Perbadanan Insurans Deposit Malaysia

Protecting Your Insurance And Deposits In Malaysia

RESPONSE TO THE CONSULTATION PAPER ON PROPOSED ENHANCEMENTS TO THE DIFFERENTIAL LEVY SYSTEMS FRAMEWORK FOR INSURANCE COMPANIES

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1.0 BACKGROUND

1.1 On 13 March 2015, Perbadanan Insurans Deposit Malaysia ("PIDM") issued a Consultation Paper on the Proposed Enhancements to the Differential Levy Systems ("DLS") Framework for Insurance Companies for public consultation. We received feedback and comments from insurer members ("members"), Bank Negara Malaysia ("BNM") and an accounting firm during the consultation period, which ended on 10 April 2015.

1.2 The respondents were supportive of the proposed enhancement to the DLS Framework in differentiating the members' risk profiles for levy assessment purposes. We appreciate the views and comments provided by the industry and PIDM has taken these into consideration in the finalisation of the revised DLS Framework.

2.0 SUMMARY OF CHANGES TO THE PROPOSED ENHANCEMENTS TO THE DLS FRAMEWORK

2.1 PIDM has revised the weightages of quantitative measures to place more emphasis on the business performance and quality of business underwritten by members. In this regard, the weightage of the combined ratio was increased from 20% to 25%, and the weightage for receivable ratio was reduced from 20% to 15%.

2.2 PIDM will provide detailed clarification to specify that operating profit used in the formula for Mean-Adjusted Return Volatility ("MARV") refer to the profit or loss arising from the members' business operations, before taxation.

2.3 As for the expense ratio, PIDM will provide detailed clarification that the commission used to determine the expense ratio shall be computed at net of reinsurance commission, and the net premium income shall include total net premium from all businesses, i.e. ordinary life, investment-linked funds and annuity.

3.0 DETAILED COMMENTS RECEIVED AND PIDM'S RESPONSE

3.1 RECEIVABLE RATIO

PIDM sought feedback on the revised receivable ratio formula and thresholds for general insurance business.

Comments Received

All the respondents have expressed their agreement or have no adverse comment to the revised formula and thresholds.

One (1) respondent suggested that insurance receivable balances be split into motor and non-motor business. Motor insurance business is on Cash-Before-Cover ("CBC") basis, which tends to record lower outstanding balances, as compared to non-motor business.

Another respondent recommended the inclusion of impairment in the computation of this indicator, and also suggested a revision to the weightage.

PIDM's Response

PIDM sees the merits in the suggestion to segregate motor insurance business' receivables from other lines of business in computing the receivable ratio. However, such segregated information is currently not available from the ageing schedule. We will reconsider this suggestion when the information is available.

The inclusion of impairment into the indicator had been discussed during the development of the DLS Framework in 2012. Members highlighted that different practices in the determination of impairment may influence the outcome of the ratio. Therefore, the computation of receivable ratio will remain at gross of impairment.

PIDM agrees to revise the weightage as suggested to put more on the underwriting performance.

3.2 MEAN-ADJUSTED RETURN VOLATILITY ("MARV")

PIDM sought feedback on the proposed indicator, MARV, including the range of results and the proposed scores for general insurance business.

Comments Received

The majority of the respondents agreed with the introduction of this new indicator.

However, two (2) respondents commented that the indicator may penalise members who record strong growth in profit. Some respondents also requested further clarification on how to apply this indicator for cases involving merger and acquisition, and also for scenarios arising from splitting of composite insurance licence as required under the Financial Services Act 2013.

There was another request for further clarification on the components of the operating profit used in the formula.

PIDM's Response

PIDM wishes to highlight that MARV is designed to measure the volatility of the members' earnings. Profitability is measured under the combined ratio.

For cases involving merger and acquisition, the existing rules stipulated in Paragraphs 3.28 to 3.30 (amalgamation) of PIDM's Guidelines on Differential Levy System for Takaful and Insurance Benefits Protection System, are still applicable.

