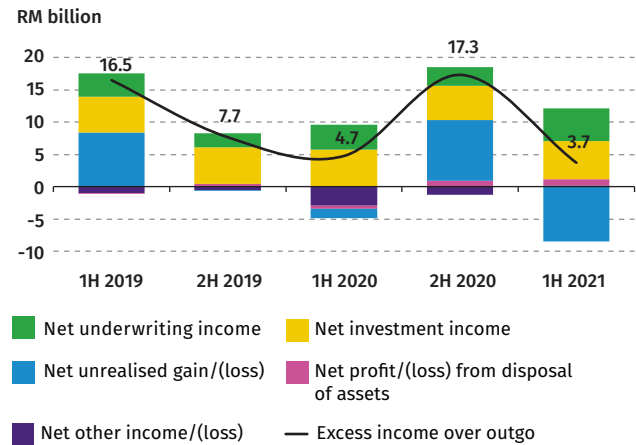


THE INSURANCE AND TAKAFUL SECTOR

The insurance and takaful sector recorded lower profitability, driven by weaker investment performance

The overall profitability of insurance and takaful funds was lower in the first half of 2021 compared to the same period in 2020. For the life insurance and family takaful funds, excess income over outgo declined to RM3.7 billion (1H 2020: RM4.7 billion) (Chart 2.23). This was driven by net unrealised losses from bond investments in line with the weaker bond market performance and, to a lesser extent, mark-to-market equity investment losses. Income from underwriting activities provided some support to profitability. Growth of new business premiums¹¹ recovered strongly at 30.2% (1H 2020: -7.1%), primarily driven by the investment-linked, Mortgage Reducing Term Assurance/Takaful (MRTA/MRTT), and medical and health business segments (Chart 2.24). This reflected the resumption of face-to-face product sales and property market activity as a result of less restrictive containment measures up until end-May. As noted in the previous publication of the Financial Stability Review, ITOs have also observed an increasing awareness among Malaysians on the important role that insurance and takaful can have in providing a financial safety net in times of uncertainty. This is expected to provide some lift to demand for insurance and takaful despite near term pressures on household incomes.

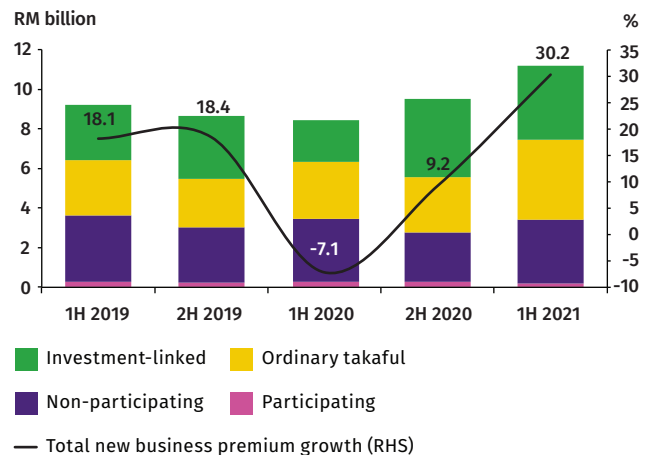
Chart 2.23: Life Insurance and Family Takaful Fund – Composition of Income and Outgo



Note: Net underwriting income refers to excess of net premium after deducting benefit payouts, agency remuneration and management expenses

Source: Bank Negara Malaysia

Chart 2.24: Life Insurance and Family Takaful Sector – New Business Premium Growth and Product Composition



Source: Bank Negara Malaysia

¹¹ Refers to both insurance premiums and takaful contributions, unless stated otherwise.

