Perbadanan Insurans Deposit Malaysia

Protecting Your Insurance And Deposits In Malaysia

CONSULTATION PAPER ON PROPOSED ENHANCEMENTS TO THE DIFFERENTIAL LEVY SYSTEMS FRAMEWORK FOR TAKAFUL OPERATORS

ISSUE DATE : 3 MAY 2019

CLOSING DATE : 24 MAY 2019

TABLE OF CONTENTS

Contents

PART A: INTRODUCTION

1.0 BACKGROUND

1.1 In year 2016, Perbadanan Insurans Deposit Malaysia ("PIDM") implemented the Differential Levy Systems ("DLST") Framework for takaful operators[1] to replace the flat-rate levy systems . The implementation of the DLST Framework is in line with our mandate to provide incentives for takaful operators to adopt sound risk management practices.

1.2 PIDM is committed to continuously enhance the effectiveness of the DLST Framework. In line with this, the DLST Framework is reviewed at least every three (3) years to:

(a) ensure that the existing criteria and indicators used are still current and relevant;

(b) address feedback received and issues encountered in its implementation; and

(c) assess the impact of changes and developments in the operating and regulatory environment on the DLST Framework.

2.0 OBJECTIVES OF THIS CONSULTATION PAPER

2.1 The purpose of this consultation paper ("CP") is to seek views and comments on the proposed enhancements to the DLST Framework. In line with PIDM's strategies and values, the consultative approach is adopted to ensure that the enhanced DLST Framework is relevant and effective.

2.2 This CP focusses on the proposed changes to the **Guidelines on Differential Levy Systems Framework for Takaful Operators** issued on 31 January 2019[2] ("DLST Guidelines"). The proposed changes to the DLST Guidelines will be reflected in the Malaysia Deposit Insurance Corporation (Differential Premium Systems in respect of Insurer Members) Regulations 2012.

[1] Takaful operators refer to all takaful operators registered under the Islamic Financial Services Act 2013, except for takaful operators licensed to solely carry out retakaful business and international takaful operators.

[2] The revised DLST Guidelines were issued on 31 January 2019 to cater for the submission of reporting forms online through PIDM's portal.

3.0 CONSULTATION PROCESS

3.1 PIDM invites written feedback and comments on this CP. To facilitate PIDM's assessment, please support each comment with clear rationale, suggestions, accompanying evidence and/or illustration, where appropriate.

3.2 Responses to this CP shall be submitted by **24 May 2019** to:

Senior General Manager
Risk Assessment and Resolution Division
Perbadanan Insurans Deposit Malaysia
Level 12, Axiata Tower
No. 9, Jalan Stesen Sentral 5
Kuala Lumpur Sentral
50470 Kuala Lumpur

(Please state **"Enhancements to DLST"** at the top left hand corner of the envelope for written comments posted to PIDM.)

Or Email: dlst@pidm.gov.my

Enquiries: Puan Izrin Irina Khairil Anuar 03-2173 7558
Encik Ahmad Farizul Hakim Kamarudin 03-2173 7572
Puan Sharifah Sakinah Syed Abdullah 03-2265 6420
Encik Azman Mokhtar 03-2173 7596

3.3 PIDM will collate the comments on this CP. PIDM's response to the comments may be made public. If you do not wish for any of your comments to be made public, please indicate accordingly in your submission.

3.4 The enhanced DLST Framework is planned for implementation in the assessment year 2020.

PART B: PROPOSED ENHANCEMENTS

4.0 OVERVIEW

4.1 In reviewing the DLST Framework, PIDM carried out a series of industry engagements and data testing, and collaborated with the technical committee of industry associations to discuss the proposed enhancements.

(a) Industry Survey
A survey was issued in 2017 to obtain takaful operators' feedback on the areas for enhancement. The feedback received were useful for PIDM's preliminary review of the DLST Framework amidst changing economic environment and regulatory developments.

(b) Focus Group Discussions
Following the survey, some takaful operators were invited for discussion on their feedback and recommendations. The discussions were constructive and the takaful operators were supportive of the proposal to introduce new indicators in the DLST Framework.

(c) Engagement with technical committee of Life Insurance Association of Malaysia ("LIAM") and Malaysian Takaful Association ("MTA")
PIDM then initiated meetings and consultation with the technical committee of LIAM and MTA to discuss and formulate concepts to align the industry's feedback with the DLST Framework's objectives.

