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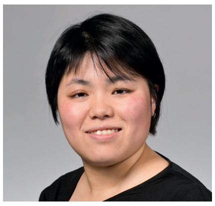
INSURANCE: ANOTHER WAY TO TAP INTO CHINA'S FINANCIAL SECTOR

The potential of China's insurance sector is enormous, given the country's ageing demographics and increasingly affluent population. Such trends, together with the regulatory revamp of 2017, should benefit Chinese insurers that can adhere to robust risk management practices and maintain a sustainable mix of protection-type products.



Bonnie Chan
Portfolio Manager, Equities
Eastspring Investments

THE GAP TO CLOSE

China's middle class has expanded rapidly, surging from around 29 million in 1999 (2% of the population) to approximately 541 million in 2015 (39% of the population) – amongst the fastest such growth rates in the world[1]. In addition, average life expectancy has increased from 67 to 76 years[2].

These trends offer insurers new opportunities to meet the needs of a burgeoning ageing population.

The demand for insurance has exploded, as people prepare for their golden years, as well as take on protection needed for unexpected deaths, medical and property expenses.

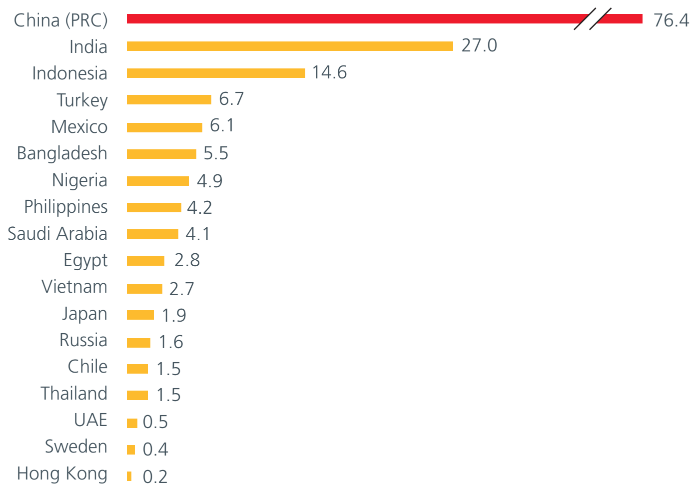
The problem is that the coverage often falls short of what is required.

In absolute terms, China has the largest insurance gap in the world.

Looking at Figure 1, China's insurance gap reached USD76.4 billion in 2018.

Fig. 1: China leads the under-insurance[4]

Global under-insurance in absolute terms (USD billion)



Together with an insurance penetration rate of 4.6% (as compared to the global average rate estimated at 6.1%[3]), China's insurance market, though the world's second largest, is still in its nascent stage.

BOOMING PREMIUMS

The need to close the gap underpins the strong growth in insurance premiums – the major source of growth for insurers.

From 2006 to 2018, annual premium income (personal and property) in China increased from RMB564.1 billion to RMB3.8 trillion, representing a rapid growth rate of 17.4% p.a. (see Fig. 2). This significantly exceeds the 6.8% p.a. growth rate for broader Asia[5].

Beneath the phenomenal growth, however, is the rise in aggressive investments and insolvency risks.

RISE OF 'PLATFORM' INSURERS

While providing protection and adhering to prudent risk management practices are the fundamental principles of insurance companies in developed markets, selected Chinese insurers have been deviating from their fundamental goals of protecting companies and individuals.

Why has this happened?

One explanation is that in the fight for market share and quick profits, a handful of insurers – after receiving permissions from the now-defunct China Insurance Regulatory Commission (CIRC) – had offered higher-yielding 'insurance' policies (a.k.a savings policies) that contained only nominal elements of risk protection.

