Perbadanan Insurans Deposit Malaysia
Protecting Your Insurance And Deposits In Malaysia

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

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PART A: INTRODUCTION

1.0 BACKGROUND

1.1 Perbadanan Insurans Deposit Malaysia ("PIDM") implemented the Differential Levy Systems ("DLS") Framework for insurance companies[1] in 2013 to replace the flat-rate levy systems that was introduced when the Takaful and Insurance Benefits Protection System ("TIPS") was first implemented in 2010. With the establishment of the DLS Framework, PIDM aims to introduce greater fairness to the levy[2] assessment process and provide incentives for insurance companies ("members") to adopt sound risk management practices.

1.2 PIDM is committed to continuously enhance the effectiveness of the DLS Framework; at least every three (3) years. The objectives are to:

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

(b) address feedback received and issues encountered since the implementation of the DLS Framework; and

(c) assess the impact of changes and developments in the operating and regulatory environment to the effectiveness of the current DLS Framework.

2.0 OBJECTIVES OF THE CONSULTATION PAPER

2.1 The purpose of this Consultation Paper ("CP") is to seek views and comments on the proposed enhancements to the DLS Framework. In line with PIDM's strategies and values, the consultative approach is adopted to ensure the revised DLS Framework is appropriate and effective.

2.2 This CP focuses on the proposed changes to the **Guidelines on Differential Levy System for Takaful and Insurance Benefits Protection System** issued on 31 January

[1] Insurance companies refer to all insurance companies that are registered under the Financial Services Act 2013, except reinsurance companies. All insurance companies conducting general insurance and/or life insurance business are subject to the DLS Framework.

[2] For the purpose of this Consultation Paper, "levy" or "levies" shall have the same meaning as "premium" or "premiums" in the Malaysia Deposit Insurance Corporation Act 2011.

2013 (“DLS Guidelines”) only. A ***revised*** DLS Guidelines will be issued after the finalisation of this CP. Unless otherwise specified, the existing requirements in the DLS Guidelines remain unchanged.

3.0 CONSULTATION PROCESS

3.1 PIDM welcomes written comments and feedback on any aspect of this CP, including suggestions on any issues or areas to be clarified or elaborated further; and any alternative proposal that PIDM should consider. To facilitate PIDM’s assessment, please support each comment with clear rationale, suggestions, accompanying evidence and/or illustration, where appropriate.

3.2 Responses shall be submitted by **10 April 2015** to:

General Manager
Insurance, Risk Assessment and Monitoring Division
Perbadanan Insurans Deposit Malaysia
Level 12, Axiata Tower (formerly known as Quill 7)
No. 9, Jalan Stesen Sentral 5
Kuala Lumpur Sentral
50470 Kuala Lumpur

(Please mark **“CP Revised DLS”** on the top left hand corner of the envelope for written comments posted to PIDM)

Or Email: dls@pidm.gov.my

Enquiries: Encik Azman Mokhtar 03-21737596
Mr Chang Wei Yuen 03-21737543

3.3 All comments will be treated in strictest confidence. PIDM will collate comments on this CP and publish its responses on PIDM’s website. Thereafter, PIDM will finalise the revised DLS Framework and follow the relevant legislative process for its implementation.

3.4 The revised DLS Framework is planned to be implemented in the assessment year 2016.

PART B: PROPOSED ENHANCEMENTS

4.0 OVERVIEW

4.1 In the review of the DLS Framework, PIDM was guided by the following:

(a) the revised DLS Framework should apply equitably to all members irrespective of their size or complexity;

(b) the revised DLS Framework must be transparent in order for members to understand and manage their profiles. This will also ensure that there is no discretion on the part of PIDM to adjust any scores arbitrarily;

(c) the revised DLS Framework must provide incentives for members to move towards the best DLS classification (lowest premium) by improving their risk profiles; and

(d) the revised DLS Framework should depend on accurate, reliable and timely information.

4.2 PIDM has carried out a comprehensive review on the existing quantitative and qualitative criteria. The thresholds for each indicators were tested based on the current and expected developments in the operating environment. Further reviews and tests were performed on the distribution of the results of the indicators to ensure its applicability over the business operating environment. PIDM also considers the alignment with the current regulatory and supervisory policies, fairness to all members, the average industry performance, as well as peer positioning of the members.

4.3 PIDM concludes that most of the indicators remain relevant. Nonetheless, we propose several revisions to enhance the quantitative criteria for a more comprehensive assessment.