Meanwhile, for scenarios arising from the splitting of composite insurance licence, we understand that members are currently developing their respective plans to address the separation of the licences. PIDM is working on addressing the treatment upon separation of composite licences and will communicate with the members in due course. PIDM welcomes discussions with members to discuss their proposed plans so that potential areas of concern may be dealt with promptly.

With regard to clarification on operating profit, PIDM wishes to highlight that operating profit for this indicator refers to the profit or loss arising from business operation, before any taxation (corporate and deferred tax). We will include a detailed definition for operating profit in the revised DLS Framework guidelines.

3.3 EXPENSE RATIO

PIDM sought feedback on the proposed expense ratio indicator, including the proposed threshold and scores for life insurance business.

Comments Received

(1) A majority of the respondents agreed with the introduction of expense ratio, including the proposed thresholds and scores, as part of the operational and sustainability assessment of life insurance business.

Nevertheless, two (2) respondents highlighted that this ratio would expose new entrants and small scale members to a competitive disadvantage, as smaller members tend to record higher expense ratio as compared to more established members. There is also a recommendation to revise the proposed score ranges.

(2) Three (3) respondents sought further clarification on commission and net premium income components used in this indicator. A suggestion was also put forward by another respondent to exclude agency remuneration from the computation, as the indicator may not work favorably for members who have significant volume of new business.

(3) Three (3) respondents proposed that PIDM retains the existing return on required capital ratio (“RoRec”), as RoRec is a comprehensive profitability measurement.

PIDM’s Response

(1) The proposed indicator and score ranges have taken fair treatment of all members into consideration. This is in line with our guiding principle to ensure equitable treatment of members regardless of their size and complexity. Also, average industry performance, peer positioning and the alignment to the regulatory policies have also been taken into account in arriving to the proposals. As such, PIDM will maintain the proposed indicator and its score ranges.

(2) For the purpose of this indicator, commission should be computed at net of reinsurance commission, and the net premium income should include total net premium from all businesses, i.e. ordinary life, investment-linked funds and annuity. PIDM will include detailed definitions for all the components used in the formula, including the above mentioned components, in the revised DLS Framework guidelines.

With regard to the suggestion to exclude agency remuneration from the computation, we wish to highlight that the overall result from our data testing does not show any irregularity for members with high volume of new business. Furthermore, agency remuneration formed a substantial portion of operating expenses. Exclusion of agency remuneration from the expense ratio would not reflect the true picture of cost efficiency.

(3) PIDM agrees that RoRec is a comprehensive profitability measurement. However, we wish to highlight that the focus of expense ratio is to measure the efficiency of cost management, not profitability. As explained in our Consultation Paper, in view of the competitive market, and the ongoing regulatory initiatives to allow for greater flexibility to the members in managing their operating expenses, cost management is becoming even more prominent in the operation of life insurance business. In this regard, expense ratio will be a more forward looking ratio to assess the efficiency of cost management.

3.4 OTHERS

PIDM sought feedback on any other indicators or matters related to the DLS Framework.

Comments Received

(1) One (1) respondent highlighted that it is important to have a stable set of indicators in the DLS Framework, as any amendments in the measures may result in the efforts of the members being unrecognised.

Other than the above comments, three (3) respondents have provided feedback on other indicators, as elaborated below. With regard to these comments, PIDM wishes to highlight that most of these comments have already been discussed in our responses in the previous Consultation Paper on the DLS Framework, which was published on 30 July 2012, and is available in our corporate website for reference.

(2) **Free Capital Index**
A respondent highlighted that the indicator is calculated based on a member's Capital Adequacy Ratio ("CAR") for all funds or all funds excluding Participating ("PAR") Fund, whichever is lower, as required under BNM's Risk-Based Capital ("RBC") Framework. As such, this may lead to a situation where the member's CAR is based on all funds excluding PAR Fund, and thus the Par Fund's strength is not being considered in this indicator.

General Insurance Business Indicators:

(3) **Gross Premium Growth Rate**
A respondent commented that growth in top line may not be translated into profit.

(4) **Business Diversification Ratio**
A respondent was of the view that the indicator does not give credit to "specialist" insurers.

