chapter four

# insurance sector

Malaysia's insurance industry has achieved significant progress in the last decade.

**The insurance industry was brought under the supervision of BNM in 1988. The close supervision of solvency and market conduct and the strengthened regulatory framework enforced in the 1990s were aimed to enhance the professional standards in the industry and consumer confidence.**

Marked improvements are evident in the operational management and financial standing of insurers as well as the more positive public perception of the industry as demonstrated by the trends that have emerged. During the period from 1988 to 1999, key insurance indicators show that:

- the market penetration increased significantly from 11.4% to 31%;
- the total paid-up capital of the industry and average capitalisation per insurer increased by 532.4% and 476% respectively;
- the industry's trading ratio improved from 308.5% to 175.7%, indicating that insurers are much less highly geared;
- the total insurance fund assets and average asset base per insurance fund increased by 545.9% and 521% respectively;
- the technical reserves of general insurers strengthened from 122.6% of net premiums to 170.3%; and
- the retention ratio of general insurance business rose from 75.6% to 87.8%.

Notwithstanding this, the insurance industry in Malaysia is relatively small by international standards. However, with the projected economic growth, a large proportion of the population will reach levels of per capita income that will significantly increase the demand for risk and savings-type products. The ability of the domestic insurance industry to capture a share of this growth will depend on the ability of insurers to maintain their competitive positions both within the industry specifically, as well as the financial sector generally, in the face of new challenges and the changing financial and economic environment.

The major challenges facing the insurance industry going forward are:

- increasing competition from traditional players as global trends of consolidation and specialisation create international insurers that are larger, better skilled and more focused on core areas of competence;
- competition from new players such as asset managers, captive insurers (general insurance), independent financial advisers and internet players who, through disintermediating core elements of the insurance value chain, are improving product range and performance, and lowering the costs to consumers;
- adapting to technological advances that have fundamentally changed the way business is conducted; and
- meeting the needs of more sophisticated and more informed consumers.

Significant changes must be made to raise performance standards in the Malaysian insurance industry in tandem with the global advances in order to narrow the gap between the standards and performance of Malaysian insurers with the established international best practices and performance standards.

In the light of these challenges, the diagnostic of the Malaysian insurance industry and of the domestic insurers in particular, reveal that:

- Malaysia's insurance industry needs to progress further towards world best practice benchmarks in terms of efficiency, effectiveness and stability. In this context, size and skills have been identified as key drivers of greater efficiency, effectiveness and stability; and
- there is a need to accelerate the pace of development given that the global insurance industry is becoming increasingly concentrated, specialised and disintermediated.

More specifically:

- domestic players in the life and general insurance industries should improve further on economies of scale;
- progress should be made towards the development of skills in areas of management, information technology and underwriting;
- competition should be encouraged to reduce acquisition costs, especially in life insurance, and premiums charged in general insurance;

- distribution channels such as independent financial advisers, banks, telephone, direct mail and the internet should be further developed;
- measures should be taken to improve the productivity and quality of the agency force; and
- the range of products available in the market should be expanded to include more sophisticated products. This will require a higher level of investments in research and development to support more initiatives in product innovation.

This process will be managed, taking into account the interests of financial system stability and consumer protection. Some elements of regulation, necessary in the past, would now need to be adapted to encourage the more rapid development of the domestic insurance industry and to stimulate performance improvement. Much of the regulatory framework currently in place was designed to develop and strengthen the domestic insurers in this rapidly changing industry. Regulation has been successful at putting domestic insurers on a sound footing, with costs declining, commissions under control and solvency ratios stable. The stage has now been reached for elements of the regulatory framework to be adapted to the changing environment to accelerate the development of the domestic insurance industry in step with external developments taking place across the global insurance market. In addition, the increasing linkages between the insurance industry and the banking sector need to be managed. As the borders between insurers, asset managers and banks continue to blur, and as banks and insurers increasingly begin to take advantage of the opportunities of bancassurance and of multi-product personal financial advisers, it will be increasingly important to ensure that regulation and supervision across the sectors are aligned.

## Vision and Objectives

The overall objective is to build an efficient, effective and stable financial sector that supports both the needs of the real economy and the socio-economic objectives of the country. The aim is also to build at the core of the financial system, strong domestic institutions that provide Malaysian consumers with world-class products and services, while meeting international commitments to liberalisation of the sector in the medium term.

