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

ISSUE DATE : 10 SEPTEMBER 2019

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1.0 BACKGROUND

1.1 On 3 May 2019, Perbadanan Insurans Deposit Malaysia ("PIDM") issued a consultation paper on the Proposed Enhancements to the Differential Levy Systems ("DLS") Framework for Insurance Companies ("CP"). The proposed enhancements are part of PIDM's proactive effort to better reflect the assessment of an insurer member's ("member") risk profile and include a more forward-looking measure under the DLS Framework, in tandem with the developments in the regulatory and business operating environment.

1.2 The consultation period ended on 24 May 2019. We received feedback and comments from members, a rating agency and accounting firms during the consultation period.

1.3 PIDM wishes to thank the respondents who have provided their comments to the CP. PIDM has carefully considered these comments and our responses are set out in Section 3. We have grouped the comments under broad topics as some comments are similar and provided our responses on that basis.

2.0 OVERVIEW OF COMMENTS RECEIVED

2.1 Generally, the respondents were supportive of the proposed enhancements to the DLS Framework in differentiating the members' risk profiles for levy assessment purposes.

2.2 PIDM takes note of the responses, particularly concerns raised, and we wish to assure members that PIDM has given due consideration to respondents' views and suggestions in finalising the enhancements to the DLS Framework.

2.3 After assessing the views and feedback received, PIDM would like to inform that there are no changes made to the proposed enhancements to the DLS Framework. That said, some comments and recommendations can be considered for future revisions.

3.0 DETAILED COMMENTS RECEIVED AND PIDM'S RESPONSE

3.1 ASSET MATCHING AND RETURN ("AMR") – A matrix between Asset Liability Duration Matching ("ALDM") and Investment Yield ("IY")
The CP proposed a new AMR indicator to measure both ALDM and IY in a matrix, with a corresponding score range. The AMR provides a more holistic assessment of members' risk profile as it assesses the ability of a life insurer to strategically invest its life insurance fund assets to match the exposure from its insurance liabilities, while maintaining an appropriate level of investment returns. PIDM sought feedback on the appropriateness of the proposal.

Comments Received
Majority of the responses were positive and supportive of the proposed AMR indicator. Most respondents agreed that AMR provides a more holistic assessment of members' risk profile. Some respondents recommended that the score range be revised. Although they agreed that the ideal position for ALDM is 100%, it was highlighted that the score range should take into consideration some acceptable mismatch, given the long term nature of life insurance contracts and the limited availability of the long tenure bonds in the market. Correspondingly, to qualify for the best score, some respondents suggested to reduce the lower limit of ALDM to below 100%, with recommendations ranging between 70% to 90%. Other comments highlighted by the respondents include: • Putting a cap in the score range may limit the flexibility of the life insurance company in investing their excess assets in search for higher yield; and • To assess a life insurance company's total exposure by including shareholders' fund in the ALDM computation.

PIDM's Response
PIDM views an ALDM of 100% as the ideal position, where assets and insurance liabilities match perfectly. Setting "Score 1" at 100% ≤ ALDM < 200% will allow PIDM to incentivise members to better match their assets to liabilities in the longer term. As mentioned in the CP, PIDM views that holding excessive assets could be unfavourable as the drop in assets value would be much greater than the drop in liabilities value if interest rates trend upwards, resulting in members' assets being inadequate to meet their long term obligations. In view of that, we proposed to put a cap in the score range to limit any adverse impacts arising from interest rate movements. In relation to the 300% limit, we wish to highlight that this is a reasonable limit based on our testing using industry's data.

PIDM's Response
The objective of the AMR indicator is to assess the ability of the life insurer to strategically invest its life insurance fund assets to match the exposure of its insurance liabilities, while maintaining an appropriate level of investment return. As such, the indicator only assesses the performance of the life insurance fund, excluding the shareholders' fund. We wish to highlight that in developing the proposed AMR indicator and score ranges, PIDM has sought to ensure the equitable treatment of members regardless of their size and complexity. PIDM has taken into account the industry's average performance and peer positioning. Hence, PIDM will maintain the proposed AMR indicator and its score ranges.

3.2 AMR – Proposed refinements to the IY indicator
PIDM sought feedback on the proposed refinements to the IY indicator as follows: • 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 or losses component; and • To replace the Malaysia Government Securities ("MGS") 5-year spot rate as the benchmark with the 3-7 years Government Bond Index Return ("BIR").