The impact on life and family ITOs from the temporary relief measures granted to policyholders¹² remained limited. Affected policyholders have been afforded the option to defer premiums due under life insurance policies and family takaful certificates for three months, without interruption in their coverage. This option, previously slated to expire by June 2021, has been extended until December 2021. Policyholders that have availed of the premium deferment option have continued to increase, although the amount of premiums deferred and covered by premium holidays¹³ remained relatively small at 8.3% of premiums in force (June 2021: 7.7%; March 2021: 6.5%).¹⁴ To account for heightened risks arising from the pandemic, some life and family ITOs have introduced additional underwriting measures, including questionnaires to assess the COVID-19 medical history and risk exposure of prospective policyholders. In selected

cases, affected policyholders could be subjected to additional underwriting conditions such as longer waiting periods. Higher premium loadings could also be imposed on policyholders with indications of higher risk to develop serious health conditions, although this would be largely dependent on further medical assessments undertaken on a case-by-case basis. Overall, such practices have so far not been widely observed to suggest a broader tightening of underwriting conditions across ITOs due to COVID-19.

The impact on ITOs' earnings from the premium deferrals as well as COVID-19 claims is expected to remain manageable, with ITOs assessed to be resilient against stressed scenarios assuming higher claims¹⁵ than observed thus far. Consistent with this, ITOs have not to date been dependent on the regulatory flexibilities accorded to them throughout the course of the pandemic.

¹² Refers to both insurance policyholders and takaful participants, unless stated otherwise.

¹³ A premium holiday refers to continued insurance/takaful coverage despite an absence of premium payments and applies to products with the premium holiday feature already in place such as investment-linked products. This flexibility is available to policyholders as long as the investment value in the unit fund remains sufficient to meet the necessary insurance cost during the premium holiday period.

¹⁴ Based on a cumulative amount from 27 March 2020 until 3 September 2021.

¹⁵ Assumptions under the stressed scenarios include: (i) COVID-19-related ex-gratia payments to policyholders and higher claims for policies without a pandemic clause; and (ii) a conservative increase in the general insurance claims ratio by up to 17%. Refer to the section on 'Assessing the Resilience of Financial Institutions' in the BNM Financial Stability Review for Second Half 2020 for further details.







Evaluating the Impact of Medical Re-pricing Deferrals on Life Insurers and Family Takaful Operators

Medical reimbursement insurance/takaful cover in Malaysia is typically designed to cover or reimburse, either fully or partially, the expenses arising from inpatient and certain outpatient medical treatments. In 2020, close to 7 million individual medical reimbursement policies/certificates were written by life insurers and family takaful operators. This represents a significant portion of life insurance and family takaful business, accounting for 68% of total protection insurance and takaful claims¹⁶ in 2020. This box examines trends in the claims experience of medical reimbursement insurance/takaful products, the effect of the pandemic, and the consequential impact on the re-pricing cycles of these products.

How are medical reimbursement insurance/takaful covers managed?

Medical reimbursement covers are typically designed with annually reviewable premium rates to reflect changes in the cost of treatment and propensity to utilise healthcare services. As these factors are difficult to predict in the long term, regular re-pricing is a standard feature of these products to ensure the sustainability of the medical insurance/takaful portfolios. Medical insurance/takaful portfolios become unsustainable when the premiums collected are insufficient to cover the expected claims cost, expenses, and profit margin of the ITOs. Key assumptions used to estimate the expected claims cost are the rate of medical claims inflation and the average cost per treatment or claim event. Similar to other countries, the cost of medical services in Malaysia has been increasing at a much faster pace than general price inflation (Table 2.2). The claims cost is also affected by changes in utilisation of healthcare services by policyholders, which may arise from demographic shifts and changes in lifestyle and behaviours. All these assumptions are combined to derive the expected claims cost which determines the required level of premiums.

Table 2.2: Comparison of Net Medical Trend Rates

	Net Medical Trend Rate* (%)		
	2019	2020	2021 (Projected)
Malaysia 	10.0	10.7	9.8
Singapore 	7.1	7.8	7.7
Global 	5.1	4.6	6.2
United States 	6.1	6.6	5.1
United Kingdom 	3.9	5.2	5.0
Australia 	4.9	4.6	4.2

*Medical trend rate net of general inflation

Source: 2021 Global Medical Trends Survey Report, Willis Towers Watson

¹⁶ Total protection claims are claims which arise from medical, death, and disability coverages, excluding surrender and maturity claims. This proportion includes medical claims from group and employer-based schemes.