Life Insurance Business Indicators:

(5) **New Business Growth Rate**
A respondent highlighted that this indicator may not work positively for large and mature members, who already have a large premium base. The respondent suggested that the score ranges be varied according to company size, and the criteria should be less stringent for larger-sized companies.

(6) **Business Concentration Ratio**
Another concern highlighted by a respondent was that the score ranges set for this indicator were too high.

(7) **Business Conservation Ratio**
A respondent expressed the view that the indicator may penalise members who have large block of policies maturing or expiring at a particular point of time. The same respondent also suggested that for investment-linked business, the indicator should include the premiums from unit funds in the computation.

(8) **Investment Yield**
A comment from a respondent suggested that the benchmarking against the MGS 5-year Spot Rate – a fixed income return rate, may not be suitable for an investment portfolio that consists of both equity and fixed income instruments.

PIDM's Response	
(1)	With regard to the changes in indicators, PIDM wishes to highlight that it is part of our commitment to continuously enhance the effectiveness of the DLS Framework, in order to ensure that the impact of changes and developments in the operating and regulatory environments are addressed in the Framework. In addition, we also would like to point out that any change introduced is not a policy change, and it is in line with the intention to encourage further efforts from members to improve their performances.
(2)	As discussed in PIDM's response in the previous Consultation Paper on the DLS Framework, CAR as reported under the RBC Framework is used for this indicator, to be consistent with BNM's requirements. Furthermore, PIDM's studies revealed that there was only a marginal difference between results that use CAR for all funds and CAR for all funds excluding PAR Fund.
(3)	This indicator is to measure the business sustainability, not profitability. In the DLS Framework, there is other indicator in place to measure profitability, namely, combined ratio.
(4)	As explained in our previous response, the formulation of this indicator aims to promote overall diversification and is not intended to discriminate against certain lines of business. As for the specialist insurers, given their ability to focus on a particular business line, the benefits of such specialisation would be reflected in other indicators, such as, profitability. Therefore, the specialist insurer would still be able to achieve a good score in spite of the business diversification ratio.
(5)	As mentioned in the previous response, based on our guiding principles, the indicators and scores ranges are set to ensure equitable treatment of members regardless of their size and complexity. The thresholds and score ranges were set based on extensive analysis using data available over a period of time, and have taken into consideration the alignment to the current regulatory and supervisory policies, fairness to all insurer members, the average industry performance and peer positioning among the insurer members.
(6)	In determining the score ranges, PIDM has taken into consideration factors such as fairness to all members, the average industry performance, and the peer positioning among the members. As a result, we are of the view that the current score ranges are appropriate.
(7)	As highlighted in our previous response, PIDM takes note that the inclusion of certain intrinsic characteristics of life insurance business, including policy maturity, may distort the result of this indicator. However, our analysis and data testing revealed that the maturity or expiry of policies has not resulted in volatility to the indicator.

As for the suggestion to include total investment-linked funds in the computation of this indicator, we wish to reiterate our previous response that this indicator measures continuous income to cover future expenses. Therefore, for investment-linked business, only the operating fund is included in this indicator as it is earmarked to cover future expenses that include mortality and administrative charges. In addition, our data testing showed that the inclusion of total investment-linked premiums had caused an irregular trend and resulted in a distortion to the indicator, especially in respect of setting the score ranges.

(8) PIDM takes note of the different investment portfolios and strategies adopted by members. In this indicator, equity index is not used as a benchmark due to its volatile nature. Therefore, the MGS 5-year Spot Rate, a more stable benchmark, is selected for this indicator. In addition, the MGS 5-year Spot Rate is also adopted given that the investment assets for life insurer members are largely allocated in bonds with consideration for a medium-term investment horizon.

4.0 NEXT STEPS

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

4.2 PIDM will issue the guidelines on the revised DLS Framework to assist members with computation and submission of the required quantitative information. Coinciding with this, PIDM plans to revise the Guidelines on Validation Programme: Differential Levy System and Premiums Calculation in respect of the validation procedures for DLS quantitative information for insurance companies.

4.3 The revised DLS Framework is planned to be effective in assessment year 2016.

Perbadanan Insurans Deposit Malaysia
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