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Taiwan's Low Interest Rate Showdown

By Steve Miles and Don Shapiro

INTRODUCTION

Taiwan has been a low interest rate market since 2002, when the highest rate available on 10 year government bonds fell below 2.5 percent. By mid 2008 it appeared that the low interest rate era might be over, as government bond rates climbed above 2.5 percent, but by year end those hopes were dashed as interest rates fell again.

The persistent low interest rate environment has created significant problems for the Taiwan insurance industry due to a large block of existing business that had been sold at very high interest rates. In the 1980s and 1990s, companies typically sold policies that guaranteed returns of 6.5 percent—and in some cases as high as 10 percent—with existing policyholders able to continue investing under the original terms. The renewal premiums on these policies have been invested at low interest rates.

The consequent losses from this business are substantial. The hope was that as investments matured, they would be reinvested at higher rates—and that these returns, along with profits from selling future business, would be enough to finance the losses on the past business. However, these hopes have not materialized as interest rates have remained low.

Now, a number of players have grown tired of waiting and have decided to exit the Taiwan market. The sellers have been European companies subject to IFRS reporting standards, market consistent valuations, and Solvency II requirements. The buyers are Taiwanese companies who use a more traditional approach of "best estimate" valuations and come under relatively weak local reporting standards. Both sides talk about the transactions in highly positive terms. The European companies claim they are adding value to their operations and releasing significant capital by transferring guarantees to local companies. For their part, the local companies refer to the opportunity to gain economies of scale and add value by undertaking a more realistic investment strategy.

But first, some facts about the market.

THE ENVIRONMENT

Taiwan is a market with a regulatory regime based on the detailed regulation of interest rate pricing and valuation. Maximum interest rates are set for each of these items and the rates of interest used are the same for pricing (yes, using commutation formulae!), valuing policy liabilities and determining surrender values. These rates are effectively locked in at policy issue.

However, around the turn of the century an intense product war occurred in Taiwan, resulting in many products being priced on the assumption of continuing high interest rates. When interest rates subsequently dropped significantly, premiums could not be invested at the required rates of return. The result is what the industry refers to as "bad bank" or "negative spread" business, in which investment returns are insufficient to support the guarantees given to customers. A typical example of the situation is shown in the first chart on page 63, but as stated above, some pricing rates were even higher, as much as 10 percent!

> "Now, a number of players have grown tired of waiting and have decided to exit the Taiwan market."

Year	Pricing Interest rate	Valuation Interest rate	TW 10-Year Gov't Bonds
2000	6.75%	6.25%	5.25%
2001	6.00%	5.75%	3.90%
2002	4.00%	4.00%	2.25%
2003	2.75%	2.50%	2.62%
2004	2.50%	2.00%	2.40%
2005	2.50%	2.00%	1.78%
2006	2.50%	2.50%	2.03%
2007	2.50%	2.50%	2.58%
2008	2.50%	2.50%	2.41%
2009	2.25%	2.25%	2.25%

Fitch Ratings has estimated the industry wide gap in Taiwan to be NT$900 billion (US$26.5 billion). If that seems like a huge number, the general opinion in the industry is that the estimate is probably too conservative, with the real figure possibly being several times as large. Total non linked assets for the Taiwan life insurance industry are around US$250 billion.

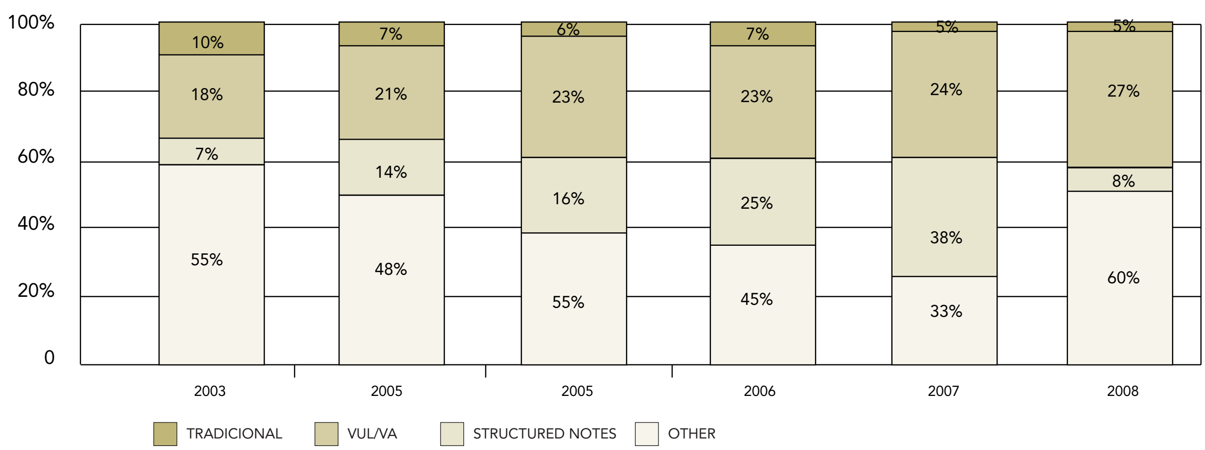
Understandably, the players in this market have tried to transfer investment risk to customers, and new product sales showed a strong trend away from Traditional products until the impact of the global financial crisis was felt in 2008.

