Taiwan Life Insurance 2004 – Market Report

I. Market Overview –

The life insurance market of Taiwan continued its growth in 2004, despite the controversial presidential election and political unease, which was expected to affect but barely had any impact on the Taiwanese economic development and investment environment. The recuperation of world economy in the first half-year reflected to the island's economy, together with relaxation of the domestic insurance regulation led to a continual growth of premium income and with high demand for a variety of insurance products.

However, growth was overcastted by warning signals of high product concentration and low underwriting profit. The source of premium income was highly concentrated on a few products: interest-sensitive annuity, investment-linked insurance and single premium policy. Moreover, profit before tax only reached NT$ 18.9bn (US$ 566mn[1]), which was a decline of 63% comparing to 2003.

II. Premium Income Continued to Grow

The economic conditions of 2004, in general, were in favor of development of life insurance market. The economic growth rate of Taiwan in 2004 was 5.71%. The average income per capita equaled to NT$ 413,786 (US$ 12,404) with a real income growth of 1.35%. Unemployment rate decreased from 4.99% in 2003 to 4.44%. With price index remained stabile while employment market continued to improve, insurance products became more affordable.

Indeed, 2004 premium income in Taiwan continued to grow. Total premium income reached NT$ 1308.5bn (US$ 39.22bn), an increase of 15.53% comparing with previous year. First-year premium rose 29.57%, amounting to NT$ 446.2bn (US$ 13.38bn). In terms of product lines, life product remained the major source of premium income; while annuity had the most significant growth rate, and personal accident fell back.

Chart: Overview of Premium Income (unit: NT$ mn)

Product Type	First-Year			Renewal			Total Premium		
	Y2004	Y2003	Change %	Y2004	Y2003	Change %	Y2004	Y2003	Change %
Life	259,985	235,559	10.37%	695,030	636,000	9.28%	955,015	871,559	9.58%
PA	12,224	15,090	-18.99%	45,667	46,464	-1.72%	57,891	61554	-5.95%
Health Insurance	20,315	20,704	-1.88%	120,264	105,218	14.30%	140,579	125922	11.64%
Annuity	153,682	73,012	110.49%	1,322	605	118.51%	155,004	73617	110.55%
Total	446,206	344,365	29.57%	862,283	788,287	9.39%	1,308,489	1,132,652	15.52%

Source: Life Insurance Association of the R.O.C. (LIA-ROC)

[1] All currency rate conversion to USD in this paper is based on the exchange rate (NT$ 33.36 / USD) published in "*World Insurance in 2004*", Sigma No.2/2005, Swiss Reinsurance Company, 2005.

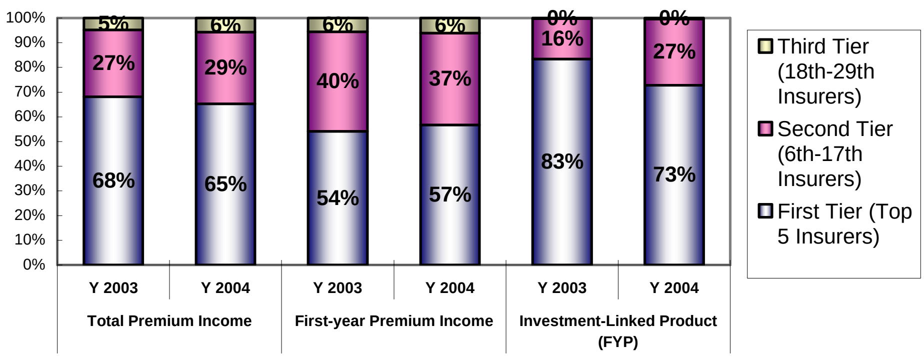
Fast Development of New Contracts

Even though first-year premium income was unintermittedly growing, persistency rate was declining. In 2004, 34% of the total premium income was comprised of first-year premium income. Meanwhile, renewal income realized in 2004 was only 76% of the total premium income received in 2003. Single-premium policy and flexible premium of investment-linked product sold in the previous year could have been the partial causes of the declining persistency rate. Nevertheless, insurers should not ignore the alarming number of heightening cases of policy surrender. There were around 990,000 contracts surrendered during the year, an increase of 10.9% from the previous year and an upswing of 59.7% by surrender value. Undoubtedly, striving for market share was crucial to insurers, but product quality should be placed at an equal level of importance.

