

# THE INSURANCE AND TAKAFUL SECTOR

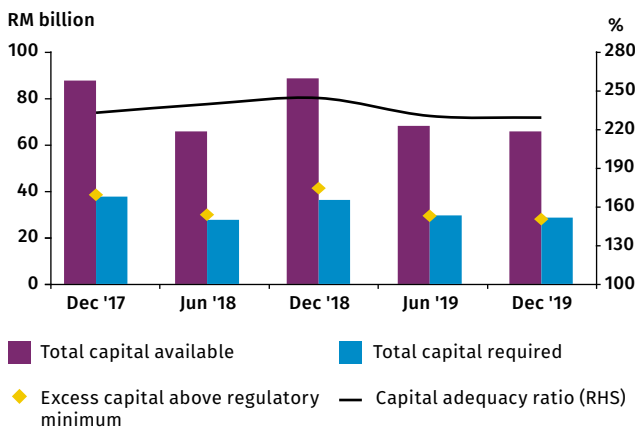
## The Insurance and Takaful Sector Remains Well-capitalised

The insurance and takaful sector maintained strong capital buffers throughout the second half of 2019, well above the prescribed regulatory level of 130% (Chart 2.8). Capital buffers held against insurance and takaful risk, the largest component of total capital required, have remained largely stable in line with the relatively benign claims environment. However, the low interest rate environment in recent years has increased the capital buffers that insurers and takaful operators (ITOs) are required to hold against market risk exposures. While this could pose some challenges, particularly for the performance of life insurance and family takaful funds if interest rates fall further, it is not expected to have a material impact on insurers' profitability or solvency (refer to the Information Box on 'Assessing the Impact of Declining Interest Rates on Life Insurers' Solvency Positions').

Profits in the life insurance and family takaful sector were supported by investment gains from holdings of debt instruments

**Chart 2.8: Insurance and Takaful Sector – Capital Adequacy Ratio**

**Aggregate capital adequacy ratio remained well above the regulatory minimum of 130%**



Source: Bank Negara Malaysia

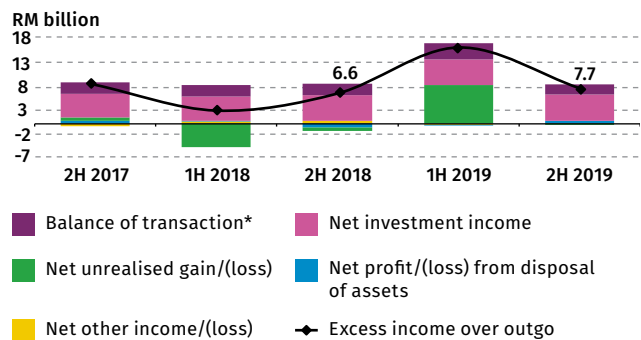
On aggregate, the insurance and takaful sector recorded higher profits<sup>7</sup> in the second half of 2019 compared to the same period in 2018. This was mainly attributed to better performance in the life insurance and family takaful sector (Chart 2.9) arising from gains on investments in debt instruments as interest rates declined. Overall returns on investments correspondingly trended higher (2H 2019: 2.6%; 2H 2018: 1.9%), offsetting the weaker performance of insurers' equity investments.

Life insurers and family takaful operators' income continued to be underpinned by growth in net premiums from both existing and new business. New premiums sustained the strong growth recorded in the first half of 2019, driven by higher sales of ordinary takaful policies, and non-participating endowment and term-life products (Chart 2.10). The strong growth of ordinary family takaful business largely reflected sustained sales of mortgage and credit-related takaful products during the period.