The claims experience of medical reimbursement covers varies across ITOs, and even across the various products of the same ITO, on account of:

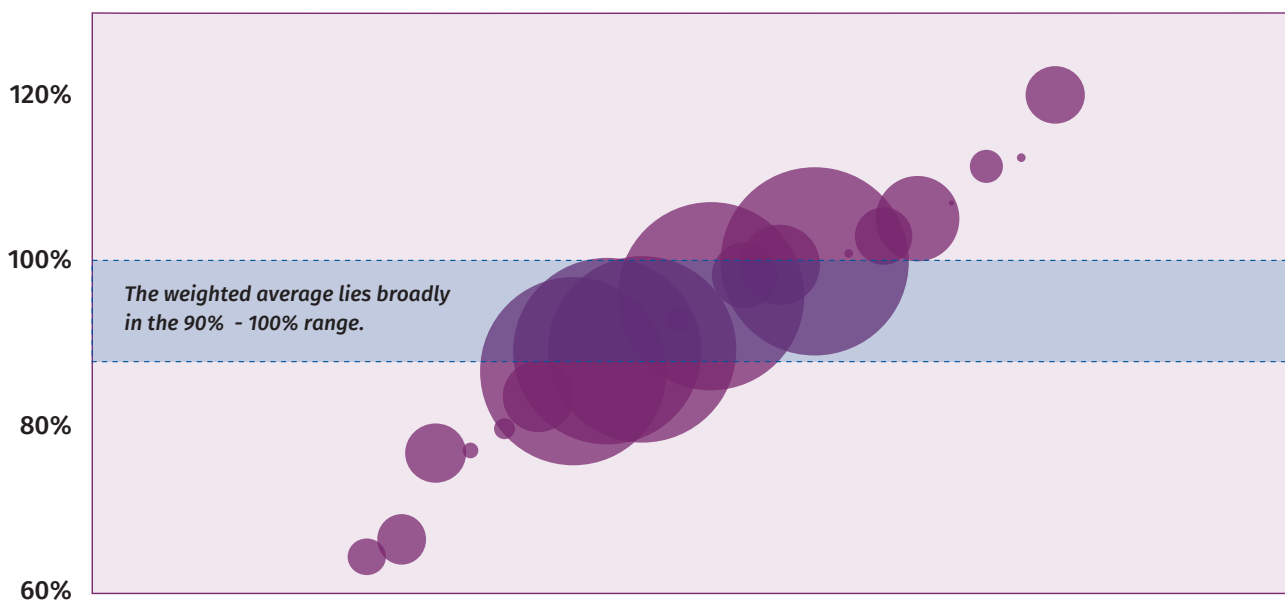
- (1) The risk profiles of individuals covered, such as age groups, which in turn affect the type of medical services utilised. For example, products covering individuals with older age profiles will likely exhibit higher medical claims inflation since the likelihood of requiring medical services and encountering surgical complications increases with age; and
- (2) Product features, which affect policyholders' tendency (and ability) to make a claim. For example, products with cost-sharing features often have lower claims payout compared to those without. In some countries, cost-sharing via deductibles or co-payments is mandated in their healthcare systems to contain the cost of medical services.

To maintain fair outcomes across policyholders, premiums are typically differentiated to take into account differences in claims experience between risks that are pooled together. For example, the premium levels for risk groups with higher tendency to claim and/or require more expensive treatments are generally set higher than those with lower risk profiles.

How has COVID-19 impacted the claims trend and what can be expected post-pandemic?

Over the period from 2015 to 2019, the combined ratio of life insurance and family takaful industry's individual medical portfolio lay broadly in the range between 90% and 100% (Diagram 2.1). It is observed that the combined ratio, which is the ratio of total claims paid and expenses to total premiums collected,¹⁷ displays a cyclical pattern of peaks and troughs that coincides with a three- to five-year re-pricing cycle commonly practised by ITOs.