High Market Concentration

Market share was highly concentrated in the hands a small number of large companies. Statistic showed that top 5 life insurance companies in the country controlled two-thirds of the market share; each of the 12 companies in the third tier owned less than 1% of the market share (see graph: market segment). The trend was similar to the previous year except in the market for investment-linked products.

Graph: Market Segment



Source: LIA-ROC

To contend with large competitors for market share, smaller insurers had taken the strategy to sell products with higher risk. The findings from observing the growth rate of individual insurers indicated that smaller companies succeed in drawing in more first-year premium growth by niche marketing with investment-linked product which linked to structured notes, interest-sensitive annuity, and short-term endowment products.

With 28 life insurers[2] in the market, the insurance sector is obviously overcrowded. Under the pressure of marginalized market, the extreme need to enhance asset-liability management

[2] Far Glory Life Insurance acquired Zurich Life Insurance on October 29, 2004, thus decreasing the number of insurance companies to 28.

and development of innovative products, acquisition or merger could be a more feasible option for small companies to survive and for the healthiness of the market development. Consequently, merger and solvency mechanism are also becoming the major challenges of the Insurance Bureau.

III. Diverse Products

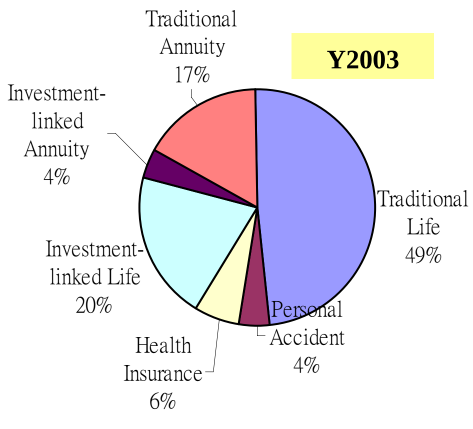
The pricing and design of new life products introduced in 2004 were impacted by several regulations commenced during the year: first, *2002 Taiwan Standard Ordinary Experience Mortality Table* was adopted for all new policies; second, interest rate for reserving dropped from 2.5% to 2.0%; and third, compulsory participating policy was ceased from selling, and was substituted by non-participating policy and optional participating policy.

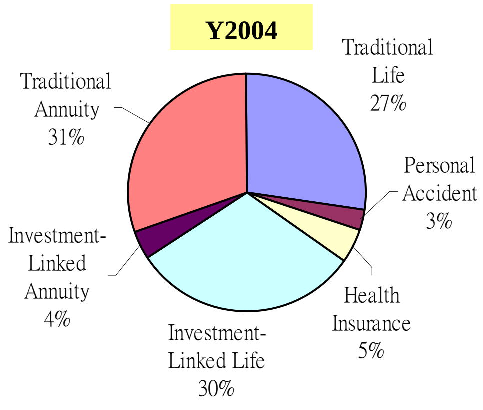
In terms of product type, annuity caught most of market attention besides investment-linked product, which had been popular for several years straight. On the contrary, high pricing had stalled the growth of traditional life insurance. With interest rate for pricing set between 2% ~ 2.95%, the only life policies sold well were whole life with increasing face amount and short-term endowments.

In the recent year, big changes were seen in the market structure in terms of new products sold. Comparing to the previous year, first-year premium income boosted the highest for annuity product (mostly interest-sensitive annuity), reaching growth rate of 135%; investment-linked product grew at 95%; investment-linked annuity rose 16%; on contrast, traditional life insurance dropped by 26%, personal accident contracted 19%, and health insurance slid by 2%.

As the result of these changes, the appropriation of life market in 2004 could be described as tripartite with three types of products dominating the market: investment-link product, annuity, and traditional life policy. The biggest distinction in market share was found in traditional life product, where the percentage dropped down to 27% from 49%, while investment-linked life and annuity (traditional plus investment-linked) picked up from 20% to 30% and 21% to 35%, respectively.

