22 November 2016

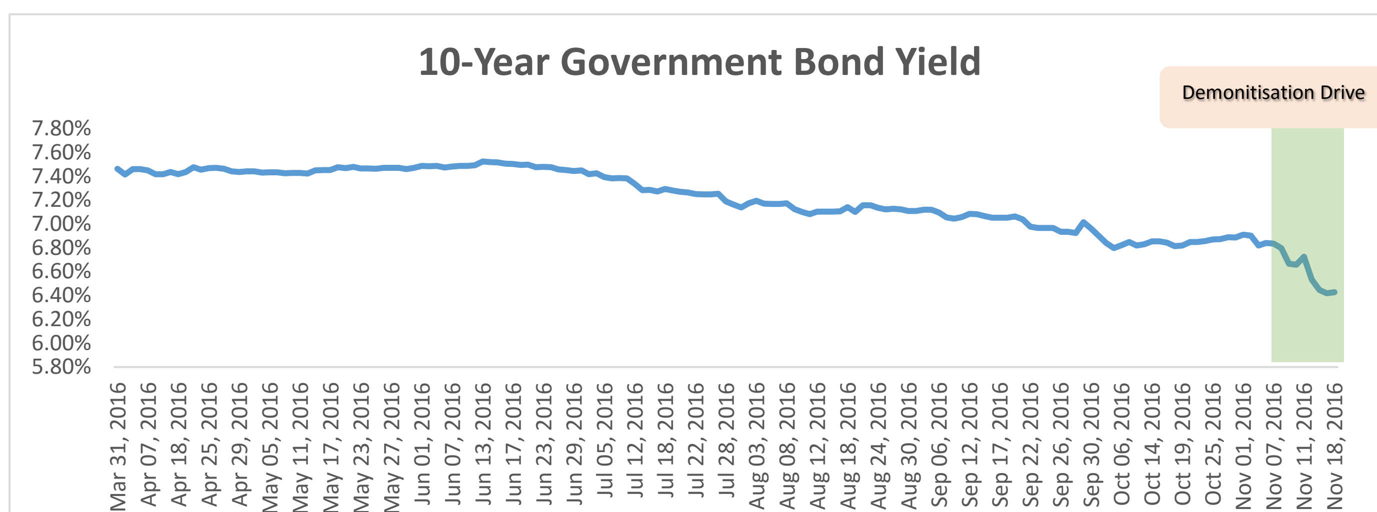
Falling interest rates in India: Should life insurers be worried?

Low interest rates and their implications on the insurance industry have been a key topic of discussion in many markets in Asia and around the world in recent years. Although interest rates in India have historically been significantly higher than most of its Asian peers, there has been a steady decline in the yield curve over the past few years.

Of particular interest has been the material fall in interest rates over the past eight months. As depicted in the chart given below, 10 year Government bond yields have fallen from around 7.5% p.a. on 31 March 2016 to around 6.4% p.a. on 18 November 2016.

Furthermore, on 8 November 2016, the Indian government announced a demonetisation scheme, withdrawing the legal tender status of Indian Rupee notes denominated in 500 and 1,000. Citizens are required to deposit the demonetised notes in their respective bank accounts before 30 December 2016. Thus far, around one third of the total demonetised amount of approximately INR 16 trillion is already deposited.

The government has stated that the objective of this exercise is to eliminate black money held in cash as well as to nullify counterfeit notes. However, one knock-on impact could be a further reduction in the interest rates given the increased liquidity with the banks.



(Source: https://www.bloomberg.com/quote/GIND10YR:IND)

Given the demonetisation drive, interest rates in India are expected to remain at a low level in the short term. Over the medium to long term, the direction and the level of interest rates may be more unpredictable. If the government incurs massive infrastructure spending in order to revive the economy, leading to a sustained level of fiscal deficit, interest rates may increase and remain at a relatively higher level. On the other hand, a more prudent management of the fiscal deficit and private investment may lead to a lower level of interest rates. In either case, the life insurance industry will need to adapt to changes in the interest rate environment.

