Investment-Linked Plans in Indonesia: Perspectives on a growing market

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KEY POINTS

- ILP sector growing fast, the middle class wants to invest
- Indications of strong and growing appetite for investment products
- ILP assets constitute a third of asset management sector's assets
- Regulatory, technology barriers being reduced
- The industry should address inefficiencies in distribution
- Companies must anticipate change, understand the market, plan accordingly and execute effectively
- The industry must collaborate to deliver an investment environment that works for everyone

Contents

Introduction

The market for regular payment investment products is growing fast in Indonesia, offering real potential for companies who can compete in this sector. Although dominated by life insurers for reasons related to the current distribution environment, a more diversified provider landscape can be expected in the future.

Ipsos Business Consulting has analysed this evolving market in Southeast Asia's largest economy, assessing the current market environment and the primary product structures, forecasting how the market is likely to develop, and identifying potential long-term strategies for current and future participants who aim to optimise their market share.

From the customer perspective, whilst there are many providers and products to choose from, the main issue is that distribution costs continue to exert significant downward pressure on net returns. Putting the needs of customers first will offer the greatest rewards for the industry in the long term, and consensus and collaboration will be needed to continue the trajectory towards that objective.

Market overview

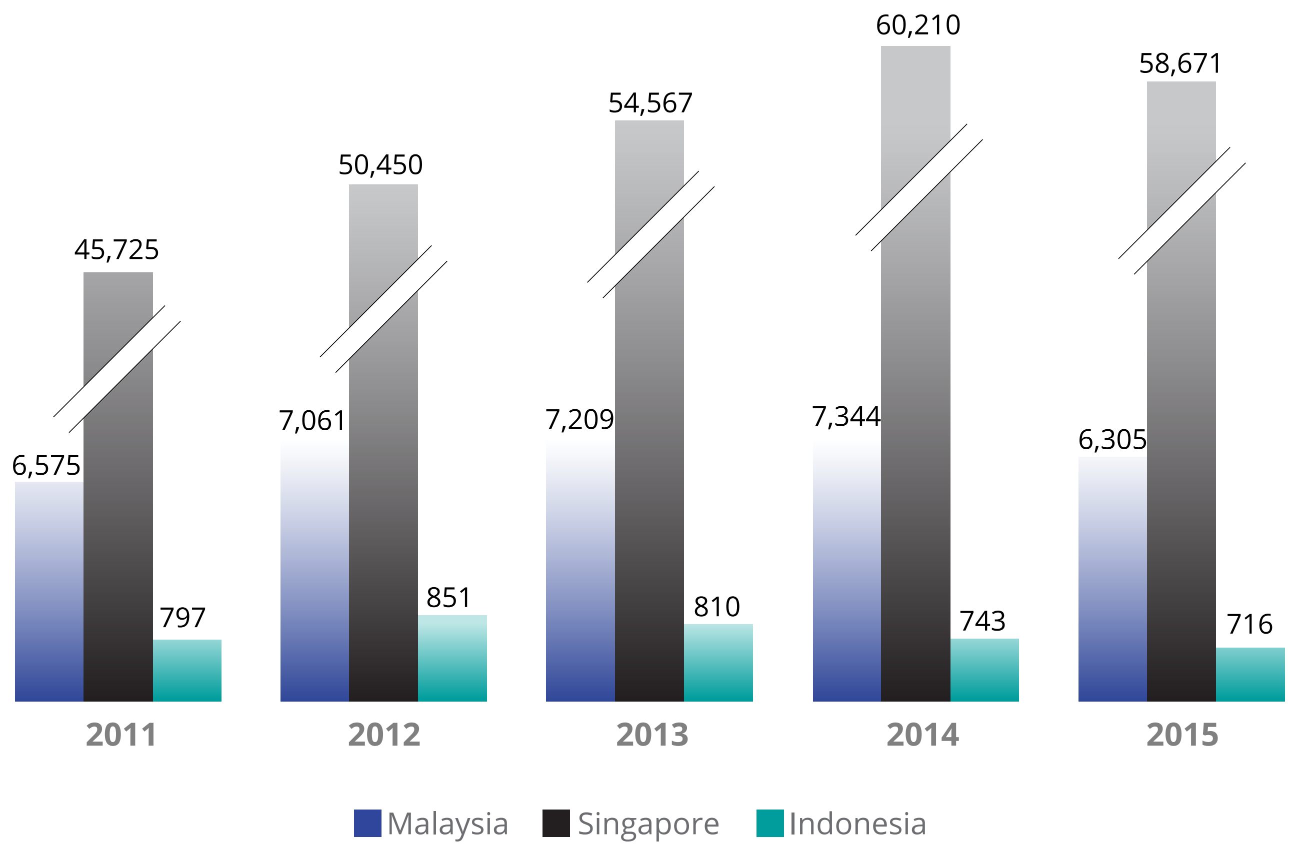
Indonesia's market for regular-payment investment products is expanding at pace, driven by Life insurers, who have achieved impressive premium growth in recent years of around 9.1 per cent per annum[1] driven by their range of investment products. Overall insurance penetration (life and general) remains relatively small, however, and incumbents in the investment products segment could face intensifying competition over the next few years from general insurers, asset managers, banks and new, non-traditional disruptive players.

