Perbadanan Insurans Deposit Malaysia
Protecting Your Insurance And Deposits In Malaysia

RESPONSE TO THE CONSULTATION PAPER ON THE REVISED DIFFERENTIAL PREMIUM SYSTEMS FRAMEWORK

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1.0 BACKGROUND

1.1 On 23 September 2013, Perbadanan Insurans Deposit Malaysia ("PIDM") issued a Consultation Paper on the Revised Differential Premium Systems Framework ("DPS CP") for public consultation. We received feedback and comments from deposit-taking members ("DTMs"), rating agency and the banking industry associations during the six-week consultation period, which ended on 31 October 2013.

1.2 Generally, PIDM received favourable response on the proposed introduction of the "matrix approach" for the assessment of the quantitative criteria under the revised DPS Framework. Industry was also receptive of the introduction of "capital buffer" as one of the dimensions of assessment under the matrix approach. We also received feedback on the proposed new indicators relating to "financial performance and condition" (the second dimension under the matrix approach), particularly in respect of thresholds and score ranges.

1.3 We appreciate the feedback, as we regard this to be an important aspect of our review process in respect of the DPS Framework. As part of the consultation process, PIDM is publishing its response to the feedback, which is set out in Section 3.

2.0 SUMMARY OF CHANGES TO THE REVISED DPS FRAMEWORK

2.1 The "matrix approach" outlined in the DPS CP will be adopted for the quantitative criteria assessment. DTMs will be assessed in a matrix comprising "capital buffer" in one dimension and "financial performance and condition" in the other dimension.

2.2 The threshold for "capital buffer" has been reduced, taking into consideration the phased-in implementation of capital buffer under Bank Negara Malaysia ("BNM")'s Capital Adequacy Framework. The definition of "capital buffer" will remain as the excess of a DTM's total capital ratio over the minimum regulatory total capital ratio imposed by BNM.

2.3 The "loan/financing growth" indicator will not be introduced at this juncture. Instead, the "asset growth" assessment (namely, "risk-weighted assets to total assets" ratio and "total asset growth" ratio) under the existing DPS Framework will be reinstated. We have also revised the computation of the "total asset growth" ratio as well as the threshold and score range for both indicators.

2.4 "Regulatory reserve" will be incorporated as part of the computation of the "loan/financing loss reserves" ratio.

2.5 The threshold and score range for "loan/financing concentration profile" will be more granular to ensure better differentiation between the aggregated sector loan concentration profiles of the DTMs.

2.6 The weightage for "funding profile" criterion will also be reduced from 30% to 25%. Consequently, a higher weightage of 25% will be assigned to the "profitability" criterion from 20% previously. In this regard, the maximum score for "return on risk-weighted assets" ratio under the "profitability" criterion will be raised to 15 from 10 while the maximum score for "loans/financing to deposits" ratio under the "funding profile" criterion will be reduced from 20 to 15.

2.7 There will also be changes to the threshold for the assessment of "financial performance and condition". The threshold will be revised upwards in light of the current level of maturity of the banking system and improved quality of DTMs' risk management standards. This is also in line with the objective of the DPS Framework, which is to provide incentives for DTMs to further improve their risk management.

2.8 The detailed changes to the DPS Framework including the thresholds and score range of the relevant indicators are provided in **Appendix 1.**

3.0 DETAILED COMMENTS RECEIVED AND PIDM'S RESPONSE

3.1 DPS Framework Methodology

PIDM sought feedback on the proposed "matrix approach" for the assessment of the quantitative criteria.

Comments Received

The majority of the respondents concurred with the proposed "matrix approach" as part of the assessment approach under the Revised DPS Framework.

A few respondents proposed that the linear approach be maintained on the basis that a separate emphasis on capital buffer assessment may penalise DTMs that have recorded strong financial performance but have maintained optimal capital position in order to maximise their shareholders' return.

We were also asked to review the distribution of thresholds for various positions under both dimensions of the "matrix approach".

PIDM's Response

PIDM will implement the "matrix approach" for the assessment of the quantitative criteria in the revised DPS Framework. The matrix categories and the corresponding quantitative scores will be maintained, as detailed in the DPS CP.