Graph. Market Share (Y2003 and Y2004)





Investment-Linked Fever Continued

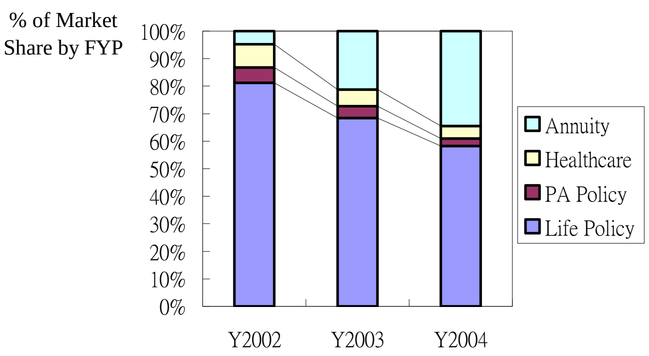
Investment-linked policies had been desirable in the market since its launch in 2000. Total first-year premium income actualized from the sales of the product in 2004 attained to NT$ 154.5bn (US$ 4.63bn) and captured 34% of the total first-year premium income earned by the industry, an increase of 81% from previous year. The 2004 premium income for investment-linked policies was NT$ 164.6bn (US$ 4.93bn), equaling to 12.59% of total premium income.

Even though investment-linked policies may have had boosted the entire premium income, the benefit for insurance companies was limited. Current regulation prohibits insurers from managing the fund on their own. Indeed, handling fee paid by investment banks that conducted the actual investment was the only profit generated from the sales of the product. Meanwhile, insurers also bore the responsibility to disclose risk and fees involved and to solve disputes related to the product.

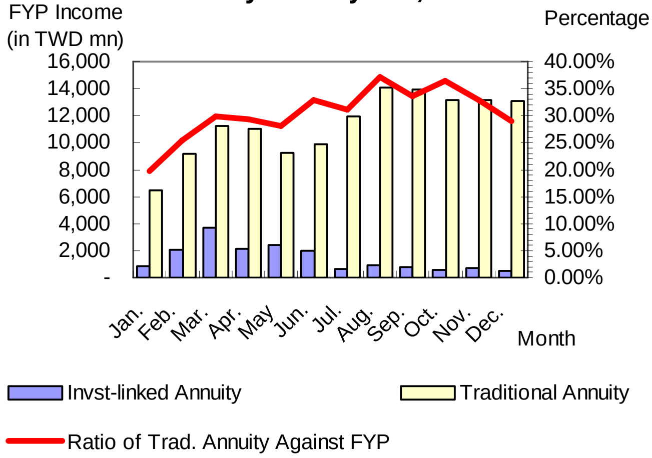
Interest-Sensitive Annuity Ascend

Interest-sensitive annuity was the key factor for the triple digit growth (130%) of the annuity market in 2004. As traditional endowment became less appealing under low interest rate, in replacement was the interest-sensitive annuity. Sold mostly via bancassurance, the product attracted buyers by offering interest rate above the bank's time-deposit rate, at 2% - 3%. However, the marketing strategy also placed the insurers at risk of elastic demand against interest rate. As depicted in the graph "Monthly annuity FYP, Y2004" shown below, market began to show signs of cooling down since October 2004 matching the period when market interest rate rose and insurance companies hesitated to adjust the rate accordingly.

Change of Ratio in FYP, 2002-2004



Monthly Annuity FYP, Y2004



Alarming Percentage of Single Premium Income

Single premium income amounted to NT$ 195.7bn (US$ 5.87bn) in 2004, accounting for 43.87% of total first-year premium income of the year. Comparing to 2003, the growth rate was 68% (NT$ 79.4bn). Differentiating by product type, 96.5% of investment-linked annuity, 68.16%

of investment-linked life policy, 57.8% of traditional annuity, and 5.4 %of traditional life sold in 2004 was paid in single premium. Ten out of 29 life insurers earned more than 50% of first-year premium income from single premium policy.

High percentage of single-premium income falsely inflated the scale of the industry, and the record is difficult to sustain. Since most single premium products were sold through bancassurance, how would the rebound of market interest rate affect banks' willingness to promote the product is something that insurers need to keep in mind.

IV. Financial Overview

Asset and Liability

2004 total assets of the life insurance industry equaled to NT$ 5,501bn (US$ 164.90bn), arose 18.86% from 2003. Allocation of the assets were as follows: 40.5% in bonds, equities, and beneficiary certificates；24.9% in foreign investments; 8.9% in collateral loan; 7.8% in policy loan; 4.2% in real estate; and 3.7% was kept as cash or bank deposits. The ratio of liability to asset was 95.5%, of which 88.4% of the assets (NT$ 4,864.5bn) were reserves, and owner's equity to total assets was 4.5%.