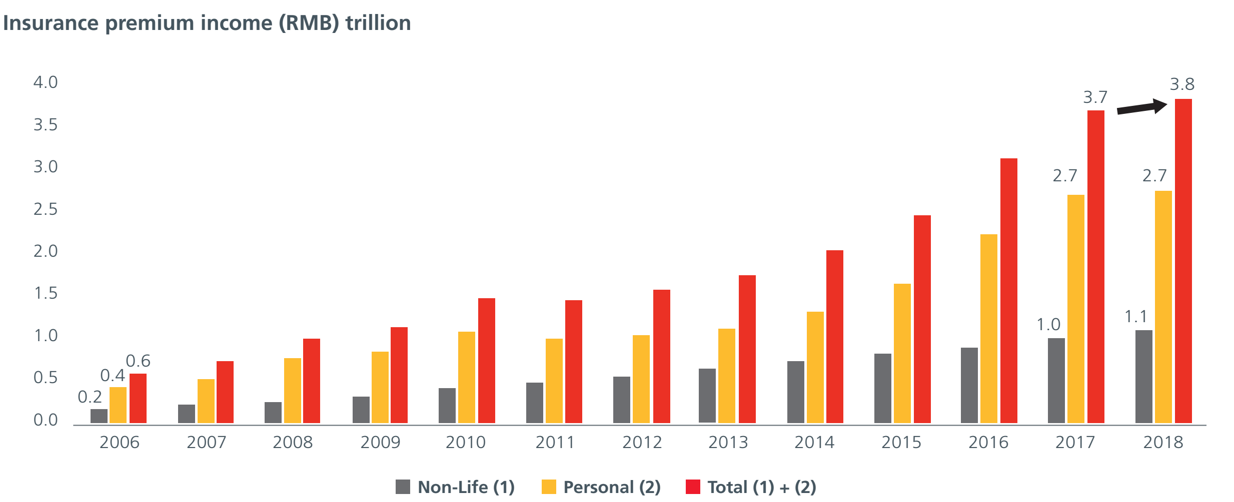
Such products, which usually offer policy holders a higher rate of return compared to bank deposits, have turned these insurers into aggressive investors as they need to make enough profits to pay back policyholders.

Some of these insurers have chosen to reach out for aggressively buying equities and overseas property projects. This practice, which makes the insurance business akin to a fundraising platform, earned such insurers the moniker of 'platform insurers'[7].

The problem is that the forays into risky assets exposed these 'platform insurers' to the volatility of the equity markets as well as the illiquidity of real estate assets, thereby increasing the risk of insolvency.

This aggressive risk-taking practice finally prompted a regulatory revamp in April 2017.

Fig. 2: Growth of insurance premiums in China[6]



TOUGHER REGULATIONS

In a surprising move, the CIRC merged with the banking regulator to form the China Banking Insurance Regulatory Commission (CBIRC)[8] – a new regulator designed to resolve unclear responsibilities and cross-regulation issues.

One key rationalisation effort is that it not only requires insurers to reduce aggressive investments (e.g. equities and alternatives), but also urges insurers to tackle risks stemming from areas such as capital management and new business development.

In addition, the new policy incentivises insurers to offer long-duration protection products by lowering the associated regulatory capital requirement, which helps boost the embedded value of the insurers.

Since then, all Chinese insurers have refocused on protection-based products. The new policy has also crimped the business model of many 'platform insurers', thus slowing the growth in insurance premiums in 2018 (see. Fig.2).

The message from the Chinese regulators is clear: "insurance means protection; insurance companies are not wealth managers".

What does it mean for the future of Chinese insurers?

REFOCUSING ON PROTECTION

For insurance companies, the margins for protection products, such as life and health insurance, are much higher and more sustainable than the margins for savings products (see Fig. 3).

This is because protection products require less capital and insurers only need to cover insurance risks. In doing so, all investment gains will flow to the insurer's shareholder fund, rather than to policyholders.

Shifting to protection products, thus, can improve the industry's profitability and solvency.

The challenge is that protection products are difficult to sell in a culture where policyholders thirst for a guaranteed return that savings products offer.

Since the regulatory changes, the solvency and the long-term outlook of China's insurance sector have improved. Moody's reported that the sector

Fig. 3: Protection-style versus investment-style (savings) insurance products[9]

Products		Premium payment terms	New business margins	Risks to insurers		Examples
Protection	Long	1 to ~40 years	70-90%	Lower	Insurance risks	Whole-life, term life, critical illness, long-term accidents
Protection	Short	1 year	N/A[10]	Lower	Insurance risks	Property & casualty, such as automobile, short-term medical, short-term accidents
Savings	Long	>10 years	30-40%	Higher	Insurance risk, investment risks	Endowment, annuity, universal life, investment-linked
Savings	Short	<10 years	15-20%	Higher	Insurance risk, investment risks	Endowment, annuity, universal life, investment-linked

had a solvency ratio of more than 200% at the end of 2017, which is more than double the regulator's requirement[11].

Life insurers, in particular, have benefited most; their core solvency ratio stood at 214%, up significantly from 204% in the previous year.

Traditional insurers – which have more exposure to protection-based insurance – are gradually regaining the market share, which they had lost to the 'platform insurers' between 2013 and 2016 (see Fig. 4).

All these developments lead us to believe that the tighter regulations are beneficial. They should help alleviate the competition among insurers to fight for premium growth, and more importantly, maintain a favourable landscape for the life insurance sector.

