guaranteed minimum maturity benefit (GMMB) to get the regulator's approval in the market.

Table 11 on the previous page contains a list of the new products recently introduced or in development.

Improved policy persistency, together with the introduction of whole life policies, has substantially increased the duration of the liabilities. Product development must consider the duration of the liabilities, since availability of assets for duration management is limited in the current financial market.

Asset-Liability Management

Lower interest rates, brought on by the economic crisis, have depressed the prof-

APPENDIX 1—SUMMARY OF LIFE INSURANCE COMPANIES IN KOREA									
	FY1999			FY2002			FY2003 (2Q)		
Company	NB (FA)	Assets	GP	NB (FA)	Assets	GP	NB (FA)	Assets	GP
Samsung	78,078	46,598	15,063	85,468	67,602	17,098	39,384	71,698	7,900
Korea Life	48,582	18,149	8,118	73,876	27,870	8,833	5,983	29,366	4,224
Kyobo	66,772	23,572	9,068	54,663	26,156	7,131	24,090	27,332	3,523
Hungkuk	8,329	3,544	1,378	7,859	3,370	1,096	4,037	3,820	541
Tongyang	6,240	2,525	1,234	13,248	3,408	1,149	7,201	3,626	654
SL	7,455	2,872	1,252	9,584	3,334	1,197	4,714	3,559	596
Kumho	5,512	2,477	1,172	5,396	2,764	827	3,046	2,913	409
Shihan	7,857	1,881	722	7,729	2,273	885	6,878	2,559	544
Green Cross	2,509	1,511	797	1,695	868	325	564	1,045	78
Dongbu	1,818	601	272	2,298	685	229	1,994	745	127
Lucky	1,451	903	254	3,591	478	197	1,521	492	100
Hanil	946	355	225	304	90	33	2	87	12\1,08
Allianz	13,226	3,983	1,495	14,310	6,160	2,233	6,647	6,524	3
ING	3,082	258	163	10,805	2,068	1,106	6,298	2,656	726
MetLife	1,949	569	220	7,568	1,299	444	3,401	1,478	264
Prudential	4,398	203	141	8,178	1,252	593	3.973	1,509	344
AIG Life	1,065	48	28	11,067	513	406	6,007	760	347
LINA	917	84	45	2,753	239	194	1,217	270	111
PCA	100	81	22	705	109	27	932	145	30
France	200	44	14	—	—	—	—	—	—
New York	79	38	10	1,447	85	53	671	106	37
Cardif	—	—	—	148	4	1	38	2	0
Total	260,563	110,295	41,695	237,309	151,094	44,091	139,412	160,827	21,178

itability of savings type products and forced life insurers to reprice all major products.

With consistent improvements in persistency rates and a shift toward protection products, life insurers are predicting that the duration of liabilities will lengthen. This will create the need for appropriate asset-liability management. This is particularly true for whole life products, which are believed to have a duration period of greater than 10 years. Most life insurers have sold these products heavily in the last few years.

Outlook

Much of the restructuring necessary to ensure the continued viability of the Korean life insurance industry appears to be successful. By looking at the financial results of FY2002, most companies have announced profits that were not seen before the economic crisis. However, the industry still faces many challenges.

Major challenges include:

- Competition and partnership with other financial institutions
- Introduction of innovative products
- Identification of new profit sources
- Development of efficient alternative distribution channels

Since the introduction of bancassurance in August 2003, life insurers have learned to work and compete with other financial institutions. From our observation of the failure of the joint ventures with foreigners in the local life insurance industry, success in bancassurance may be difficult unless banks and insurers learn to work together.

As we noted in previous sections, life insurers will see a lot more market opportunities, but they will also encounter new competitors in other financial institutions.

Introducing innovative new products will be critical for life insurers to effectively serve consumers and compete with these financial institutions.

Korean life companies have enjoyed heavy expense loading in premiums during the last few years. Without question, expense loading was a main source of profit for them to overcome the financial difficulties after the economic crisis. They can expect more pressure to reduce the loading significantly if they want to compete with other financial institutions in new areas, such as bancassurance, corporate pensions and investment-linked products.

These companies should also realize their current distribution channels might not be efficient enough to deliver their new products to consumers. Their current channels may not be adequate to actively sell their innovative products in different markets.

Korean life insurers overcame difficult times in the past simply by downsizing their operations and becoming more cost efficient. However, the newly emerging business environment will require substantial changes, including new business operations and company structures. This will be the real challenge. ☐

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CONGRATULATIONS!

The following are newly-elected members of the International Section Council. They will each serve a three-year term, beginning in October 2004:

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