Investment-linked business sustained its growth at 7% for the full year of 2019. Despite adjustments to new regulatory requirements<sup>8</sup> to improve policyholder outcomes which came into effect in July 2019, new

**Chart 2.9: Life Insurance and Family Takaful Sector – Composition of Income and Outgo**

**Higher excess income over outgo driven by net unrealised gains**



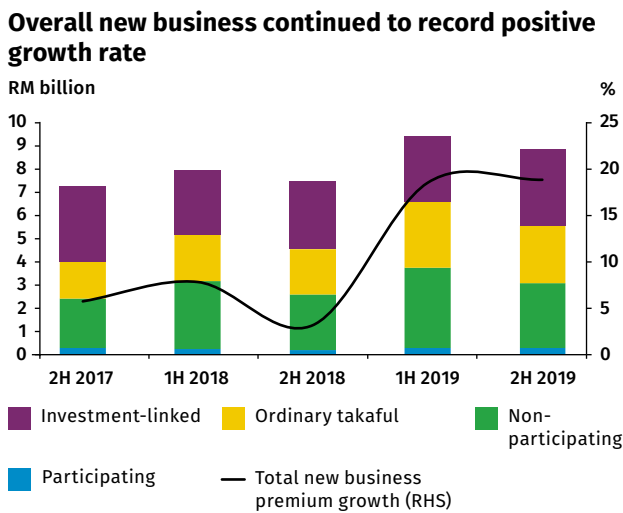
\* Excess of net premium after deducting benefit payouts, agency remuneration and management expenses

Source: Bank Negara Malaysia

<sup>7</sup> For life insurance and family takaful business, profits refer to excess income (net premiums) over outgo (benefit payouts, agency remuneration and management expenses) of the life insurance and family takaful funds.

<sup>8</sup> ITOs have to comply with requirements on the Minimum Allocation Rate, which specifies the minimum proportion of premiums/contributions for investment-linked policies/certificates to be allocated to the unit funds, and the Sustainability Test, which requires investment-linked premiums/contributions to be set at sustainable levels to ensure coverage is able to last for the entire expected term. These requirements will be implemented in phases from July 2019 to July 2020.

**Chart 2.10: Life Insurance and Family Takaful Sector – New Business Premium Growth and Product Composition**



Source: Bank Negara Malaysia

business performed better (+11%) in the second half of 2019 relative to the same period last year. It remains too early to assess the impact of the requirements on longer-term profitability. However, ITOs have taken various measures to manage the impact, including refining their product designs, increasing reinsurance/retakaful support or rebalancing business portfolios. This is expected to mitigate any longer-term effects on profitability although the extent of adjustments by ITOs will only become clearer in the coming year.

Business performance also benefitted from improvements in persistency following the implementation of the Balanced Scorecard (BSC) initiative, which better aligns sales incentives with the quality of advice provided to individuals who buy insurance or takaful products. In 2019, more than 800 additional agents recorded persistency rates<sup>9</sup> above 90% in the first year. Continued improvements in sales practices driven by the BSC are expected to lend support to premium growth while reducing mis-selling risks.

In the general insurance and takaful sector, profitability declined in the second half of 2019 mainly due to higher motor claims paid (+6%) (Chart 2.11). Going forward, several factors are expected to continue to drive higher claims in the motor segment. Amendments to the Civil Law Act 1956 and the Compendium of Personal Injury

<sup>9</sup> Refers to a new product sold/marketed (other than a single premium or contribution product) which remains in force at the end of the following policy or certificate year.

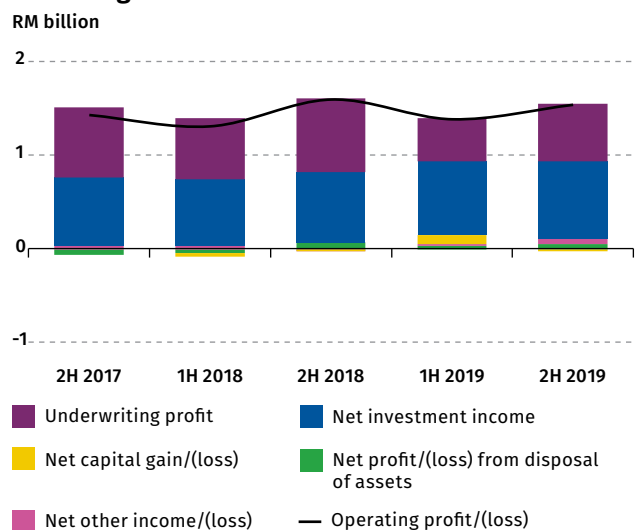
Awards which came into effect in September 2019 and October 2018, respectively, have increased the scope and amount of compensation payable for loss of life, loss of earnings, loss of dependency and personal injury. This is expected to add up to 3.3% to average claims costs for third party bodily injury and passenger liability claims.