The introduction of the "matrix approach" will enable the risk profiles of the DTMs to be better differentiated based on two dimensions. Its intention is to reflect the link between strong capital buffer and sustainable financial performance. The objective is to incentivise DTMs to have strong "capital buffer" and "financial performance and condition" levels and thereby achieve the maximum score of 60 for the quantitative criteria.

The "matrix approach" assessment also allows for different incentives and emphases depending on the position of the DTMs in the matrix.

PIDM has also taken into consideration the request for a review of the thresholds for various positions under both dimensions of the matrix. The threshold for "capital buffer" has been lowered in view of the phased-in arrangement of the capital buffer requirements under BNM's Capital Adequacy Framework.

The threshold for the position at the vertical axis of the matrix is also revised in recognition of the current level of maturity of the banking system and improved quality of DTMs' risk management standards. As outlined in the DPS CP, the highest position of the vertical dimension in the matrix would be accorded to DTMs that have obtained a score of 85 and above in the "financial performance and condition" assessment. For the second highest position, the DTMs concerned would need to achieve scores ranging between 70 and 85, compared to a range of between 65 and 85, as proposed in the DPS CP. DTMs with scores of below 50 will be at the lowest position of the vertical axis.

Another change proposed within the assessment of "financial performance and condition" is the weightage assigned to its three assessment criteria, namely "profitability", "asset profile" and "funding profile". The weightages have been changed to 25%:50%:25% respectively from the initial weightages proposed in the DPS CP of 20%:50%:30%. PIDM considers that a 25% weightage for the new criterion, "funding profile", is more appropriate.

3.2 CAPITAL BUFFER DIMENSION

PIDM sought feedback on the proposed "capital buffer" assessment and its proposed threshold.

Comments Received

Most of the comments received were requests for PIDM to revisit the proposed threshold for "capital buffer", in view of the more stringent capital buffer requirements under Basel III and the gradual phased-in implementation of the buffer requirements under BNM's Capital Adequacy Framework.

Some respondents proposed that in determining "capital buffer", it should be based on the excess of a DTM's total capital ratio over the minimum regulatory capital requirement of 8%, instead of the individual DTMs' minimum regulatory capital imposed by BNM, in order to have a uniform comparison across DTMs.

A few respondents commented that the "capital buffer" assessment was not comparable between DTMs given the different approaches adopted for the computation of the capital requirements.

There were also proposals for PIDM to consider the "capital buffer" assessment above the allotted buffer maintained by DTMs under the Internal Capital Adequacy Assessment Process ("ICAAP").

PIDM's Response

PIDM will implement the "capital buffer" assessment as one of the dimensions of the "matrix approach" assessment of the quantitative criteria. A strong capital level is crucial in ensuring that DTMs remain solvent as it represents the last line of defence against any unexpected losses.

PIDM agrees to lower the threshold for the "capital buffer" dimension. The "capital buffer" threshold for the best position of the horizontal axis of the matrix is set at a minimum of 4% instead of 5% previously. As part of the continuous review process, we may revisit the capital buffer threshold in future enhancements of the DPS Framework.

With regard to the expectation of the minimum capital buffer to be maintained by DTMs, PIDM will be assessing the DTMs' TCR against the minimum regulatory TCR imposed by BNM. The minimum regulatory TCR under the capital adequacy framework is 8%. A higher minimum capital adequacy requirement may be imposed by BNM on a particular DTM to reflect the specific risk profile of that DTM. In such an event, the higher minimum capital adequacy requirement will be applied in determining the level of "capital buffer" for the specific DTM concerned.

PIDM acknowledges the different approaches adopted for the computation of the capital requirements as provided under Bank Negara Malaysia's capital adequacy framework. In this revision, the DPS framework will take the total capital ratio ("TCR") as disclosed in the financial statements without any distinction between the different capital calculation approaches. This is one of the areas that PIDM will continue to study for future enhancement, together with considerations relating to the ICAAP.

3.3 PROFITABILITY CRITERION

PIDM sought feedback on the indicators under the "profitability" criterion, including the threshold and the proposed scores.

Comments Received

There were several recommendations for PIDM to consider a different threshold and score range in respect of DTMs which adopt the various approaches for calculation of capital requirements, including the risk-weighted assets under BASEL II.