Diagram 2.1: Distribution of Life Insurers and Family Takaful Operators' Total Medical Combined Ratios for the Period 2015 - 2019



Note: The size of the bubbles generally denotes the size of medical business by claims, averaged for the top 5 writers

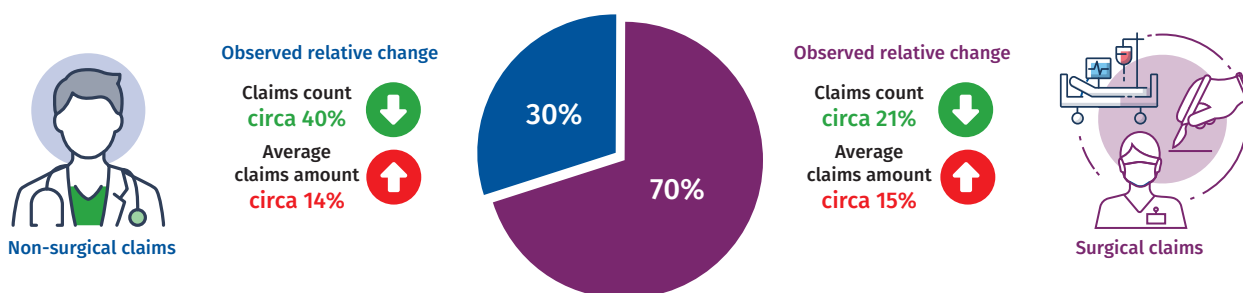
Source: Bank Negara Malaysia estimates

¹⁷ A combined ratio of 100% indicates that the premiums collected are fully depleted by claims and expenses, with no profit left for the ITO as a return for underwriting the portfolio.

In 2020, the combined ratios of the medical portfolios of ITOs decreased. It was observed that the lower claims were driven primarily by temporary factors, such as movement restrictions, reduced social contact due to the implementation of remote working and learning, and hesitation to seek non-critical medical treatment at hospitals during the pandemic. The number of claims in 2020 decreased compared with 2019, with most claims coming from critical treatments that could not be deferred. However, the reduction in the number of claims during the pandemic period was partially offset by the increase in the average cost per treatment of 14% for non-surgical treatments and 15% for surgical treatments (Diagram 2.2), which exceeded the respective long-term trends of 8% and 9% per annum.¹⁸ This was partly attributable to the more severe and urgent nature of illnesses being treated and claimed for, as well as additional costs arising from pandemic-related protocols such as lab tests for COVID-19 and higher utilisation of disposable medical supplies (including personal protective equipment).

Diagram 2.2: Claims Experience Over the Pandemic Period by Claims Type

Lower medical claims incidence but average medical claims inflation continued to rise during the pandemic period



Note: The annualised relative change in claims count and average claims amount is based on a comparison between 2019 experience to that over the pandemic period (2020 up to 1H 2021). The annualised relative change experienced by each individual life insurer and family takaful operator may differ from the above aggregate statistics

Source: Bank Negara Malaysia estimates using data from life insurers and family takaful operators with significant medical business

The number of claims is expected to normalise once the pandemic abates and movement restrictions are gradually lifted. Incidences of hospitalisation from common non-surgical treatments such as stomach flu and dengue fever are expected to return to past trends. Although the extent of the rebound in medical claims post-pandemic is uncertain, observations from other markets suggest the possibility of a temporary increase in utilisation of healthcare services. This can be contributed by a sharp increase in the number of claims compared to the pandemic period due to delayed non-critical treatments, and diagnoses from postponed medical visits by individuals who had earlier avoided going to hospitals due to COVID-19 concerns (Gardner and Fraser, 2021; Berlin et. al, 2020).

