

Implementation of Risk-Based Capital Framework for Insurers

The Risk-Based Capital Framework for Insurers (RBC) came into effect on 1 January 2009 after almost two years of parallel run with the previous solvency regime from April 2007. The framework aims to better align the regulatory capital requirements with the underlying risk exposure of each individual insurer, improve the transparency of prudential buffers, and allow greater flexibility for insurers to operate at different risk levels that are commensurate with risk management infrastructure and practices. A new set of valuation rules was also introduced to ensure that assets and liabilities are valued in a realistic and market-consistent manner.

A key objective of RBC is to ensure that prudential buffers reflect the underlying risk profiles of individual insurers. To achieve this, RBC requires more explicit quantification of the various risks inherent in the insurance business. This provides insurers with an additional tool to manage business more effectively, by identifying the sources of risk, and implementing the appropriate measures to mitigate, manage or remove risks. In the long run, having an improved understanding of the relationship between risk and capital, together with business strategies centred on sound risk management practices, will enable insurers to achieve sustainable profitability whilst safeguarding policyholders' interests.

Under RBC, capital adequacy requirements are more granular and risk-sensitive compared to the previous solvency regime which did not differentiate between the nature and sources of risk. For example, insurers whose asset portfolios are concentrated in high-risk assets or assets that are inadequately matched with the corresponding liabilities will be required to hold more capital under RBC compared to the previous solvency regime. Similarly, insurers who underwrite volatile lines of business or are highly concentrated in a single line of business will be required to hold more capital than insurers with diversified portfolios of relatively stable lines of business. The new solvency measure is hence a better reflection of financial strength and has resulted in greater differentiation between insurers with varying risk profiles. The new capital adequacy requirements are also based on explicit capital charges for market, credit, insurance and operational risks, thereby enhancing transparency and improving insurers' ability to identify, measure and manage the risks inherent in the insurance business. This will enable insurers to respond to emerging risks in a more pre-emptive manner.

With the introduction of RBC, insurers with capital resources that are commensurate with their risk profiles will have higher Capital Adequacy Ratios (CAR), thus allowing for the more efficient deployment of any 'excess' capital towards value generating activities. A number of insurers with inadequate capital and exhibit low CAR under RBC have undertaken remedial actions, and are in the process of reducing the overall level of risk exposure or injecting additional capital. Throughout the parallel run, the Bank has required these insurers to submit capital management plans with specific milestones on strategies and action plans to improve their capital positions. These milestones and action plans are closely monitored to ensure an orderly transition to the RBC regime.

**Chart 1
Capital Adequacy Positions of Insurers as at December 2008**

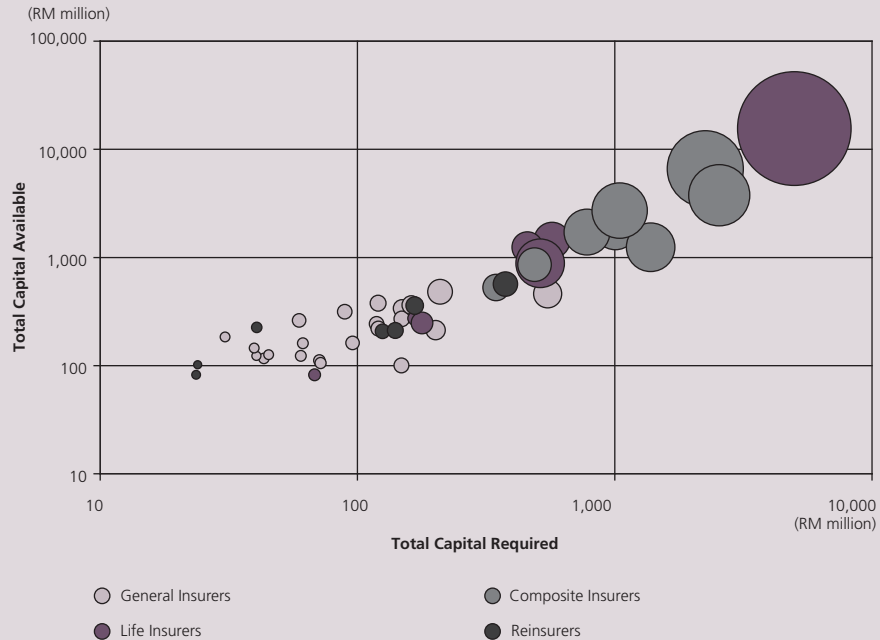


Chart 1 provides a snapshot of the current solvency levels in the industry by comparing the capital available against the capital required (All Funds) for insurers in the general, life, composite and reinsurance sectors, with the size of the bubbles denoting relative size by total assets. Life and composite insurers are typically larger, offer a wider range of products including complex products, and have greater exposure to market risk, hence the higher capital requirements.

