Perbadanan Insurans Deposit Malaysia

Protecting Your Insurance And Deposits In Malaysia

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

**ISSUE DATE : 15 JUNE 2022**

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## 1.0 BACKGROUND

1.1 On 6 August 2021, Perbadanan Insurans Deposit Malaysia ("PIDM") issued a Consultation Paper on the Revised Differential Premium Systems Framework ("DPS CP") for public consultation.

1.2 Under the revised Differential Premium Systems Framework ("DPS framework"), PIDM introduced two (2) new assessment criteria, namely the "safety and soundness criteria" and the "resolution centric criteria" ("RCC"), to promote an effective incentive mechanism. While the enhancement is envisaged to be simple yet dynamic in providing incentives, the underlying revisions also seeks to:

(a) lessen the impact of double counting by limiting the use of duplicative financial or regulatory ratios;

(b) manage cliff effects as result of the tiered scoring structure in the current DPS framework along with the matrix model that can lead to steep improvements in scores despite a marginal improvement/deterioration of financial indicators; and

(c) introduce an incentive structure that considers resolvability, in particular positions that can influence loss given failure.

1.3 Through the consultation process, PIDM sought feedback on a total of nine (9) aspects of the proposed revised DPS framework. At the end of the consultation period, PIDM received written feedback and comments from 42 deposit-taking members ("DTMs") and three (3) accounting firms covering all the areas consulted.

1.4 We appreciate the feedback received, as we regard this to be an important aspect of the review process to obtain valuable inputs from the industry prior to finalising the DPS framework. As part of the consultation process, PIDM is publishing its response to the feedback, which is set out in Section 4.

## 2.0 EXECUTIVE SUMMARY

2.1 PIDM received favourable response on the proposed introduction of two (2) new assessment criteria under the revised DPS framework. The feedback and recommendations received had also supported PIDM in making the refinements, particularly on the formula and definitions of the components used in the proposed new indicators.

2.2 The revised DPS framework including the area of refinements made based on the industry's feedback are summarised as follows:

| Current Framework | Revised DPS Framework | | |
|---|---|---|---|
| | **Consultation Paper** | **Key Comments** | **Final Proposal** |
| **1. Assessment Criteria** | | | |
| *Safety and soundness assessment:*<br>i) Quantitative criteria (60%)<br>- Matrix approach with two (2) assessment dimensions namely capital buffer and financial performance.<br>ii) Qualitative criteria (40%)<br>- Based on BNM's Composite Risk Rating ("CRR") and Other information. | *Two (2) assessment criteria:*<br>i) Safety and Soundness Criteria<br>- Based on BNM's CRR and is intended to differentiate DTMs by their risk profiles and risk management control functions.<br>ii) Resolution Centric Criteria ("RCC")<br>- Three (3) indicators serve as incentive structure that considers resolvability, in particular positions that can influence loss given failure. | i) Majority of respondents were receptive to the introduction of the two (2) assessment criteria, namely safety and soundness criteria and RCC.<br>ii) Proposed refinements to formula and definitions relating to RCC indicators to better meet PIDM's objectives. | Maintain the proposed two (2) assessment criteria under the revised DPS framework.<br><br>We have also incorporated some of the DTMs' suggestions in finalising the proposed indicators under RCC. |
| **2. Scoring Methodology** | | | |
| *Tier scoring structure:*<br>- Matrix model with fixed thresholds. | *Linear Interpolation:*<br>- The score for RCC indicators within the applicable threshold is determined via a linear interpolation method based on the upper and lower range of set thresholds. | DTMs viewed positively the introduction of linear interpolation method. | Maintain the proposed linear interpolation method to help minimise potential cliff effects. |
| **3. Annual Premium Rate Computation** | | | |
| *Fixed premium rate:*<br>DTMs classified into one of the four premium categories based on their overall DPS score and the corresponding premium. | *Variable premium rate, which is computed as follows:* | Proposed to review the mapping of PIDM's current premium rates to the proposed BPR as | Maintain the annual premium rate computation as per the consultation paper |