In the short term, the average treatment cost could also increase due to poorer health conditions worsened by delays in seeking treatment (Mathews and Cherney, 2020). Demand-supply dynamics may also push costs higher, particularly for hospital supplies and services that may increase due to higher demand. Based on 2018 claims data, hospital supplies and services accounted for 60% and 70% of claimable surgical and non-surgical treatment costs respectively in Malaysia.¹⁹ Further, higher charges from pandemic-related protocols are likely to persist in the foreseeable future.

Over the longer term, it is uncertain how the pandemic will affect underlying medical trends. The accelerated adoption of telehealth services by international insurers during the pandemic has been a notable development that could improve the efficiency of providing healthcare and reduce cost. However, balanced against this is the yet unknown effects of long COVID²⁰ in the insured population which could increase the utilisation of healthcare services (Aon, 2021; Willis Towers Watson, 2020).

¹⁸ The compounded annual growth rate from 2013 – 2018 of average billed amount based on an independent study commissioned by the industry through the Medical Cost Containment Task Force.

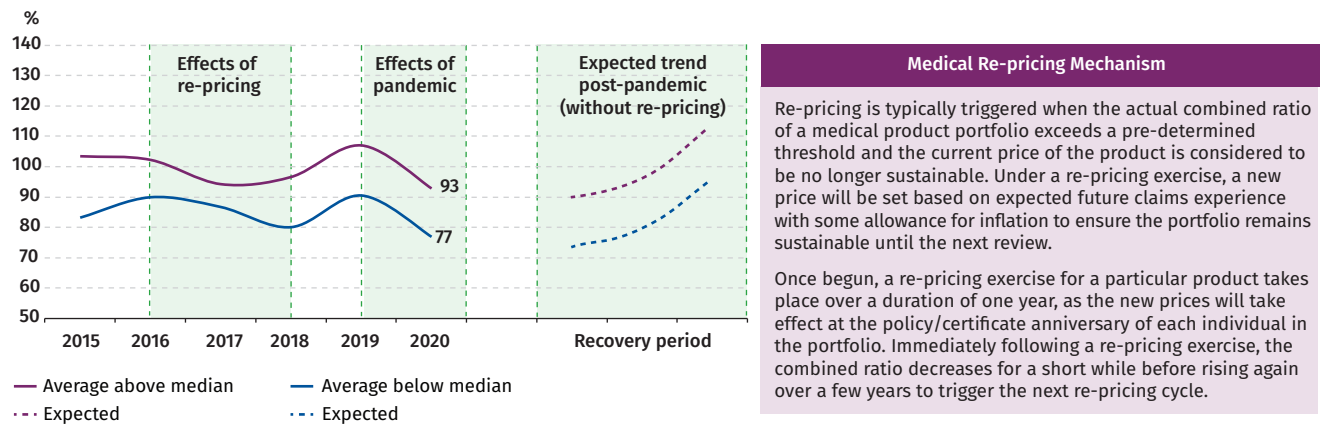
¹⁹ Based on the independent study commissioned by the industry through the Medical Cost Containment Task Force.

²⁰ Longer-term health conditions that may affect some patients after contracting COVID-19.

What is the impact of delaying the re-pricing cycle?

Notwithstanding these expected trends (Chart 2.25), most ITOs agreed to defer any earlier planned re-pricing exercises in 2020 to preserve the affordability of medical covers. ITOs will be carefully evaluating the risks of continuing to delay the re-pricing cycle, especially for portfolios with the highest combined ratios prior to the pandemic (Chart 2.26). For such portfolios, there is considerable risk that a sharp rebound in claims once the pandemic fears subside could lead to steeper or more frequent price increases in the near term. This could have a disproportionate impact on some individual policyholders given the larger adjustments made over a shorter period of time. In the takaful business, which is based on risk sharing between takaful participants, there could be additional concerns relating to fairness and equity if the medical tabarru' charges are not increased in line with risk expectations, as other takaful participants will be subsidising the losses attributed to medical claims to a greater extent than originally represented to participants.