(d) Positional and Trend Analysis
PIDM conducted extensive data testing based on recent data and analysed the trends. The thresholds for each indicator were tested based on current developments in the business environment. Further reviews and tests were performed on the distribution of the results of the indicators taking into consideration the average industry performance and peer positioning of the takaful operator.

(e) Consultation with Bank Negara Malaysia ("BNM")

As part of its comprehensive review process, PIDM also consulted BNM to seek their views from supervisory perspective.

4.2 Based on PIDM's review, the DLST Framework methodology and criteria remain relevant and current in meeting its objectives. Takaful operators will continue to be assessed based on a combination of quantitative and qualitative criteria. Nevertheless, several enhancements and refinements are proposed under the quantitative criteria as set out below.

Introduction of New Indicators		
Existing Indicator	**Proposed New Indicator**	**Business Type**
Investment Yield ("IY")	Asset Matching and Return ("AMR") A matrix between: a) Asset Liability Duration Matching ("ALDM"); and b) IY.	Family Takaful Business
Expense Gap Ratio ("EGR")	Takaful Operator Efficiency Ratio ("TOER")	Family/General Takaful Business

Refinement of Existing Indicator		
Existing Indicator	**Proposed Refinement**	**Business Type**
IY[3]	▪ To replace "total assets" with "total investment assets". ▪ To include changes in gross "fair value through other comprehensive income" ("FVOCI") reserves as part of the net capital gains/losses component. ▪ To replace the Government Investment Issues ("GII") 5-year spot rate as the benchmark with the GII 3-7 year Bond Index Return ("BIR").	Family Takaful Business

Please refer to Appendix I: Proposed Enhanced DLST Framework.

[3] Under the proposed enhancements, IY will be a sub-indicator of the AMR indicator.

4.3 No changes are proposed in respect of the qualitative criteria. The levy categories, reporting reference date and source of information also remain unchanged.

5.0 ASSET MATCHING AND RETURN - A Matrix of Asset Liability Duration Matching and Investment Yield

5.1 The existing DLST Framework for family takaful business assesses takaful operators from the profitability and business sustainability perspectives. PIDM proposes an asset based indicator for a more holistic assessment of takaful operators' risk profile.

5.2 Assets are an important component of family takaful business as it is generally a long tail business that requires adequate levels of assets to meet its long term obligations. Given that long tenure assets and takaful liabilities are profit rate sensitive, inadequate assets to match liabilities due to non-parallel movement would eventually result in financial health deficit. Hence, it is important to measure the asset-liability matching position of the business.

5.3 Investment returns are also important to ensure that takaful operators generate sufficient and sustainable returns to meet takaful certificate owners' reasonable expectations and internal investment target returns. However, investment objectives are often linked to takaful operators' business mix profile. This means that long term business would require takaful operators to invest in long term assets, foregoing high investment returns and vice versa.

5.4 As business profile and investment returns are the two (2) main considerations in setting a strategic asset allocation, PIDM proposes to introduce the AMR, which measures both ALDM and IY in a matrix. The AMR measures the ability of a family takaful fund to strategically invest its assets to match the exposure from its takaful liabilities while maintaining an appropriate level of investment returns.

5.5 The proposed matrix and score range are as follows:

Asset Liability Duration Matching

Investment Yield	100% ≤ ALDM < 200%	80% ≤ ALDM < 100% OR 200% ≤ ALDM < 300%	ALDM < 80% OR ALDM ≥ 300%
IY ≥ BIR	Score 1	Score 2	Score 4
IY < BIR	Score 2	Score 3	Score 4

Note: BIR refers to the Bond Index Return based on the Malaysian Government Investment Issues index.