4.4 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 DETAILS OF PROPOSED REVISED INDICATORS FOR GENERAL INSURANCE BUSINESS

Receivable Ratio

$$\frac{\text{Insurance Receivables}}{\text{Gross Premiums}} \times 100\%$$

5.1 Receivable ratio has been a good indicator since the implementation of the DLS Framework. In order to make the ratio more effective and reflective of the current operating environment, PIDM proposes to make some revision to the receivable ratio. We propose to revise the component of the total insurance receivables to recognise the total amount due from reinsurers or ceding companies at more than 90 days, instead of 60 days. This is in line with the practices of quarterly settlement of amounts due from reinsurers to members. The computation of total gross outstanding premiums and agents' balances remain unchanged, at more than 60 days.

5.2 With this proposal, the ratio is now more aligned with the impairment triggers that are generally used by the members. The information is also consistent and readily available in Bank Negara Malaysia ("BNM")'s Insurance Companies Statistical Submission.

5.3 In addition to the above, PIDM has also reviewed the scoring thresholds for receivable ratio. PIDM proposes that the existing threshold be revised to further promote operational efficiency and good business practices. The proposed thresholds is envisaged to be more reflective of the current position and trends of the industry. The corresponding scores for this indicator are as follows:

Table 1: Proposed thresholds for Receivable Ratio

Existing Thresholds	Proposed Thresholds	Score (%)
Receivable ratio ≤ 15.00%	Receivable ratio ≤ 10.00%	20
15.00% < Receivable ratio ≤ 20.00%	10.00% < Receivable ratio ≤ 15.00%	14
20.00% < Receivable ratio ≤ 25.00%	15.00% < Receivable ratio ≤ 20.00%	7
Receivable ratio > 25.00%	Receivable ratio > 20.00%	0

Feedback 1:
PIDM seeks feedback on the revised receivable ratio formula and thresholds.

Mean-Adjusted Return Volatility ("MARV") on Operating Profit/(Loss)

$$\frac{\text{Semi-standard deviation of operating profit/(loss) over 3 years}}{\text{Mean operating profit/(loss) over 3 years}}$$

5.4 PIDM considers the sustainability of earnings to be an important criterion in differentiating the risk profile of members, in addition to its ability to generate profits. Sustainability of earnings can serve as a critical determinant of a member resilience. Volatile earnings trend will render the members capital positions more vulnerable in the event of losses as capital may be eroded if the earnings are inadequate to absorb the losses.

5.5 In this regard, PIDM proposes to introduce MARV to replace the operating margin ratio for general insurance business. MARV is used to measure the downside risk of profitability. It gauges the downside volatility of the profits over a three -year period, and hence provides an indication on its sustainability, instead of a one-year assessment on the profit performance under the operating margin ratio.

5.6 MARV is calculated as the semi-standard deviation of a general insurer member operating profit/(loss)[3] over a three-year period divided by its mean operating profit/(loss) over the same period.

5.7 The proposed thresholds and the corresponding scores for this indicator are as follow:

Table 2: Proposed thresholds for MARV

Proposed Thresholds	Score (%)
$0 \leq$ MARV ≤ 0.2	15
$0.2 <$ MARV ≤ 0.5	10
MARV > 0.5	0
MARV is negative or the mean operating profit/(loss) is zero	0

Note:
An insurer member which has less than three (3) years of operating profit/(loss) data shall not be assigned a score under this ratio. In such a case, the scores for this ratio shall be determined on a proportionate basis as specified in the Insufficient Quantitative Information section of the DLS Guidelines.

3 Similar definition as per DLS Guidelines.

5.8 Illustrations for the computation of MARV:

Formula:

$$\frac{\text{Semi-standard deviation of operating profit/(loss) over 3 years*}}{\text{Mean operating profit/(loss) over 3 years}}$$

$$\text{* Semi-standard Deviation} = \sqrt{\frac{1}{(n-1)} \times \sum_{i=t}^{t\text{-}2} (r_i - \text{Mean})^2 \text{, only when } r_i < \text{Mean}}$$

where,
r_i = operating profit
Mean = the average operating profit over 3 years
t = preceding assessment year
t-1 = one year before the preceding assessment year
t-2 = two years before the preceding assessment year
n= number of observations. i.e. 3

Illustration 1:

Insurer Member A
Operating Profit for 2012 (RM' mil) : 240 (r_{t-2})
Operating Profit for 2013 (RM' mil) : 150 (r_{t-1})
Operating Profit for 2014 (RM' mil) : 180 (r_t)

$$\text{Mean} = \frac{240 + 150 + 180}{3} = 190$$

Given the operating profit for 2013 (r_{t-1}) and 2014 (r_t) were less than the mean of RM190 million, the semi-standard deviation will be computed as follows:

$$\text{Semi-standard deviation} = \sqrt{\frac{(0)^2+(150\text{-}190)^2+(180\text{-}190)^2}{(3\text{-}1)}}$$

$$= \sqrt{\frac{1{,}700}{2}}$$

$$= 29.15$$

$$\text{Mean-Adjusted Return Volatility} = \frac{\text{Semi-standard deviation of operating profit}}{\text{Mean operating profit}}$$

$$= \frac{29.15}{190}$$

$$= 0.15$$

In this case, insurer member A scores 15% for this indicator.