IMPACT ON THE LIFE INSURANCE SECTOR

The sudden reduction in the interest rates can be expected to have an adverse impact on life insurance companies operating in the market. Some of the implications are described below:

- Lower yields on fixed interest assets may make it challenging for companies to meet any existing investment guarantees, especially if reinvestment yields fall below those assumed for pricing or reserving. For longer-term, non-participating savings/investment oriented products, this would be a particular challenge. If policyholders' behaviour also changes (e.g. with fewer policyholders lapsing/surrendering products that offer attractive guarantees), this may have further adverse implications. Companies would need to revisit reserving assumptions to reflect the impact of lower interest rates and prudent lapse/surrender rates, leading to higher level of reserves. The capital requirements would then also increase, as they are directly linked to the level of reserves held.

- A significant portion (in excess of 80% to 85%) of of life insurers' participating funds are invested in fixed income securities, which would be expected to yield less. In line with their internal bonus management frameworks, companies are required to actively manage the bonuses to be declared on participating business. With a possible expectation of lower investment returns in the future, companies may need to reduce the future bonus rates in order to control the future build-up of guarantees. Simultaneously, companies would be required to manage the expectations of their policyholders about the level of future bonuses.

- Lower yields may further squeeze the profitability for shareholders. Nonetheless, most companies will need to consider whether it is necessary to re-price existing products, especially savings oriented participating and non-participating products, to either offer lower benefits or increase the premium rates. Although in theory, a reduction in distributor compensation may also be possible, companies may not adopt this route in practice. This is because it may have a further negative impact on the level of new business for an industry that is yet to fully recover from the regulatory changes in 2010 limiting the charges on unit-linked business.

- Any re-pricing may make savings-oriented participating and non-participating products less attractive as compared to more equity-oriented products such as unit-linked insurance plans or mutual funds. Should insurers move to selling a greater proportion of unit-linked products (on which insurers typically earn lower profit margins), the overall new business margins of insurers may also come down.

A sharp movement in interest rates tends to grab the attention of the risk management function within life insurance companies. Companies may now need to consider investing in more advanced tools/techniques to control the investment/re-investment risk stemming from such changes in interest rates. For example, insurers should consider investing in robust asset-liability matching (ALM) tools or looking at the merits of transferring risk to financial markets using interest rate derivatives. Some insurers have already started to use interest rate derivatives to hedge the investment guarantees within non-participating portfolios and other insurers may follow suit.

Companies may also need to use such ALM techniques more actively in order to devise an optimal investment strategy that would aim to maximise the return to the policyholders, whilst meeting the internal risk management requirements of the insurers.

CONTACT

If you have any questions about this e-Alert, please contact:

Richard Holloway
Managing Director - South East Asia & India, Life
133 Cecil Street, #12-02 Keck Seng Tower
Singapore 069535
Office +65 6327 2301
Fax +65 6221 0642
Mobile +65 9732 0150
Email **richard.holloway@milliman.com**

Sanket Kawatkar
Principal and Consulting Actuary
B/712, 215 ATRIUM
Chakala, Andheri-Kurla Road, Andheri (E)
Mumbai 400 059, India
Office +91 22 6784 8410
Fax +91 22 6784 8401
Mobile +91 98201 81681
Email **sanket.kawatkar@milliman.com**

Shamit Gupta
Consulting Actuary
Global Business Square
601, Sixth Floor, Plot No 32
Institutional Area, Sector-44
Gurgaon 122 022, India
Office +91 124 464 1507
Fax +91 124 408 8588
Mobile +91 98330 31513
Email **shamit.gupta@milliman.com**

Philip Jackson
Consulting Actuary
B/712, 215 ATRIUM
Chakala, Andheri-Kurla Road, Andheri (E)
Mumbai 400 059, India
Office +91 22 6784 8413
Fax +91 22 6784 8401
Mobile +91 96192 94144
Email **philip.jackson@milliman.com**

This e-Alert presents information of a general nature and is intended solely for educational purposes. It is not intended as advice for any specific situation and may not be relied upon for any purpose. You should always consult qualified professionals familiar with your circumstances before adopting any strategy or taking any action. Milliman does not guarantee the veracity, reliability or completeness of this e-Alert and has no responsibility for damages alleged to have been caused by it. This e-Alert is not directed at residents in any jurisdiction where it would contravene local law.

Copyright 2016 Milliman, Inc. All rights reserved.