Perbadanan Insurans Deposit Malaysia

Protecting Your Insurance And Deposits In Malaysia

RESPONSE TO THE CONSULTATION PAPER ON REVISED DIFFERENTIAL PREMIUM SYSTEMS FRAMEWORK

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TITLE	Response to the Consultation Paper on Revised Differential Premium Systems Framework		

BACKGROUND

1. PIDM issued a consultation paper on the Revised Differential Premium Systems ("DPS") framework for public consultation on 13 July 2010. Comments were received from member institutions ("members"), rating agency and consulting firms during the one-month consultation period which ended on 13 August 2010. As part of the consultation process, PIDM is publicly disclosing its response on the comments received.

OVERVIEW OF COMMENTS RECEIVED

2. The majority of respondents agreed with the proposed revision to the quantitative criteria in ensuring the DPS framework remains current and relevant. In brief, they agreed with the proposals to remove the efficiency criterion, the enhancement to the asset concentration criteria and asset quality criteria, the changes in computation of asset growth criterion and also the usage of information in the financial statements in completing the DPS quantitative information.

3. Apart from that, members also supported PIDM's proposal to revise the asset quality criterion in tandem with the implementation of FRS 139 – *Financial Instruments: Recognition and Measurement*. Meanwhile, with respect to the proposal to change the score threshold for capital criterion, PIDM received good feedback, which are generally in line with the current ongoing discussion and consultation at the international arena on further changes to the regulatory capital requirement. Detailed comments and responses are attached as **Appendix 1**.

4. After assessing the feedback received in the context of the current operating environment, PIDM will be incorporating the following changes into the original DPS framework:

   (a) the indicators in the capital criteria will remain unchanged. However, the score thresholds are refined while the proposed new thresholds for upper bands in the DPS consultation paper ("CP") will be removed;

   (b) the profitability indicators are unchanged with refinement to the threshold in the return on risk-weighted assets indicator as proposed in the DPS CP;

(c) the efficiency ratio will be removed as proposed in the DPS CP;

(d) the indicator for asset concentration will be changed as per the proposal in the DPS CP. However, the threshold for the household sector is reduced to 55% from the 60% proposed in the DPS CP, to be in line with the industry average;

(e) the indicator of net non performing loans ("NPL") to capital base will be replaced with net impaired loans to capital base indicator. The computation of net impaired loans (total impairment less individual provisions) is retained as proposed in the DPS CP;

(f) the gross NPL and loan in arrears to gross loan ratio will be revised to total impaired loan ratio as proposed in the DPS CP. Further refinement is made to the thresholds to be more conservative and gives benefit to a more prudent management of financing assets;

(g) the risk-weighted assets for the operational risk will be excluded from the computation of asset growth criterion as proposed in the DPS CP; and

(h) the source of information in completing the DPS quantitative information will be based on the members' financial statements as proposed in the DPS CP.

5. PIDM also takes note of the suggestion to have a different set of thresholds and scores for members that are adopting the Basel II Internal Rating Based ("IRB") approach. In view of data limitations and its recent implementation, such criteria can only be considered in future revisions of the DPS framework. Moreover, PIDM will continue to monitor changes in accounting and regulatory developments which may results in further enhancement and revision to the DPS framework.

6. A summary of the DPS criteria, thresholds and scores as well as the comparison of revised and current DPS criteria are attached in **Appendix 2 and Appendix 3**.

MOVING FORWARD

7. PIDM appreciates the feedback received in response to its DPS CP. We have incorporated the above noted changes into the draft regulations, which will be forwarded to the Treasury Solicitor and the Attorney General's Chambers as part of the legislative process. As part of this process, there may be amendments or refinements to the draft regulations. Such regulations are subject to the approval of the Minister of Finance, and the public will be informed through PIDM's website once the regulations come into force. PIDM will also issue revised guidelines on the DPS framework to assist members to compute and submit the required quantitative information. This revised DPS guidelines shall replace the existing DPS guidelines issued in year 2008.

Perbadanan Insurans Deposit Malaysia
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Appendix 1

Topic and Issues	Comments Received	PIDM's Responses
Proposal to remove Efficiency Criterion Question 1: PIDM seeks your comment on the proposal to remove efficiency criterion from the existing DPS framework.	Majority of respondents agreed to remove the efficiency criterion. One respondent proposed that the efficiency criterion should not be removed but to review or revise the current threshold.	PIDM will proceed to remove the efficiency criterion. The score of 5 for Efficiency Ratio has been distributed to the scores for Net Impaired Loans to Capital Base Ratio (3 points) and Total Impaired Loans Ratio (2 points).
Proposal to change indicator for Asset Concentration Criterion Question 2: PIDM seeks your comment on the proposed indicator, threshold and score for the asset concentration.	In general, the respondents agreed with the proposed revision of the asset concentration indicator. **Household Sector Asset Concentration Ratio** One respondent proposed to remove household sector as a first filter where PIDM should consider assessing concentration by customer orientation i.e. SME. Several respondents proposed a lower threshold for household sector asset concentration ratio or a higher threshold for aggregate sector loans concentration especially for loans to residential property and purchase of transport vehicles.	**To Implement/Future Review** PIDM will retain household sector as a first filter as the household exposure is considered to be more stable and diversified given the populous retail base vis-á-vis the high customer concentration inherent in a corporate banking portfolio. PIDM will revise threshold for the Household Sector to 55% from 60% to give benefit to a larger pool of retail based members after considering the 3-year industry average.