Profitability of the general insurance and takaful sector declined due to weaker underwriting performance, particularly in the motor segment

In addition, repair costs for newer vehicle models have continued to trend higher. The increased pricing flexibility accorded to ITOs under the phased liberalisation of Motor Tariffs has partly relieved higher claims cost pressures on overall underwriting performance. However, premium adjustments have largely remained modest, falling within a 10% band around tariff rates for most policies, reflecting both regulatory guidance and competitive pressures in the industry. Ongoing consultations with the Government and industry on the next phase of liberalisation are focusing on providing stronger incentives for road safety

**Chart 2.11: General Insurance and Takaful Sector – Composition of Operating Profits**

**Slight deterioration in operating profits attributed to lower underwriting profit, particularly in the motor segment**



Source: Bank Negara Malaysia

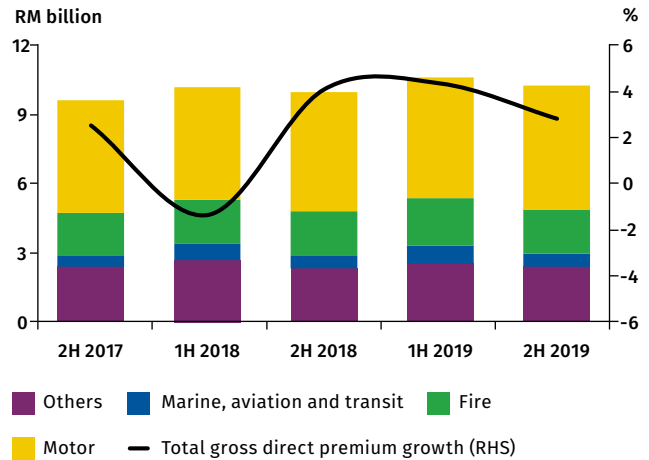
and increasing transparency in the assessment of claims as well as repair costs in order to keep premiums affordable. This remains critical to preserve access to motor insurance without undermining the solvency of ITOs.

The overall performance of general ITOs continues to be largely supported by premium growth in the motor and fire segments which collectively account for more than 70% of total premiums (Chart 2.12). In 2019, premium growth in these segments moderated slightly in line with lower motor vehicle sales and more competitive pricing of new fire products.<sup>10</sup> The gradual liberalisation of the fire tariffs could pose continued pressure on profits although ITOs are expected to maintain positive underwriting margins given the historically favourable claims experience.

The COVID-19 pandemic and the consequent impact on economic activity and financial markets will adversely affect premium and contribution growth in 2020. In response to the pandemic, the Bank has also supported a number of measures by ITOs to preserve continuous coverage for policyholders and takaful participants who are experiencing financial constraints as a result of the pandemic. These include additional flexibility for policyholders and takaful participants to reinstate or make alterations to their policies in order to preserve coverage, the waiver of certain fees and charges, and the option of deferring payments of premiums and contributions without affecting their coverage.

**Chart 2.12: General Insurance and Takaful Sector – Gross Direct Premium Growth and Product Composition**

**Gross direct premium grew at a slower pace**



Source: Bank Negara Malaysia

Based on internal assessments, the impact of the slower premium and contribution growth and relief measures can be absorbed by the ITOs without affecting claims paying ability. The Bank has also taken steps to reflect planned enhancements to the capital framework for ITOs which aim to improve the risk capture and overall consistency of the framework. These enhancements are expected to cushion any impact of the relief measures on solvency, and reduce risks of pro-cyclical behaviour by ITOs in response to significant volatility experienced in the financial markets. The measures taken are expected to enable ITOs to continue supporting households and businesses in managing their risks through these exceptional circumstances.