This apparently positive regulatory revamp, coupled with the booming demand for insurance protection, should be positive for insurance companies.

AN UNDERAPPRECIATED OPPORTUNITY

Shares of the traditional Chinese insurers, however, have fallen sharply following the lower premium growth mostly stemming from the lower-margin policies. In 2018, major Chinese insurance shares (H-shares)[13] lost 26.4% on average, lagging the broader MSCI China index, which fell by 18.9%[14].

The underperformance saw the price-to-embedded value[15] (P/EV) of these traditional Chinese insurers fall to an extremely attractive valuation level by the end of 2018, down more than one standard deviation below their five-year average (see Fig. 5).

Although not as cheap as they were at last December's low, their market valuations remain within an 'attractive' range.

In contrast to some of their Asian peers, Chinese insurers are generally trading at a discount to their embedded value, leaving a bigger margin of safety for investors.

Together with the 13.9% of return-on-embedded value (ROEV) for 2019[17], the current discount to EV also suggests that investors have yet to recognise the potential contribution of the higher-margin new businesses[18] arising from the restoration of market share.

Valuations aside, insurance companies are typically more isolated from the China's counter-cyclical policies.

Therefore, the industry appears to be a more direct beneficiary of the country's demographics.

Fig. 4: Traditional insurers regaining market share[12]

Market share (%) based on gross written premium

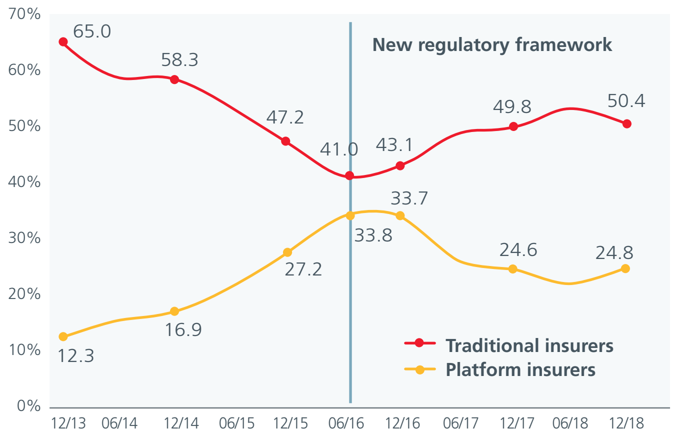
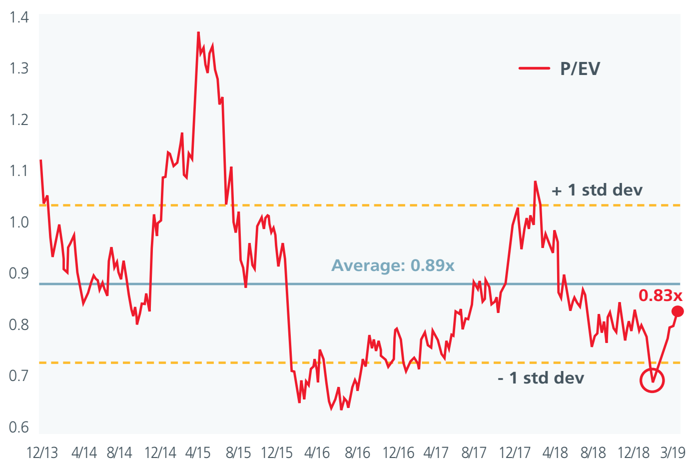


Fig. 5: Valuations of traditional Chinese insurance companies (H-shares)[16]

Price-to-Embedded Value (X) from 31/12/2013 to 25/03/2019



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A MORE DIRECT BENEFICIARY

China's insurers typically receive less global attention than the state-owned banks, who often appear in news headlines relating to the country's monetary stimulus.

In a push to support China's flagging economy, for example, Premier Li Keqiang urged the country's three largest commercial banks to increase lending to small and privately-owned businesses[19].

Such counter-cyclical lending not only exerts pressure on interest margins, but also increases the risk of bad debts, putting Chinese banks into a more difficult situation.

It is therefore not surprising to see an anaemic earnings growth of 6.9% in MSCI China's banking sector for 2019[20].

Fortunately, the insurance sector does not share such a daunting mandate. Along with the favourable regulatory revamp, the MSCI China insurance sector is expected to have a higher earnings growth of 24.7%[20].

LOOKING FORWARD

Nevertheless, risk management remains an evolving story in China's insurance sector, and industry consolidation is expected to continue throughout 2019. Premium growth, on the other hand, is likely to remain subdued in the near term.

