Impact of Stock Market Performance to Insurance's Claim Paying Ability Profile

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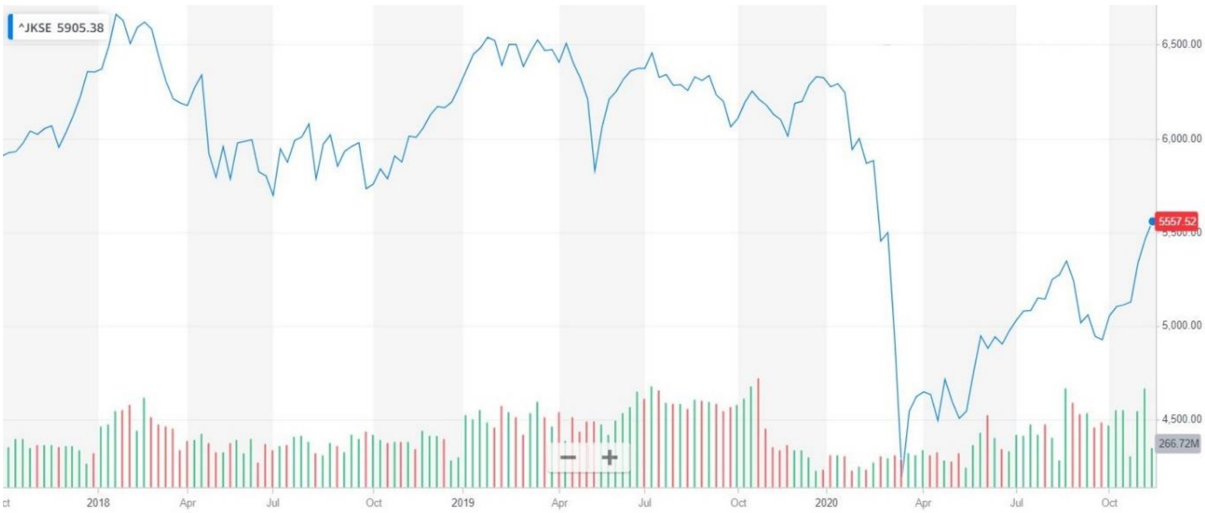
EXECUTIVE SUMMARY

The stock composite index in Indonesian Stock Exchange (better known as Jakarta Composite Index or JCI) has sharply fluctuated in 2020 following the Covid-19 outbreak, significantly affecting the performance of the insurance industry investment portfolio, either through direct stock holding or mutual funds. We will examine to what extent such a phenomenon impact the insurance industry, notably in the operating performance profile, and discuss it further from the credit rating perspective. Our observation reveals that an aggressive investment allocation has led to a significant deterioration of the companies' credit profiles, which probably explains why many companies adopt a more conservative investment policy.

STOCK PERFORMANCE

JCI in 2020 has witnessed the largest drop since the Asian financial crisis back in 1998. After reaching its peak in January 29, 2018 at 6,680.62 and the opening year 2020 at 6,023.61, the index started to tumble from 6,325.41 on January 14, 2020 to 5,884.17 on February 3, 2020 due to the outbreak of Covid-19. After a brief recovery, it returned to its downward trend to 5,361.25 on March 2, mainly for fear of the imminent economic recession, globally and domestically, following lockdowns resulting in a halt in the movement of goods and people. Since the country officially announced its first Covid-19 case on March 2, 2020, the market plummeted on almost every trading day and ultimately hit the bottom at 3,937.63 on March 24, 2020. At that point, JCI had dropped 41.1% from its record high and 34.6% from the beginning of the year.

Figure 1. Jakarta Composite Index - closing level



source : IDX, Yahoo Finance

STOCK AND INSURANCE INDUSTRY

An insurance company mainly generate profits in two ways. First is through its core business activity, by collecting higher premiums than the claims company paysout which is commonly referred to as underwriting profit. Second is investing the funds from the premiums that are yet to pay the claims which is commonly known as float. The size of the float is positively related with that of the business. Stock is one of the essential components in insurance companies' investment portfolio which can be obtained by directly purchasing it through dealers or securities companies or in the form of a mutual fund from a fund manager.

