Asia-Pacific Financial Forum
Interim Report to the APEC Finance Ministers

ANNEX H
Constraints on Promoting Long-Term Investment in the Asia-Pacific

CONSTRAINTS ON PROMOTING LONG-TERM INVESTMENT IN THE ASIA-PACIFIC REGION

Regulatory issues		
Key issues	Problems/Constraints	Solutions/Recommendations
Bank-centric regulations	Application of regulatory requirements derived from bank-oriented regulations may negatively impact insurers' role to provide long-term investments and stabilize the financial systems.	Insurance regulations should take into account the specific nature of the insurance business and should not apply regulations which are targeted for bank deposits or other financial products with short-term liquidity needs.
	High risk charges for long-term investments, including infrastructure projects and equities may discourage insurers and pension funds to provide such investments.	Avoid bank-centric capital-weighted rule and consider the characteristics of long term assets supporting long-term liabilities, as well as the effect of asset diversification.
	Capital constraints on traditional long-term products may drive the companies to shift to short-term investment products, making long-term investments hard to be justified.	Capital charges should be looked into, for the companies to have incentives to promote long-term products, taking into account the interaction between long-term assets and liabilities.
	Bank-oriented regulations with focus on systemic risks and inter-connectedness, not properly reflecting the nature of insurance and pension funds, may dis-incentivize insurers to stabilize the financial system and market, rather than mitigate systemic risks.	Insurance and pension regulatory framework should holistically promote the role of insurers and pension funds to support macro-economy, sustainable development, social security, and long-term insurance protection, and pay due care to the issue of pro-cyclicality.
	It may affect negatively on the insurers' and pension funds' equity and long-term debt instruments and efficient risk management tools, such as hedging instruments.	Regulations should be designed in a way to promote and incentivize the insurers' and pension providers' role to stabilize the financial system and market and its ability to manage risks efficiently.
Short-term oriented economic regime	Economic valuation may produce a significant volatility for long-term business, which may not be relevant to the insurers' capacity to meet long-term obligations.	Economic based regime should have a long-term vision. Avoid replacing the existing regulatory regimes simply with a regime based on an economic based regulations
	If such a regime is used for regulatory interventions, insurers with no concern in solvency positions for the foreseeable future may be forced to take remedial actions, including the exit from long-term business and investments, in response to short-term fluctuations in financial markets.	Avoid the introduction of a regulatory regime which would require immediate regulatory actions in response to short-term market fluctuations
	Short-term oriented regimes tend to capture the risk assessment with a snapshot and consider long-term business and long-term investments excessive risk taking.	Long-term nature of the business model and illiquid nature of liabilities should be properly taken into account, when designing the regulatory regime.
	Short-term oriented economic solvency regimes may incentivize	Measures should be taken to mitigate impacts on long-term protection

	insurers to transfer risks to customers, shift away from long-term protection business and investments, and discourage them from investing assets other than fixed income assets.	business and the assets supporting such contracts (See also Accounting issues)
"One-size-fits-all" models	There are a variety of insurance and pension products, insurers' and pension providers' roles, needs and consumer behavior, and development stage across the markets. The adoption of regulatory requirements based on "one-size-fits-all" models would not capture the diversity that exists in the region and may produce unexpected negative consequences for insurance and capital markets, as well as social security system.	Consider an approach to start from the regulatory framework in each jurisdiction, which has been sufficiently evolved and tested on the characteristics of each jurisdiction, and harmonize those regimes from a unified point of view.
	Due to the difference in business models and existing regulatory framework, the application of prescriptive international standards would not ensure the overall comparability or level playing field in the region.	International standards should be principle-based and aim to achieve the comparable outcome by taking into account the diversity in the region, rather than imposing identical prescriptive requirements in jurisdictions.
	A model based on one jurisdiction may not meet the regulatory objectives in other jurisdictions.	Consider the use of different valuation approaches for different purposes. The use of existing regulatory regime in each economy may be an option.
Accounting issues		
Key issues	Problems/Constraints	Solutions/Recommendations
Volatility in the balance sheet	Scope – treatment of participating policies	
	IASB's proposed "mirroring approach"[1] would limit the scope to contracts which require an entity to hold underlying items and specify a link between the payments to the policyholder and the returns on those items. It would not capture a wide range of participating policies and products that are sold in the Asia Pacific region.	The scope of contracts for which the insurance liabilities and the related assets are consistently measured and presented, reflecting the assets-liabilities interaction could be expanded to include all contracts, including those where all or part of the cash flows are dependent on returns from underlying items.
	It would result in non-economic volatility in balance sheet of insurers selling certain long-term products, which may produce unintended consequence for insurers' ability to support long-term investment, sustainable economic growth and market stability.	Appropriate measures should be taken to minimize pro-cyclicality and disincentives for insurers to provide long-term business and long-term investments. In setting those measures, the different business models, role of insurers and development stage