To this end, recommendations have been developed to implement a programme that will build the capabilities of domestic insurers to compete effectively, while ensuring that Malaysian consumers have access to the best products and services that meet their requirements. Ultimately, the desired end game is an insurance industry that:

- is an effective mobiliser of long-term savings to support economic growth;
- is financially resilient to market volatility and competitive pressures;
- adopts international best business and management practices;

- is at the cutting edge of innovation with a broad range of products for consumers at competitive prices;
- conducts business through a broad range of distribution channels for the convenience of consumers;
- displays high ethics and professional standards; and
- is more productive and cost-efficient.

## Recommendations

The desired end game envisioned for the Malaysian insurance sector will be achieved in three phases as follows:

**PHASE I**

**Building the capabilities of domestic insurers**

Under this phase, insurers will be allowed greater operational and management flexibility to develop and optimise on skills, scale and technology. Recommendations include deregulatory measures in specific aspects of business activities that will encourage innovation in the market, allow insurers access to a broader product range, enable them to leverage on distribution channels and promote increased levels of competition within the domestic market.

**PHASE II**

**Promoting consolidation and strengthening incentives for improved performance**

Under this phase, concerted measures will be taken to establish the foundation necessary to support a greater role for market discipline to complement regulation and supervision of the insurance industry. The same foundation will also serve to prepare the industry for the progressive liberalisation in the third phase. The focus under Phase II will be on strengthening the financial resilience of insurers and enhancing consumer protection. The expected results of the recommendations under this phase are domestic industry consolidation and the convergence of performance standards in the domestic industry towards best practice and performance benchmarks.

**PHASE III**

**Stimulating innovation through progressive liberalisation**

With the necessary foundations in place, measures will be taken under Phase III to progressively liberalise the insurance sector. This will provide Malaysian consumers with greater access to world-class products

and services. The process of gradual liberalisation is also expected to act as a powerful catalyst to hasten the development of the domestic industry to international standards. Opportunities for entry into the market will be made available under this phase.

The detailed recommendations under each phase are set out below. The order in which the recommendations are presented under Phase I and II do not necessarily indicate their order of implementation. Given some overlap between the objectives of building domestic capabilities, and promoting consolidation and strengthening incentives for improved performance, some of the recommendations under Phase II will be implemented together with the Phase I recommendations.

## I. Building the Capabilities of Domestic Insurers

### Recommendation 4.1:

**Remove restrictions on outsourcing**

Consonant with trends towards the disintegration of the business system across many industries worldwide, restrictions on outsourcing have already been to a large extent removed for most of an insurer's business support functions. To enable insurers to further develop their core competencies and effective business strategies, remaining restrictions on the outsourcing of non-core business activities by insurers, including the accounting, investment, collection, payment and distribution functions, will also be removed.

### Recommendation 4.2:

**Allow all players in the market to operate via the internet**

Insurers and reinsurers will be allowed to conduct insurance business over the internet which is rapidly growing in importance and expected to have a profound impact on the competitiveness and efficiency of the insurance industry, especially in the general insurance sector.

### Recommendation 4.3:

**Promote incentives for the growth of bancassurance**

Among the critical conditions identified for the successful growth of bancassurance is the ability of banks to own insurers and distribute insurance and pension products, as well as the ability of banks and insurers to share customer information. Currently, insurers are already permitted to distribute their products through banks operating in Malaysia.

To further promote the growth of bancassurance:

- favourable consideration will be given to banks or bank-holding companies which wish to acquire or increase their interests in insurers under the industry consolidation exercise; and
- flexibility will be accorded to insurers and banks in bancassurance partnerships to share customer information.

### Recommendation 4.4:

**Remove the 'file-and-use' system for life insurance products in the long term**

The current requirement for insurers to submit particulars of new life products and changes to existing life products at least 30 days before the products are offered to the public will be maintained to ensure fair terms and proper disclosure to

prospective policyholders. It is also necessary to prevent 'product dumping' by insurers seeking to win market share and to ensure that insurers are able to finance the new business growth.

However, as the market matures in the long term and as regulations on product transparency and consumer protection mechanisms develop further, a review of the 'file-and-use' system will be made.

### Recommendation 4.5:

**Open up the pension industry to insurers**

To increase the market share of domestic life insurers, the management of pension funds by insurers will be further promoted. A step in this direction has already been taken with the recent move to allow employees to use their contributions to the Employees Provident Fund (EPF) for the purchase of annuities from a panel of insurers. The social and economic impact of the EPF annuity scheme on the insurance industry is being closely monitored and will be carefully considered before further opening up of the pension industry is pursued. The consideration of any move in this direction will take into account the nation's interests in achieving the most efficient and effective management of its pension funds.

### Recommendation 4.6:

**Uplift restrictions on employment of expatriates**

To accelerate the development of skills and expertise in the insurance industry, particularly in the current dynamic business environment, existing restrictions on the number of expatriate specialists that may be employed by insurers will be removed for both domestic as well as foreign insurers. Domestic insurers are expected to benefit most from the inflow of foreign talent since the transfer of knowledge across borders already takes place among the foreign insurers.

