Perbadanan Insurans Deposit Malaysia

Protecting Your Insurance And Deposits In Malaysia

RESPONSE TO THE CONSULTATION PAPER ON DIFFERENTIAL LEVY SYSTEMS FRAMEWORK FOR TAKAFUL OPERATORS

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1.0 BACKGROUND

1.1 On 15 December 2014, Perbadanan Insurans Deposit Malaysia ("PIDM") issued a Consultation Paper on the Differential Levy Systems Framework for Takaful Operators ("DLST Framework" or "Framework") for public consultation. We received feedback and comments from takaful operators and Bank Negara Malaysia ("BNM") during the consultation period, which ended on 6 February 2015.

1.2 The respondents were supportive of the proposed implementation of the DLST Framework in differentiating risk profiles of takaful operators for levy assessment purposes. We appreciate the views and comments provided by the industry and PIDM has taken these into consideration in the finalisation of the Framework.

1.3 Overall, the respondents' main feedback was on the weightages of quantitative measures, the consideration of industry performance in setting of score ranges and the clarification about components used in the computation of quantitative indicators.

2.0 SUMMARY OF CHANGES TO THE DLST FRAMEWORK ARISING FROM FEEDBACK RECEIVED

2.1 PIDM has revised the weightages of quantitative measures to place greater emphasis on the business performance indicators of the general and family takaful business. The key changes to the weightages are as follows:

(a) ***General takaful business*** - The loss ratio's weightage is increased from 10% to 20% to place greater emphasis on the general takaful business performance and the quality of business underwritten. For the receivable ratio, the weightage is reduced from 20% to 15%. While we continue to emphasise operational efficiency, we recognise that receivables form a relatively lower proportion of assets for takaful operators;

(b) ***Family takaful business*** - The investment yield weightage is increased from 10% to 15% to place more emphasis on the family takaful business performance and the importance of achieving good investment returns; and

(c) ***Both takaful businesses*** - The weightage for the expense gap ratio was relatively high compared to the business performance indicators such as loss ratio and investment yield and therefore, the weightage is reduced from 25% to 20% to balance the emphasis between cost efficiency and business performance.

2.2 PIDM has refined the formula for expense gap ratio and has included the surplus transfer for mudharabah/hybrid operational models.

3.0 DETAILED COMMENTS RECEIVED AND PIDM'S RESPONSE

3.1 DLST FRAMEWORK METHODOLOGY
PIDM sought feedback on the proposed DLST Framework methodology.

Comments Received
Overall, majority of the respondents concurred with the proposed combination of the quantitative and qualitative criteria. The respondents were receptive of the matrix approach as part of the assessment under the DLST Framework. (1) Some respondents commented on the variances between the proposed DLST Framework and the Differential Levy Systems Framework for insurance companies ("DLS Framework"), which was implemented in 2013. Respondents highlighted the differences in the indicators used between the family takaful business and the life insurance business. (2) The respondents commented that the proposed weightage for qualitative criteria should be lower given its subjective nature as compared to the objective nature of the quantitative criteria.

PIDM's Response
(1) PIDM has maintained, where possible, consistency with the DLS Framework. However, due to the differences inherent in the nature of takaful business, business profile of takaful operators and the development stage of the industry, there will be some variations in quantitative criteria, score ranges and weightages. The variations were necessary as DLST's proposed capital, operational and sustainability measures emphasise the assessment areas relating to the role of the takaful operators and their key fiduciary duties, including the efficiency in managing the operating expenses and the ability to provide qard to the takaful funds. Moreover, the variations also assess the ability of the takaful business to be financially self-sufficient to meet their takaful contractual obligations to the participants, thus reducing their potential dependence on the takaful operator for qard. (2) The 40% qualitative scoring mainly comprises the 35% weightage which is derived from BNM's supervisory rating. This weightage reflects BNM's direct supervisory relationship with the takaful operators and are forward-looking.

Only the remaining 5% qualitative score shall be assigned by PIDM, based on information that has come to its attention that may impact the financial safety and soundness of the relevant takaful operator.