Investment-linked plans (ILPs) constitute the core set of regular payment investment products sold by the Life industry with most major players focused on this segment for new business premium growth.

ILPs are primarily investment vehicles sold for wealth accumulation purposes. They have an insurance element, but this is secondary to the investment function. Whilst it is technically accurate to describe this business as insurance, therefore, doing so does not give the full picture.

***The growth** in life insurance premiums reflects the growing market for regular payment investment vehicles for middle-class Indonesians who wish to invest in the securities markets.*

Insurance density (IDR, thousands)

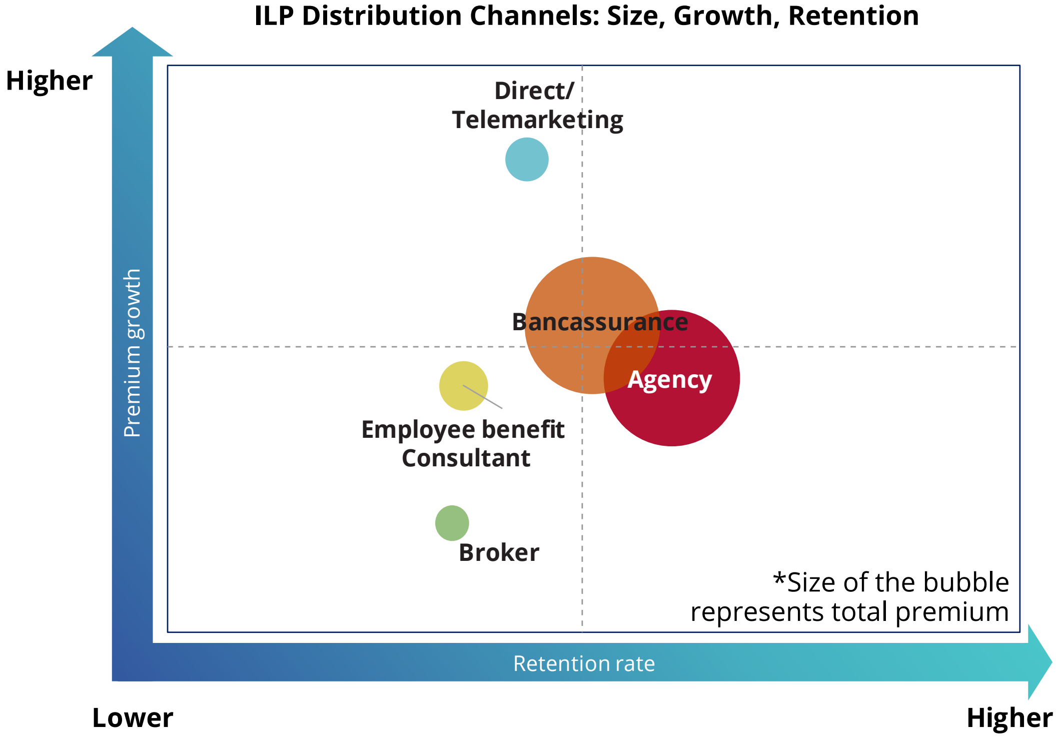


Source: OECD

[1]OJK, LIA

ILPs account for about 90 per cent of new business premiums for some of the market leaders. The segment features familiar international names such as Prudential, AIA and Manulife. These companies have extensive distribution networks, typically comprising tied agents and bancassurance ventures. The top five companies by premium income generate about 44 per cent of the industry's annual sales and about 53 per cent of ILP sales.[2] Agents — one of two primary channels for ILPs with the other being banks — are typically paid on a commission-only basis. While agents have a slightly better track record for business retention overall, the experience for individual companies can be very different