<table>
<tr><th rowspan="2">Current Framework</th><th colspan="3">Revised DPS Framework</th></tr>
<tr><th>Consultation Paper</th><th>Key Comments</th><th>Final Proposal</th></tr>
<tr>
<td>rates and minimum premiums charged to DTMs as below.
<table>
<tr><th>Premium Category</th><th>Minimum Premium</th><th>Premium Rate</th></tr>
<tr><td>PC1</td><td>RM100,000</td><td>0.06%</td></tr>
<tr><td>PC2</td><td>RM200,000</td><td>0.12%</td></tr>
<tr><td>PC3</td><td>RM400,000</td><td>0.24%</td></tr>
<tr><td>PC4</td><td>RM800,000</td><td>0.48%</td></tr>
</table>
</td>
<td>(i) Base Premium Rate (“BPR”) based on the outcome of the safety and soundness assessment criteria.
<table>
<tr><th>CRR</th><th>Risk Grade</th><th>BPR</th></tr>
<tr><td>Low</td><td>1</td><td>0.06%</td></tr>
<tr><td>Moderate</td><td>2</td><td>0.12%</td></tr>
<tr><td>Above Average</td><td>3</td><td>0.24%</td></tr>
<tr><td>High</td><td>4</td><td>0.48%</td></tr>
</table>
(ii) The final premium rate charged will be the BPR less RCC adjustment of a maximum 50% of the BPR, which is dependent on the interpolated score of RCC indicators.</td>
<td>some DTMs may experience higher BPR charges under the safety and soundness assessment criteria.</td>
<td>and the detailed rationale is provided in Paragraph 4.1 (A).</td>
</tr>
<tr><th colspan="4">4. Minimum Premium Charges</th></tr>
<tr>
<td>DTMs shall pay the annual premium amount computed based on the DPS framework, subject to the minimum premium amount as below:
<table>
<tr><th>Premium Category</th><th>Minimum Premium</th></tr>
<tr><td>PC1</td><td>RM100,000</td></tr>
<tr><td>PC2</td><td>RM200,000</td></tr>
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<tr><td>PC4</td><td>RM800,000</td></tr>
</table>
</td>
<td>DTMs shall pay the annual premium amount computed based on the revised DPS framework, subject to the minimum premium amount assigned to its Risk Grade as below:
<table>
<tr><th>Risk Grade</th><th>Minimum Premium</th></tr>
<tr><td>1</td><td>RM100,000</td></tr>
<tr><td>2</td><td>RM200,000</td></tr>
<tr><td>3</td><td>RM400,000</td></tr>
<tr><td>4</td><td>RM800,000</td></tr>
</table>
</td>
<td>Proposed to review the treatment of Minimum Premium amount on small DTM, in light of the new incentive structure.</td>
<td>Introduce a fixed minimum premium of RM100,000 (premium floor) for all DTMs under the revised DPS framework.</td>
</tr>
<tr><th colspan="4">5. Implementation of the Revised DPS Framework</th></tr>
<tr>
<td>NA</td>
<td>PIDM plans to finalise the revised DPS framework in 2022, for implementation in the assessment year 2023.</td>
<td>NA</td>
<td>Have in place a transitional arrangement that will see the revised DPS framework be implemented no earlier than AY 2025</td>
</tr>
</table>

| Current Framework | Revised DPS Framework | | |
|---|---|---|---|
| | Consultation Paper | Key Comments | Final Proposal |
| | | | to allow for DTMs to adequately prepare and acclimatise to the proposed revisions. |

## 3.0 THE REVISED DPS FRAMEWORK

**Assessment Criteria**

3.1 The safety and soundness criteria assessment is to be anchored on BNM's CRR as a means to differentiate DTMs by their risk profiles, considering the comprehensiveness and robustness of BNM's risk-based supervisory framework. The Base Rate ("BR") for each Risk Grade, as determined by BNM's CRR, will be maintained as per the DPS CP. However, the "BR" will be renamed as the Base Premium Rate ("BPR") to avoid any confusion with other similar terminologies already used in the banking system.

3.2 Meanwhile, the RCC assessment is designed to incentivise DTMs based on a set of RCC indicators, which consider balance sheet strength, capacity to absorb loss and funding stability. In this regard, PIDM maintained the three (3) indicators with an equal weightage to measure and incentivise aspects of resolvability. The RCC indicators and formula, as detailed in the DPS CP, remains largely applicable, with the following revisions to the definition and computation following the industry's feedback:

**(a) Free Tangible Asset Cover ("FTAC") Ratio**

The definition of "intangible assets" for the purposes of computing the FTAC ratio under the revised DPS framework has been aligned to BNM's Capital Adequacy Framework (Capital Components) to ensure consistent treatment between regulators.

