

REGULATING THE INSURANCE INDUSTRY THE MALAYSIAN APPROACH

By: Mr. Majid Mohamad
President & CEO
Labuan Re, Malaysia

1. The dramatic worldwide revolution in the financial industry is causing governments and regulators everywhere to review their approaches to regulating and supervising the industry. In the US, the separation between commercial banks and investment banks has become more porous. The Glass-Steagall Act will continue to be loosened by market forces.
2. In Britain, Government has shifted responsibility for banking supervision away from the Bank of England, but left the Bank still responsible for the stability of the financial system as a whole. Britain has set up a new omnibus regulatory agency, the Financial Services Authority, combining 9 different existing regulators, to oversee all components of the financial industry.
3. In the developed countries, there has been substantial questioning and debate on how governments should manage financial institutions and markets. There is broad consensus on the goals of public policy: at the macro level, to protect the stability of the financial system; and at the micro level, to protect individual investors and depositors and policy owners. Now the debate is on how to achieve these two goals in a way, which ensures the maximum effectiveness and efficiency of the financial system.
4. The debate is far-reaching because there are tensions and trade-offs between the macro and micro goals. For example, if regulators go too far in protecting consumers by establishing strict rules, setting very high standards and take minimum risks, it creates a problem of moral hazard, that virtually ensures that institutions and markets will not function efficiently and effectively. Conversely, should the regulators take a more “relaxed” attitude in regulating the industry, hoping that the players would self-regulate themselves, there could trigger a systemic failure should a small members of players failed as a result of mismanagement, lapses in control or poor business decision.
5. As the debate goes on, regulators around the world are finding ways to balance between the two extremes – strict regulation (old approach) and a more relaxed approach. In particulars, the following principles would influence their decision in deciding the best approach in regulating the industry.

a. The need to maintain high standards of integrity and sound financial management.

Most regulators felt that these standards must never be compromised. There should be no contradiction between keeping standards high and creating a more dynamic and vibrant environment.

b. The need to shift emphasis from regulation to supervision.

If the regulators rely heavily on regulation to maintain high standards, there is a need for more rigid rules. Since these rules will be applied to all companies, they will hinder growth and innovation in the good companies. By depending less on regulation and more on supervision, good and bad companies can be dealt with differently. Certain regulators felt that they should not impose onerous requirements which penalize many good companies, just to safeguard against a few bad ones. They opined that the supervisory style should incorporate a greater understanding of business needs, and be more tolerant of business imperatives. This will also help reduce regulatory costs.

c. The attitude towards risk would change as the industry matures.

Certain regulators in developed countries take the stance that companies should be allowed to assume the risk profiles, which

they themselves are comfortable with, within prudential limits.

d. Focus more attention on systematic risk, rather than protecting individual customers.

All over the world, the primary responsibility of regulators is to avoid major disruption to the industry they regulate and a loss of confidence in the financial system as a whole. While the regulators need to protect customers' interest, they also have to enable insurance companies to take considered business risks. There is a need to judiciously balance between avoiding risks and grasping opportunities.

e. Regulators should allow customers to judge and take business risks for themselves.

Business risk, fraud and mismanagement should be clearly distinguished. Regulators should protect customers from the latter, for example by formulating rules and regulation and acting timely against mis-selling or delays or repudiation of legitimate insurance claims.

f. Regulators should rely more on market discipline and full information disclosure to protect customers,

rather than extensive regulation, formal or informal. The regulator's role is to make sure there is transparency and full disclosure, so that the playing field is level. Then the public can decide which companies are sound and can be trusted and which companies should be avoided.

g. All regulations should provide greater transparency;

rules should be as clear as possible. Things, which are not expressly forbidden, but are informally and administratively discouraged, should be kept to the minimum. It is the duty of the regulator to be skeptical of human motives. But it is also the responsibility of the regulator to distinguish between a traffic offence and a murder, and not to treat every company as a culprit until proven otherwise.

h. There must be close cooperation and partnership between regulators and the regulated.

It is a common policy by most regulators around the world to keep the relationship with the industry at arms length but not adversarial. This is to avoid conflict of interest and being seen as “too friendly” as to be taken advantage by the regulated. But at the same time, the regulated are in the best position to help regulators keep abreast of new developments in the industry. Candid, thoughtful feedback, including dissenting views, are essential to help the regulator fine tune policies and avoid mistakes.

6. As a developing country, Malaysia has taken a ‘lighter touch approach’ in regulating the insurance industry i.e. manage new developments in a gradual and orderly manner. While the ‘old approach’ i.e. to maintain high standards, establish strict rules,

and take minimum risks is being maintained as the pillar for sound regulatory principles, new developments such as the rise of consumerism, convergence of financial industry, globalization and the explosion of information technology have somewhat change the approach in regulation the insurance industry in Malaysia to a more proactive and developmental.

7. The regulator has made it clear of their objectives in regulating the insurance industry, that are:

a. To protect public interest

by ensuring that the insurer is financially solvent and able to meet obligations.

b. To promote fairness and equity

by ensuring members of the industry are fair and equitable in their dealings.

c. To foster competence

by insisting on a high level of professional competence and integrity.

d. To play a developmental role

by encouraging the industry to take an active part in the industry and economic development.

8. To achieve the above objectives, an integrated approach in the regulation and supervision has been adopted by transferring the regulatory function of the insurance industry from the Government’s Treasury to the Central Bank of Malaysia (Central Bank) which also

regulates the banking industry. This move was prompted by the view that there is growing convergence of cross-holdings and integration of interests between banks and insurance companies.