3.2 PROPOSED TREATMENT OF COMPOSITE TAKAFUL OPERATORS

PIDM sought feedback on the proposed separate assessment for general and family takaful business and the total score to be apportioned using "net contribution" for the operational and sustainability measures scores.

Comments Received

Generally, the respondents agreed with the proposed apportionment approach but several respondents sought clarification on the definition of "net contribution".

PIDM's Response

PIDM clarifies that "net contribution"[1] is defined as gross contribution, net of retakaful.

3.3 TREATMENT OF NEW TAKAFUL OPERATORS AND AMALGAMATION

PIDM sought feedback on the treatment of new takaful operators and amalgamation.

Comments Received

Overall, the respondents agreed with the proposed treatment of new takaful operators and amalgamation.

A few respondents sought guidance on the proposed treatment of takaful operators upon the separation of takaful composite licenses as required by the Islamic Financial Services Act 2013.

PIDM's Response

We understand that takaful operators are currently developing their respective plans to address the separation of the licenses. PIDM is working on addressing the treatment upon separation of composite licenses and will communicate with the takaful operators in due course. PIDM welcomes discussions with takaful operators to discuss their proposed plans so that potential areas of concern may be dealt with promptly.

3.4 TRANSITION PERIOD AND PROCESS

PIDM sought feedback on the transitional period and process required by the Framework.

Comments Received

All respondents agreed with the proposed one (1) year transition period and process.

[1] As defined under BNM's Guideline for Takaful Operators Statistical System.

3.5 REPORTING REFERENCE DATE

PIDM sought feedback on the proposed reporting reference date and the calculation of quantitative information based on calendar year-end information of takaful operators whose financial year-end is not 31 December.

Comments Received

Several respondents suggested that the calculation of quantitative information should be based on the takaful operators' audited financial statements, based on their respective financial year-end. Some respondents highlighted this would provide further assurance on the accuracy and reliability of financial information.

PIDM's Response

The main objective of the DLST Framework is to differentiate the takaful operators according to their risk profiles based on the same reference period. Therefore, the assessment process must be fair and uniform for all takaful operators. Hence, different periods may reflect different risk profiles for takaful operators due to varying market conditions.

PIDM will maintain 31 December as the reporting reference date to maintain uniformity of the assessment period.

3.6 SUBMISSION DATE

PIDM sought feedback on the proposed submission dates and requirements.

Comments Received

All respondents agreed with the proposed submission date of 30 April for the quantitative information as well as the requirements.

3.7 INFORMATION INTEGRITY

PIDM sought feedback on the control mechanisms that takaful operators have put in place to ensure the accuracy and reliability of the information.

Comments Received

The majority of respondents indicated that the existing controls in place are adequate to ensure the integrity of information submitted while other respondents highlighted the additional assurance of using takaful operators audited financial year-end results, as discussed in para 3.5 Reporting Reference Date.

3.8 INSUFFICIENT QUANTITATIVE INFORMATION

PIDM sought feedback on the proposed method for scoring criteria where certain information is unavailable.

Comments Received
All respondents agreed with the proposed method.

3.9 FILING RESUBMISSION
PIDM sought feedback on the proposal for filing resubmission.

Comments Received
All respondents agreed with the proposal.

3.10 APPEAL PROCESS
PIDM sought feedback on the proposal for appeal process.

Comments Received
All respondents agreed with the proposal.

3.11 FREE CAPITAL INDEX
PIDM sought feedback on the use of average of four (4) quarters of capital adequacy ratio (“CAR”) within the calendar year of the preceding assessment year.