PIDM's Response

PIDM will retain the indicators for the "profitability" criterion in the revised DPS Framework i.e., Return on Risk-weighted Assets ("RORWA") ratio and Mean-adjusted Return Volatility ("MARV").

Given the increased weightage for the "profitability" criterion from 20% to 25%, the score range for the RORWA ratio is also revised with the maximum score raised to 15 from 10 previously. Meanwhile, the threshold and score for MARV set out in the DPS CP will be adopted.

PIDM takes note of the various capital assessment approaches adopted by DTMs in the calculation of regulatory capital, including the computation of the risk-weighted assets. As stated earlier, PIDM will not make any distinction between the different capital calculation approaches. Therefore, the threshold and score range for the RORWA ratio will be consistent for all DTMs.

3.4 TOTAL IMPAIRED LOAN/FINANCING RATIO

PIDM sought feedback on the proposed revision to the threshold and scores for Total Impaired Loan/Financing Ratio.

Comments Received

There were no major comments on the proposed revision to the threshold and scores for "total impaired loan/financing" ratio, which is an existing indicator of the DPS Framework.

PIDM's Response

PIDM will implement the "total impaired loans" ratio set out in the DPS CP.

3.5 LOAN/FINANCING LOSS RESERVES RATIO

PIDM sought feedback on the proposed "loan/financing loss reserves" ratio including the threshold and scores.

Comments Received

Several respondents commented that the requirements under FRS 139 would already ensure that the level of loan loss provisioning is sufficient and reflective of the credit risk of the DTMs.

There were also proposals for PIDM to include regulatory reserves as part of the computation of "loan/financing loss reserves" ratio to reflect its nature as a reserve to absorb potential losses.

PIDM's Response

PIDM will implement the "loan/financing loss reserves" ratio as one of the indicators in the revised DPS Framework. A high level of "loan/financing loss reserves" ratio will generally indicate prudent management practices of the DTM and will better protect the DTMs' capital against adverse deterioration in their asset quality. The introduction of this indicator is to incentivise DTMs to maintain robust provisioning methodologies as part of their risk management practices.

The threshold and score range outlined in the DPS CP are retained as they remain appropriate in providing incentives for DTMs in respect of loan loss provisioning.

PIDM agrees with the suggestion to include regulatory reserves as part of the computation of the "loan/financing loss reserves" ratio. Regulatory reserve is a form of buffer against future losses that DTMs may be required to set aside apart from the individual and collective impairment allowances.

3.6 LOAN/FINANCING CONCENTRATION PROFILE

PIDM sought feedback on the proposed "loan/financing concentration profile" indicator, threshold and scores.

Comments Received

Several respondents proposed an increase to the threshold limit for exposure to the retail segment, on the basis that such exposure is more diversified and a low threshold would penalise DTMs with a large retail portfolio.

There were also suggestions that the source of information for sectoral concentration should be based on the DTMs' financial statements instead of the statistical reports submitted to BNM.

PIDM's Response

PIDM will implement the "loan/financing concentration profile" indicator as one of the indicators for the "financial performance and condition" assessment. The objective of this indicator is to promote overall diversification of the DTMs' loan portfolio, without indicating a preference for any particular sector. PIDM will therefore maintain the 20% trigger limit for categorising a sector as being concentrated.

We also revised the threshold for the "aggregated sector loan/financing concentration profile". A full score will be accorded to DTMs that have fully diversified their loan portfolio. Meanwhile, concentration in one sector of up to 25% will qualify for the second highest score. DTMs with "aggregated sector loan/financing concentration profile" exceeding 50% will not obtain any score.

PIDM will provide details of the source of information for all indicators in the revised DPS Guidelines.

3.7 LOAN/FINANCING GROWTH

PIDM sought feedback on the proposed "loan/financing growth" indicator including the threshold and scores.

Comments Received

The majority of the respondents proposed that PIDM reconsiders the "loan/financing growth" indicator.

Generally, the comments related to the appropriateness of the indicator, as DTMs viewed loan/financing growth as dependent on the overall business strategies of the DTMs and the economic cycles. DTMs may have different views and expectations on the optimal loan/financing growth depending on the economic landscape and their risk appetites.