### Recommendation 4.7:

**Remove restrictions on opening branches**

Current restrictions on the opening of branches by insurers are intended to ensure that insurers do not expand beyond their capacities in a manner that would put their financial positions at risk. To avoid limiting the potential for insurers to achieve higher market penetration and profitability, the restriction on the number of new branches will be removed first for domestic insurers, and subsequently for foreign insurers. Approvals for new branches however, will be subject to an assessment of the financial capacity of the insurer to sustain its expansion plans.

### Recommendation 4.8:

**Allow insurers to distribute other personal financial service (PFS) products**

To enable insurers to make more effective use of the agency force and other distribution channels, insurers will be allowed to distribute PFS products other than insurance on behalf of licensed third parties. This is in keeping with the trend towards the emergence of one-stop financial service providers that offer consumers a broad range of savings and investment options. It will also allow insurers to compete with other providers of financial services such as banks which are already allowed to offer a range of financial products, including insurance, as third party distributors.

### Recommendation 4.9:

**Introduce independent financial advisers (IFAs)**

Consumers in Malaysia currently find it difficult to obtain professional independent advice on financial options, including insurance, that will most effectively meet their financial needs. Different forms of representations received from various tied agents and distributors who act for, and are remunerated by particular financial institutions tend to make comparisons between alternative solutions difficult for consumers.

Therefore, certified IFAs who can represent a broad range of competing financial service providers will be introduced in Malaysia. Products sold by IFAs for other institutions may include insurance policies, unit trusts, bonds, shares, mortgage loans, savings accounts and term deposits. Requirements on the certification, admission and standards of 'best advice' for IFAs would need to be developed. Mechanisms, including an ombudsman function, for consumers to seek recourse against any misconduct by IFAs will also have to be in place before IFAs are introduced into the market.

### Recommendation 4.10:

**Introduce reinsurance quota regulations**

Prior to lifting the existing voluntary cessions to the national reinsurer, Malaysian National Reinsurance Berhad (MNRB), the maximum reinsurance cession rates will be specified for certain lines of business, the level depending on the availability of domestic capacity to absorb those risks. This is aimed at ensuring that the goal of optimising national retention capacity is not compromised with the eventual removal of voluntary cessions to MNRB.

### Recommendation 4.11:

**Remove voluntary cessions to MNRB**

To enhance competition in the reinsurance sector to the benefit of insurers and ultimately consumers, voluntary cessions to MNRB will be gradually removed. The market agreement governing the voluntary cessions to MNRB is subject to regular revisions with a view to progressively reducing the percentage of business required to be ceded to MNRB.

### Recommendation 4.12:

**Allow qualified players to sell takaful products**

To foster a competitive and innovative takaful sector to complement conventional insurance, qualified players will be licensed under the Takaful Act 1984 to sell takaful products. The opportunity to offer takaful products will allow for the development of a niche market for domestic players.

### Recommendation 4.13:

**Remove caps on operating expenses**

The existing cost control guidelines have served the industry well in the past by instilling financial discipline among insurers and promoting healthy competition. However, with the rapid changes taking place in the market, driven in large part by technological advances, such cost controls may be perceived to inhibit insurers from making large investments necessary to remain relevant and competitive.

To spur the development of a more efficient and effective insurance sector, the limits on operating expenses (including management expenses, agency commissions and agency-related expenses) and restrictions on agency structure will be gradually removed. The expected effects include greater management freedom for insurers to make investment decisions to improve their long-term competitive positions, attract and retain best talent, and create value to increase market share. While operating expenses may rise in the short term, the more price competitive environment and more consolidated market will contain operating expenses and in the process, stimulate the growth of alternative and more efficient distribution channels.

**Recommendation 4.14:**

**Encourage commission disclosure**

With the abolition of cost controls, insurers will be encouraged to disclose the amount of commissions paid to agents. Disclosure promotes transparency by providing consumers with information on the pricing structure of products sold by insurers, hence enabling consumers to make more informed decisions between alternative products available in the market.

**Recommendation 4.15:**

**Deregulate pricing of general insurance products**

While tariffs applicable to the dominant motor and fire classes of business in the general insurance sector have been effective in controlling unhealthy undercutting, they have also kept overall prices for general insurance products relatively higher than in most deregulated markets.