Comments Received
A majority of the respondents agreed with the use of the average of four (4) quarters of CAR. In reference to the use of Individual Targeted Capital Level (“ITCL”) in the Free Capital Index (“FCI”) formula, some respondents proposed for the Supervisory Targeted Capital Level (“STCL”) to replace the ITCL as it would provide a standard benchmark amongst the takaful operators. One (1) respondent also suggested that PIDM uses the STCL, as the Risk-Based Capital Framework for Takaful Operators (“RBCT”) allows the capital available in the takaful funds to be recognised and is limited to meeting the individual takaful fund’s own capital required or surrender value capital changes (whichever is higher); with an additional 30% buffer to meet the STCL[2] requirement. There was also a proposal to extend the FCI range of results and increase the number of matrix categories. A suggestion was also made to reduce the range of FCI results as RBCT was recently introduced and more time was needed to adjust to the new capital regime.

PIDM’s Response
STCL serves as the minimum supervisory capital level and is standardised across all takaful operators and therefore, it may not reflect the differences in risk profile between takaful operators. The purpose of FCI is to measure the excess capital above a takaful operator’s own

[2] Under paragraph 9.2 of the Risk-Based Capital Framework for Takaful Operators.

specific requirements. Therefore, PIDM is of the view that the use of ITCL in the FCI calculation would best reflect the capital level that commensurates with the individual takaful operator's risk profile, their capital strength and is in line with PIDM's objectives of assessing the adequacy of the capital buffer available to ensure that the takaful operators remain solvent in the event of any expected or unexpected losses.

From PIDM's testing and analysis, we believe the score ranges are appropriate and do not encourage excessive capital buffers while maintaining an adequate buffer.

3.12 RECEIVABLE RATIO

PIDM sought feedback on excluding the wakalah fees from the proposed formula for the receivable ratio.

Comments Received

Several respondents agreed with the current formula, inclusive of wakalah fees and the respondents commented that the information required to exclude wakalah fees from the receivable ratio is not readily available.

PIDM's Response

In view of the feedback, PIDM will include the wakalah fees in the components of the receivable ratio.

3.13 LOSS RATIO

PIDM sought feedback on whether it is feasible to exclude wakalah fees from the proposed formula for the loss ratio.

Comments Received

Several respondents agreed with the current formula, inclusive of wakalah fees and the respondents commented that the information required to exclude wakalah fees from the loss ratio is not readily available.

One (1) respondent proposed that PIDM considers using the combined ratio to measure the takaful operator's profitability.

PIDM's Response

In view of the feedback, PIDM will include the wakalah fees in the components of the loss ratio.

The combined ratio is a useful measure to assess takaful operator as a whole as it includes management expenses and commissions. However, the objective of the loss ratio is to focus the assessment on the general takaful business performance only. Therefore, PIDM will maintain the loss ratio, as we are assessing the sustainability and quality of the business underwritten by the general takaful business.

3.14 NEW BUSINESS GROWTH RATE
PIDM sought feedback on the proposed method and requested for suggestions for other appropriate methods.

Comments Received
One (1) respondent requested PIDM to revisit the threshold and ensure that it is reasonable and reflects industry performance.

PIDM's Response
PIDM has conducted extensive data analysis on takaful operators when setting the score ranges and is of the view that the current score ranges are reflective of the current industry performance.

3.15 BUSINESS CONCENTRATION RATIO
PIDM sought feedback on the proposed method and requested for suggestions on other appropriate methods.

Comments Received
Respondents suggested that the score range reflects industry performance and the average industry concentration rate. Several respondents also proposed that PIDM considers the product type and product characteristics, such as, high persistency or providing greater recognition of single contribution business.

PIDM's Response
PIDM has explored several permutations of the business concentration ratio during the research and development phase. Our testing has considered making adjustments for different product types, distribution channels and providing greater recognition for single contribution. However, there were no significant differences observed between our testing results based on those permutations and our proposed formula. Therefore, PIDM will maintain the current formula and score range.

3.16 BUSINESS CONSERVATION RATIO
PIDM sought feedback on the proposed method and requested for suggestions on other appropriate methods.

Comments Received
A majority of respondents agreed with the proposal while some respondents suggested excluding certain products such as those distributed by bancatakaful. The rationale was that these products are not distributed by agents and therefore, they are not comparable with other distribution channels.

One (1) respondent also suggested that the thresholds be revised to align with industry average.