Profit and Loss

The pre-tax profit of 2004 for the industry came to NT$ 18.9bn (US$ 0.566bn). Twelve insurers had positive earnings, summing to NT$ 38.4bn, and the rest of 16 companies had a net loss totaled to NT$ 19.5bn. Comparing to 2003, pre-tax profit was lessened by NT$ 32.4bn (-63.22%).

Table: Profit and Loss Accounts for Life Insurance Unit: NT$ mn

ITEM	Y2003	Y2004	Change Rate
Operating Revenue	1,529,010	1,770,665	15.80%
Financial Receipts	220,436	227,382	3.15%
Miscellaneous Revenues	13,934	21,331	53.09%
Total Income	**1,763,380**	**2,019,378**	**14.52%**
Operating Expenses	1,620,140	1,885,063	16.35%
Financial Expenses	1,701	3,310	94.62%
Business & Administrative Expense	78,283	75,464	-3.60%
Depreciation and Amortization	7,940	9,287	16.96%
Miscellaneous Expenses	3,987	27,374	586.57%
Total Expenses	**1,712,051**	**2,000,497**	**16.85%**
Profit / Loss (Pre-Tax)	**51,329**	**18,881**	**-63.22%**

Source: LIA-ROC

Several reasons could help explain the corroded profit. Augmentation of investment overseas together with appreciation of the Taiwanese currency had caused hedging cost for foreign exchange to climb. Investment overseas increased NT$ 218.5bn (US$ 6.5bn) over the year, reaching NT$ 1348.8bn (US$ 40.4bn). Meanwhile, New Taiwan Dollar appreciated NT$ 2.06 to US dollar in 2004. The cost of currency exchange, therefore, soared from 0.5% to 2%; cost of hedging jumped to around NT$ 21.4bn in a year. Another reason to explain the profit drop was that a number of insurers had complied in advance with the newly passed Taiwan GAAP Standards 35 on Impairment of Assets, reflecting a more accurate recoverable amount of their assets.

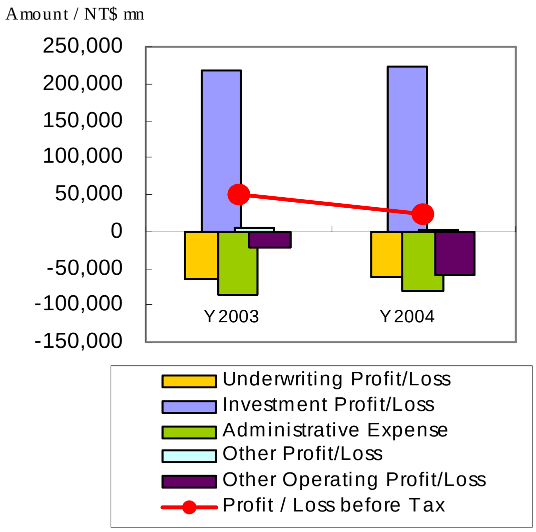
Chart. Cost of Currency Exchange

Year	Amount of Foreign Investment* (NT$ bn)	Estimated Cost of Currency Exchange	Amount of Cost (NT$ bn)
2004	1348	X 2.0%	27.0
2003	1129.5	X 0.5%	5.6
Difference			21.4

Source *: LIA-ROC

Besides the aberrations described in the paragraph above, the loss and profit table also indicated that operating expense was actually exceeding operating revenue. Fierce competition in Taiwanese market had driven insurers into price war, which left almost no margin for underwriting profitability (see graph Profit and Loss Analysis).

Graph. Profit and Loss Analysis



The majority of the profit for life insurers was actually contributed by incomes from financial investment. Net profit from investment in 2004 was approximately NT$ 223.4bn (US$ 6.7bn), 2.3% increase from 2003. Following the lifting of overseas investment ceiling to 35% in 2004, the Bureau is looking to further expand to the ceiling to 50%. It can be predicted that the role of financial investment would only grow more important in the future. How to reduce the risk of ever-growing investment overseas and the cost of hedging, and to enhance the underwriting profitability become the most essential challenges faced by life insurers.