Chart 2.25: Medical Combined Ratios from 2015 to 2020 and the Expected Impact of Delaying Re-pricing



Medical Re-pricing Mechanism

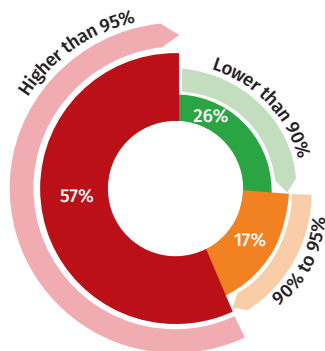
Re-pricing is typically triggered when the actual combined ratio of a medical product portfolio exceeds a pre-determined threshold and the current price of the product is considered to be no longer sustainable. Under a re-pricing exercise, a new price will be set based on expected future claims experience with some allowance for inflation to ensure the portfolio remains sustainable until the next review.

Once begun, a re-pricing exercise for a particular product takes place over a duration of one year, as the new prices will take effect at the policy/certificate anniversary of each individual in the portfolio. Immediately following a re-pricing exercise, the combined ratio decreases for a short while before rising again over a few years to trigger the next re-pricing cycle.

Note: Data represents yearly renewable individual medical insurance policies. The average combined ratio is aggregated for all life insurers that are higher or lower than the median life insurer for each calendar year. Data has been adjusted to address any data issues

Source: Bank Negara Malaysia estimates using data from life insurers

Chart 2.26: Distribution of Life Insurers and Family Takaful Operators by Pre-pandemic Medical Combined Ratios



Note: Data represents 2019 medical claims experience

Source: Bank Negara Malaysia estimates

What can be done to better manage the re-pricing of medical insurance/takaful business?

While re-pricing enables ITOs to manage the sustainability of their business, the Bank requires ITOs to implement re-pricing exercises in an objective and fair manner, based on actual past claims experience and expectations of future claims experience that are reasonable and supportable. Prior to the pandemic, the Bank was also concerned when ITOs delayed re-pricing exercises for too long as a competitive strategy. Lengthy delays are likely to result in sharp and unexpected premium adjustments subsequently to catch up with claims inflation. This may leave policyholders who are unable to afford the higher premiums with limited options to obtain replacement coverage due to advancement in age or changes in their health status. To promote fairer outcomes for policyholders, ITOs are required to establish an internal policy to govern the medical re-pricing exercise, which includes setting out objective indicators and thresholds used by ITOs to trigger re-pricing, as well as the methodology used to determine the new price. The implementation of these policies must be monitored and reviewed to ensure that it is applied consistently and with due regard to the fair treatment of policyholders. The Bank is also reviewing existing regulations to allow more flexibility for ITOs to moderate the extent of re-pricing required for smaller product portfolios that may be more likely to experience greater volatility in claims experience.

Following earlier signs of improvements in the economy in 2021, some ITOs have resumed re-pricing recently. However, these ITOs have also put in place measures to support medical policyholders who may have difficulties maintaining higher premium payments given the current exceptional circumstances. The measures aim to ease cashflows of policyholders without forgoing protection, allowing them time to financially recover. Options made available to policyholders include enabling them to maintain premiums at the original amount before re-pricing, by temporarily switching to a cheaper plan or product. Policyholders exercising this option would be able to revert to their original coverage within a specified period without new or additional underwriting. This is in addition to the existing option for affected policyholders to temporarily defer premium payments.

Over the longer term, containing medical claims inflation, which is a major driver of re-pricing, remains a key priority to preserve sustainable access to medical reimbursement coverage from private ITOs. This requires a concerted effort from multiple stakeholders – including healthcare providers, regulators, ITOs, support service providers, and end consumers – to deliver longer-term reforms in the delivery and consumption of private healthcare services. Such reforms are further discussed in the article on ‘Managing Medical Claims Inflation’ published in the Bank’s Annual Report 2019.