<sup>10</sup> Under the phase 1 of the tariff liberalisation, general ITOs are able to introduce new products and add-on covers priced at market-determined rates.

## Assessing the Impact of Declining Interest Rates on Life Insurers' Solvency Positions

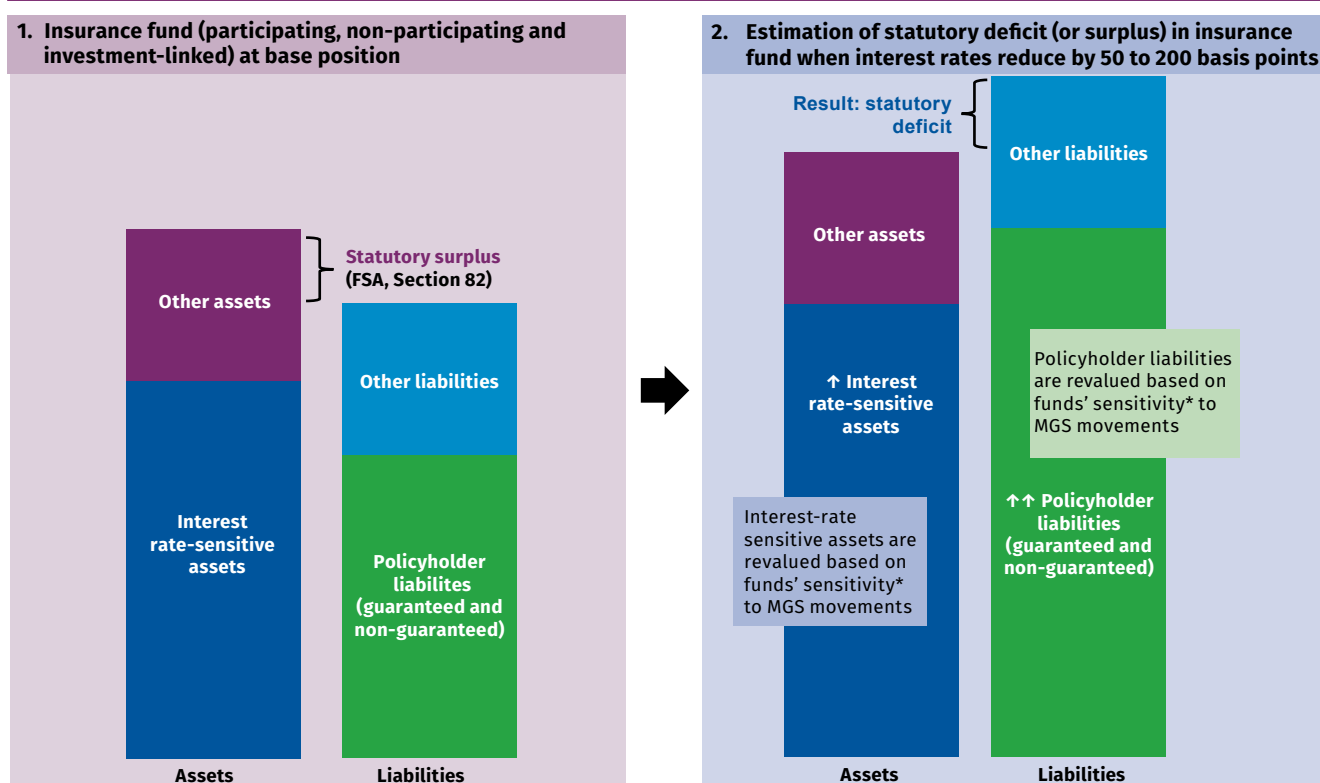
### Background

Life insurance companies generally operate with a negative duration gap given the lack of long-term financial assets available to match the duration of their liabilities arising from products with much longer policy terms of more than 15 years. As a result, declining interest rates can have a bigger impact due to upward adjustments in the value of liabilities<sup>11</sup> that exceed assets. This in turn will reduce a life insurer's solvency position. Given the prolonged low interest rate environment, a sensitivity analysis was carried out to assess Malaysian life insurers' solvency positions under declining interest rate scenarios.