Score Range	ALDM	IY	Score
Score 1	100% ≤ ALDM < 200%	IY ≥ BIR	15
Score 2	100% ≤ ALDM < 200%	IY < BIR	10
	80% ≤ ALDM < 100% OR 200% ≤ ALDM < 300%	IY ≥ BIR	
Score 3	80% ≤ ALDM < 100% OR 200% ≤ ALDM < 300%	IY < BIR	5
Score 4	ALDM < 80% OR ALDM ≥ 300%	IY ≥ BIR	0
	ALDM < 80% OR ALDM ≥ 300%	IY < BIR	

5.6 PIDM views an ALDM of 100% as the ideal position, where assets and takaful liabilities match perfectly. Although an ALDM position greater than 100% may be viewed favourably, holding excessive assets could be unfavourable as asset value drops much greater than liabilities value if profit rates trend upwards. Hence, PIDM proposes a ceiling limit for the score range. This is also consistent with BNM’s profit rate capital charges in its Risk Based Capital Framework for Takaful Operators (“RBCT Framework”).

Asset Liability Duration Matching

5.7 ALDM assesses the estimated value of a takaful operator’s assets over its takaful liabilities for a specific reporting period. It emphasises exposure to the risk of future mismatch between assets and takaful liabilities under a stressed profit rate environment. ALDM estimates the percentage (%) of the dollar duration of assets against the dollar duration of takaful liabilities. Dollar duration measures movement in the value of assets or takaful liabilities due to changes in profit rates. It is vital for takaful operators to ensure that their takaful liabilities are adequately covered by matching assets.

5.8 The proposed ALDM formula is as follows:

$$\textbf{ALDM} = \frac{\textbf{ADD}}{\textbf{LDD}}$$

$$\text{Asset Dollar Duration ("ADD")} = \frac{(A2 - A1)}{[2*(A0)*(Y/10000)]} * A0$$

$$\text{Liability Dollar Duration ("LDD")} = \frac{(L2 - L1)}{[2*(L0)*(Y/10000)]} * L0$$

A0 = the base value of asset
A1 = the asset's value when its profit rate/yield rises by Y basis points
A2 = the asset's value when its profit rate/yield falls by Y basis points
L0 = the base value of liability
L1 = the liability's value when its profit rate/yield rises by Y basis points
L2 = the liability's value when its profit rate/yield falls by Y basis points
Y/10000 = profit rate/yield changes (in 2 decimals)
Note: For the calculation of ALDM, Y=100

5.9 The data requirements for the ALDM computation are as follows:

Data Requirements	Source of Information	Remarks
<u>A0/L0</u> Both asset and liability valued at base value profit rate/yield	RBCT Framework – Reporting Form: Takaful Participants' Risk Fund – (iii) Profit Rate Risks, Form E1-2-1 (aggregate base value[4] for all takaful participants' risk fund[5] within Malaysia)	The asset component is to be computed based on all assets that are exposed to profit rates as defined in *BNM/RH/PD 033-4 Risk-Based Capital Framework for Takaful Operators Appendix II section 3.* The liability component is to be computed based on Takaful Liabilities as defined in *BNM/RH/GL 004-20*
<u>A1/L1</u> Both asset and liability valued at base value profit rate/yield + 100bps	Other supporting information	

[4] As defined in BNM/RH/PD 033-4 Risk-Based Capital Framework for Takaful Operators Appendix II section.
[5] Aggregated base value for both asset and liability from all Takaful Participants' Risk Fund (e.g Participants' Special Account, Group Family Takaful Account, Investment-Linked Risk Fund).

Data Requirements	Source of Information	Remarks
<u>A2/L2</u> Both asset and liability valued at base value profit rate/yield - 100bps		*Guidelines on Valuation Basis for Liabilities of Family Takaful Business*. The stress factor is ±100bps on profit rate/yield. The data includes all Takaful Participants' Risk Fund (e.g Participants' Special Account, Group Family Takaful Account, and Investment-Linked Risk Fund).

Investment Yield

5.10 For IY as a sub-indicator of AMR, PIDM proposes minor refinements taking into consideration the industry's views and financial reporting developments as summarised below.

Proposed Refinements	Rationale for changes
To replace "total assets" with "total investment assets" in the denominator.	IY measures the quality of investment assets. Therefore, the yield should be measured against income generating assets instead of total assets, which include non-investment assets.
To include changes in gross FVOCI reserves as part of the net capital gains/losses component.	This change is due to the adoption of the Malaysian Financial Reporting Standard ("MFRS") 9 - *Financial Instruments* - where FVOCI is one of the classifications for investment assets. This change aims to measure investment returns in totality.