Topic and Issues	Comments Received	PIDM's Responses
	Aggregate Sector Loans Concentration Ratio One respondent commented that 20% concentration indicator for aggregate sector loans concentration may not be appropriate as it ignores the fact that the country's economy and loan distribution is highly concentrated in certain sectors.	PIDM takes note of the suggestion to assess concentration by customer orientation and will consider this in future enhancements. **No Change/Future Review** This will be reviewed in future enhancement.
Proposal to Revise the Indicators for Asset Quality and to Increase the Score for Asset Quality Criterion from 10 to 15 Points Question 3: PIDM seeks your comments on the proposed revised indicators for the asset quality to reflect the adoption of FRS 139. Question 4: What are your comments on the proposed weight, threshold and score for asset quality indicators?	Majority of the respondents agreed with the proposal to revise the asset quality indicators in tandem with the implementation of FRS 139 - *Financial Instruments: Recognition and Measurement.* **Net Impaired Loans to Capital Base Ratio** Several respondents proposed that the computation for the formula of Net Impaired Loans to Capital Base Ratio should also include the deduction of the Collective Impairment Provision.	PIDM will implement the proposal to increase the score weight for asset quality to 15 points from 10 points. **Net Impaired Loans to Capital Base Ratio** PIDM is retaining the computation of Net Impaired Loans Ratio (i.e. [Total Impairment - *(less)* Individual Provisions] / Capital Base) as we view the ratio to be a conservative measure of a member's ability to fully absorb losses arising from financing assets classified as 'impaired'. Given the interim provisioning requirement on collective provisions (i.e. 1.5% of total loans not assessed on individual basis), a deduction of

Topic and Issues	Comments Received	PIDM's Responses
		total collective provisions in calculating net impaired loans will render the ratio less meaningful. PIDM notes that for a number of members, this will result in negative Net Impaired Loans to Capital Base Ratio. Nevertheless, we will continue to monitor the accounting and regulatory developments in this respect, and will consider such developments in the next DPS Framework revision.
	One respondent suggested that certain exemption should be given to members that are adopting the IRB approach for Basel II.	PIDM views that it is too early at this juncture to differentiate members adopting either Standardised Approach ("SA") or IRB approach.
	Total Impaired Loans Ratio Several respondents suggested a revision to the threshold and score of this indicator as the previous indicator takes into account the element of the loans in arrears.	**Agreed** PIDM agrees with the suggestion to revise the threshold for Total Impaired Loans Ratio. The revision to the threshold is viewed to be more conservative and is intended to give benefit to a more prudent management of financing assets. Moreover, the previous threshold had taken into account the loans past due, which has since been omitted from the measurement.

Topic and Issues	Comments Received	PIDM's Responses
Proposal to Revise the Score Threshold for Capital Criterion Question 5: What are your comments on the proposed refinement to Risk-weighted Capital Ratio ("RWCR") and Core Capital Ratio ("CCR") thresholds and scores?	**RWCR and CCR** Several respondents proposed to maintain the current upper band thresholds for RWCR and CCR, which are already 50% and 100% respectively above the existing regulatory threshold requirements. It is viewed that the existing thresholds for RWCR and CCR at 12% and 8% are already adequate. Some suggested that, it is also prudent to wait for further developments of the regulatory direction of the proposed Basel III.	**Agreed/Future Review** PIDM will maintain the current upper band thresholds for RWCR and CCR as per the current framework. Meanwhile, to better reflect the members' capital position, we have further refined the existing thresholds at the middle bands as the existing are too wide. At this juncture, we are of the view that these thresholds have already provided ample capital buffer. Moreover, ongoing discussions and consultation on bank capitalisation at the international arena may result in further refinement to the members' capital requirements in the near future. PIDM has taken the stance to wait for further development of the regulatory direction and plans.
	Other respondents proposed to have a different set of thresholds and scores for members that are adopting the IRB Basel II approach. They also suggested to PIDM to allow members under Basel II IRB approach not to deduct the "excess Expected Loss" from the capital base.	PIDM views that it is too early to differentiate members adopting either the SA or IRB approach given its recent implementation and lack of available data.