For general insurance companies with a shorter term nature of insurance policy, they generally invest the float in low risk instruments such as money market, high grade corporate bonds, or government bonds. As for life insurance companies with long-tail products or claims to be paid farther in the future, the float is of longer term, they have more flexibilty to invest in various instruments, including in stocks whose prices tend to fluctuate over the short term. Several insurance companies even specialize in selling a combination of insurance policy with guaranteed return investment product. To enable the company to cover the redemption value plus the profit promised to its policy holders, it calls for investment in higher return assets that also entail higher risks.

STOCK INVESTMENT CONTRIBUTION TO INSURANCE INDUSTRY

In general, stock investment portfolio and mutual fund investment portfolio in life insurance industry contribute around 25% and 30%, respectively. With a proxy of equity mutual fund share out of total mutual fund portfolio at around 20%, we can estimate that stock related investment in life insurance industry is approximately 25% + (20% x 30%) = 31%. Conversely, a general insurance industry that has a short tail nature, holds stock related investments at approximately 10%, with most of its investments being secured in time deposits, focusing on liquidity management as well as maintaining reciprocal business with its partnering banks.

With investment portfolio constituting between 84% and 88% of total assets, stock related investments account for around 26% of life insurance industry's total assets and 8% of general industry's total assets. Accordingly, excessive fluctuations in the stock market will adversely affect the value of a life insurance company's asset more considerably in comparison to the general insurance industry, prompting us to focus our observation on the stock market impact on life insurance this point forward.

DIFFERENT BUSINESS MODEL, DIFFERENT IMPACT

The stock-only investment portfolio in life insurance plunged by 28.1% as of March 2020 from its January 2020's position. The magnitude of the impact depends on the type of the business model that the life insurance company employs. The first model –considered to be more sustainable – focuses on matching the investment allocation with the life of its insurance policies, and/or having significant portion of unit-linked products in the investment portfolio. By matching the life or tenor of the investments to the insurance policy, it will allow the life insurance companies more time to adjust to the impact of a short-term volatility which is usually conducted through cost averaging approach when the stock prices decline. On the other hand, the life insurance companies with a significant presence of unit-linked products can pass the investment risk to the policy holders, hence they will not bear the unit-link products' investment losses. The second model, which is more vulnerable, is the one that guarantees a certain return over a period of time, typically 5 years at the maximum. In case of a sudden market reversal, the companies under this category will be deprived of the flexibility to sell the underlying investments (mostly made up of stocks in pursuit of higher return) at a respectable price.

PROFITABILITY POINT OF VIEW

Viewed from the profitability of operating performance, at this juncture it is difficult to gauge because the investment portfolio shows such a poor performance contributing negatively to the life insurance industry's income profile. The worst performance was recorded in March 2020, when the investment result was negative IDR43.6 trillion compared to a gross premium of IDR40.8 trillion. Under the normal situation, investment outcome contributes significantly to the company's profit, averaging between 10% and 12% of total top line revenues, for example, in 2019 investment contributed 10.5% to the top line revenues (gross premiums and investment yield combined).

INSURANCE INDUSTRY FROM THE RATING'S PERSPECTIVE

Regarding the quality of an insurance company, we focus the assessment on the capacity to settle the claims. Using the top down approach, we first assess the industry risk, then cascade to the business and financial risks of the company.

For the business risk assessment, the first assessment is the size of its market share in the industry, or a niche market and compare its competitiveness against its competitors. We also assess the company's ability to gain new businesses, via its established marketing and distribution channels, IT infrastructures, as well as other resources such as human resource. We also examine the management factor, focusing on its policy and track record to achieve the previously set targets.

With respect to the financial risk assessment, we focus our assessment on four parts: (1) capitalization and reserve aspect with the risk-based capital ratio used as one of the anchor ratios; (2) operating performance where we examine the income generating capability, including its efficiency of the company's operation as reflected in the combined ratio along with its components (loss, expense, commission) and return on assets; (3) liquidity and financial flexibility by assessing the cash flows and liquid assets proportion; and last but not least, (4) asset quality, where we review the risks associated with the asset composition of the company. We classify stocks as a high risk asset, rendering companies with significant stock presence in its investment portfolio to score lower on asset quality. This is typically the case with life insurance companies whose guaranteed return investment insurance product as their main source of premium generation. We also look at receivables aging profile (both premiums and reinsurance) over 60 days to assess its collection performance, and the portion of cash and investments in low risk asset class (such as time deposits).