To achieve its objectives, RBC is supported by a new set of valuation rules, requiring insurance liabilities and the related assets to be valued on a realistic basis, using market values or market value proxies, and which reflect the prevailing conditions in the business and economic environment.

The implicit margins that existed in the old valuation rules for insurance liabilities have been replaced with explicit margins for adverse deviations, which are now based on the actual experience of each individual insurer. For example, general insurers are now required to ensure that reserves are sufficient to meet expected claims based on the actual volatility of the claim patterns observed in the individual portfolios. Similarly, life insurers must hold reserves based on actual experience of mortality, morbidity, expenses, and persistency, instead of using a standardised mortality table with a fixed margin for prudence. In addition, insurers who underwrite innovative products with financial guarantees must hold additional reserves to ensure that those guarantees can be met even in adverse market conditions.

On the asset side, the introduction of market values has resulted in a more realistic balance sheet in accordance with the requirements of the relevant accounting standards. In response, many insurers have already taken the necessary steps to optimise asset portfolios according to risk appetite and expected return, while others are planning to make similar tactical shifts at the right market levels. Investment strategies are being rebalanced in response to prevailing market conditions and to improve the degree of matching between assets and liabilities. Portfolio changes during the parallel run have resulted in an increased level of assets of higher quality, which has served to support insurers well in the light of ongoing uncertainties in the capital markets.

The introduction of RBC has also provided the insurers' management teams with an additional quantitative tool to analyse and monitor the risks inherent in insurance activities. This shift of focus towards risk and its relationship with capital requirements has enhanced overall risk awareness and improved the quality of operational risk management and corporate governance. Many insurers are enhancing operations to improve their risk profiles, for example, by improving the quality of risk selection and underwriting, and by reducing volatility in loss experience through better claims management. Life insurers are also placing greater emphasis on product design and pricing, particularly to enhance the capital efficiency of their product range.

A survey of insurers also revealed positive changes to the intensity and breadth of oversight and discussion by Boards and Board Committees as a result of additional information arising from RBC. The same survey also revealed that many insurers are exploring other avenues to complement existing risk mitigants or increase available capital resources, such as reinsurance to transfer out excess insurance risks, derivatives to hedge asset-related risks or by the use of hybrid capital instruments.

Another positive development in the insurance industry arising from the introduction of RBC is the enhancement of insurers' technical expertise. The increased granularity and complexity of RBC computations have inevitably increased the demand for technical expertise, especially in the areas of realistic valuation of assets and liabilities, stress testing and the calculations for the various components within RBC. For example, insurers without access to in-house actuarial expertise have engaged external consultants to assist in the technical aspects of the RBC requirements. This is expected to further enhance insurers' technical competency through knowledge from such engagements. Furthermore, the increased proficiency of insurers in areas such as financial modelling will also support more effective risk management by enabling insurers to better anticipate emerging risks and to respond pre-emptively. Arising from the RBC requirements and the resulting increase in interaction with technical experts, insurers now recognise the need for developing such expertise internally or by obtaining the required support from group resources or external consultants.

The implementation of RBC is expected to further raise the overall level of resilience of Malaysian insurers, as the industry players continue to optimise their risk profiles and capital positions over the near future. The improvement in the quality and depth of statutory reporting brought on by RBC has also enhanced Bank Negara Malaysia's supervisory capabilities by providing an additional tool to identify problem areas early. Finally, the current market turmoil has also highlighted the need for a highly robust prudential framework that is supportive of strong capital adequacy, liquidity positions and risk management practices of insurers during periods of stress, while reducing the procyclical effects of regulation through economic cycles. To achieve this, the Bank is continuously reviewing and recalibrating the methodologies and parameters within RBC, to ensure that they remain relevant and appropriate at all times.