PIDM's Response

We take note that different distribution channels may have an impact on the business acquisition and renewal. We believe that each takaful operator has its own strategy with regard to distribution network and types of products sold. Regardless of its business strategy, conservation of business remains an important aspect of business sustainability for family takaful business. PIDM has also conducted extensive data testing analysis in setting the score ranges to cater for current industry performance while incentivising takaful operators to improve their business conservation ratio.

3.17 INVESTMENT YIELD

PIDM sought feedback on the proposed method and requested for suggestion on other appropriate methods.

Comments Received

A few respondents commented that the indicator would encourage risk taking to improve investment returns and achieve higher scores for this ratio.

One (1) respondent also highlighted using a takaful operator's strategic asset allocation as a benchmark for investment yield performance.

PIDM's Response

In developing the ratios for the Framework, PIDM has considered the industry average to set the thresholds to avoid aggressive risk taking activities. Furthermore, takaful operators are typically expected at a minimum, to achieve the risk-free rate. Therefore, the score ranges were based on the Government Investment Issues spot rate.

The use of strategic asset allocation to benchmark across takaful operators would be challenging as it would not be comparable across takaful operators and therefore, setting score ranges would be challenging.

3.18 EXPENSE GAP RATIO

PIDM sought feedback on the use of 'change in expense liabilities' in the formula and the proposed method as well as request for suggestion on other appropriate methods if any.

Comments Received

Overall, the majority of respondents were positive about the inclusion of the expense gap ratio in the DLST Framework.

The respondents sought clarification on the definition of wakalah fees used in the formula and a few respondents proposed modifications to the expense gap ratio formula to include mudharabah and combined mudharabah/wakalah operational models.

Several respondents also suggested that the score range be relaxed to reflect the industry performance.

PIDM's Response

In view of the comments received, PIDM has carried out further data testing to refine the formula and incorporate mudharabah operational models.

The revised formula:

$$\frac{Management\ Expenses + Commission\ Expenses}{Earned\ wakalah\ Fee + mudharabah\ surplus\ transfer} \text{ x } 100\%$$

We clarify that the commission expenses shall be the gross commissions paid by the takaful operators.

For family and general takaful business, the earned wakalah fees will follow the definition of wakalah fee in Takaful Operators Statistical System ("TOSS"), less the changes of expense liabilities.

We have also included the surplus transfer for mudharabah business to cater for those operators with mudharabah and combined mudharabah/wakalah operational models.

With these refinements, we are of the view that the expense gap ratio will provide a better assessment on the ability of a takaful operator to meet its fiduciary duty to participants in managing the takaful funds and paying the expenses incurred in the course of running the business.

3.19 OTHERS

PIDM sought comments and feedback on any aspect of the consultation paper, including suggestions for particular issues or areas to be clarified or elaborated further and any alternative proposals that PIDM should consider.

Comments Received

Several respondents proposed a reduction in weightages assigned for gross contributions growth rate and new business growth rate due to concerns about the potential slower growth in the takaful sector.

PIDM's Response

PIDM views are that for takaful operators, long term growth is important for the sustainability of both the general and family takaful business. We have also developed the proposed weightages based on our testing of historical data and our expectations of future growth.

Therefore, the gross contributions growth rate and the new business growth rate weightages reflect their importance, especially as there are a number of takaful operators that are at the developing stage of their life cycle.

4.0 NEXT STEPS

4.1 The draft regulations in respect of the DLST Framework will be submitted to the Minister of Finance for approval.

4.2 Once approved, PIDM will issue the guidelines on the DLST Framework to assist members to understand the detailed sources of information for the formulae, the mechanics of the computations and the requirements for the submission of the requisite quantitative information.

4.3 The DLST Framework is planned to be effective in assessment year 2016 with a one-year transitional period. Coinciding with the implementation of the DLST Framework, PIDM plans to enhance the Guidelines on Validation Programme: Differential Levy System and Premiums Calculation in respect of the validation procedures for DLST quantitative information for takaful operators.

Perbadanan Insurans Deposit Malaysia
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