

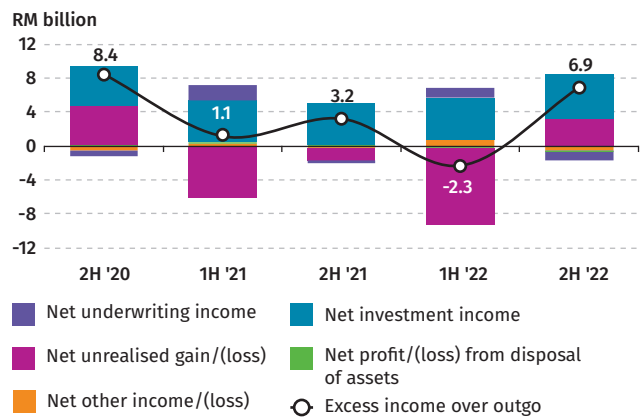
THE INSURANCE AND TAKAFUL SECTOR

Profitability of insurance and takaful funds recovered on the back of improved investment performance

In the second half of 2022, overall profitability of insurance and takaful funds improved compared to earlier in the year due to better investment returns. Life insurance and family takaful funds recorded higher net unrealised gains from investments as bond yields fell and equity markets improved, particularly towards the end of the year, resulting in positive excess income over outgo (Chart 2.21). However, for the year as a whole, profitability of life insurance and family takaful funds remained below pre-pandemic levels, reflecting the volatile financial market conditions, especially in the first half of the year.

Underwriting performance was adversely affected by an increase in medical payouts (2H 2022: RM4.3 billion; 1H 2022: RM3.5 billion; 2020-2021 half-yearly average: RM2.9 billion). This was mainly driven by higher claims associated with both necessary and elective medical procedures which were postponed during the pandemic, as well as medical inflation. Going forward, medical payouts are expected to rise further in line with the cost of medical treatments and normalisation of claims patterns to its long-term trends. The impact of medical inflation on insurers and takaful operators (ITOs) is expected to be manageable as premiums and contributions for medical products are reviewed periodically to take into account emerging claims experience. This helps to align the price of insurance and takaful coverage with the cost of providing such coverage.⁷ Nonetheless, ongoing efforts from various stakeholders to address medical inflation will remain important to preserve access to affordable medical insurance and takaful coverage. This includes measures to promote greater cost transparency, advocate greater oversight of medical treatment costs, and improve the design of product and payment options to better suit consumer needs and promote responsible behaviours.

Chart 2.21: Life Insurance and Family Takaful Fund – Composition of Income and Outgo

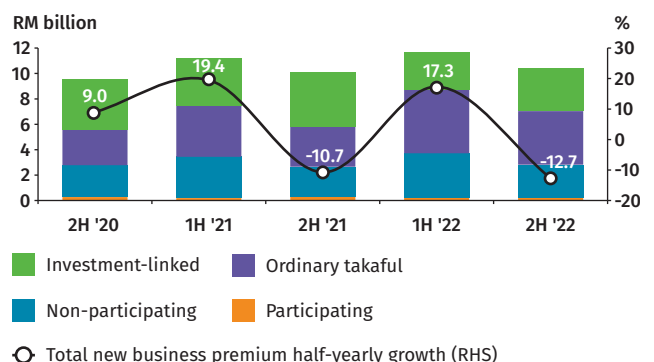


Note: 1. Data excludes investment-linked unit funds.
2. Net underwriting income refers to excess of net premium after deducting benefit payouts, agency remuneration and management expenses.

Source: Bank Negara Malaysia

The decline in underwriting income has also been on account of new business premiums declining. This was consistent with general seasonal trends (Chart 2.22) with the exception of Mortgage Reducing Term Takaful products which continued to trend upwards on the back of improving property market activity. Investment-linked new business premiums also grew by 12.5% in the second half of the year (2H 2015-2019 average: 17.4%), reflecting the intensification of campaign rollouts by ITOs in the latter half of the year to achieve year-end sales targets.

Chart 2.22: Life Insurance and Family Takaful Sector – New Business Premium Growth and Product Composition

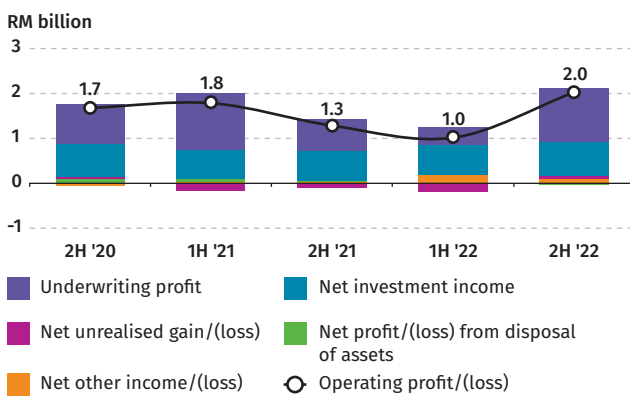


Source: Bank Negara Malaysia

⁷ Refer to the box article on 'Evaluating the Impact of Medical Repricing Deferrals on Life Insurers and Family Takaful Operators' in the BNM Financial Stability Review for First Half 2021 for further details.