There were also suggestions for PIDM to set different thresholds and score ranges given the different levels of maturity in the banking system i.e., conventional DTMs versus Islamic DTMs. Hence, adopting the same threshold for both Islamic and conventional DTMs may not be equitable as Islamic DTMs are expected to achieve strong growth in the future.

A few respondents proposed a variation to the assessment of "loan/financing growth" indicator, including maintaining the existing asset growth criterion.

PIDM's Response

Excessive growth is one of the well-used leading indicators that may signal future vulnerabilities. In this regard, growth criteria will remain as one of the criteria core to the DPS framework.

PIDM however, is conscious about dictating the business growth of the members. Echoing the comments received during the consultation, PIDM understands the high dependency of loan growth on the economic cycle and also the maturity level of the industry. This needs to be studied further, especially in assessing the optimal growth for the DTMs collectively.

PIDM will reinstate the "asset growth" assessment as per the existing DPS Framework i.e., the "risk-weighted assets to total assets" ratio and "total asset growth" ratio . A DTM with a higher risk profile coupled with an aggressive asset growth will be more vulnerable to deterioration in the operating environment. The "total asset growth" indicator is also more comprehensive as it covers the DTMs' expansion of the on-balance sheet assets as well as the off-balance sheet assets.

The thresholds for both indicators have been revised, after taking into consideration the current operating environment and industry trend. The "total asset growth" ratio will also measure year-on-year growth instead of three-year moving average asset growth, in order to better capture aggressive growth by DTMs.

3.8 LOANS/FINANCING TO DEPOSITS RATIO

PIDM sought feedback on the proposed "loans/financing to deposits" ratio ("LD ratio") including the threshold and scores.

Comments Received

There were several recommendations relating to the introduction of the indicator for the funding criterion. One of it was the proposal to adopt the indicators introduced under the Basel III Liquidity Framework, i.e., the Liquidity Coverage Ratio ("LCR") and the Net Stable Funding Ratio ("NSFR") or the use of "Adjusted LD ratio" under BNM's existing Liquidity Framework.

There were also proposals for PIDM to review the granularity of threshold and score range.

PIDM's Response
PIDM will implement the LD ratio as one of the indicators in the revised DPS Framework. The preference for the LD ratio instead of an "adjusted LD ratio" is that the LD ratio will give a better reflection of the extent of the DTM's reliance on more sensitive funding sources to fund future loan growth. The adoption of the LD ratio as an indicator is intended to provide incentives for DTMs to manage their balance sheets prudently with appropriate matching of customer deposits to their lending activities. PIDM recognises that the indicators introduced under BASEL III's Liquidity Framework would be another dimension of assessment of the DTMs' liquidity and funding profile. The enhancement to the Liquidity Framework is currently being enhanced by BNM. As such, the inclusion of the liquidity indicator is very much in the plan for future enhancement. PIDM agrees with the proposal to revise the threshold and score range for the LD ratio. With a maximum score of 15 for this indicator, the four levels of thresholds and score ranges are deemed appropriate to distinguish the risk profiles of the DTMs while providing incentives for DTMs to manage their balance sheets prudently.

3.9 COMPOSITION OF INDIVIDUAL DEPOSITORS
PIDM sought feedback on the proposed "composition of individual depositors" indicator including the threshold and scores.

Comments Received
Several respondents recommended variations to this indicator, such as inclusion of other form of stable deposits recognised under Basel III, such as deposits from small and medium enterprises or assessing the composition of deposits based on deposit type. There were also comments from the DTMs that this indicator may be a disadvantage to those who adopt different funding strategies. Clarification was also sought on the definition of individual depositors, i.e., whether they include deposits received from sole proprietors.

PIDM's Response
PIDM will implement the "composition of individual depositors" as one of the indicators in the revised DPS Framework. PIDM maintains that individual depositors are generally regarded as the more stable source of deposits. Additionally, the size of deposits placed by individuals will be much smaller compared to deposits from corporates and hence the impact from unexpected withdrawals will be more manageable. PIDM takes note of the regulatory developments related to liquidity that are currently being enhanced by BNM. Once these requirements are in place, PIDM will conduct the impact assessment and will consider variations to the assessment of funding stability in future enhancement of the DPS Framework. For the purpose of the DPS Framework, the definition of individual depositors shall be the same as the one stated in the respective DTMs' financial statements.