**(b) Net Impaired Asset Cover ("NIAC") Ratio**

PIDM will align the treatment of proposed dividend to be consistent with BNM's Implementation Guidance on Capital Adequacy Framework (Capital Components) ("Implementation Guidance") issued on 9 December 2020, which considers a portion of dividend to be reinvested under a dividend reinvestment plan ("DRP") as part of the total capital computation. For the purpose of this ratio, the proposed dividend deducted from "Total Capital" is allowed to be reduced by a portion of dividend to be reinvested by shareholders under DRP, subject to meeting the requirements as stipulated under BNM's Implementation Guidance.

**(c) Composition of Core Fund ("CCF")**

Funding from Cagamas will be recognised as a stable source of core funds and will be added to both the numerator and the denominator when computing this ratio. The upper threshold of this indicator will also be revised from 60% to 50% taking into consideration the industry's distribution analysis following the computational adjustments.

**Linear interpolation method for RCC Indicator Score**

3.3 The scores for each RCC indicator within the applicable threshold are determined via a linear interpolation method based on the upper and lower range of the respective thresholds. A DTM with an RCC indicator that meets or exceeds the upper threshold will obtain a score of 100%. Conversely, if the RCC indicator is at or falls below the lower threshold, the DTM will receive a score of zero (0).

**Annual Premium Rate Computation**

3.4 Another key enhancement under the revised DPS framework is a change from the existing fixed premium rate (by premium category) to a variable premium rate computation. Under the revised DPS framework, each DTM will be assigned a BPR based on the outcome of its safety and soundness assessment. The final premium rate charged will be the BPR less RCC adjustment, which is dependent on the interpolated score of its RCC indicators. Essentially, the premium rate will be set "along-the-curve" vis-à-vis the DTM's risk profile and RCC performance, rather than "boxed" into a fixed premium category as per the existing DPS framework.

3.5 PIDM will be introducing a fixed minimum premium of RM100,000 (premium floor) for all DTMs under the revised DPS framework. This will simplify the rules for minimum premium charges that will ease implementation for DTMs, and at the same time to ensure the application of the revised DPS framework is fair and equitable to all DTMs.

**Transitional Arrangement**

3.6 As the RCC indicators are more aligned to the measurement of loss given failure, PIDM recognises that DTMs may require more time to familiarise and acclimatise to the new indicators, recalibration of performance expectations, and necessary system and process enhancement, based on the revised DPS framework. In this regard, PIDM will put in place a transitional arrangement that will see the revised DPS framework be implemented no earlier than AY 2025.

3.7 During the transition period, DTMs will be required to submit information pertaining to the RCC indicators under revised DPS framework for monitoring purposes. At the same time, DTMs will continue to be assessed under the existing DPS framework for annual premium charges. The details of the additional information submission during the transitional phase and the implementation of the revised DPS framework will be communicated in due course.

## 4.0 FEEDBACK/COMMENTS RECEIVED AND PIDM'S RESPONSES

### 4.1 Assessment Criteria

| A. Safety and Soundness Criteria |
|---|
| Feedback on the proposed safety and soundness criteria assessment which is anchored on BNM's CRR. |

| Comments Received |
|---|
| Majority of respondents concurred that anchoring the safety and soundness assessment criteria to BNM's CRR provides a more holistic and comprehensive view of the DTM's risk profile, and also minimise the duplication in the DPS framework.<br><br>However, a few respondents commented that the use of CRR as sole driver for the safety and soundness criteria may lead to concentration or overreliance on a single assessment factor, and suggested that other risk measures to be used in complement to the CRR such as the existing regulatory ratios and other common risk assessment indicators.<br><br>There were also suggestions for PIDM to review the proposed mapping of PIDM's current premium rates to the proposed BPR as some DTMs may experience higher BPR charges under the safety and soundness assessment criteria. |

| PIDM's Response |
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| PIDM maintains for the assessment of safety and soundness criteria to be anchored on BNM's CRR, which is an outcome of BNM's holistic risk based supervisory framework. The CRR is reflective of the DTM's inherent risks and risk management control functions. It is also viewed to be more adept at capturing risks arising from dynamic changes in the financial and operating landscape as well as the adequacy of any mitigating actions taken by the DTMs. |

PIDM is of the view that the CRR provides for adequate differentiation of risk across DTMs, given that BNM carries out a vigorous assessment before categorising DTMs into four (4) distinct risk ratings depending on the level of weaknesses and concerns with regard to overall safety and soundness.