Comments Received
Majority of the respondents were agreeable to the proposed refinements, noting that the refinements to the IY formula will reflect a more realistic investment return. Additionally, BIR is a more comparable benchmark, as it reflects fair value changes of the investment assets. One (1) respondent commented that the bond yield calculation should exclude the unrealised gains or losses, as this may produce counter-intuitive outcomes. For example, if interest rates rise, insurance liabilities value would drop, reducing the overall risk. Concurrently, assets value would also drop, resulting in unrealised losses that may affect the IY result.

PIDM's Response
In relation to the suggestion of excluding the unrealised gains or losses on bond yield from the IY formula, PIDM wishes to highlight that the objective of IY is to measure the member's investment performance in totality, and should not be limited to realised gains or losses.

3.3 AMR – Proposed indicator assessed at total life insurance fund level
The proposed AMR is assessed at aggregate level (i.e. total life insurance fund level) that does not address the non-fungibility between various life insurance funds. In view of this, PIDM sought views and proposals to address the non-fungibility issues, including:

3.3 AMR – Proposed indicator assessed at total life insurance fund level

- Any standardised approach in the industry to compute ALDM and IY at life insurance sub-fund level;
- The potential challenges if AMR indicator is computed at life insurance sub-fund level; and
- The most appropriate way to assess AMR for an insurance company as a whole.

Comments Received

1) Most respondents were agreeable to measure AMR at aggregate level, as it is a pragmatic approach to standardise the assessment for all members. However, two (2) respondents proposed to calculate the AMR at sub-fund level and later aggregate at total fund level based on weightage.

2) One (1) respondent commented on the exclusion of participating fund from the proposed ALDM calculation.

PIDM's Response

1) PIDM acknowledges that it is beneficial to measure AMR by sub-funds. Nevertheless, this would impose added complexity to the computation. One of the challenges faced when assessing the AMR at sub-fund level is to set the appropriate benchmark or score range at sub-fund level, given the different nature and profile of sub-funds in terms of product design, reserving methodology and investment strategy or mandate. Furthermore, it will be challenging to consolidate the different scores at sub-fund level to derive a total fund level benchmark or score range. Such granular measure may defeat the key guiding principle of the DLS Framework, which is to assess the members' risk profile in an objective and transparent manner.

   As part of our extensive study, we have also explored the weighted average mechanism, which had minimal impact on the results. Hence, PIDM is of the view that it is impractical to measure AMR by sub-funds at this point.

   As such, PIDM will maintain the proposed AMR indicator and score ranges, which are measured at aggregate level, considering the operational challenges faced to measure ALDM by sub-funds. Nevertheless, PIDM takes note of all the comments and proposals and will continue to study and engage with the industry as well as all relevant stakeholders.

PIDM's Response

2) In the proposed ALDM calculation, the asset component is based on all assets exposed to interest rate risk, while the liability component is based on guaranteed insurance liabilities (including participating life policies), as defined in BNM/RH/PD 032-12 Risk-Based Capital Framework for Insurers. The liabilities on non-guaranteed benefits of participating life policies are excluded from the ALDM computation, as this component hinges on the performance of the fund.

3.4 AMR – Hedging of interest rate volatility via derivatives

PIDM sought feedback on the hedging of interest rate volatility via derivatives, in relation to:

- The use of derivatives to manage interest rate risk and the extent of it;
- The implications on hedging instruments arising from the implementation of Malaysian Financial Reporting Standard ("MFRS") 9;
- Any consideration to use derivatives for hedging purpose in the future; and
- The applicability of including hedging as part of the AMR indicator or any other indicator.

Comments Received

Two (2) respondents stated that they are currently using derivatives to hedge interest rate risks, while the majority of the remaining respondents do not use derivatives for hedging interest rate risks.

On the applicability of incorporating the hedging of interest rate volatility via derivatives into the AMR indicator, some respondents commented that this would better reflect the actual interest rate volatility and the risk profile of the life insurance company. Additionally, this is consistent with the calculation of the Interest Rate Risk Charges in the Risk-Based Capital Framework for Insurers. On the other hand, two (2) respondents indicated that hedging of interest rate volatility should not be considered as it does not yield symmetrical results.

PIDM's Response

PIDM takes the view that the need to incorporate hedging into the AMR indicator is not critical at this juncture. PIDM recognises that members adopt different risk management measures including hedging via derivatives. However, PIDM is of the view that the shock parameter of 100 basis points used in the ALDM formula is not excessive enough for the members to apply hedging, based on the past 11 years' MGS bond spot yield data. Furthermore, the majority of respondents do not currently hedge interest rate volatility via derivatives.

PIDM's Response

As such, PIDM will maintain the AMR proposal that does not take into consideration the hedging of interest rate volatility via derivatives. Nevertheless, we take note of the comments received, and will continue to study and engage with the industry.