Proposed Refinements	Rationale for changes
To replace the GII 5-year spot rate as the benchmark with the GII 3-7 year BIR.	The BIR is a more holistic measurement of investment performance as it comprises investment income and capital gains/losses over a period. It is computed by taking the difference between the index value as at the last trading date of December for two (2) years immediately preceding the current assessment year and the index value as at the last trading date of December for one (1) year immediately preceding the current assessment year, as published by Bond Pricing Agency Malaysia Sdn Bhd ("BPAM").

5.11 The proposed refined IY formula is as follows:

$$IY = \frac{2 \times (I + C)}{\text{Total investment assets } (t) + \text{Total investment assets } (t-1) - (I + C)} \times 100\%$$

Note:

"Total investment assets" include investment properties, financing, investments, foreign assets , cash and deposits as well as other invested assets which generate returns or are held for speculation in anticipation of a future increase in value.
I = Investment income
C = Capital gains or losses including changes in gross AFS/FVOCI reserves

5.12 The illustration for the AMR computation is set out below.

Illustration for the AMR computation:

Takaful Operator ABC recorded the results below for the calendar year 2017, with an IY of 5%. Based on information from BPAM, the BIR calculation is as follows:

[5600] Bond Index Performance

Index	TR BPAM All Bond Index
Principle	Islamic
Aggregate	Govt Related
Index Type	Government
Tenure	3Y ~ 7Y

**The table above is extracted from BPAM.*

Bond Index as of 30.12.2016 = 146.492
Bond Index as of 29.12.2017 = 152.301

$$\text{BIR 2017} = \frac{(152.301 - 146.492)}{146.492} * 100$$
$$= 3.97\% \text{ (rounded to 2 decimals)}$$

The ALDM computation:

Scenario	Asset Value (RM mil)	Liability Value (RM mil)
Base value	100	80
Profit rate/yield +100bps	96	75
Profit rate/yield -100bps	104	85

$$\text{ADD} = \frac{(104 - 96)}{(2*100*0.01)} * 100$$
$$= \text{RM 400 mil}$$
$$\text{LDD} = \frac{(85 - 75)}{(2*80*0.01)} * 80$$
$$= \text{RM 500 mil}$$
$$\textbf{ALDM} = \textbf{RM 400 mil/RM 500 mil * 100}$$
$$= \textbf{80\%}$$

With a score of 80% for ALDM and an IY of 5%, Takaful Operator ABC's AMR indicator is placed at Score range 2 which is 10%.

	100% ≤ ALDM < 200%	80% ≤ ALDM < 100% OR 200% ≤ ALDM < 300%	ALDM < 80% OR ALDM ≥ 300%
IY ≥ 3.97%	Score 1	Score 2	Score 4
IY < 3.97%	Score 2	Score 3	Score 4

Score Range	Score
Score 1	15
Score 2	10
Score 3	5
Score 4	0

Feedback 1:

1. Please provide feedback on the following:
   a) Does the AMR indicator provide a more holistic assessment of takaful operators' risk profile?
   b) Is the proposed measurement approach i.e., the matrix and score range for the AMR indicator appropriate?
   c) What are your views on the proposed refinements to the IY indicator?

2. The proposed AMR indicator is assessed at the total family takaful fund level and combines both the ALDM and IY. PIDM seeks feedback on the following:
   a) The proposed AMR indicator at the aggregate level does not address the non-fungibility between the various family takaful funds. What are your views and proposals to address this issue?
   b) Does your company compute the ALDM and IY at the family takaful sub-fund level? Please elaborate.
   c) Is there any standardised approach across the industry to compute the ALDM and IY at the family takaful sub-fund level? If yes, please explain.
   d) What are the potential challenges if the AMR indicator is computed at the family takaful sub-fund level and how should these challenges be addressed?
   e) If the AMR indicator is computed at the family takaful sub-fund level, how best can the overall company level assessment be made?

3. PIDM also seeks your views on the hedging of profit rate volatility via derivatives:
   a) Does your company use derivatives to manage profit rate risk? If yes, what is the percentage (%) of its aggregate notional amount against its total investment assets (as defined in paragraph 5.10 of this CP)?
   b) What are the implications on hedging instruments to your company, arising from MFRS 9?
   c) If your company currently does not undertake derivative transactions, would your company be considering the use of derivatives for hedging purpose in the future?
   d) Should PIDM take into consideration the hedging of profit rate volatility via derivatives as part of the AMR indicator or any other indicator? Please explain.