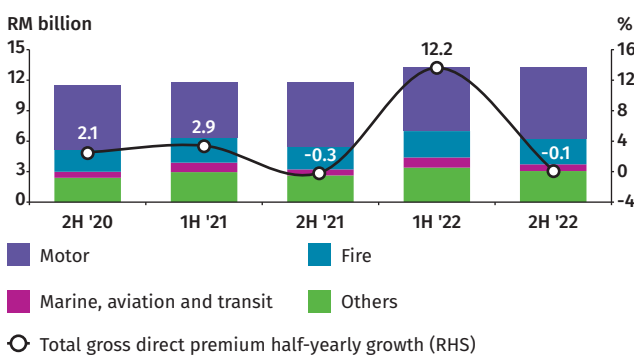
For general insurance and takaful funds, operating profit in the second half of 2022 strengthened (Chart 2.23), driven by stronger underwriting and investment performance. The higher underwriting profits mainly reflected the absence of large claims recorded in the first half of 2022 in the aftermath of severe floods at the end of 2021. Meanwhile, gross direct premiums continued to be supported by the continued growth in motor premiums amid high vehicle delivery for orders made during the sales tax exemption period.⁸ The fire segment also recorded a smaller decline in premiums in the second half of 2022 compared to the previous year with the recovery in property market activities (Chart 2.24). Given the significant contribution to underwriting performance from these two major lines of business, the ongoing gradual liberalisation of applicable insurance tariffs will have an important bearing on future performance.

Chart 2.23: General Insurance and Takaful Fund – Composition of Operating Profits



Source: Bank Negara Malaysia

Chart 2.24: General Insurance and Takaful Sector – Gross Direct Premium Growth and Product Composition



Source: Bank Negara Malaysia

⁸ The registration deadline with the Road Transport Department (JPJ) was extended to 31 March 2023, for buyers who booked their cars by 30 June 2022 under the sales tax exemption period.

In the reinsurance market, recent renewals indicate signs of hardening. ITOs reported increased reinsurance rates on renewal of cover, higher reinstatement cost for reinsurance coverage when limits are exhausted, and higher deductible thresholds that apply for claims, especially for excess of loss treaties.⁹ More onerous clauses such as loss participation clauses which require ITOs to partially contribute to reinsured losses, have also been introduced. In addition, ceding commissions paid to ITOs have been on a reducing trend. The hardening in the reinsurance market has been driven mainly by large losses from natural catastrophes in recent years leading to reduced global capacity. ITOs expect the hardening cycle to persist in the near term. While this could place upward pressure on direct premium rates, particularly affecting costs borne by businesses for commercial insurance, steps being taken by ITOs to optimise their reinsurance programmes would help moderate the impact on business costs. Any impact is further mitigated by the relatively low contribution of insurance costs to total business costs. The Bank continues to monitor the impact of developments in this area on end-consumer premiums and the adequacy of reinsurance arrangements put in place by ITOs to protect against a more volatile claims environment.

To date, most (80%) ITOs have entered the next phase of liberalisation of motor and fire tariffs,¹⁰ having met the requisite prudential and market conduct conditions and committed to plans to digitalise their motor claims process. ITOs have been observed to use the pricing flexibility accorded by the liberalisation to better capture the underlying risks within their product segments and improve product offerings with new and more innovative design features to preserve affordability amid increasing competition (e.g., pay as you drive products). With the resumption of travel activities and normalisation of motor claims, motor premium rates which were lowered during earlier periods when movement control orders were in place have also started to normalise in line with claims experience. Overall, these developments have had a relatively modest impact, with motor rates staying within a +/- 15% band from the previous tariff rates,

⁹ Refers to types of reinsurance contracts/retakaful certificates that protect ITOs from particularly large or catastrophic losses, where re-ITOs agree to cover a portion of losses that exceed a certain threshold.

¹⁰ Greater pricing flexibilities for motor and fire products will be accorded to ITOs that meet the Bank's expectations and requirements on reforms to the motor claims ecosystem.

while fire tariff rates have been reduced by 15% for the more profitable segments with greater flexibility provided to match the underlying risk. Adjustments to premiums and contribution rates have also continued to take place in a gradual manner.