9. Since assuming its supervisory role in 1988, the Central Bank 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. Gradually, the emphasis has been shifted from regulation to supervision since it was recognized 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 was the adoption of the **risk-based supervision approach**.
10. The risk-based approach to supervision emphasizes the following elements. Firstly, dynamic off-site surveillance and early detection of problems and secondly, effective planning and scoping to customize 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.

11. 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 and non-life insurance associations, in consultation with the Central Bank have defined a set of parameters to be used for the conduct of stress tests by insurers. The test 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. Insurance 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 insurer's financial performance and condition.

12. 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 the Central Bank 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 the Central Bank.
13. 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.

14. The overall assessment of the financial and general condition of an insurer is performed based on the EMAS framework. EMAS is the acronym for **E**arnings capacity, **M**anagement quality, **A**sset quality and **S**olvency and capital adequacy. The details of the individual components are as follows:

a. 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.

b. 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.

c. 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.

d. 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.

- 15.** To deal with unhealthy market practices and to ensure that the rights of policy owners and the public are adequately safeguarded, the Central Bank has set up a market conduct examination unit to conduct examinations relating to market conduct issues. This initiative also aims at promoting a fair marketplace for consumers and insurers and to ensure compliance with the provisions of the regulatory framework concerning market practices.

- 16.** In order to support the objective of developing the industry, the Central Bank has introduced a series of measure aimed at protecting the interest of the insuring public, promoting fairness and equity, and fostering a viable and competitive industry capable of servicing the needs of a growing economy were implemented. Emphasis was given to greater financial discipline and more effective corporate governance to ensure that the insurance industry is progressing hand in hand with other components of the financial industry.
- 17.** With the challenges of a globalised and liberalized market, organically driven growth through incremental increases in asset size and financial strength would probably take too long and would not be a feasible option in the light of the rapid and volatile changes taking place regionally as well as globally. A quantum leap is necessary to enable the local insurers to compete successfully in the global market place. With that in mind, the Central Bank has taken a proactive steps in ensuring the domestic market would be able to meet the challenges brought about by the increased competition, convergence of financial products, changes in customer needs and rapid technological changes.
- 18.** One of the major initiative taken by the Central Bank was the launching of a master plan to guide the orderly development of the Malaysian insurance industry encompassing the following:

a. development of a core of strong key players which will be the market leaders, meeting most of the insurance needs of the country;

b. development of the insurance sector into an important component of the financial system;

c. introduction of new, innovative products and tapping into new areas to increase insurance penetration;

d. improvement of service to policy owners through more responsive and caring public relations and the application of the latest technology in the provision of efficient service; and

e. introduction of new distribution channels, as a means of cost reduction and efficient delivery of products.

19. In response to the plan, the Central Bank urged the players to immediately rethink and revamp their business strategies. There was an urgent need for them to consider strategic action plans, which include:

a. Mergers and Acquisitions

Mergers and acquisitions (M&A) are common in matured markets for strengthening market position. This is aimed at establishing a core of insurers, which can take advantage of the globalization process, withstand foreign competition, as well as meet domestic demand for insurance services. To encourage M & A activities, the Central Bank has over the years, made it mandatory

of all insurers to have a certain minimum paid-up capital.

b. Strategic Alliance

To gain access into a market or acquire expertise in a particular field, one route which can be effective is to form alliances with other insurers or other service industries. Such a “marriage” will enable both parties to exploit the synergies of their alliance. An excellent example is bancassurance, which involves the overlapping of certain areas of banking and insurance to cover all the financial and insurance needs of a client under one roof. Almost all big and well-capitalised banks in Malaysia have an insurance subsidiary or working with insurance companies as a strategic partner in cross-selling insurance products.

c. Improving Productivity and Efficiency of Operations

Benchmarking against best practices in specific aspects of insurers’ operations and management become part of the Central Bank’s examination check list. This is to ensure that the insurance companies conduct business exceed or at least at par with best practices of world class companies. There must also be a paradigm shift, a change in mind-set to reengineer the existing processes in order to improve productivity and efficiency.

d. Enhancing Underwriting Skills

Insurers are encouraged to improve professional efficiency through enhancing the skills, knowledge and training of their employees. At the same time, they should develop multi-skilled personnel with improved work attitudes and competencies. Insurers cannot neglect investment in human resource development and must create technical expertise, since knowledge is a key element of success. Realising this, the Malaysia Insurance Institute (MII) which focus on teaching technical as well as soft skills to personnel in the insurance industry was established with the Governor of the Central Bank as Chairman. MII is also a centre for Asean Insurance Training and Research Institute (AITRI), an insurance training institute established by ASEAN member countries.

e. Enhancing Public Image

All over the world, insurance industry suffers from an unfavorable image due to the structure of the industry as well as the “intangible” nature of insurance products. This gives rise to fraud, misselling and unfulfilled promises made by components of the industry that affect the whole insurance industry. The insurance industry must strive to educate the public on insurance and its importance in the lives of the ordinary members of the public.

An increase in public awareness and knowledge of insurance will dispel many misconceptions and unrealistic expectations of the insurance industry and pave the way for greater market penetration. A number of projects have been initiated by the Central Bank in cooperation with the insurance associations. “Insurance Info”, an on-line insurance information service has been set-up to facilitate the public in knowing further about insurance products and services.

20. Given the rapid changes facing the insurance industry worldwide, the regulatory framework will need to continually evolve and adapt to keep pace with underlying trends and developments. Although the approach to regulation and supervision might differ from country to country, depending on each country’s level of industry maturity, the ultimate goal of ensuring that the interests of policy owners are protected and that confidence in the industry is maintained, remains as important objective for regulators. To achieve these, the strategic focus for regulators would 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 liberalized environment. ■