as it depends on their specific proposition and the customer groups they target. For example, those targeting higher net worth individuals via an appropriate bancassurance partner might see better retention experience from that channel.

ILP Distribution Channels: Size, Growth, Retention



Source: OJK, LIA, Ipsos Business Consulting Analysis

The fact that consumers are primarily seeking long-term investment, rather than straight insurance, means there is space for non-life players who can provide long-term investment vehicles. The creation of a successful, customer-focused investment product market therefore presents opportunities and challenges for the financial sector generally. Asset managers, for example, currently have a predominantly institutional focus but this will change in due course as the Indonesia market becomes more like other major markets and barriers to competition, particularly those related to distortions caused by commission, are reduced.

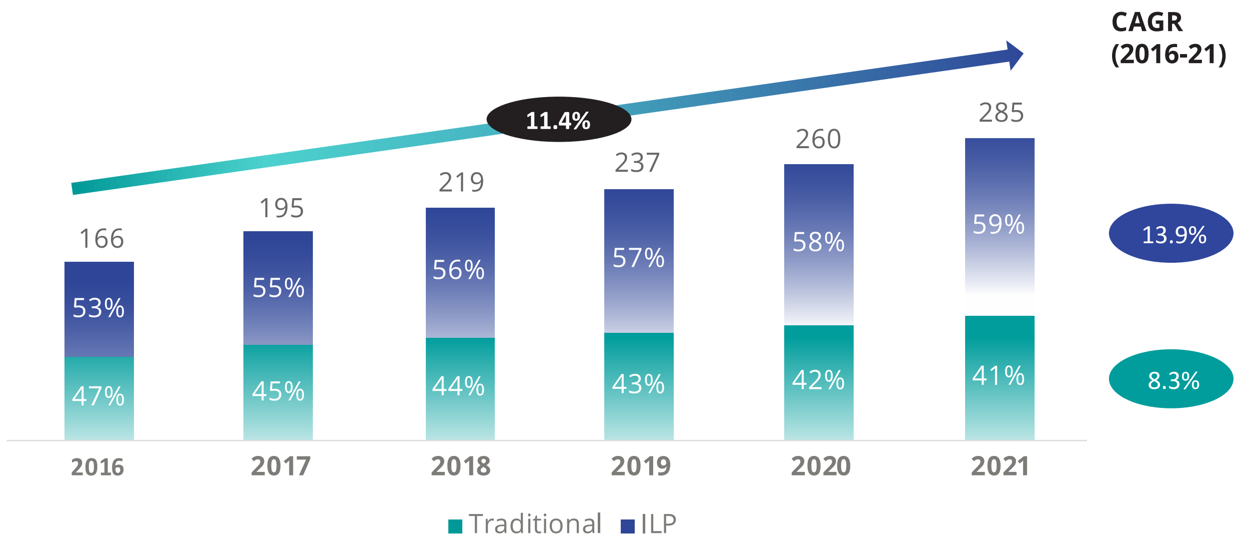
[2]OJK

Investment-linked plans

A core product for Indonesia's life industry

ILP products currently sold in Indonesia are similar to the products sold by life companies in other markets: acquisition costs can be high, but product providers can benefit from attractive margins as long as they effectively manage the book of business once it is acquired. Indonesia's ILP segment is growing fast with many players building their strategy on these products.