3.10 QUALITATIVE CRITERION
PIDM sought feedback on the assessment criteria and score range for the "qualitative" criterion.

Comments Received
There were no major comments related to the assessment criteria and score range for the "qualitative" criteria.

PIDM's Response
PIDM will maintain the assessment criteria and score range for the "qualitative" criterion as per the existing DPS Framework as an incentive for DTMs to improve their overall risk management. The "qualitative" criterion assessment will comprise "Supervisory Rating" and "Other Information".

3.11 OTHER MATTERS
PIDM sought feedback on other matters related to the DPS Framework.

Comments Received
Several respondents commented that a different threshold range should be set for Islamic and conventional DTMs in relation to certain indicators so as to reflect the different nature and level of maturity between these industries. There was also feedback for PIDM to take into consideration the impact of the revised DPS Framework on new DTMs given that the new DTMs would need more time to stabilise their operations.

PIDM's Response
In determining the indicators (including the thresholds and score ranges) to be adopted in the DPS Framework, PIDM considers the relevance and applicability of these indicators to conventional as well as Islamic DTMs. Based on analysis conducted by PIDM, the indicators identified in the DPS Framework are relevant for the assessment of the DTMs' risk profiles regardless of the nature and the level of maturity of the industry. The threshold range is intended to provide incentives for sound risk management practices by the DTMs. Nonetheless, as stated in the existing DPS Framework, the method for computation of specific indicators may be customised to reflect the specific nature of Islamic DTMs' operations. PIDM will provide specific details on the formula and source of information for all the indicators in the revised DPS Guidelines. With regard to new DTMs, PIDM acknowledges that the risk profiles of new DTMs may not be significant in the initial years of operations. Therefore, PIDM will maintain the provision that new DTMs shall be automatically categorised under premium category 1 for the first two assessment years. For the subsequent assessment years, new DTMs will not be required to include financial information of its first assessment year in the computation of the indicators. This will minimise the impact of drastic fluctuations in the financial information. Where there is insufficient information to compute the indicators, the scores for such indicators will be determined on a proportionate basis, similar to the provisions in the existing DPS Framework.

4.0 NEXT STEPS

4.1 The draft regulations in respect of the revised DPS Framework will be submitted to the Minister of Finance for approval.

4.2 PIDM will issue the revised guidelines on the DPS Framework to assist DTMs with the computation and submission of the required quantitative information. The revised DPS Guidelines will replace the existing DPS Guidelines issued on 18 April 2014.

Perbadanan Insurans Deposit Malaysia
4 June 2014

Appendix 1

Summary of Changes to the Revised DPS Framework

CONSULTATION PAPER	FINAL PROPOSAL

Capital Buffer Dimension

The threshold for "capital buffer" has been revised to a lower threshold, taking into consideration the phase-in implementation of capital buffer under BNM's Capital Adequacy Framework.

Consultation Paper – Current Threshold:

	Capital Buffer			
Position Under the Matrix	**4**	**3**	**2**	**1**
Threshold	< 2.0%	≥ 2.0% to < 4.0%	≥ 4.0% to < 5.0%	≥ 5.0%

Final Proposal – Revised Threshold:

	Capital Buffer			
Position Under the Matrix	**4**	**3**	**2**	**1**
Threshold	< 2.0%	≥ 2.0% to < 3.0%	≥ 3.0% to < 4.0%	≥ 4.0%

Financial Performance and Condition Dimension

The threshold for "financial performance and condition" at the vertical axis of the matrix is revised in recognition of the current level of maturity and improved quality of risk management standards of the DTMs.

Consultation Paper – Current Threshold:

Position under the Matrix	Threshold
1	≥ 85%
2	≥ 65% to < 85%
3	≥ 50% to < 65%
4	< 50%

Final Proposal – Revised Threshold:

Position under the Matrix	Threshold
1	≥ 85%
2	≥ 70% to < 85%
3	≥ 50% to < 70%
4	< 50%

Return on Risk-weighted Assets Ratio

The maximum score for "return on risk-weighted assets" ratio under the "profitability" criterion will be raised to 15 from 10.