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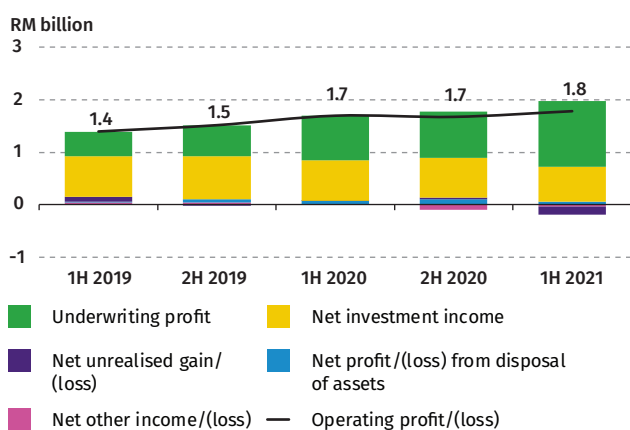
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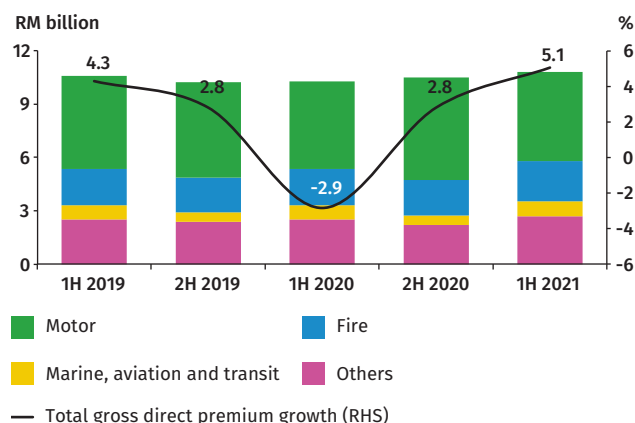
General insurance and takaful funds recorded a slight increase in operating profits to RM1.8 billion (1H 2020: RM1.7 billion), driven by better underwriting performance (Chart 2.27). Gross direct premiums were bolstered by revised premium rates in the fire, and contractors' all risks and engineering segments (1H 2021: +14%; 1H 2020: +4%) following higher claims from several large fire and explosion incidents in the last two years (Chart 2.28). Higher premiums were also supported, to a lesser extent, by a recovery in the motor segment amid a rebound in car sales following the extension of the vehicle sales tax exemption, which is in place until December 2021, and the easing of containment measures prior to the FMCO. A modest increase in general reinsurance rates was observed amid a hardening of the global reinsurance market, mainly affecting the commercial and specialised lines of business. Reinsurance support for the coverage of business interruption losses arising from infectious and contagious diseases – already limited in terms of global capacity and take-up – may also be further reduced in the wake of the pandemic. However, this had little impact on the overall profitability of ITOs. Some smaller ITOs continued to experience considerable earnings volatility due to a higher reliance on investment income to support overall profitability. Risks of heightened volatility in the financial markets therefore remain significant for these ITOs.

Chart 2.27: General Insurance and Takaful Fund – Composition of Operating Profits



Source: Bank Negara Malaysia

Chart 2.28: General Insurance and Takaful Sector – Gross Direct Premium Growth and Product Composition



Note: Others include contractors' all risks and engineering

Source: Bank Negara Malaysia

Despite the lower interest rate environment, the long-term asset allocation and investment strategies of life and family ITOs have remained largely stable. The life insurance industry is also expected to remain resilient in an environment of prolonged low interest rates.²¹ In comparison, general ITOs have been observed to shift more of their cash holdings into Collective Investment Schemes (CIS)²² over the past few years to generate higher returns, while still maintaining sufficient liquidity to meet short-term obligations. General ITOs' cash and deposit holdings declined further to 15.1% of total assets (December 2020: 18.4%), while their bond holdings have also increased in tandem over the recent period to 28.9% of total assets (December 2020: 27.6%). Additionally, general ITOs were also observed to have increased their investments in equities during this period, taking advantage of attractive equity prices. ITOs' investment risk management practices remain generally sound. Investment strategies continue to be largely driven by ITOs' board-approved strategic asset allocation and tactical asset allocation plans that have not changed significantly in response to market developments in recent periods. This continues to be supported by satisfactory monitoring and governance arrangements that serve to contain risk exposures in asset classes that have experienced greater volatility.