Life insurance gross premium forecast (IDR, trillions)



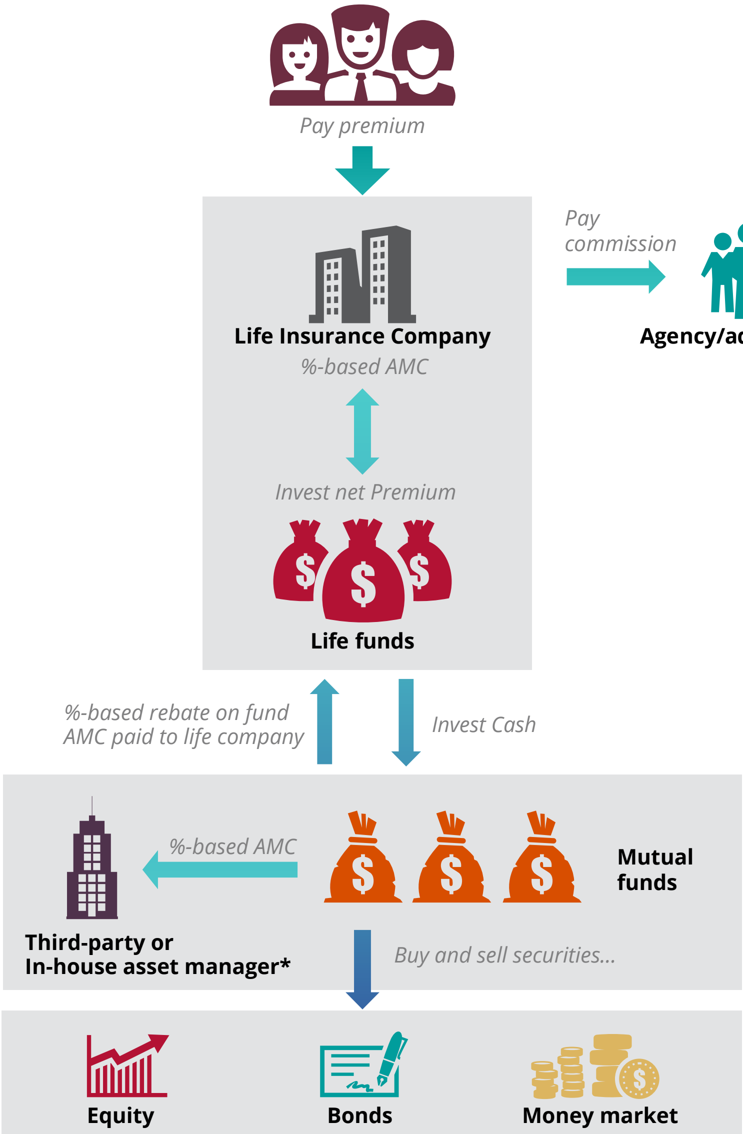
Source: OJK, LIA, Ipsos Business Consulting Analysis

ILPs enable retail customers to invest in a range of securities and funds through a regular payment product structured to provide upfront distributor remuneration. The principles are straightforward:

- Customers commit to paying regular premiums over an agreed period, which is often decades.
- A proportion of the total premiums are invested in underlying funds.
- Customers can also sign up for various insurance options, usually at an additional cost.
- Forecasts are provided of expected fund value at the end of the term under various performance rates, typically creating an expectation of significant long-term gains.

The structural approach to ILPs varies but, broadly speaking, value is shared between the customer, adviser, life company and asset manager[4].

