Increasing role of Insurance Companies in the Capital Market

Amitabh Chaudhry
Managing Director & CEO
HDFC Standard Life Insurance Co.Ltd.

In any economy, a well functioning capital market helps channel savings to the productive sectors of the economy in an efficient and transparent manner. An efficient capital market provides appropriate returns on the savings while the productive sectors get capital at market determined rates. India has been quite fortunate in having a public equity capital market and a debt capital market for quite some time now.

Among the institutional framework for channeling the savings of the economy, banks have been the pre-dominant channel for garnering the financial savings. Insurance companies have largely played a second fiddle to the banking channel in respect of garnering savings.

Over the last two decades, the Government has opened up the voluntary institutional channels - banks, insurance, mutual funds etc, to more private and foreign players in order to improve the efficiencies of garnering and deploying the savings. The mandatory savings channels - Pension funds and Provident funds continue to be managed closely, though initial measures to open up these sectors have also been taken.

Over this period, the traditional channels of financial savings like banks have been slowly and steadily yielding ground to the mutual funds and insurance industry as distribution reach continues to expand and the awareness among the general public about the available alternatives, increases.

While the Insurance space was dominated by a single large public sector firm, the opening up of the space in the year 2000 bought in many private sector players. Over the last 16-17 years that the private insurers have been in operation, this space has grown at a respectable rate of growth. While the initial decade saw the firms inching up their presence in the market, the Asset Under Management (AUM) grew significantly over the last 6-7 years.

Trends in Household Financial Savings

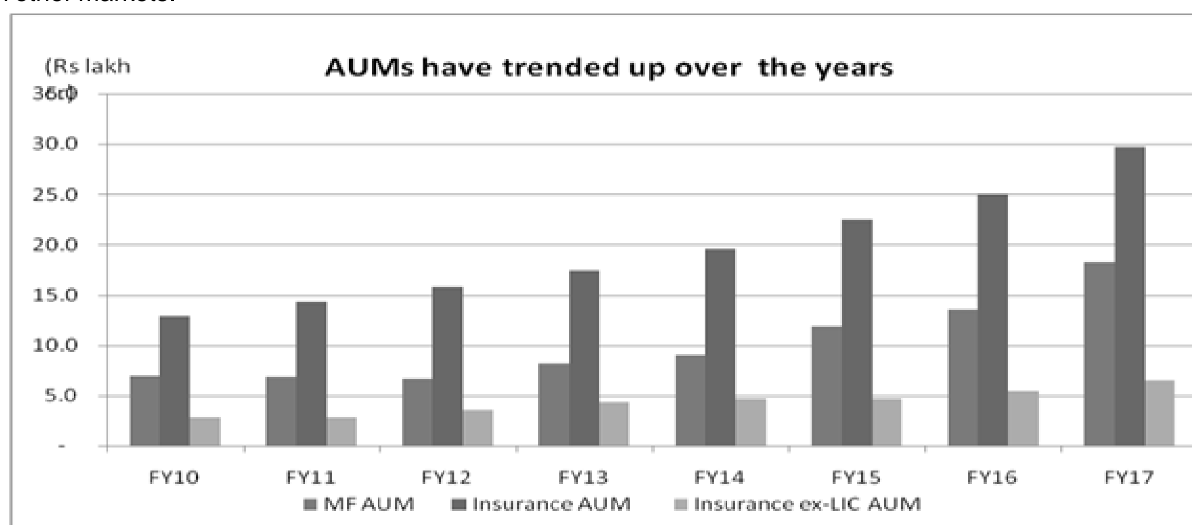
While the institutional framework for channeling financial savings through public markets has been developing, the trend for financial savings itself has been through different phases. The period from the emergence of the financial crisis in 2008 up until 2012-13, saw household financial savings taking a hit on account of a period of low economic growth, high inflation and the relative attractiveness of alternative asset classes like gold which offered higher returns and a hedge against inflation. But, subsequently, over the last 3-4 years, the household savings have incrementally come back to financial savings, with the insurance channel being among the preferred mode of savings. With a growing economy, low inflation environment, an ever increasing distribution reach and improving financial literacy, we see the savings in financial instruments including insurance growing rapidly in the coming years.

Source: Reserve Bank of India

Although the Indian insurance sector has grown, it is still small in relative proportions, compared to that of most developed countries, where assets are often close to 50% of GDP. In India, assets as a share of GDP increased from about 10% in 2001 to 18.1% in 2017. The potential for growth in India is therefore quite huge, especially as India's household savings rate is high, around 28%, and more so because more than 40% of household savings are deployed in non-financial assets.

The role of the insurance industry, along with mutual funds, will continue to grow in the Indian Capital markets, as the markets themselves continue to mature further over the coming years.