Utilization of Funds

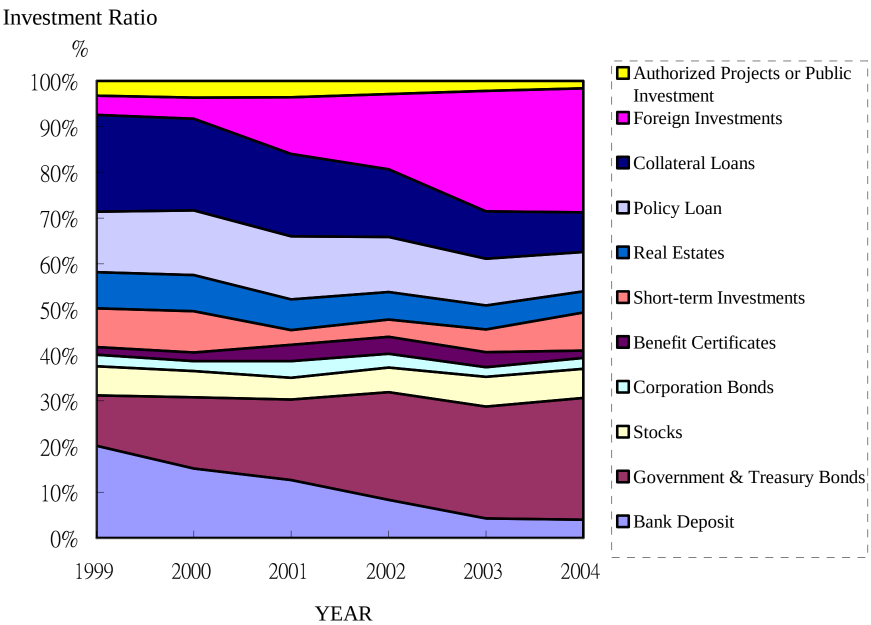
The amount of life insurance funds available was NT$ 5112.6bn (US$ 153.3bn), in which 97.3% was utilized. Top two investment targets were foreign investment (27.11% or NT$ 1348bn) and government and treasury bonds (26.61% or NT$ 1323bn). Largest surge was found in short-term investments (96.36%). Return on fund utilization averaged to 4.91% for the industry, with 5 insurers achieved more than 5% and 20 insurers attained between 2~5%.

Table: Investment Portfolio of Life Insurance in Taiwan, 2004 Unit: NT$ mn

ITEM	By End of 2004		End of 2003	Change in %	Change %	% of Owner's Equity & Various Reserve Accounts	
	Amount	%	Amount			Total	Ceiling Set by the Law
Bank Deposit	200,012	4.02%	180,810	19,202	10.62%	3.91%	10
Securities	2,251,456	45.28%	1,743,124	508,332	29.16%	44.04%	N/A
Government & Treasury Bonds	1,322,955	26.61%	1,031,339	291,616	28.28%	25.88%	N/A
Stocks	317,924	6.39%	273,632	44,292	16.19%	6.22%	
Corporate Bonds	118,741	2.39%	88,101	30,640	34.78%	2.32%	35
Beneficiary Certificates	80,358	1.62%	139,430	-59,072	-42.37%	1.57%	5
Short-Term Invest.	411,478	8.28%	210,622	200,856	95.36%	8.05%	35

Real Estate	230,343	4.63%	221,781	8,562	3.86%	4.51%	30
Policy Loan	429,675	8.64%	430,427	-752	-0.17%	8.40%	N/A
Collateral Loans	431,951	8.69%	439,964	-8,013	-1.82%	8.45%	35
Foreign Investments	1,347,990	27.11%	1,110,983	237,007	21.33%	26.37%	35
Authorized Projects or Public Investments	80,813	1.63%	90,450	-9,637	-10.65%	1.58%	10
Total	4,972,240	100.00%	4,217,539	754,701	17.89%	97.26%	
Owner's Equity & Various Reserve Accounts	5,112,566		4,377,355	735,211	16.80%	100.00%	

Graph. The Trend of Acquisition of Investment, 1999-2004



Due to the sliding of interest rate in the recent years, the ratio of investment being injected into bank deposit and collateral loans were gradually decreasing. In the meantime, investment ratio for government treasury and bonds was increasing. Subsequently to the amplification of the foreign investments ceiling, many insurers augmented the amount and ratio to invest overseas. As of end of 2004, three insurers engaged more than 30% of their available funds in foreign investment, 11 insurers set between 20% to 30%, and seven insurers slot in less than 10%.