3.5 MEAN-ADJUSTED RETURN VOLATILITY ("MARV")

PIDM sought feedback on the proposed refined MARV formula. The CP proposed to exclude changes in gross Available for Sale ("AFS") reserves from the MARV formula, as reserves movement is not part of operating profit.

Additionally, clarification will be provided on the composition of the "other income/outgo" to only include income or outgo arising from business operations. This component should exclude income or outgo not arising from business operations, for example Day-1 adjustments due to the adoption of new accounting standards.

Comments Received

Respondents have no objection to the refined MARV formula to exclude changes in gross AFS reserves from the formula. Respondents are also agreeable to exclude any income or expenses not arising from day-to-day business operations from the composition of "other income/outgo".

PIDM's Response

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3.6 PROFITABILITY MEASURE FOR LIFE INSURANCE BUSINESS – Future enhancements

PIDM sought feedback on the potential approaches of measuring profitability based on surplus arising for life insurance business ("Surplus Arising").

Comments Received

Respondents mainly do not consider the use of Surplus Arising as an approach to measure profitability for the following reasons:

- Adequacy of surplus may vary depending on portfolio size and risk;
- Small and fast growing players who face high initial business strains may be penalised;
- Profitability measure needs to be revisited with the implementation of the new insurance contract financial reporting standard under MFRS 17;
- Profitability is not reflective of sound risk management; and
- Surplus is not a true reflection of the insurance company's sustainability.

PIDM's Response
PIDM takes note of the comments highlighted and will continue to conduct studies to identify an appropriate measure of profitability, particularly on the appropriateness of Contractual Service Margin ("CSM") as one of the measures to assess profit level of life insurance business when MFRS 17 comes into effect. At the same time, we are continuously engaging relevant stakeholders on the development of MFRS 17 and its potential impact on the DLS Framework.

3.7 BUSINESS CONCENTRATION RATIO ("BCR") – Future enhancements
PIDM sought feedback on the proposal to exclude the Yearly Renewable Term ("YRT") products from the single premium component in the BCR once BNM's revised reporting form is effective.

Comments Received
1) Majority of respondents are agreeable to exclude YRT products from the single premium component since it is similar to regular premium products. However, some respondents suggested YRT to be included in regular premium component. 2) Two (2) respondents proposed to consider credit-related products as part of regular premium products since these products are profitable and their risks are manageable. 3) One (1) respondent suggested to include YRT as part of the numerator with regular premiums, by applying the annual premium equivalent ("APE") method on YRT products (i.e. weighted at 10%). Similarly, another respondent proposed to consider applying the APE method on all single premium products when calculating the BCR. 4) One (1) respondent proposed to lower the weightage for BCR from 25% to 15% and spread the difference to other indicators since BCR overlaps with AMR.

PIDM's Response
1) As mentioned in the previous response to the CP on Differential Levy System Framework for Takaful and Insurance Benefits Protection System dated 30 July 2012, BCR aims to promote a balanced portfolio that ensures an appropriate composition of single and regular premium products for a continuous future stream of income. 2) With regards to the suggestion to include YRT in regular premium component, PIDM acknowledges that the premiums for YRT products are payable yearly for one-year coverage. Nevertheless, YRT products may have differing features, with some exhibiting characteristics of single premium products and others, regular premium products. As

PIDM's Response
such, PIDM proposes to exclude YRT products from single premium component once BNM issues the revised reporting form, with separate classification for YRT products. As for the treatment of single premium credit-related products (e.g. mortgage reducing term assurance products), we take note that these products are profitable and have manageable risks. We wish to reiterate that BCR is to measure the business sustainability, not profitability, as previously highlighted in our response to the CP back in 2012. 3) The APE method proposed is not suitable for this purpose, as applying 10% weightage to the single premium component will distort the actual business composition and will not provide the actual proportion between regular and single premium. 4) We take note of other respondents' proposal to reduce the weightage of BCR. However, we will maintain the current weightage, as an appropriate composition of single and regular premium products ensures continuous future steam of income. Furthermore, concentration in a single source of business may also affect the business sustainability of members moving forward.

4.0 GOING FORWARD

4.1 PIDM will proceed with the legislative process to get the draft regulations on the revised DLS Framework gazetted.

4.2 PIDM will also issue the guidelines on the revised DLS Framework to assist members with the computation and submission of the required quantitative information. The revised Guidelines on DLS Framework will replace the existing Guidelines issued on 31 January 2019.

4.3 The regulations and guidelines on the revised DLS Framework are planned to be effective in assessment year 2020.

Perbadanan Insurans Deposit Malaysia
10 September 2019