[1] Mirroring approach: For contracts meeting the criteria in paragraph 33 of the IASB Insurance Contracts Exposure Draft (ED), an entity determines the fulfillment cash flows that are expected to vary directly with returns on underlying items and measures those fulfillment cash flows on a different basis from the other fulfillment cash flows. An entity shall decompose the cash flows in a way that maximizes the extent to which the measurement both: (a) expresses the cash flows in a way that illustrates the extent to which they are expected to vary with returns on underlying items; and (b) maximises the minimum fixed payment that the policyholder will receive.

		should be taken into account.
	Discount rate for long-duration products	
	Discount rate largely based on the current risk-free rate would not reflect the asset liability interaction of the insurers, and may bring volatility in the balance sheet that may not represent the underlying economics.	The choice of discount rate should be reflective of the business model of the issuer of the contract.
	Significant volatility may occur where there is an observable but not deep and liquid market. The rate may not be observable.	Measures should be taken to avoid short-term fluctuations in the medium to long-term. One solution may be grading from market consistent rate to long-term average rate.
Volatility in the income statement	Short term fluctuation based on the current market or fair value measurements may not reflect the long-term nature of the business and would not provide useful information to assess assets or projects in the long run.	The use of OCI on both for insurance liabilities and corresponding assets (i.e. IFRS4 and IFRS9) should be allowed to reflect the long-term nature of the business.
	The use of OCI [2] for presenting changes in discount rates is potentially a significant improvement, but not in isolation. When assets are valued and presented differently, volatility in the income statement may occur due to the accounting mismatch.	The OCI solution should not be mandatory but optional to avoid accounting mismatch, taken into account different business models. The population of assets qualifying for OCI treatment may also be expanded.
Complexity	The currently proposed model is highly complex and would impose practical burdens and costs on insurers, particularly for those with long-duration products. Lack of understandability would reduce transparency.	Unnecessary complexities should be removed, and understandability for preparers and users should be improved.
	The proposed requirement for bifurcation of cash flows is difficult to implement and inconsistent with how contracts, typically long-term products, are designed and managed.	One measurement basis should be used for all insurance contracts without bifurcation of cash flows.
Consistency	Proposed treatment of changes in estimated cash flows is not consistent with that of discount rate, and would not reflect the economic reality faced by insurers. For example, changes in the present value of future profits are partly reported in OCI (unrealized investment gains/losses) and partly reported in CSM [3] (mortality and	The treatment of changes in estimated cash flows and that of discount rate should be designed in a way to reflect the economic reality faced by insurers and to pay particular due care to adverse consequences for long-duration contracts where interest rates decline.

[2] OCI (Other Comprehensive Income) is a component of total equity which includes, but not limited to, unrealized gains or losses from available for sales securities.

[3] CSM (Contractual Service Margin) is defined as a component of the measurement of the insurance contract representing the unearned profit that the entity recognizes as it provides services under the insurance contract.

	expense gains/losses related to future periods). It would not therefore provide relevant and useful information to users. This problem is significant for insurers with traditional long-duration products at transition.	
Transition requirements	The retrospective measurement[4] for existing and past long-duration contacts would be extremely burdensome and costly and often practically impossible due to lack of data, and may have significant financial impact.	Flexibility should be given in adopting transition requirements to reduce operational difficulties and minimize financial impact at transition, reflecting conventional accounting practice. Complexity should be significantly reduced. One solution may be to take a full prospective approach.
Presentation	The proposed earned premium volume metric[5] is unhelpful and incomparable with revenues reported by insurers not using IFRS. This problem is significant for insurers with traditional long-duration products.	The metric should be comparable to conventional accounting practice, in order to maintain comparability, and avoid competitive disadvantage for insurers using IFRS.
	Neither the insurance industry nor investors/analysts/policyholders use or understand the proposed metric.	The metric should reflect the need of general users. Premium received is widely recognized as the most essential and reliable information both for users and preparers.
	Separation of investment components[6] from revenues and claims payment would be practically difficult and would not reflect the business reality. This problem is significant for insurers with traditional long-duration products.	Investment components from revenues and claims from traditional long-duration products should not be separated. The different nature of insurance contracts from bank deposits and pure investment contracts should be properly reflected.
Field testing	Testing is selective and does not consider the interaction with the proposed financial instruments standards.	Another series of full “real world” field testing is needed to avoid unintended consequences, including the impact on the ability of insurers to provide long-term business and investments

[4] Retrospective measurement: IAS 8 specifies when it would be impracticable to apply this [draft] Standard to measure an insurance contract retrospectively. In those situations, an entity shall, at the beginning of the earliest period presented measure the insurance contract as the sum of: (i) the fulfillment cash flows in accordance with this [draft] Standard; and (ii) an estimate of the remaining contractual service margin, using the information about the entity's expectations at initial recognition of the contract that were determined in accordance with paragraph C6 of the ED.

[5] The proposed earned premium volume metric: Accordingly, insurance contract revenue can also be expressed as the sum of: (a) the latest estimates of the expected claims and expenses relating to coverage for the current period excluding those recognized immediately in profit or loss in accordance with paragraphs 60(a) and 60(d) of the ED. That amount relates to the latest estimates of the expected claims and expenses before the claim is incurred and excludes any repayments of investment components that are included in the latest estimates of the expected claims; (b) the change in the risk adjustment; (c) the amount of the contractual service margin recognized in profit or loss in the period; and (d) an allocation of the portion of the premium that relates to recovering directly attributable acquisition costs. The entity allocates the part of the premium relating to the recovery of those costs to each accounting period in the systematic way that best reflects the transfer of services provided under that contract.