China's steady economic growth, coupled with its low insurance penetration rate and rising awareness of longevity risks, will continue to support the Chinese insurance market over the long term.

Given the slowdown in the sale of riskier products, the creditworthiness of Chinese insurers should continue to improve as they enhance their business strategies and risk management practices.

Yet, there is still a need to be selective.

At Eastspring, we favour insurance companies that have a more sustainable product mix (life and health) and a well-established agency force (more productive and less costly than bancassurance), as well as stronger financial profiles.

We believe that such companies are better positioned to benefit from the structural changes; and likely to be rewarding for long term investors.

As long as the reform measures remain in place, China's insurers are a viable alternative for investors to tap into the country's financial sector.

Sources: [1]PovcalNet, citing World Bank Data. There is no standard statistical definition of "middle class", to facilitate cross-country comparisons, the World Bank uses a dollar-per-day amount expressed in purchasing-power-parity (PPP) dollars. Pew Research Center, in a study, defines middle class people are those who live on USD10 or more a day. Data as at 31 December 2015 (latest data available). [2]World Bank Data, from 1986 to 2016 (latest data available), data extracted as at 25 January 2019. [3]Swiss Re, sigma, No. 3/2018. https://www.swissre.com/institute/research/sigma-research/sigma-2018-03.html [4]A World At Risk: Closing The Insurance Gap, citing EM-DAT, CEBR (Centre for Economics and Business Research) analysis. The insurance purchased to cover risks and actual cost.[5]Swiss Re Institute, from 2008 to 2017. [6]The China Banking and Insurance Regulatory Commission (CBIRC), as at 31 December 2018. Personal insurance include life, medical and accidents. http://bxjg.circ.gov.cn/web/site0/tab5201/info4132169.htm [7]Platform insurers tend to use the insurance business merely as a financing platform and generate profits primarily through investments rather than mortality gains. In other words, they are like an investment holding company that funds its purchases by selling insurance products. [8]In April 2017, China Insurance Regulatory Commission (CIRC) was merged with China Banking Regulatory Commission. https://www.reuters.com/article/us-china-parliament/china-to-merge-regulators-create-new-ministries-in-biggest-overhaul-in-years-idUSKCN1GP003 [9]Eastspring Investments, generic numbers based on listed companies' annual reports, for illustrative purpose only. [10]New business margin applies to policies with premium payment terms longer than one year. [11]Moody's, as at May 2018. Solvency ratio is a key indicator of an insurance company's ability to replay long-term liabilities and debts. [12]Credit Suisse, 22 March 2019; citing data from China Banking Insurance Regulatory Commission (CBIRC), December 2013 to December 2018. Traditional insurers include China Life, Ping An, China Pacific Insurance (CPIC), Taiping Life, New China Life, People's Insurance Company of China (PICC). Platform insurers include Anbang Life, Huaxia Life, Hexie Health, Foresea Life, Tian An Life, Sunshine Life and Evergrande Life. The rest of market shares from other much smaller players. [13]H-shares of six key Chinese insurers have their shares listed and traded in Hong Kong. Also known as "H-shares" and denominated in Hong Kong dollars. H-shares are reminiscent of American Depository Receipts (ADR). [14]Bloomberg. Total returns in US dollars with dividend reinvested, net of tax. From 31 December 2017 to 31 December 2018. [15]The embedded value (EV) represents the sum of present value of all future profits (premium income) from the existing business. In other words, EV represents the value generated from the business sold by the insurer, if it were to stop writing any more new business. [16]Eastspring Investments, 25 March 2019, citing Credit Suisse's report, with data from Reuters, IBES (12 Month Forward), Credit Suisse Estimates, from 31 December 2013 to 25 March 2019. Shares prices and embedded value of China Life, Ping An, China Pacific Insurance (CPIC), Taiping Life, New China Life, People's Insurance Company of China (PICC).[17]Company data, Credit Suisse Estimates, as at 18 February 2019. Average of RoEV of Hong Kong-listed China Life, Ping An, China Pacific, New China Life, China Taiping, and PICC Group (H-shares). [18]Value of new business (VNB) indicates the value of an insurance company on the basis of the new business it wrote in the previous year. VNB is also termed as embedded value of new business measured at the point of sale. [19]China urges banks to boost small business financing. https://www.ft.com/content/73325fc0-0fe0-11e9-a3aa-118c761d2745 [20]MSCI, IBES, Datastream, Bloomberg, JP Morgan estimates, as at 7 February 2019. Consensus EPS growth for 2019.

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