V. Future Outlook

Facing the New Interest Trend

If interest rate were to pick up in 2005 as forecasted, it would become a disadvantage to the sales of certain popular products in 2004 such as interest-sensitive annuity, whole life with increasing face value, and short-term endowment, as their interest pay out loses attraction against bank deposits. To certain extend, life insurers also faced the possible risk of policy surrender, and banks' willingness to market for the product could take a downturn. To reduce the risk, restructuring products toward protection orientation could be the tactic to take. In addition, insurers may consider reduce their reliance on bancassurance and provide more professional trainings to their sale representatives.

Merger and Acquisition

As underwriting profit for traditional product narrows and sales trend of interest sensitive product reverses, smaller companies would find even tougher struggles competing against large companies to gain market share, thus merger and acquisition might become a natural course of action to take. Regulators also would like to see market competition eased by reducing the number of insurance entities. In fact, the Bureau is presently revising amendments on merger and acquisition guidelines as well as exit mechanism in preparation to fulfill the expected outcomes in the market.

Internal Funds

Noticed that the advantage did not but should be aligned with responsibility attached with the sales of the upspringing investment-linked products, Taiwan Insurance Institute submitted to the Bureau a proposal calling for the permission for insurers to establish internal funds. The proposal aimed to prevent insurers from becoming simply brokers for investment banks, instead, insurers would be allowed to issue policies linked to their own internal funds. The practice not only would effectuate insurers to enhance their financial management ability, it would also push insurers to differentiate their investment management which focuses more on long-term stability as oppose to short-term return which is emphasized by investment banks.

Pension System

The Labor Pension Act was to be commenced on July 1, 2005, opening opportunity for qualified life insurers to participate in "annuity insurance scheme" and "annuity insurance beyond life expectancy." Moreover, it is predicted that the implementation of the pension system will draw public attention to retirement plan and stimulate the market demand for annuity, just as the effect that the national health plan had for private health insurance products. The age structure of the Taiwanese society also parallels with the trend of retirement market. Population ratio of senior citizen (65 year-old) has increased from 4.43% in the 1980s to 9.48% by the end of 2004, fitting the aging society defined by the United Nations.

The occupational retirement pension plan is obviously an opportunity to be developed. To outrace competitors in the market, the winning team will need to possess an outstanding retirement planning skills of insurance sales representatives, also, an excellent product design ability to create innovative products to complement the pension plan and further satisfy the need of consumers.

Importance of Investment

Intense market competition and low underwriting profitability underlines the importance of financial investment's role as a source of income for insurers. Aiming to give more investment flexibility to insurance companies, the Bureau has expanded the scope of investment targets over recent years, like relaxing corporation bond restriction to include BBB+ or better rating bonds and allowing investment to acquire up to 25% of the shares of insurance company in Mainland China. Also the Bureau is currently under consideration to further uplift foreign investment ceiling to 50%. To take full advantage of the flexibility of fund utilization, insurers should be more careful in determining asset allocation through examination of liability structures of the individual entities.

Accounting Standards

The Taiwan GAAP Standards No. 34 on Financial Instrument: Recognition and Measurement and No. 35 on Impairment of Assets are to be enforced in 2005 and 2006, respectively, for the purpose of making the financial statements, utilization of funds and risk control more transparent. However, Standard No. 34 calls for assets and liabilities of financial instruments to be recorded in market value, while, insurance liability is not included in the requirement. In Taiwan's situation, the insurance liability will continue to be recorded on historical value, thus causing accounting mismatching in the basis of evaluations. Calculation of financial index, such as return on equity, could be biased due to the change. To minimize the effect, life insurers could equip themselves with asset evaluation tools, simulate in advance possible scenarios of asset allocation, and strengthen risk control. In case the adoption of Accounting Standard No. 35 led to an overwhelming impairment of assets, life insurers must prepare to explain in detail the reasons for the distortion to avoid market panic.

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