ILP High Level Structure



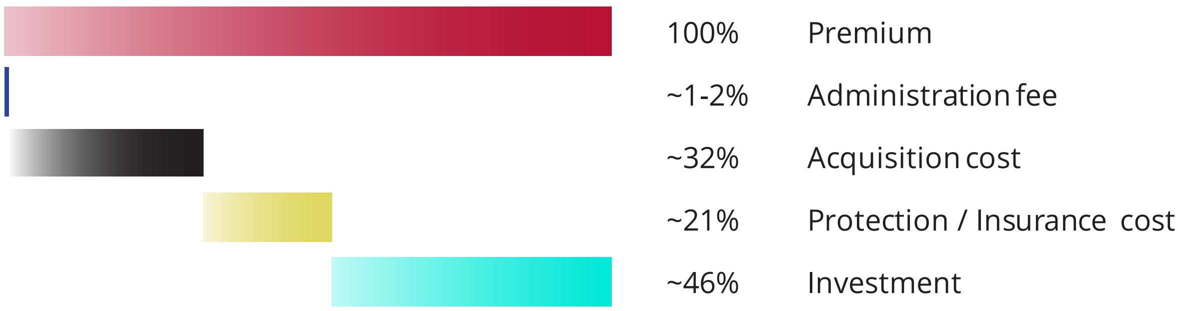
*Depending on the operational model used, in-house managers may allocate assets at the life fund level and also invest directly in securities rather than mutual funds

Source: OJK, LIA, Ipsos Business Consulting Analysis

[3]There are other parties in the value chain, such as custodians and securities brokers, but these are ignored here for simplicity.

On face value, ILPs should be an attractive savings mechanism. However, the current market structure in Indonesia can mean high distribution costs, and these are ultimately paid by the customer through the charging structure.

Premium breakdown



Source: Ipsos Business Consulting Analysis

Product providers generally seek to recover distribution costs during the initial years of the product term. Charges during that period are correspondingly non-trivial. Given that many customers stop paying premiums (or encash completely) well before the end of the agreed term the actual net returns can be significantly lower than they might have initially expected.

ILP products in Indonesia have traditionally been provided by Life companies. By an amendment to regulation, however, the regulator has recently enabled general insurance companies to write investment-linked business. This amendment to 'PAYDI' (the acronym in Indonesian language for 'investment-linked business') has opened the gates for general insurers to compete in the life industry's fastest growing core product segment. As a result, several players have active plans to enter the market. Considerable investment in infrastructure and human capital is required to launch investment products, however, and it will be interesting to see whether these new players choose to innovate or simply apply current ILP structural approaches to a health insurance-based rather than a life insurance-based product framework.

Market insights

Pressure points and prospects for asset growth

Existing players face increasing pressure from a variety of factors:

- Imperfect distribution combined with complex product structures and retention issues.
- An asset management sector that could increasingly look beyond the institutional market for new areas of growth.
- The growth of online platforms.
- Threat from disrupters and non-traditional players.
- Evolving regulatory framework, specifically the PAYDI amendment but also, potentially, other changes.

ILP Market Pressures

Customer expectations

Risk from some current sales/marketing techniques setting unrealistic expectations

Bargaining power

Intermediaries use their bargaining power to extract value from product providers. These costs are ultimately passed on to the customer.

Regulation

PAYDI shows how the regulatory framework can evolve. Future developments could encompass:

- Greater transparency in disclosure of structures and charges
- Regulation of some common product characteristics
- Greater control of intermediary and provider sales and marketing techniques
- Enhanced compensation regimes

Substitutes

- The life sector created the current long-term investment product market, however, asset managers can easily serve the same market if barriers are reduced. For example, in the UK this market is largely served by asset managers.
- PAYDI enables general insurers to enter the ILP market which will increase competition if they develop effective product strategies.