6.0 TAKAFUL OPERATOR EFFICIENCY RATIO

6.1 PIDM proposes to introduce the TOER to replace the EGR. The competitive market and the ongoing regulatory initiatives namely, BNM's Life Insurance and Family Takaful Framework, which allow takaful operators greater flexibility in managing operating expenses, have made cost management even more prominent in the operation of family and general takaful business. The TOER is a more forward looking indicator that assesses the efficiency and ability of takaful operators in managing the expenses incurred in operating the takaful funds against the income received from such funds. The TOER is a good addition to the operational and sustainability assessment of takaful operators.

6.2 The TOER is calculated by benchmarking the management expenses and commission expenses of a takaful operator against earned wakalah fees, other fees and profit/surplus sharing to shareholder's fund. It measures the expenses incurred to produce every ringgit of income received. This is important as expenses overrun will erode the capital of takaful operators. This may affect their viability and ability to meet their obligations to takaful certificate owners.

6.3 The proposed TOER formula is as follows:

$$\frac{\text{Management Expenses+ Commissions Expenses}}{\text{Earned Wakalah Fees+Other Fees+Profit/Surplus Sharing}} \times 100\%$$

6.4 The proposed thresholds and the corresponding score range for the TOER are set out below.

Proposed Thresholds	Score (%)
Takaful Operator Efficiency Ratio $\leq$ 90%	20
90% < Takaful Operator Efficiency Ratio $\leq$ 95%	14
95% < Takaful Operator Efficiency Ratio $\leq$ 100%	7
Takaful Operator Efficiency Ratio > 100%	0

6.5 The data requirements for TOER are set out below.

Data Requirement	Source of Information	Remarks
Management expenses	Income Statement, Form GT2/FT2, as specified in the Guidelines for the Takaful Operators Statistical System ("TOSS").	Management expenses refer to the expenses incurred where: i. shareholders' fund refers to all expenses relating to shareholders and corporate affairs; and ii. takaful funds refer to all expenses relating to takaful business other than commission that are borne by the shareholders.
Commission expenses	Income Statement, Form GT2/FT2, as specified in the Guidelines for TOSS.	Commission expenses refer to the expenses incurred for general takaful fund and family takaful fund where: i. general takaful fund refers to commissions paid or payable to the intermediaries on direct takaful business; and ii. family takaful fund refers to commissions paid or payable to the intermediaries on direct family takaful business. It aggregates gross commission on direct family business and agency-related expenses which include ordinary family, investment linked and annuities.

Data Requirement	Source of Information	Remarks
Earned wakalah fee = Wakalah fee – changes of expense liabilities	Income Statement, Form GT2/FT2, as specified in the Guidelines for TOSS.	Wakalah fee refers to fees charged by a takaful operator that adopt the wakalah (agency) concept in its takaful business.
	Form M of the RBCT Framework – Reporting Form for shareholder fund's expense liabilities for <u>general takaful business</u> as at the reporting period. Form L1 of the RBCT Framework – Reporting Form for shareholder fund's expense liabilities for <u>family takaful business</u> as at the reporting period.	Changes of expense liabilities refer to the increase or decrease within the preceding assessment year of the shareholder fund's expense liabilities*. It is computed by taking the difference between the gross expense liabilities after zerorisation as at 31 December of one (1) year immediately preceding the current assessment year, and the gross expense liabilities after zerorisation as at 31 December of two (2) years immediately preceding the current assessment year. **Expense liabilities is the expected future expenses payable from the shareholder's fund in managing the takaful funds.*
Other fees	Other supporting information.	Other fees refer to the fees applied to maintain the takaful certificate or to manage the fund(s) where the fees are charged on the contribution based on the contract entered with the participants. "Other fees" may include, but are not limited to the following:

Data Requirement	Source of Information	Remarks
		i. Certificate fees; ii. Surrender charges; iii. Service/administrative fees; iv. Investment management charges, whether such charges are variable; v. Switching charges; vi. Partial withdrawal charges; and vii. Any other charges as specified in the certificate contract.
Profit/Surplus Sharing	Income Statement, Form GT2/FT2, as specified in the Guidelines for TOSS.	Profit/Surplus Sharing refers to the distributable profit from takaful funds which have been approved by the Board for one (1) year immediately preceding of current assessment year.