Meanwhile, applying complementary indicators to the safety and soundness assessment, especially in the form of regulatory ratios or requirements, may work against the objective of minimising duplication within the DPS framework. PIDM is also mindful of applying any direct benchmarks against regulatory ratios as we look to avoid the unintended consequences of setting expectations beyond what is required by regulators.

PIDM's proposed mapping of the BPR to Premium Category rates under the current DPS framework is in line with the intent to continue differentiating members within four (4) broad categories under the safety and soundness criteria and to maintain the "double-up of rates" as incentive for marked improvements in risk profiles and control functions. PIDM notes that some members may experience a recalibration of its safety and soundness position as a result, however the impact of this is deemed manageable as it is further balanced-out with the introduction of RCC incentives within the revised DPS framework. As a whole, the revised DPS framework offers a maximum 50% downward adjustment to the BPR as a measure to incentivise positions that have a positive impact on resolution and the resolvability of the DTMs.

**B. Resolution Centric Criteria ("RCC")**

Feedback on the overall proposed RCC assessment and suggestions for other RCC indicators to be considered in addition to the three (3) proposed indicators.

**Comments Received**

There were suggestions for PIDM to consider using existing regulatory ratios or measures commonly used by bank supervisors given the familiarity with the ratios, which are actively tracked by most DTMs as part of ongoing risk management and regulatory compliance.

Some respondents recommended amendments to the proposed RCC indicators to better meet PIDM's objective including the definition and computation for a better clarity.

| PIDM's Response |
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| PIDM will retain the RCC indicators given its objective to incentivise aspects of resolution and resolvability, with some revisions to the definition and components after considering DTM's feedback as set out in Para 4.2.<br><br>The selected RCC indicators are intended to provide incentives for balance sheet strength, capacity to absorb losses and funding stability. Collectively, these indicators serve as the proxy for measuring loss in the event of failure as they represent some of the components influencing losses in resolution. PIDM had also leveraged on data available from resolution experiences internationally and/or loss experience of past crisis including the industry distribution analysis, to the extent possible, in determining the thresholds for the RCC indicators.<br><br>The use of existing regulatory ratios or existing supervisory measures may lead to duplication or double counting of elements already considered as part of the BNM's CRR. PIDM tries to also refrain from applying any direct benchmarks against regulatory ratios. This is to avoid the unintended consequence of setting expectations beyond what is required by regulators or prudential requirements. |

4.2 **Proposed indicators under RCC assessment**

| A. Free Tangible Asset Cover Ratio |
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| Feedback on the proposed indicator, including the formula and threshold. |

| Comments Received |
|---|
| Clarification was sought on the proposed upper threshold for FTAC ratio. Some respondents viewed the upper threshold of 1.3 times to be punitive, while others felt that it may lead to pressure on performance indicators (i.e. return-on-equity), particularly when DTMs are striving to maximise their scores for the FTAC ratio.<br><br>A few respondents also requested clarification in relation to the definition of "intangible assets" including the treatment of the software license. There was also a comment that there may be other asset and liabilities categories, for example, "deferred tax assets and liabilities" or "right-of-use assets and lease liabilities" that should be considered in the definition of "Free Tangible Assets". |

Some respondents requested PIDM to provide further clarity on the definition of "other pledged assets".

**PIDM's Response**

With respect to the feedback on the upper threshold, PIDM is of the view that the upper threshold of 1.3 times is conservative based on benchmarking conducted, while the interpolation methodology adopted for DTMs with FTAC ratio from 1.0 times to 1.3 times will help smoothen the impact on the DTMs. Given the range, DTMs have the opportunity to strike an optimum balance between its business objectives and maintaining a healthy balance sheet profile that would minimise losses in resolution.

As mentioned in the DPS CP, the setting of thresholds has been benchmarked against historical loss rate, by asset classes, based on the Malaysian and international experiences and/or past crises to the extent possible. The upper threshold reflects the assumption that the fair values of tangible assets reflected on the DTM's balance sheet may not be recoverable at par in resolution. Taking into consideration the outcome of the benchmarking process and the industry distribution analysis, PIDM will retain the upper threshold of 1.3 times.

The definition of "intangible assets" for purposes of computing the FTAC ratio under the revised DPS framework has been aligned to BNM's Capital Adequacy Framework (Capital Components) to ensure consistent treatment between regulators. Accordingly, the adjustment for intangibles in the computation of the FTAC Ratio will be consistent with the regulatory adjustments in relation to goodwill and other intangibles (Para 19) as well as deferred tax assets and liabilities (Para 20) under the Capital Adequacy Framework (Capital Component).