The increasing heft of the domestic institutions also augurs well for the public capital markets. Short term moves in the markets, in the past, have often been dictated by the buying / selling of foreign investors due to their relatively rapid pace of building positions in Indian assets or liquidating those positions. A large and vibrant domestic institutional strength helps absorb the large scale rapid buying / selling by the foreign investors and help contain the market price volatility, especially if the rapid moves are triggered by developments that affect the foreign participants in other markets.



Source: AMFI, IRDA

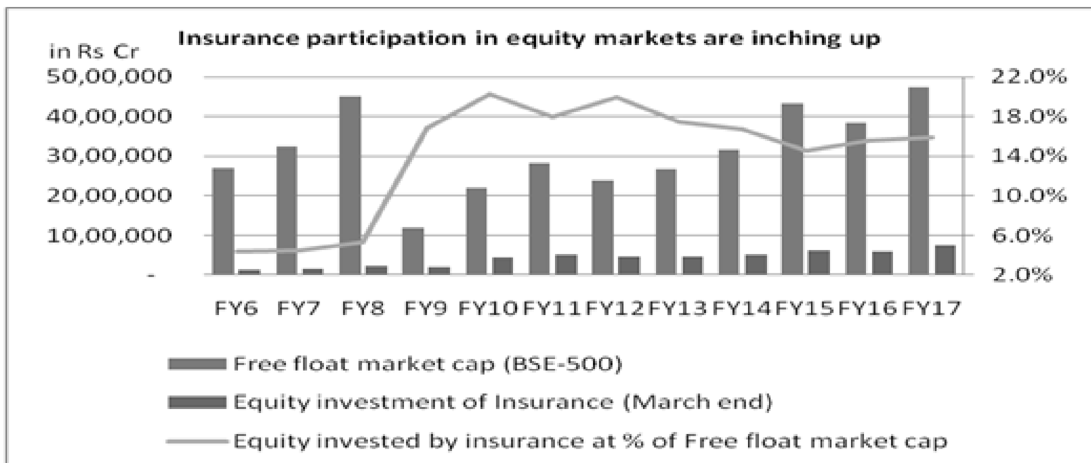
What sets Insurance apart?

i) Product design

Both - Insurance and Mutual Funds, provide an institutional framework for channeling voluntary savings to the capital markets. However, there are key differences in the nature of the products offered by the institutions that sets insurance apart from the domestic mutual fund industry.

The investment products offered by Insurance companies are long term in nature with defined maturity. Thus the initial expectations setting for the savers, with regard to the investment horizon is in line with the underlying asset character. Moreover, with regular premium payments, the insurance product enforces a disciplined savings pattern for the customers.

The insurance industry, itself, has undergone significant changes in the past few years. The changes and the innovations on the product side as well as the interface with customers have helped improve the value proposition for customers. The product structures and associated costs and conditions are simplified and are transparent. The chief grouse against a bundled product like insurance was on the relative opacity of the structure and the incidence of higher costs. The new generation products, now, are simpler, transparent and quite competitive in their cost structures, as compared with the other institutional channels, and in quite a few cases, do have lower costs.



Source: Life Insurance Council of India

ii) Investment Management

The structure for insurance products affords the insurance companies the latitude to take investment decisions for long term horizons. The investment funds available with the insurers are 'sticky' in nature, giving the fund managers the required confidence to take decisions with a longer horizon in mind as well as free them from the constraints of managing liquidity risks in the investment portfolios. This benefit is of immense value during periods of high market volatility or general aversion to market risks, when a number of investment opportunities are available at attractive valuations. The ability to take contra decisions due to limited 'liquidity risks' in the insurance portfolio also helps improve market liquidity and depth.

iii) Alternate Investments

Extending further, on the point of 'sticky funds' available with insurance companies, the investments, then have the ability to actively take on 'liquidity risks' to enhance the returns on the investments. A key emerging trend among the insurance firms has been to explore alternative investment opportunities beyond the conventional listed space. Within the constraints of product design, regulatory guidelines, prudential exposure norms and the insurer's risk appetite, a number of capital market investments outside of the listed investments' universe are available. Unlisted investments are finding greater acceptance with insurance companies. Recent innovations in the capital markets like the Infrastructure Investment Trusts (InVITs), Alternate Investment Funds (AIFs), Security receipts of Asset Reconstruction Companies (ARCs) have found ready investors in the insurance industry as they offer longer term investment horizons that match the insurance liabilities while providing a diversification benefit with higher expected returns.

Widely covered and researched listed equity space offers mostly market linked returns which historically (last 10 years) have been in the range of 7-12% in the broader markets, while at the same time the unlisted space has offered higher returns. This too is likely to be an area of interest for the insurance companies in the future.