Illustration 2:

Insurer Member B

Operating Loss for 2012 (RM' mil) : (60) (r_{t-2})
Operating Profit for 2013 (RM' mil) : 100 (r_{t-1})
Operating Profit for 2014 (RM' mil) : 150 (r_t)

$$\text{Mean} = \frac{(60) + 100 + 150}{3}$$

$$= 63.33$$

Given the operating loss for 2012 (r_{t-2}) was less than the mean of RM63.33 million, the semi-standard deviation will be computed as follows:

$$\text{Semi-standard deviation} = \sqrt{\frac{(-60-63.33)^2+(0)^2+(0)^2}{(3-1)}}$$

$$= \sqrt{\frac{15{,}210.29}{2}}$$

$$= 87.21$$

$$\text{Mean-Adjusted Return Volatility} = \frac{\text{Semi-standard deviation of operating profit}}{\text{Mean operating profit}}$$

$$= \frac{87.21}{63.33}$$

$$= 1.38$$

In this case, insurer member B scores 0% for this indicator.

Feedback 2:
PIDM seeks feedback on the proposed indicator, MARV, including the range of results and the proposed scores.

6.0 DETAILS OF PROPOSED REVISED INDICATOR FOR LIFE INSURANCE BUSINESS

Expense Ratio

$$\frac{\text{Management Expenses}^{4} + \text{Agency Remuneration}^{4}}{\text{Net Premium Income}^{4}} \times 100\%$$

6.1 PIDM proposes to introduce the expense ratio to replace the return on required capital ratio. In view of the competitive market, and the ongoing regulatory initiatives to allow greater flexibility to members in managing 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. This ratio will also be a good addition to the operational and sustainability assessment of the members.

6.2 The expense ratio is calculated by benchmarking management expenses and agency remuneration of a member against the premium income generated. It measures the expenses incurred to produce every ringgit of premium income. In other words, it indicates how efficient the member is in managing its expenses to generate premium income.

6.3 The proposed thresholds and the corresponding scores for this indicator are as follow:

Table 3: Proposed threshold for Expense Ratio

Proposed Thresholds	Score (%)
Expense Ratio < 20%	15
20% ≤ Expense Ratio < 30%	10
30% ≤ Expense Ratio < 40%	5
Expense Ratio ≥ 40%	0

Feedback 3:
PIDM seeks feedback on the proposed expense ratio indicator, including the proposed thresholds and scores.

[4] As defined under the BNM's Guidelines for Insurance Companies Statistical Submission.

Feedback 4:
PIDM seeks feedback on any other indicators or matters related to DLS Framework.

Perbadanan Insurans Deposit Malaysia
13 March 2015

APPENDIX 1: PROPOSED REVISED DLS FRAMEWORK

	Quantitative	+	Qualitative
Criteria Approach	**Quantitative**	+	**Qualitative**
Weightages	**60%**		**40%**

Criteria Components

Quantitative

	All Insurer Members	
Capital	Free Capital Index ("FCI")	
	General Insurance Business	Life Insurance Business
Operational & Sustainability Measures	• Gross Premium Growth Rate (20%) • Business Diversification Ratio (25%) • **Receivable Ratio** (20%) • Combined Ratio (20%) • **Mean-Adjusted Return Volatility on Operating Profit/(Loss)** (15%)	• New Business Growth Rate (15%) • Business Concentration Ratio (25%) • Business Conservation Ratio (25%) • Investment Yield (20%) • **Expense Ratio** (15%)

Qualitative

All Insurer Members
• BNM Supervisory Rating (Composite Risk Rating) • Other Information

Scoring Approach

Quantitative – **Matrix Approach**:
The FCI together with the Operational & Sustainability Measures determine the position of an insurer member in the matrix.
The position of the insurer member in the matrix would determine the quantitative score of DLS Framework which carries a maximum score of 60%.

Qualitative – The Supervisory Rating holds a maximum score of 35%, while the remaining score of 5% is assigned to 'Other Information'