PIDM also takes note of DTM's comment on the other pledged assets, where further clarification on the definition will be provided in the revised DPS Guidelines.

**B. Net Impaired Asset Cover Ratio**

Feedback on the proposed indicator, including the formula and threshold.

**Comments Received**

It was suggested for PIDM to align the treatment of proposed dividend with the BNM's Implementation Guidance on Capital Adequacy Framework (Capital Components) issued on

9 December 2020, which allows the electable portion of dividend to be invested by shareholders of the DTM under a DRP to be added back to the "Total Capital" computation.

Several respondents requested a clarification whether the "gross carrying amount" and "credit equivalent amount" used in the computation of NIAC ratio refers to credit impaired assets.

Clarification was also sought on the scope of other assets for the purpose of this indicator i.e. whether cash and cash equivalents or short-term interbank placements are considered as part of other assets.

**PIDM's Response**

PIDM will allow DTMs to offset the amount of proposed dividend deducted from Total Capital with the dividend to be reinvested by DTM's shareholders under DRP (i.e. the electable portion), subject to meeting the requirements stipulated under BNM's Implementation Guidance on Capital Adequacy Framework (Capital Components). This is to incentivise DTMs that have put in place a credible DRP as a means to strengthen their capital position as well as to recognise shareholders' capacity and commitment to support capital.

PIDM wishes to clarify that the "gross carrying amount" and "credit equivalent amount" used in the computation of net impaired assets shall be applied to the on-balance sheet and off-balance sheet impaired assets before the deduction of lifetime expected credit losses.

PIDM also reiterates that the scope of impaired assets to be included in the computation of NIAC ratio is confined to assets that subject to impairment requirement under Malaysian Financial Reporting Standards 9.

**C. Composition of Core Funds**

Feedback on the proposed indicator, including the formula and threshold.

**Comments Received**

Several respondents commented that the proposed CCF should be replaced with other similar liquidity measures or ratios that are already being reported to BNM, such as the Liquidity Coverage Ratio and Net Stable Funding Ratio.

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|---|
| There were also suggestions for PIDM to recognise other funding sources such as Cagamas funding and investment accounts as a core fund. |

| PIDM's Response |
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| The focus of the CCF under the revised DPS framework lean towards supporting an orderly resolution of DTMs. In this regard, the indicator seeks to provide incentive for DTMs to maintain a stable liability structure that minimises the likelihood of a bank-run scenario and reduces the need for a fire sale of assets at depressed values. This contributes towards preserving asset value and reducing funding needs in resolution.<br><br>PIDM agrees to recognise Cagamas funding as components for both Core Funds and Total Available Funds i.e. numerator and denominator. In this regard, PIDM has also revised the upper threshold of the CCF from 60% to 50% to accommodate changes in the computation of this ratio under the revised DPS framework as well as its corresponding effect on the latest industry distribution analysis.<br><br>Meanwhile, for Islamic DTMs, investment account funding will be excluded from the computation of CCF, given the embedded loss absorbing capacity of the funding source. |

4.3 **Other Areas**

| Other Matters |
|---|
| PIDM seeks feedback on other matters related to the revised DPS framework. |

| Comments Received |
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| There were suggestions for PIDM to review the treatment of Minimum Premium amount on small DTM, in light of the new incentive structure.<br><br>A few respondents also proposed a simplified approach for premium rate computation specifically tailored for DTMs with small total insured deposits. |

| PIDM's Response |
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| PIDM will be introducing a fixed Minimum Premium of RM100,000 (premium floor) in place of the Minimum Premium amount of RM100,000, RM200,000, RM400,000 and RM800,000 |

| |
|---|
| prescribed based on Risk Grades as proposed in DPS CP. The introduction of a fixed minimum premium will simplify the rules of Minimum Premium charges and ensure the revised DPS framework is consistently applied to all DTMs. |

## 5.0 NEXT STEPS

5.1 PIDM will proceed with the legislative process for the issuance of the regulations on the revised DPS framework. The guidelines on the revised DPS framework will be issued in due course.

5.2 PIDM will also issue a guidance to advise on details of the transitional arrangement for the revised DPS framework, including the submission requirements during the transition period.

Perbadanan Insurans Deposit Malaysia
15 June 2022