Despite this trend, local companies are still willing to purchase existing blocks of in force business from willing sellers, as recent history has shown.

THE SELLERS

ING, for example, sold its Taiwan life insurance business to Fubon Financial Holding for the equivalent of US$600 million (EUR 447 million) in a deal announced last October. Paid partly in shares, ING now holds a 5 percent stake in Fubon. On the transaction ING booked a loss of EUR 292 million. The company had been operating in Taiwan since 1987, originally through its U.S. subsidiary, Life of Georgia; it later expanded by acquir-

Taiwan Product MIx



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An Actuary Experience … | from Page 63

ing Aetna's operations in 2001. While bowing out of the insurance sector in Taiwan, ING remains active in the market in wholesale banking, fund management, and real estate.

In February, Prudential U.K. announced the sale of the bulk of its PCA Life Assurance unit in Taiwan to China Life (the Taiwan entity, not the mainland Chinese company of the same name) for a token NT$1 (about 3 US cents), and in addition will buy a 10 percent share (valued at around US$64 million) in the local company, which is controlled by the influential Koo family. The British insurer will continue to market insurance in Taiwan through its banking and telemarketing channels, and Barry Stowe, chief executive of Prudential Asia, leavened the news of the sale to China Life with a series of press comments about the importance of the Taiwan insurance market within the region.

Aegon announced its departure in late April this year, just slightly more than a year after opening a new headquarters building in Taipei with some fanfare. The Hague based company is selling the Taiwan unit for EUR 65 million to the Zhongwei Co., a holding company formed by the heads of Meifu Development and Taiwan Glass. Aegon estimated that it would take a charge of about EUR 300 million on the sale.

Perhaps Prudential best summarized the issue in its announcement of the sale, where it said:

"As an EU domiciled company, Prudential adheres to the European Union Insurance Group Directive (IGD), under which it is required to carry significant economic capital reserves against this back book. On completion of this transfer there will be a net increase in Prudential's IGD surplus of approximately £800m, further strengthening its already robust IGD position. The Group's embedded value as reported under the European Embedded Value (EEV) principles will increase by £90m after restructuring costs. The transfer will have an estimated one off IFRS negative impact of £595m including restructuring costs to be reported on completion. There is no impact on Prudential's dividend paying capacity." (Note £800m = USD1,280m, £90m = USD144m, £595m = USD952m, assuming £1 = USD1.60).

Prudential's calculations would have been based on risk neutral market consistent assumptions, typically using a government bond rate as the basis for calculating risk free values. One of the principles of risk free values is that value is not affected by the asset mix.

THE BUYERS

China Life also believed it got a good deal when it promoted the benefits to be gained from the extra sales force and economies of scale. Like other local companies, China Life publishes a traditional embedded value where discounted values are based on best estimate assumptions. Typical assumptions used for recently published embedded values have been:

"There is an additional factor for embedded values in Taiwan. How do you discount the negative earnings from the existing business written at high interest rates?"

	Cathay Life	Shin Kong	Fubon	China Life
	2008	2008	2008	2007
In Force Investment Return Assumption	3.45% ~5% and 5.3% (yr 5+)	5%	3.66%~5.36%	5.05%
NB Investment Return Assumption	3.45% ~5% and 5.3% (yr 5+)	5%	3.04%~5.36%	5.05%
Discount rate	10% then 11% (yr 5+)	10%	10%	12%
Value of In Force % Assets	9%	3%	4%	4%
Value of 1yrNB as % sales	16%	12%	5%	5%

Under the approach used for traditional embedded values, the extra income expected from using riskier assets, with a higher expected return, increases value—even if the risk discount rate is adjusted. Whilst creating value from investing in riskier assets is not necessarily the intention of a traditional embedded value methodology, it is normally the result. Indeed Fubon (which bought ING) recently announced that it will be selling some of the bond investments in the ING portfolio and investing in real estate.

There is an additional factor for embedded values in Taiwan. How do you discount the negative earnings from the existing business written at high interest rates? Discounting at a risk adjusted rate of interest reduces the value of the negative spread.

At the time of writing, AIG's company in Taiwan, Nan Shan Life is reported to be under consideration for purchase by a number of suitors. However the regulator has informed overseas suitors that they must have a local partner for their bid. According to newspaper reports, the three local partners left in the bidding process are Cathay Financial Holding Co., Fubon Financial Holding Co. and Chinatrust Financial Holding Co. After this transaction well over 90 percent of the negative spread should be in the hands of local companies.

THE WINNERS?

The recent global financial crisis has called into question how markets price assets and risks. Whilst markets are not perfect estimators of the intrinsic value of an asset, they are accepted by many commentators to be the "least worst" model that we have. Financial reporting should reflect business behavior, not drive it, but events in Taiwan seem to suggest the opposite.

Who will the winners be? Certainly the sellers have been able to release capital and increase their embedded values. For the buyers to be winners, they need to achieve what seem to be optimistically high returns or significant economies of scale so their reinvestment assumptions and value of new business assumptions can be realized. And if the buyers become losers, who will pick up the bill?

We have seen how the Japanese market approached the problem of negative spread by reducing policyholder benefits for negative spread business. Although this does not seem to be on the government agenda at this stage, there is talk of this being an eventual option—and this option would be much easier to introduce as a measure to save locally owned rather than overseas owned companies. □