Looking ahead, ITOs will remain susceptible to heightened financial market volatility given their sizeable bond and equity investments. The upwards reversion of medical claims to their long-term trend will also have some impact on profitability in 2023, as mobility continues to normalise. Over the longer term, the impact of COVID-19 variants on premium growth and profitability remains to be seen, as higher awareness can lead to both higher demand for insurance and higher related claims. The ongoing phased liberalisation of motor and fire tariffs may weigh on the performance of some general ITOs in the short-term given higher competition for market share. However, in the longer run, premium adjustments that are commensurate with the risk of individual segments will support risk-based pricing consistent with a more sustainable business model and aligned with efforts to encourage safe driving. This in turn is necessary to preserve the continued provision of protection coverage by the private sector. The Bank will continue to monitor developments in rate adjustments to ensure that any adjustments (upwards or downwards) do not create market dislocations that could affect access to coverage or disproportionately impact segments of the insured population. In addition, the increasing severity and frequency of flood-related claims¹¹ underscores the susceptibility of general ITOs' profitability to climate-related risks. The demand for insurance protection is anticipated to rise moving forward as climate events continue to manifest. Hence a more robust approach to managing climate-related risks will be crucial, along with strong capital and sound reinsurance arrangements, to ensure that ITOs are adequately resilient to potential downside risks.

Another notable development in the industry is the coming into force of MFRS 17 Insurance Contracts on 1 January 2023.¹² In general, the new accounting standard does not significantly affect short-term insurance/takaful contracts as the effect of the

new measurement model is similar to that used in MFRS 4. However, for long-term insurance or takaful contracts, more consistent applications of accounting treatments under MFRS 17 along with the explicit recognition of unearned income through a "contractual service margin" could more fundamentally affect the measurement and presentation of insurance contracts in financial statements by life and family ITOs. Based on a survey conducted by the Bank, all ITO respondents expect shareholders' equity positions to still remain positive under the new accounting standard. The degree to which the financial results and operations are affected, however, will vary across companies, depending on their business mix, and the assumptions and methods used to derive liabilities under the new measurement approach.¹³ For example, some life and family ITOs expect to report higher shareholders' equity under the new standard as higher liabilities arising from the recognition of contractual service margins are offset by other changes in assumptions and methodology.

The implementation of MFRS 17 will not materially affect regulatory capital requirements¹⁴ as the Bank's Risk-Based Capital Framework (RBCF), including the basis for valuation of insurance and takaful liabilities, remains applicable for ITOs. The Bank's current basis for valuation of insurance and takaful liabilities under the RBCF differs from MFRS 17 but remains prudent as it requires ITOs to consistently provision for the risk of adverse deviation, use risk-free rates to discount guaranteed cashflows, and adopt prudent valuation methodologies.¹⁵ Nonetheless, the Bank is conducting a review of the existing RBCF, taking into account market and technical developments since it was first issued in 2009 (for insurers) and 2012 (for takaful operators). In light of changes in the financial reporting requirements and the ongoing review of the RBCF, Perbadanan Insurans Deposit Malaysia (PIDM) is also currently consulting on an approach to simplify the Differential Levy Systems Frameworks for insurance companies and takaful operators to reflect these changes.¹⁶

¹¹ Total losses from the 2021 flood event stood at RM2.2 billion, approximately seven times higher than the largest recorded losses in the past decade (2017: RM 323.4 million).

¹² MFRS 17 Insurance Contracts contains more comprehensive accounting treatments for insurance and takaful contracts and will supersede MFRS 4 Insurance Contracts. The application of MFRS 17 is expected to provide more relevant information on the impact of insurance contracts on an entity's financial position and performance.

¹³ The MFRS 17 introduces a measurement model which is applied to all insurance contracts, consisting of fulfilment cash flows (discounted present value of cashflows adjusted for non-financial risk) and the contractual service margins (the unearned profit from the contract).

¹⁴ Except for marginal impact from the reclassification of financial assets.

¹⁵ For example, setting up of sterling reserves for non-unit liabilities of investment-linked business.

¹⁶ For further details, please refer to the PIDM Consultation Paper on the Proposed Revised Differential Levy Systems Frameworks (<https://www.pidm.gov.my/pidm2022/media/downloads/2023/CP/Consultation-Paper-on-DLS-Frameworks.pdf>).

Moving ahead, the insurance and takaful sector is expected to remain resilient, supported by strong capital and liquidity positions. The aggregate industry capital adequacy ratio of 226% remains well above the regulatory minimum of 130% (Chart 2.25). Capital buffers in excess of regulatory requirements stood at RM37.5 billion. Macro stress tests conducted by the Bank also affirm that under adverse scenarios, most insurers would remain resilient with sufficient capital buffers (refer to the section on 'Assessing the Resilience of Financial Institutions' for more details).

Chart 2.25: Insurance and Takaful Sector – Capital Adequacy Ratio