6.6 The illustration for the TOER computation is provided below.

Illustration for the TOER computation:

<u>**Takaful Operator ABC**</u>

As at 31 December of the Preceding Assessment Year	RM' 000
Management expenses	**25,000**
Commission expenses	**10,000**
Earned wakalah fees (a-b) a. Total wakalah fees received by the shareholders' fund b. Changes of expense liabilities	**23,000** 30,000 7,000
Other fees (a+b+c+d) a. Total certificate fee	**5,000** 2,000

b. Total service fee c. Total fund management charge d. Total surrender charge	1,500 1,000 500
Profit/Surplus sharing	**12,000**

$$\text{TOER} = \frac{\text{Management Expenses + Commission Expenses}}{\text{Earned Wakalah Fees + Other Fees + Profit/Surplus Sharing}} \times 100\%$$

$$= \frac{\text{RM 25 million + RM 10 million}}{\text{RM 23 million + RM 5 million + RM 12 million}} \times 100\%$$

$$= \underline{\underline{87.50\%}}$$

In this case, takaful operator ABC obtains a 20% score for this indicator.

Feedback 2:

PIDM seeks feedback on the proposed TOER formula and thresholds, as well as any other comments on this indicator.

PART C: FUTURE ENHANCEMENTS

7.0 PROFITABILITY MEASURE FOR FAMILY TAKAFUL BUSINESS

7.1 Profitability is an important measure of a takaful operator's sustainability. Under the present DLST Framework, IY is one the indicator that assesses the earnings performance of a family takaful business. For future enhancements, PIDM would like to explore the possibility of introducing a profitability indicator, in particular, based on the surplus arising for family takaful business. This will be facilitated by BNM's revised reporting manual on the sources of surplus arising for family takaful business issued in July 2018, which would enhance the consistency in reporting.

> **Feedback 3:**
> PIDM seeks feedback on the potential approaches of measuring profitability based on surplus arising for family takaful business. Please provide recommendations and explain.

8.0 BUSINESS CONCENTRATION RATIO

8.1 Business Concentration Ratio measures the proportion of single contribution certificates against the regular contribution business to promote an appropriate composition of the two businesses to generate continuous future stream of income. Part of the component in the single contribution business is the Yearly Renewable Term ("YRT") products such as medical certificates. The contribution for these products are payable yearly for one-year coverage. Although YRT is renewable every year, different YRT products may exhibit some characteristics of single or regular contribution products.

8.2 Presently, YRT contribution is classified as single contribution business and we understand that BNM is enhancing the reporting forms to declassify YRT separately from single and regular contribution. PIDM proposes to exclude the YRT product from the single contribution component in the Business Concentration Ratio once BNM's revised reporting form is effective.

> **Feedback 4:**
> PIDM would like to seek for your feedback and comments on the above proposal.

Perbadanan Insurans Deposit Malaysia
3 May 2019

APPENDIX I: PROPOSED ENHANCED DLST FRAMEWORK

Criteria Approach	**Quantitative**	+	**Qualitative**
Weightages	**60%**		**40%**
Criteria Components	(see table below)		(see table below)
Scoring Approach	**Matrix Approach**: The combined score of the capital measure and the operational and sustainability measure, will determine the position of a takaful operator in the quantitative criteria matrix. The position of the takaful operator in the matrix would determine the quantitative score of DLST Framework which carries a maximum score of 60%.		The Supervisory Rating holds a maximum score of 35%, while the remaining score of 5% is assigned to 'Other Information'

Quantitative – Criteria Components

	All Takaful Operators	
Capital	Free Capital Index ("FCI")	
	General Takaful Business	Family Takaful Business
Operational & Sustainability Measures	• Gross Contribution Growth Rate (25%) • Business Diversification Ratio (20%) • Receivable Ratio (15%) • Loss Ratio (20%) • **Takaful Operator Efficiency Ratio (20%)**	• New Business Growth Rate (25%) • Business Concentration Ratio (20%) • Business Conservation Ratio (20%) • **Asset Matching Return (15%)** • **Takaful Operator Efficiency Ratio (20%)**

Qualitative – Criteria Components

All Takaful Operators
• BNM Supervisory Rating (Composite Risk Rating) • Other Information