Consultation Paper – Current Threshold and Score:

Threshold	Score
RORWA Ratio ≥ 2.75%	10
2.00% ≤ RORWA Ratio < 2.75%	6
1.00% ≤ RORWA Ratio < 2.00%	3
RORWA Ratio < 1.00%	0

Final Proposal – Revised Threshold and Score:

Threshold	Score
RORWA Ratio ≥ 2.75%	15
2.00% ≤ RORWA Ratio < 2.75%	10
1.00% ≤ RORWA Ratio < 2.00%	5
RORWA Ratio < 1.00%	0

CONSULTATION PAPER	FINAL PROPOSAL
Loan/Financing Loss Reserves Ratio	
"Regulatory reserves" has been incorporated as part of the computation of the "loan/financing loss reserves" ratio.	
The "loan/financing loss reserves" ratio is calculated as the sum of individual impairment provisions and collective impairment provisions against the gross impaired loans/financing.	The revised formula is calculated as the sum of individual impairment provisions, collective impairment provisions and regulatory reserves against the gross impaired loans/financing.
Loan/Financing Concentration Profile	
The threshold and score range for the "loan concentration profile" has been expanded to refine the differentiation between the concentration profiles of the DTMs.	
Current Threshold and Score:	Revised Threshold and Score:

Current Threshold and Score:

Threshold	Score
Aggregated Sector Loan Concentration Profile ≤ 20%	10
20% < Aggregated Sector Loan Concentration Profile ≤ 50%	5
Aggregated Sector Loan Concentration Profile > 50%	0

Revised Threshold and Score:

Threshold	Score
Aggregated Sector Loan Concentration Profile = 0%	10
0% < Aggregated Sector Loan Concentration Profile ≤ 25%	8
25% < Aggregated Sector Loan Concentration Profile ≤ 50%	5
Aggregated Sector Loan Concentration Profile > 50%	0

CONSULTATION PAPER	FINAL PROPOSAL
Loan/Financing Growth	**Risk-weighted Assets to Total Assets Ratio and Total Asset Growth Ratio**
The "loan/financing growth" indicator will not be introduced. Instead, the "asset growth" assessment under the existing DPS Framework will be reinstated, i.e., "risk-weighted assets to total assets" ratio and "total asset growth" ratio .	The "risk-weighted assets to total assets" ratio and "total asset growth" ratio will be reinstated, which serve to measure the asset growth vis-à-vis the risk profiles of the assets. Revision is also made to the computation of the "total asset growth" ratio as well as the threshold and score range for both indicators.

CONSULTATION PAPER	FINAL PROPOSAL
	Revised Threshold and Score:

Range of Results		
Risk-weighted Assets to Total Assets Ratio	**Total Asset Growth Ratio***	**Score**
Risk-weighted Assets to Total Assets Ratio < 60%	Total Asset Growth Ratio < 15%	15
Risk-weighted Assets to Total Assets Ratio < 60%	Total Asset Growth Ratio ≥ 15%	10
Risk-weighted Assets to Total Assets Ratio ≥ 60%	Total Asset Growth Ratio < 15%	5
Risk-weighted Assets to Total Assets Ratio ≥ 60%	Total Asset Growth Ratio ≥ 15%	0

* The "total asset growth" ratio will be computed based on year-on-year growth instead of three-year moving average asset growth to better capture aggressive growth of the members.

Loans/Financing to Deposits Ratio

The maximum score for "loans/financing to deposits" ratio under the "funding profile" criterion will be reduced from 20 to 15, including some revisions to the threshold.

Current Threshold and Score:

Threshold	Score
Loans/Financing to Deposits Ratio ≤ 80%	20
80% < Loans/Financing to Deposits Ratio ≤ 85%	15
85% < Loans/Financing to Deposits Ratio ≤ 90%	10
90% < Loans/Financing to Deposits Ratio ≤ 100%	5
Loans/Financing to Deposits Ratio > 100%	0

Revised Threshold and Score:

Threshold	Score
Loans/Financing to Deposits Ratio ≤ 80%	15
80% < Loans/Financing to Deposits Ratio ≤ 90%	10
90% < Loans/Financing to Deposits Ratio ≤ 100%	5
Loans/Financing to Deposits Ratio >100%	0