### Methodology

The sensitivity analysis assessed the change in value of life insurers' assets and liabilities for each fund (i.e. participating, non-participating and investment-linked funds) following parallel declines in interest rates ranging from 50 basis points (bps) to 200 bps. The assessment is undertaken separately for each fund in line with requirements<sup>12</sup> for insurers to maintain minimum solvency positions at the fund level. In assessing the impact on funds' solvency positions, the assessment excludes additional buffers within shareholders' funds and fungible surpluses from other funds that can typically be applied to offset any deficit that might arise. Results at the fund level are then used to estimate the impact to the capital adequacy ratio (CAR) at the company level. For this analysis, the value of non interest rate-sensitive assets is assumed to remain constant. This assumption is considered conservative as assets such as equities and properties typically appreciate in value when interest rates decline (Diagram 2.1).

Diagram 2.1: Illustration on Sensitivity Analysis Approach



\* Sensitivity refers to the expected changes in valuation of assets and liabilities of a particular fund as interest rates move downwards by 100 basis points

Source: Bank Negara Malaysia

<sup>11</sup> Insurance liabilities are derived by computing the net present value of future benefit payouts and expenses. The risk free rate or the internal rate of return are typically used as the discount factor.

<sup>12</sup> Based on the Financial Services Act 2013 (FSA), all licensed insurers are required to maintain assets in an insurance fund of a value equivalent to or higher than the liabilities of that fund.

### Results and findings

Based on the sensitivity analysis, the Malaysian life insurance sector is expected to remain resilient with the aggregate industry CAR sustained above the prescribed regulatory level of 130% even under a scenario of 200 bps parallel decline in interest rates. The results reflect the favorable claims experience and relatively strong pricing power that life insurers have. Out of 42 funds offered by all 14 life insurers, only four insurance funds of three life insurers were insolvent under the different scenarios. In aggregate, these funds account for 1.5% of the total value of all life insurance funds (Table 2.1). In each case, the insurance companies have adequate capital buffers to support the insolvent funds.

**Table 2.1**

#### Impact of Interest Rate Reduction on Insurance Funds' Solvency

Interest Rate Reduction (bps)	Number of Funds Becoming Insolvent			Size of Insolvent Funds (% of Total Life Insurance Industry Fund)
	Participating	Non-participating	Investment-linked	
-50	-	-	-	-
-100	-	-	-	-
-150	-	2	1	0.8
-200	-	3	1	1.5

Source: Bank Negara Malaysia

The impact of interest rate shocks on individual funds, largely depends on the type of fund (Table 2.2), which influences the expected cash flows and discount rates applied. The impact on non-participating funds was the most pronounced relative to other funds given that their liabilities are all guaranteed and hence, are valued using risk-free discount rates i.e. MGS yields.

Participating funds on the other hand, were less sensitive to interest rate movements relative to non-participating funds. This reflects the nature of a participating policy, which comprises both guaranteed and non-guaranteed benefits. Non-guaranteed benefits represent the share of the insurer's business profits attributable to the policyholders, which may vary over time depending on the fund's business and investment performance. They are valued using a fund-based yield (FBY), which is more closely aligned to the risk profile and outlook of the participating fund, as the discount rate. The resulting valuation changes from a movement in the FBY therefore tends to be less sensitive to changes in interest rates compared to non-participating funds.

Investment-linked funds are also less sensitive to lower interest rates compared to non-participating funds. This reflects the feature of an investment-linked policy where any increase in the cost of insurance is borne by the policyholder's unit investment fund. If the policyholder's unit investment fund becomes depleted, the policy will lapse and the corresponding insurance liability of the insurer will cease. This reduces the expected amount of future net outflows and liabilities for the insurer.

**Table 2.2**

#### Average Sensitivity of Insurance Funds to 100 bps Decline in Interest Rates

	Participating	Non-participating	Investment-linked
Assets (%)	+8.0	+8.6	+5.9
Liabilities (%)	+12.4	+15.8	+7.4

Source: Bank Negara Malaysia