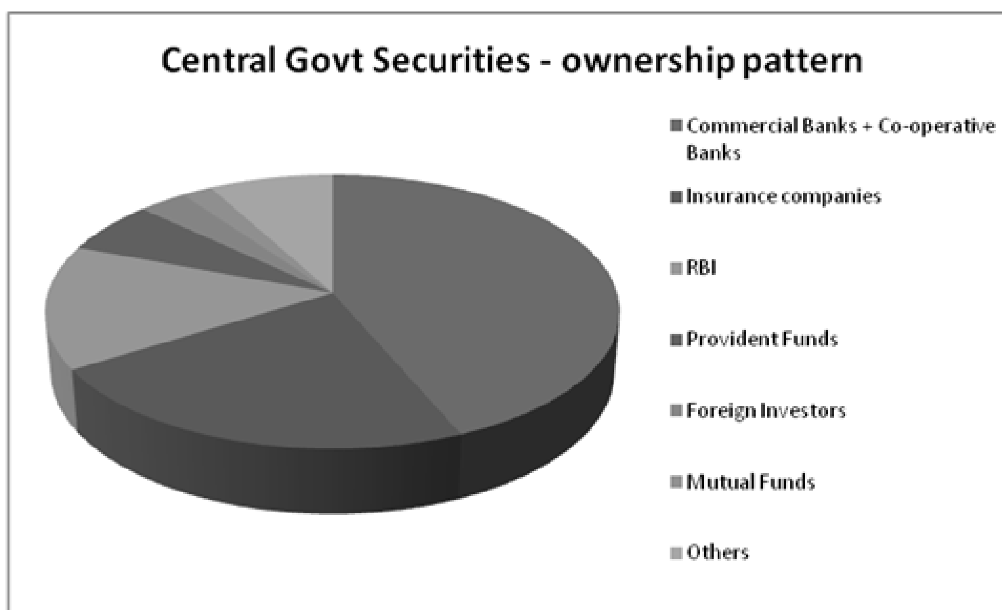
In the last few months, Indian markets have seen issuance of new class of instrument called InVITs, which are basically dividend paying instruments backed by underlying operating infrastructure assets with finite lifetime and cashflows which can be variable or stable. The assets can be tolled road projects with variability of traffic as risk factors or power transmission assets with relatively stable annuity earnings. These class of assets are also quite in line with the investment horizon of the insurance firms and offers additional upside to traditional fixed income instruments in form of higher yield or potential future upside from incremental cashflow generating assets.

As the industry growth matures further, the propensity of the insurance industry to provide capital to companies at earlier stages of their growth will increase. This propensity will increase as the insurance companies' risk appetites grow with the increasing demand for better returns on their investments and improvement in their risk assessment and risk management capabilities. In a nutshell, insurance companies will increasingly provide a substantial portion of risk capital to Indian companies in the coming years.

iv) Debt Capital

While most discussions on capital markets usually refer to equity markets - listed or unlisted, the role of insurance companies is quite unique in the debt capital markets. Among the suite of products offered by any insurance company, there are a number of products that cater to customers with limited risk appetites and those seeking some form of assured returns. These products have been the mainstay of the insurance industry in the past and continue to form a significant portion of funds managed by the insurance industry even today. The appropriate asset-liability

management of these investments necessitates significant investments in debt instruments. Due to the varied tenure of liabilities, the insurance industry has the ability to provide debt capital for varied tenures. Banks, which, in fact, are the largest providers of debt capital are usually constrained to provide long term debt due to the nature of their liabilities. Insurance companies, along with the retiral funds are natural providers of long term debt capital in the economy. Again, in view of the 'sticky' nature of investor funds, the investment decisions of the insurance fund manager is not constrained by liquidity considerations.



Source: RBI

Challenges to increasing participation of Insurance in capital markets

While the participation of insurance companies in the capital markets has been widening, there still exist some key challenges to insurance companies' investments. The regulatory guidelines impose tight constraints on the amount of investments in corporate bonds, bonds with lower credit ratings, equities with lower or no dividend track record and extremely limited ability to use derivative instruments for hedging specific risks in the investment portfolio.

While the regulations do limit the risks that insurance companies can add in their portfolios to avoid jeopardising their solvency ratios, we expect the regulator to incrementally ease some of the restrictions to allow the insurers to take greater risks. The changes are likely to be accompanied by requirements for the insurance companies to account for market risks is assessing their solvency status. This will help insurance companies in offering greater diversity in risk profiles in their product offerings.

Conclusion

India is a growing economy with high savings rate which is increasingly getting into more productive financial assets driven by expectation of lower inflationary environment and higher growth expectations over the coming years. Insurance, which, globally is one of the most important avenues of financial savings is bound to increase its share in the Indian context with rising distribution reach and financial literacy among the citizens. With the very nature of the investments coming into the Insurance firms being of long term sticky nature, the avenues available to the firms to invest is vast and is expanding rapidly. Apart from the listed equity and debt space, with the support of the regulations, the companies are gradually spreading the investments into the private equity, venture fund and other alternative investments such as InVITs, Security receipts, AIFs, unlisted equity etc. What is further required is a gradual easing of restrictions on investments by the regulator over the coming years as the market and the companies mature. We believe, Insurance investments in capital markets are bound to grow in leaps and bounds over the next few decades as we bridge the gap with the more developed markets.