Topic and Issues	Comments Received	PIDM's Responses
Proposal to Revise the Score Threshold for Profitability Criterion Question 6: What are your comments on the proposed revision to the Return on Risk-weighted Assets threshold and scores?	One respondent proposed to align the risk-weighted assets of the first year Basel II IRB banks with that of the industry, which are predominantly Basel II SA banks that are already with operational risk charge.	**No Change/Agreed** PIDM will implement the revise threshold as proposed in the CP. PIDM is revising the requirement for assessment year 2011 only, members adopting IRB approach are required to calculate profit or loss before tax and zakat divided by its risk-weighted assets for position as at 31 December 2010 (1-year risk-weighted assets). Thereafter, members adopting IRB approach are to revert to original computation where members' profit or loss before tax and zakat divided by its average risk-weighted assets. This is to ensure the standardisation in the computation of average risk-weighted asset after the requirement to incorporate Operational Risk.
	Two respondents proposed to exclude operation of Labuan's subsidiaries in computation of risk-weighted asset.	Besides that, for the purpose of this indicator only, PIDM will allow members to exclude Labuan operations in calculating risk-weighted asset; this will provide a better indicator of earnings achieved at bank level.

Topic and Issues	Comments Received	PIDM's Responses
Proposal to Revise the Formula for Asset Growth Criterion Question 7: What are your comments on the proposal to exclude RWA for Operational Risk in the computation of the asset growth criterion?	Majority of the respondents agreed with the proposal to exclude risk-weighted asset for operational risk in the computation of asset growth.	**To implement** PIDM will implement the proposed revision.
General Requirements Question 8: What are your comments on the calculating DPS information based on financial statements rather than Bank Negara Malaysia ("BNM") Financial Institutions Statistical System ("FISS")?	Majority of the respondents agreed with the proposal to compute DPS quantitative information based on members' financial statement. Several of the respondents agreed with the proposal as it will result in efficient validation process as most of the quantitative information in the financial statements have been audited.	**To implement** PIDM to implement the proposed revision. The proposed revision will eliminate the different basis of reporting between "global" and "domestic" figures in the current various BNM's FISS reporting. This will ensure consistencies in the computation of various indicators used as data is extracted from a single source. **To Review** PIDM will review the current external auditor's validation requirements to be in line with the changes in the DPS framework.

Topic and Issues	Comments Received	PIDM's Responses
	There were general enquiries with regards to the external auditors' validation on the submission of DPS and Total Insured Deposits by members.	**To review** PIDM takes note of the comments and the requirement for external auditors' validation will be reviewed from time to time. The external auditors' validation programme is not part of scope of the revised DPS framework.

Appendix 2

SUMMARY OF CRITERIA, MEASURES AND SCORES (AS AMENDED)

CRITERIA AND SCORE RANGE	SCORE	MAXIMUM SCORE
Quantitative Criteria		***60***
Capital		**20**
Risk-Weighted Capital Ratio ("RWCR")		10
RWCR ≥ 12%	10	
RWCR ≥ 11% but < 12%	8	
RWCR ≥ 10% but < 11%	6	
RWCR ≥ 9% but < 10%	4	
RWCR ≥ 8% but < 9%	2	
RWCR < 8%	0	
Core Capital Ratio ("CCR")		10
CCR ≥ 8%	10	
CCR ≥ 7% but < 8%	8	
CCR ≥ 6% but < 7%	6	
CCR ≥ 5% but < 6%	4	
CCR ≥ 4% but < 5%	2	
CCR < 4%	0	
Profitability		**15**
Return on Risk-Weighted Assets Ratio ("RoRWA")		8
RoRWA ≥ 2.75%	8	
RoRWA ≥ 2.25% but < 2.75%	6	
RoRWA ≥ 1.75% but < 2.25%	4	
RoRWA ≥ 1.00% but < 1.75%	2	
RoRWA < 1.00%	0	
Mean Adjusted Return Volatility ("MARV")		7
MARV ≥ 0 but ≤ 0.3	7	
MARV > 0.3 but ≤ 0.7	4	
MARV > 0.7	0	
MARV is negative or the mean profit/(loss) before tax and zakat is zero	0	

