

# *Supervision of the Insurance Industry*

## **Background**

Supervision of the insurance industry aims to ensure that the conduct of insurers' business is undertaken in a sound and prudent manner and that the interests of the policy owners are adequately protected, thereby ensuring that confidence in the industry is maintained.

Insurance products are generally difficult to understand and evaluate as they take the form of contractually agreed promises to pay benefits or compensation in the event of the occurrence of certain specified events or risks. As a result, there is a need for insurers and insurance intermediaries to convey all material information pertinent to the insurance contract to the consumer, prior to the conclusion of an insurance contract. Insurers also have a fiduciary responsibility over the substantial funds contributed by policy owners. These funds, which are significantly larger than the stake of the shareholders, should be managed prudently. Any mismanagement of such funds would lead to losses in the savings of policy owners and thus, adversely affect the confidence of the public. There is, therefore, a need to ensure that persons of integrity are at the helm of insurers, to discharge their fiduciary responsibility in the best interests of policy owners, and that there are prudential rules in place, to govern the management of such funds.

## **Developments in the Supervisory Framework**

Bank Negara Malaysia (BNM) took over the supervision of the insurance industry in 1988. The primary reason for the move was to enable an integrated approach in the regulation and supervision of major financial institutions, in view of the growing convergence of cross-holdings and integration of interests between banks and insurance companies. Since assuming its supervisory role, BNM has sought

to forge the insurance industry to become stronger and more resilient, through measures aimed at increasing financial discipline, raising public accountability and enhancing management efficiency. The rapid developments in the insurance industry as a result of stronger competition, technological advances, product innovation and improvements in management information systems have prompted a review of the traditional approach to supervision where heavy reliance is placed on periodic on-site examinations. It was recognised that there is a need to continually monitor the financial condition of insurers as their risk profiles were changing rapidly. One of the key initiatives undertaken in 1997 was the adoption of the risk-based supervision approach.

## **Risk-Based Approach to Supervision**

The risk-based approach to supervision emphasises the following elements. Firstly, dynamic off-site surveillance and early detection of problems, and secondly, effective planning and scoping to customise examinations to suit the size, activities and risk profiles of insurers. A dynamic off-site surveillance system is considered essential as an insurer's risk profile can change dramatically. Recognising this, an off-site surveillance unit was set-up to review the financial and non-financial information submitted, such as annual and quarterly returns and reports from internal auditors and external auditors as well as actuaries.

In addition to the analysis on the financial health and condition of insurers, the off-site surveillance unit also monitors compliance with prudential requirements such as minimum paid-up capital and solvency requirements. An early warning system has also been implemented to detect emerging problems amongst insurers so that timely supervisory action can be undertaken. In tandem with these efforts, the Life Insurance Association of

Malaysia (LIAM) and the General Insurance Association of Malaysia (PIAM), in consultation with BNM, have defined a set of parameters to be used for the conduct of stress tests by insurers. The tests are designed to provide a self-monitoring mechanism that will enable insurers to project their financial positions under various economic conditions by applying stress factors such as unfavourable movements in stock indices and property markets, slow down in new business growth, deteriorating claims experience and increasing lapsation and surrender rates. Member companies have agreed to carry out the stress tests semi-annually, the results of which are to be reported to the board of directors. All these initiatives complement each other to provide a dynamic profile of the insurers' financial performance and condition.

However, for the supervisory function to be effective, the off-site surveillance function has to be augmented by on-site examinations. The ability to conduct examinations, is a vital part of the supervisory process. It provides information that supplements the analysis of the financial, statistical and non-financial information submitted by insurers. On-site examinations provide an avenue for the verification of data and information submitted, and also constitute a means to assess the insurer's financial strength and management capability. It allows BNM to obtain information and detect problems that cannot be obtained through off-site financial surveillance, particularly in areas such as accounting irregularities or deficiencies in management, conduct of business and other problems which cannot be detected from the submissions to BNM.

On-site examinations under the risk-based approach focus on assessing the types and extent of risks to which insurers are exposed. More resources would hence be directed to assess an insurer's risk management processes while the degree of transaction testing would be adjusted based on the quality of risk management practices

and materiality of activities and functions being reviewed.

The overall assessment of the financial and general condition of an insurer is performed based on the **EMAS** framework. EMAS is the acronym for **Earnings capacity**, **Management quality**, **Asset quality** and **Solvency and capital adequacy**. The details of the individual components are as follows:-

- **Earnings capacity** - In this rating, an evaluation is made on the quality and trend of an insurer's earnings, on the basis of both the underwriting and operating profits and in relation to the performance of the industry. An insurer must earn reasonable profits to build-up its reserves, support future premium growth and assist it, in withstanding adverse fluctuations in both the underwriting and investment results. Good quality earnings also help to inspire the confidence of policy owners, investors and the public at large.
- **Management quality** - This is one of the most important components in EMAS as an insurer's overall performance is dependent on the strategic vision, track record and risk appetite of management. The management of an insurer is therefore assessed on the above qualities as well as the adequacy of its succession planning.
- **Asset quality** - This rating evaluates the quality, liquidity and diversification of an insurer's portfolio of assets. An insurance company would be exposed to considerable risk if, for example, it held assets that were unusually concentrated in any particular company or sector or it invested in highly speculative or illiquid assets.
- **Solvency and capital adequacy** - An assessment is made on the quantity and quality of the capital supporting the solvency margin. A strong capital base is essential in ensuring that an insurer is able to withstand any adverse impact on its reserves and in assessing whether the insurer is able to meet its obligations to policy owners

and claimants. The financial capability and flexibility of an insurer's holding company is also taken into account as a strong holding company can provide the necessary capital support, when required.

### **Market Conduct Examination**

To deal with unhealthy market practices and to ensure that the rights of policy owners and the public are adequately safeguarded, BNM has set up a market conduct examination unit in the year 2000, to conduct examinations relating to market conduct issues. This initiative also aims to promote a fair marketplace for consumers and insurers and to ensure compliance with the provisions of the regulatory framework concerning market practices.

### **Conclusion**

Given the rapid changes facing the insurance industry, the supervisory framework will need to continually evolve and adapt to keep pace with underlying trends and developments. However, the ultimate goal of ensuring that the interests of policy owners are protected and that confidence in the industry is maintained, remains unchanged. Looking forward, the strategic focus will be on financial surveillance, risk management practices, corporate governance, management quality and public accountability as the cornerstones for strengthening the financial resilience of insurers within a more competitive and liberalised environment.