The fluctuation of stock prices has a direct impact on the operating performance, although on unrealized basis, since it contributes to income profile through other comprehensive income (OCI), while stock composition, in addition to affecting asset quality profile, also bears an impact on the capitalization and reserve due to its correlation with the risk-based capital calculation. In the case that a company seek to circumvent the calculation by masking the guaranteed return product under unit-linked scheme, we will make an internal adjustment so as to better reflect the asset quality risk. Regarding the liquidity and financial flexibility assessment, we assign a lower score for companies that sell guaranteed return or guaranteed payback, as we view them as a disadvantage. With a definite term of time and size of payback, there is a heightened risk since the company must liquidate the assets to pay policy holders under an unfavorable price.

Furthermore, we also take into account the parent support element to complete the credit assessment. A strong track record of support or strong business synergy between the parent and its subsidiary is an advantage for the subsidiary's rating.

PEFINDO'S PORTFOLIO

At the moment, PEFINDO has a published life insurance portfolio of 3 companies. We classified stock related investment into high risk investment (HRI). The tables below describe the ratio of HRI to total investments (HRI/TI) during the last 6 years, including the interim figures as of June 2020 (1H20).

Table 1. PEFINDO's life insurance portfolio – High Risk Investment to Total Investment

HRI/TI	1H20	FY19	FY18	FY17	FY16	FY15	RATING
Mandiri Inhealth	0.0	0.1	0.0	1.0	0.6	4.6	idAA
BNI Life	0.0	4.4	1.8	6.0	9.0	8.7	idAA+
Taspen Life	5.0	8.1	7.6	11.4	4.4	0.0	idA+
Median	0.0	4.4	1.8	6.0	4.4	4.6	

source: PEFINDO's data

As for the general insurance, the portfolio consists of 11 companies with the rating being published. Number of rated general insurers are bigger than life insurance companies, since general insurance companies mostly obtain businesses from its counterparties such as banks and financing companies. The banks and financing companies, in turn, require these general insurance companies to be rated by a rating agency, mostly to comply with their internal policy. Meanwhile, life insurance businesses are mostly derived from retail segment and customers that are not requiring a rating as a mandatory information.

Table 2. PEFINDO's general insurance portfolio – High Risk Investment to Total Investment

HRI/TI	1H20	FY19	FY18	FY17	FY16	FY15	RATING
Bhakti Bayangkara	1.7	1.7	2	2.1	0.9	0.1	idBBB
Askrida	0.9	0.7	0.5	0.3	0.4	0.3	idA+
ACA	40.7	41.2	36.8	31.8	28.8	34.3	idA+
Binagriya Upakara	6.6	10.5	7.2	14.3	1.9	0.1	idBBB+
Asuransi Sinarmas	39.3	38.2	43.6	53.3	54.5	10.3	idAA+
Tripakarta	1.3	1.6	1.1	1.1	1.1	0.2	idA-
PLN Insurance	0.7	1	1.8	1.7	2.2	4.2	idBBB+
Videi	0.0	0.0	0.0	0.0	0.0	0.0	idBBB
BCA Insurance	0.0	0.0	0.0	0.0	0.0	0.0	idAA
BRI Insurance	0.1	0.1	0.2	0.2	0.1	0.1	idAA-
Jasindo	1.2	2.7	3.6	1.4	1.2	1.3	idAA
Median	1.2	1.6	1.8	1.4	1.1	0.2	

source: PEFINDO's data

Based on our portfolio, insurance companies generally show a more conservative investment portfolio, with only a few exceptions, since a regulation stipulates that those companies is required to hold partly government bond/infrastructure investment portion, typically consisting of high rating instruments. In addition, in the wake of several claim non-payment cases regarding guaranteed investment products, the regulator has tightened its surveillance, thereby prompting those companies to improve their risk management, which generally has resulted in more prudent and conservative investment decisions.