New entrants

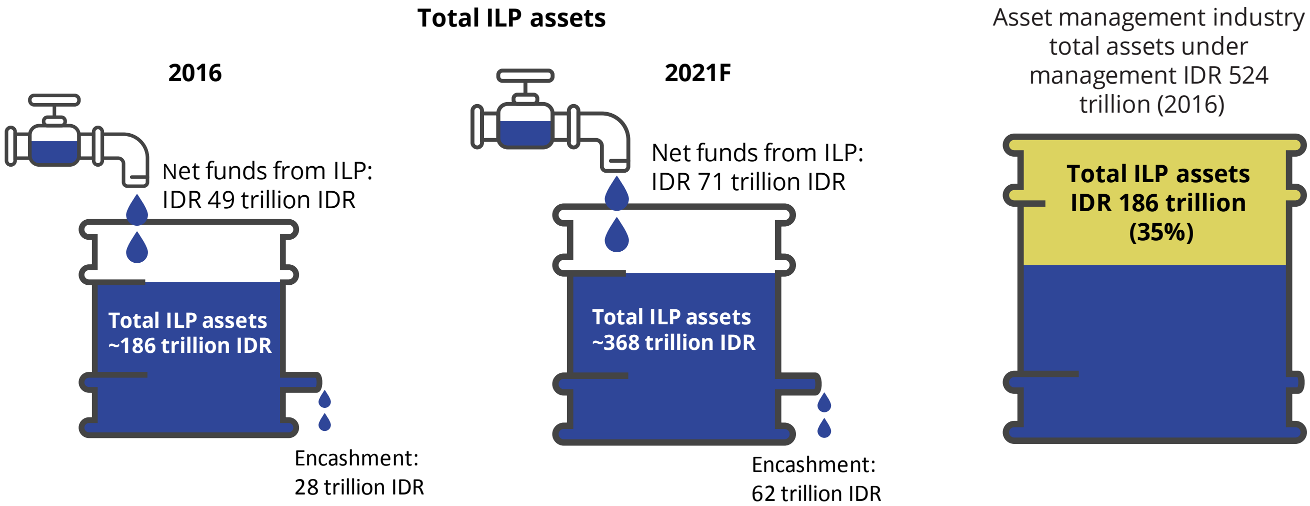
- Similar propositions: new entrants may be unencumbered by legacy issues (e.g. systems) enabling them to develop superior products within the current distribution system
- New propositions: technology players can develop targeted strategies and propositions outside of traditional distribution constraints

Source: Ipsos Business Consulting Analysis

The evolving customer and regulatory environment continues to create opportunities for new entrants and disrupters who can provide substitutes or improve on the existing proposition structures, in particular with respect to resolving inefficiencies in the distribution landscape.

Aside from initial revenue, annual charges are the key source of long-term value for product providers, with an expected annual revenue pool from ILP assets of about IDR 9.2 trillion on a medium-term horizon, growing fast. This revenue pool will be accessible to those who can build a reputation for providing sustainable and efficient long-term investment product solutions.

ILP Asset volumes



Source: OJK, APRDI, Ipsos Business Consulting Analysis

Many ILP players face significant challenges to asset growth because of poor customer retention rates. Customers will sign-up for periods spanning decades, then leave after only a few years. This can mean actual returns are negative for a significant number of customers, raising questions as to whether the average customer is seeing a positive return on a risk-compensated basis. From the product provider's perspective, having paid commission to a distributor based on the sale of a plan designed to run for many years, the premature termination of premiums and withdrawal of cash is highly undesirable. It deprives them of on-going revenue from annual asset-based charges and rebates and they may face reputational risks in addition.

Providers can seek to improve retention and therefore drive additional value from the back book by considering the following areas:

Customer expectations

- Does the organisation actively control how it manages customer expectations from initial contact through to the end of the product term?
- How are expectations set when the product is sold? Does the provider have adequate control over that?
- Are the expectations in line with what the product is designed to deliver?

Communication

- How often does the product provider communicate with customers?
- Is the tone of voice and level of detail appropriate?