[6] The investment component is defined as the amounts that an insurance contract requires the entity to repay to a policyholder even if an insured event does not occur.

		and retirement security in the region.
	Quality may be compromised by a compressed completion process. In such case, there will be significant challenges faced by the region in the implementation phase.	It is preferable to have a set of high quality of standards that have been adequately tested. That would facilitate the implementation of the standards in the region.
Market issues		
Key issues	Problems/Constraints	Solutions/Recommendations
Underdeveloped capital market		Collaborate with Capital Markets Work Stream
	Paucity of long-term fixed income assets (i.e. longer than 20 years)	Facilitate development of capital markets, particularly in emerging markets, including more transparency and market infrastructure
	Local currency bond markets for both sovereign and corporate not deep enough	Development of local capital markets
	Local currency capital markets often are too small to support.	Integration of regional capital markets to achieve economies of scale; through common platforms for bond issuance or EU-style passport concept
	Inflation linked bonds are available only in a few economies	Issue and promote inflation linked bonds
Few viable projects that can attract market financing		Collaborate with Asia Pacific Infrastructure Partnership and ABAC
	High political/regulatory risk with few options for mitigation	Use risk mitigation measures like ADB or IFC guarantees (e.g. CGIF)
	Poor governance/rule of law	Develop stronger credit assessment, rating agencies and bankruptcy regime
	Poor project preparation (e.g. unclear objective and criteria, missing technical details, unrealistic assumptions, faulty financial analysis)	See ABAC Enablers of Infrastructure Investment Checklist
	Faulty PPP structures	See above
Lack of infrastructure financial instruments		Collaborate with FMI/Cross Border Practices Work Stream
	Few market instruments that allow risk associated with infrastructure project financing to be allocated to creditors based on risk and return appetite.	Create new forms of securitization or restructuring that splits risk by maturity and risk profile (e.g. banks take shorter maturities and construction risk and insurers take longer maturities)
	Infrastructure tends to have lower credit rating which blocks participation by insurers.	Use MDB credit wraps to enhance credit rating Consider a sovereign backstop
	Infrastructure bonds are not standardized, in particularly between markets, and therefore not marketable in a single efficient pool.	Common multi-economy platforms for debt issuance; integration of regional capital markets; harmonize bond issuance processes and documentation; work with banks to standardize project financing documentation
	Lack of data on risk profile of infrastructure projects of long term assets which may result in excessively high capital charge.	Project to collect more global data on infrastructure financing vehicles and default performance

Lack of market instruments to manage portfolio risk		Collaborate with Capital Markets Work Stream
	Undeveloped derivative markets, including interest rate swaps, especially long dated ones, and bond futures	Liberalize and develop hedging and derivatives with appropriate supervision oversight
	Currency and maturity hedging is costly or restricted by regulation.	Avoid "one-size-fits-all" approach in the Asia Pacific region, taking into account the development of the markets in each economy
	Hedges are more costly and less available due to requirement to trade on exchanges and high capital risk weightings.	See above
Constraints on insurance business which limits insurance penetration and mobilization of long-term capital	Demand side	
	Restrictions on new product development, including slow approval process	Regulations should encourage product innovation and flexibility
	Restrictions on competition	Promote competition in project and pricing; promote liberalization and access to foreign capital and capacity as a key driver for growth and development of insurance markets
	Lack of tax incentives for long-term savings through insurance	Create tax incentives for long-term savings as a public good, in order to build saving culture among consumers
	Lack of consumer awareness of insurance	Financial literacy programs for insurance
	Lack of mandatory insurance schemes	Create mandatory retirement programs
	Lack of private insurance options for retirement	Create a private sector pillar consistent with the World Bank's Three Pillar approach for pensions
	Supply side	
	Withholding tax and capital gains tax discourage investors for local currency bonds.	Device tax advantages to help long term investors
	Regulatory restrictions on investment	As the industry matures, ease restrictions on investment consistent with appropriate prudential standards; regulators and industry exchange on best practice in investment strategies for institutional investors
Operational issues		
Key issues	Problems/Constraints	Solutions/Recommendations
Weakness in credit rating	Weak capacity for credit assessments; lack of comparable credit rating could lead to excessive capital requirements for infrastructure or completely block such investments; some economies lack capable credit agencies.	Encourage transparency of credit ratings by permitting international credit rating agencies to enter markets and by promoting development of local credit rating agencies
Lack of experience	Institutional investors lack experience in investing in infrastructure	As opportunities increase, insurance companies like to hire needed expertise
Uncertainty in	Lack of clarity in areas of creditors'	Develop clear laws and regulations

legal framework	rights and resolution processes	regarding resolution; in the event of a default allow those mechanisms to operate and monitor their impact