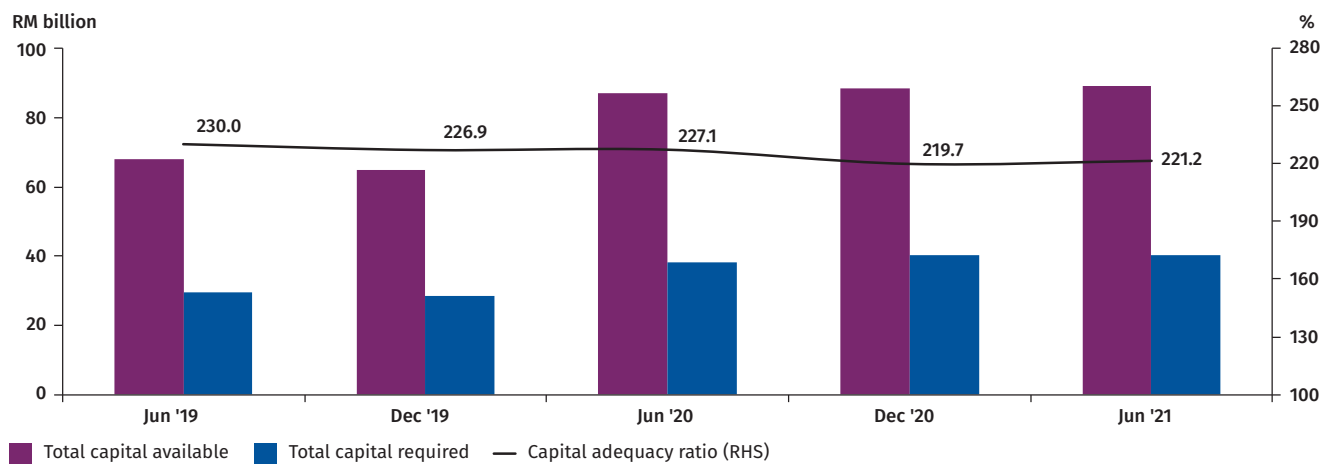
²¹ Refer to the Information Box on 'Assessing the Impact of Declining Interest Rates on Life Insurers' Solvency Positions' in the BNM Financial Stability Review for Second Half 2019.

²² Largely comprise investments in unit trust funds with fixed income investments as the underlying assets.

Going forward, financial market volatility and prospects of rising bond yields will continue to weigh on earnings of ITOs given their sizeable financial investments. Nonetheless, the insurance and takaful sector is expected to remain resilient. A sensitivity analysis conducted²³ on the balance sheet of ITOs shows limited impact to their solvency positions in the event of a sharp rise in bond yields. This is underpinned by the strong capitalisation of ITOs.

The aggregate industry capital adequacy ratio (CAR) of 221.2% remains well above the regulatory minimum of 130% (Chart 2.29). All ITOs also continue to maintain capital ratios above their internal capital target levels that range between 150% and 250%. As at end-June 2021, aggregate excess capital buffers above the regulatory minimum stood at RM36.8 billion. Stress tests conducted on insurers²⁴ also affirmed their ability to withstand severe potential shocks.

Chart 2.29: Insurance and Takaful Sector – Capital Adequacy Ratio



Source: Bank Negara Malaysia

²³ Refer to the section on Market Risk in the chapter 'Coping with an Uneven Recovery: Key Developments in the First Half of 2021' for details of a sensitivity analysis conducted on the balance sheet of ITOs to bond yield movements.

²⁴ Refer to the section on 'Assessing the Resilience of Financial Institutions' in the BNM Financial Stability Review for Second Half 2020 for further details.