Handling and monitoring complaints

- Are complaints logged, monitored and reviewed?
- Do common themes emerge?
- What actions are taken to resolve issues that cause complaints?

Servicing

- Do customers have a good experience when they contact the product provider?
- Are service standards clear and consistent?
- Do front-line staff have the necessary training to handle customer queries accurately and confidently?
- Is the process for passing customer queries on to another team smooth?

Investment proposition

- Is the underlying investment proposition fit for purpose?
- Does it evolve and improve over time?
- Is it flexible?
- Is the product management function aligned to the investment management function?

***Overall,** managing customer expectations is paramount, as this drives long-term acquisition and retention.*

International overview

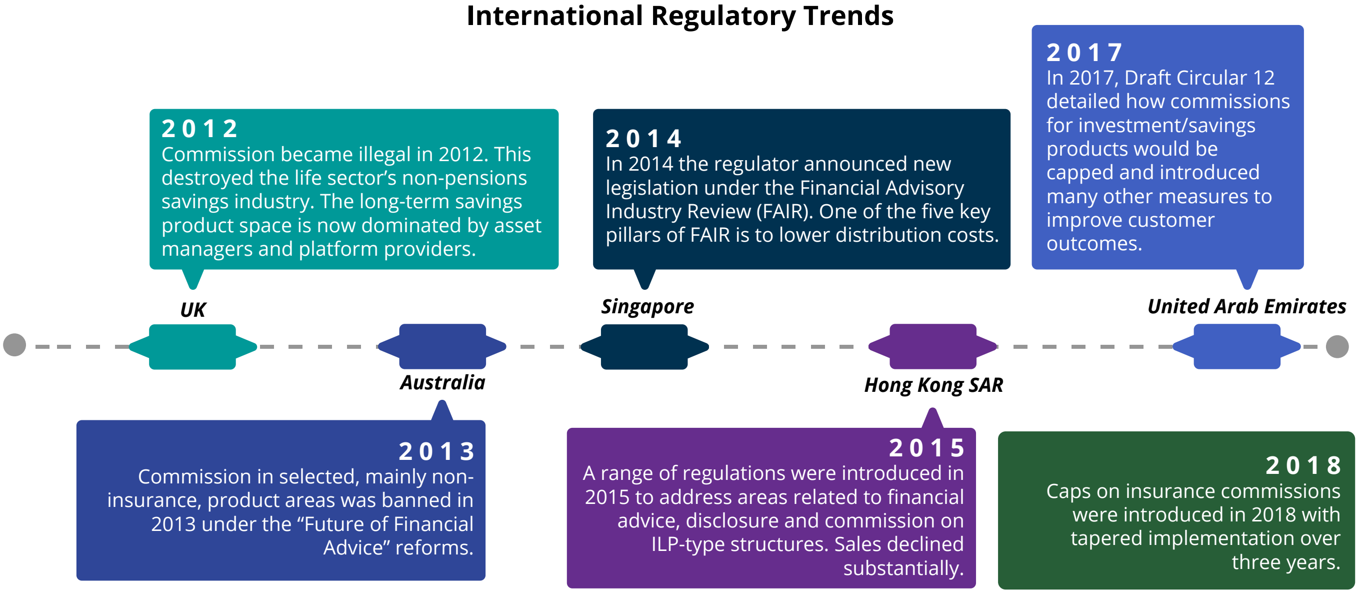
Regulatory trends

With regards to the Life industry generally and the dynamics of the distribution landscape in particular, the current environment in Indonesia has similarities to Hong Kong and Singapore from the late-90s to the early-2010s, as well as European markets from the late-80s to the late-2000s, where investment products were a key driver of sales and revenue. The market is characterised by high upfront distribution costs, pay-to-play arrangements where providers bid for exclusivity/priority with distributors, and poor customer retention. Distribution, rather than product differentiation, is often regarded as the key factor critical to success.