CRITERIA AND SCORE RANGE	SCORE	MAXIMUM SCORE
Asset Quality		**15**
Net Impaired Loans to Capital Base Ratio		8
Net Impaired Loans to Capital Base Ratio ≤ 20%	8	
Net Impaired Loans to Capital Base Ratio > 20% but ≤ 40%	5	
Net Impaired Loans to Capital Base Ratio > 40% but ≤ 60%	2	
Net Impaired Loans to Capital Base Ratio > 60%	0	
Total Impaired Loans Ratio		7
Total Impaired Loans Ratio ≤ 4%	7	
Total Impaired Loans Ratio > 4% but ≤ 6%	5	
Total Impaired Loans Ratio > 6% but ≤ 8%	3	
Total Impaired Loans Ratio > 8% but ≤ 10%	1	
Total Impaired Loans Ratio > 10%	0	
Asset Concentration		**5**
Household Sector Concentration Ratio; and Aggregate Sector Loans Concentration Ratio		5
Household Sector > 55% of Total Loans Outstanding; and Aggregate Sector Loans Concentration < 50%	5	
Household Sector > 55% of Total Loans Outstanding; and Aggregate Sector Loans Concentration > 50%	3	
Household Sector < 55% of Total Loans Outstanding; and Aggregate Sector Loans Concentration < 35%	5	

CRITERIA AND SCORE RANGE	SCORE	MAXIMUM SCORE
Household Sector < 55% of Total Loans Outstanding; and Aggregate Sector Loans Concentration < 50%	3	
Household Sector < 55% of Total Loans Outstanding; and Aggregate Sector Loans Concentration < 75%	1	
Household Sector < 55% of Total Loans Outstanding; and Aggregate Sector Loans Concentration > 75%	0	
Asset Growth		**5**
Risk-Weighted Assets To Total Assets Ratio; and Total Asset Growth Ratio		5
Risk-Weighted Assets To Total Assets Ratio < 70% and Total Asset Growth Ratio < 20%	5	
Risk-Weighted Assets To Total Assets Ratio < 70% and Total Asset Growth Ratio ≥ 20%	3	
Risk-Weighted Assets To Total Assets Ratio ≥ 70% and Total Asset Growth Ratio < 20%	1	
Risk-Weighted Assets To Total Assets Ratio ≥ 70% and Total Asset Growth Ratio ≥ 20%	0	

CRITERIA AND SCORE RANGE	SCORE	MAXIMUM SCORE
Qualitative Criteria		***40***
Supervisory Rating ("SR")		**35**
SR of 1 or equivalent	35	
SR of 2 or equivalent	28	
SR of 3 or equivalent	14	
SR of 4 or equivalent	0	
Other Information		**5**
No circumstances that represent a threat to the safety and soundness of the member	5	
Circumstances may materially affect the safety and soundness of the member	3	
Circumstances materially affect the safety and soundness of the member	0	
TOTAL		**100**

Appendix 3

COMPARISON OF REVISED AND CURRENT DPS CRITERIA AND WEIGHT/SCORE

Revised		Current		Remarks
Criteria	**Weight / Score**	**Criteria**	**Weight / Score**	
Quantitative Criteria	***60***	***Quantitative Criteria***	***60***	
Capital	**20**	**Capital**	**20**	
Risk-weighted Capital Ratio	10	Risk-weighted Capital Ratio	10	Refined threshold
Core Capital Ratio	10	Core Capital Ratio	10	Refined threshold
Profitability	**15**	**Profitability**	**15**	
Return on Risk-weighted Assets	8	Return on Risk-weighted Assets	8	Refined threshold
Mean Adjusted Return Volatility	7	Mean Adjusted Return Volatility	7	Unchanged
		Efficiency	**5**	
		Efficiency Ratio	5	Removed
Asset Quality	**15**	**Asset Quality**	**10**	Increased score weight
Net Impaired Loans To Capital Base Ratio	8	Net Non Performing Loans (NPLs) To Capital Base Ratio	5	New indicator
Total Impaired Loans Ratio	7	Gross NPLs and Loans In Arrears To Gross Loans Ratio	5	New Indicator
Asset Concentration	**5**	**Asset Concentration**	**5**	
Household Sector Concentration Ratio; and Aggregate Sector Loans Concentration Ratio	5	Aggregate Sector Asset Concentration Ratio and Residential Property Asset Concentration Ratio	5	New indicator
Asset Growth	**5**	**Asset Growth**	**5**	
Risk-weighted Assets To Total Assets Ratio; and Total Assets Growth Ratio	5	Risk-weighted Assets To Total Assets Ratio; and Total Assets Growth Ratio	5	Unchanged; refined formula
Qualitative Criteria	***40***	***Qualitative Criteria***	***40***	
Supervisory Rating (SR)	**35**	Supervisory Rating (SR)	**35**	
a. SR 1 (Low Risk)	35	a. SR 1 (Low Risk)	35	
b. SR 2 (Moderate Risk)	28	b. SR 2 (Moderate Risk)	28	Unchanged
c. SR 3 (Above Average Risk)	14	c. SR 3 (Above Average Risk)	14	
d. SR 4 (High Risk)	0	d. SR 4 (High Risk)	0	
Other Information	**5**	Other Information	**5**	Unchanged
Total Score	**100**	**Total Score**	**100**	