The international regulatory environment for investment products written by insurers has evolved considerably over the past decade. Insurers traditionally have had an edge over the asset management industry when it comes to creating attractive adviser remuneration mechanisms and this area has increasingly been the focus of regulatory attention.

Specifically, they have investigated whether sales incentive structures have created excessive misalignment between adviser and customer interests, particularly in relation to investment products

International Regulatory Trends



Source: Ipsos Business Consulting Analysis

The UK, one of the most aggressive jurisdictions, has made commission illegal. Australia, Hong Kong, Singapore and the UAE have also brought in increasingly tough regulations in an attempt to improve alignment of interests between customers, advisers and product providers.

Ipsos Business Consulting's view

Strategies for success

Indonesia's savings and investments sector offers significant potential for product providers across a range of specialised areas, although the competitive environment does need to be further strengthened.

As part of positioning the industry to deliver a 'best in class' 21st century product landscape, a more optimum distribution framework is required for customers and product providers alike. This will help facilitate long-term sustainable growth for the sector. In the near-term, providers can adopt more effective strategies to improve their performance in the current environment.

The future direction of the industry will be defined by those players who are able to anticipate change, obtain superior information on market characteristics, plan accordingly and execute effectively.

- Life insurers must anticipate an increasingly sophisticated and demanding customer marketplace, and a more diverse product landscape. They will continue to leverage existing areas of potential competitive advantage, such as combining insurance and investment, although they may find this has less traction over time. Improving retention rates should be a priority for the industry as a whole given the high cost of acquisition.

- General insurers now have an opportunity to diversify by adding an investment element to some of their products, for example health insurance. Such developments will require significant investment both in product and operational capability. Providers will therefore need to carefully assess potential options, specifically issues relating to market entry and distribution. Clear focus will be needed on what they are building, as well as how it will help them compete and deliver long-term revenue growth.

- The asset management sector's customer base in Indonesia is predominantly institutional. Asset managers should see the expanding middle class and its evident appetite for capital-at-risk investment products as a significant opportunity to build efficient and targeted investment-based savings products for retail investors. Fundamentally the customer is looking for long term market exposure and asset growth, and that is exactly what asset managers provide.

- Banks will actively consider how to structure their product ranges in a way that maximises both their own revenue and their customers' long term wealth. Given that banks generally are parts of groups with various other entities such as life insurers, general insurers and asset managers, they have a great deal of freedom to think creatively and develop differentiated propositions for different target customer wealth tiers.

- New entrants and disrupters should seek to take advantage of inadequacies in the current market structure. Product distribution is one area that offers scope for fresh thinking. Amazon's recent announcement it will move into the health sector in the United States is an example of the disruptive pressures that traditional financial institutions will increasingly face.

The number of people in Indonesia with sufficient income to consider capital-at-risk investment products remains relatively small, despite the country's large population. ILPs have performed a role in attracting consumers to the concept of investment as well as the concept of insurance, but the overall retail investment environment struggles to gain mass appeal.

The reasons for this must be addressed if the industry is to achieve its potential. Ipsos Business Consulting believes the wider retail market for investment products can expand faster and more sustainably if the financial services industry as a whole works to improve and diversify the product and distribution landscape.

***At** what point should the ILP market be considered sufficiently developed for regulated commission?*

ILPs are currently a very important value driver for the industry, and not just for insurance companies: assets for these products currently represent around a third of total funds under management in the asset management sector.
A corollary of this is that the industry has tremendous exposure to a product type that has often been problematic elsewhere: the consequences of a sustained market downturn or crash could be severe in several respects.

Industry stakeholders should collaborate to deliver an investment environment that works for everyone.

A 'new world' architecture is possible, which would create a better balance between product providers, distributors and customers. Product design could be centred on customer needs and advice processes could become more formalised. The industry needs a degree of collective agreement on how to achieve this, but overall it can be said that in a market with such potential it is highly desirable to continue to improve outcomes for all stakeholders, ensuring the investment industry can have increasing appeal to the people of Indonesia in the coming decades.

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