With the marked improvements in financial discipline and market conduct among insurers over the last decade and the more stringent solvency requirements introduced under the Insurance Act 1996, measures will be taken to progressively deregulate the pricing of fire and motor insurance products. The deregulation of compulsory motor insurance pricing will be pursued at a later stage as the premium rates for this class are already currently below cost. In lieu of tariffs, a 'file-and-use' system similar to that currently employed for life insurance products will be introduced for certain classes of business. To avoid 'product dumping' in the short term, insurers will not be allowed to introduce products with rate plans that have expected negative margins.

Apart from more competitive prices for consumers, price deregulation in the general insurance sector is also expected to have additional benefits in the form of:

- accelerated consolidation as a result of pressures on profit margins;
- increased specialisation and greater product sophistication as insurers begin to develop unique value propositions and products for different segments of the market in order to remain competitive;
- growth of alternative distribution channels to reduce business acquisition costs;
- development of more sophisticated pricing techniques to reduce cross-subsidisation between product lines; and
- greater efficiency in the industry as insurers strive to maintain profit margins by exercising more control over their expense and claims costs.

## II. Promoting Consolidation and Strengthening Incentives for Improved Performance

### Recommendation 4.16:

**Increase the statutory minimum paid-up capital of insurers**

To accelerate the consolidation process that will enable domestic insurers to capture the size and scale needed to compete effectively in a more deregulated and liberalised market, the statutory minimum paid-up capital required to be maintained by direct insurers will be increased progressively. Innovative players with unique value propositions should still be able to raise funds to meet the new capital requirements, while players with no distinctive competitive advantages will be compelled to consolidate.

### Recommendation 4.17:

**Strengthen 'fit and proper' regulations for board members and senior management**

Given the increasing importance placed on the role of directors in corporate governance, and with it, greater responsibilities expected to be shouldered by directors, it is essential that the boards of insurers comprise members who possess the necessary educational qualification and experience in insurance or related fields which will enable them to effectively discharge their governance responsibilities. Accordingly, 'fit and proper' regulations prescribed under the Insurance Act 1996 will be strengthened to explicitly specify the minimum required qualification or experience for directors and senior management executives of insurers. The new requirements will be enforced for all new appointments as well as reappointments.

### Recommendation 4.18:

**Encourage the introduction of performance incentives and evaluation processes**

Performance incentives and evaluation processes will be established to ensure that board members and senior management act to increase shareholder value over time. In this respect, insurers will be encouraged to adopt best practices relating to the formation of nominating and remuneration committees responsible for developing policies on the appointment and remuneration of directors and senior management executives. The committees, consisting wholly or mainly of non-executive directors will also make recommendations on board appointments and carry out annual assessments of the effectiveness of the board as a whole as well as individual directors.

Insurers will also be required to make disclosure of compensations to senior management and directors in the annual report. Minimum disclosure of total compensations paid in aggregate will be required, with insurers free to disclose individual compensations at their discretion.

### Recommendation 4.19:

**Raise the entry requirements for the agency force**

There is uniform consensus in the industry that the pre-contract examinations are too simple and theoretical, both in the life and general insurance sectors. There is a need to raise entry requirements

for the agency force. To this end, pre-contract examinations which individuals must pass to qualify as agents will be updated in line with higher standards applied in more developed markets.

### Recommendation 4.20:

**Introduce additional compulsory exams as part of continuing education programmes for agents**

To ensure that agents continuously upgrade their knowledge and skills, additional compulsory examinations and/or practical tests will be introduced. Agents will be required to pass these examinations/tests after a certain period of service to be allowed to continue to operate as agents.

### Recommendation 4.21:

**Further strengthen performance-based supervision**

Effective solvency supervision is vital to maintaining stability in the industry under more deregulated and competitive market conditions. To support this, supervisory systems and reporting requirements will be continually updated in tandem with developments in the market and changing risk profiles. This includes reviewing and updating performance indicators used as early warning signals and enhancing the statutory annual and quarterly returns. Indicators of contagion risks across banking and insurance sectors arising from structural or business linkages will also be developed to support the consolidated supervision of financial groups.

### Recommendation 4.22:

**Ensure effective enforcement of regulations**

An important aspect of managing consolidation and the stability of the insurance system as competition intensifies is defining a standard intervention process for troubled insurers. The Insurance Act 1996 already provides for the direction and control of defaulting insurers by BNM. These provisions will be reviewed to assess their adequacy in the light of experience gained from the recent Asian financial crisis and will be enhanced accordingly to ensure the effective enforcement of solvency regulations.

### Recommendation 4.23:

**Establish prudential risk management standards**

International developments with respect to minimum capital adequacy ratios for insurers will be monitored. In the long term, the introduction of a risk-based capital model that applies different capital requirements for different risk profiles based on an insurer's asset structure and business mix will be considered. The decision of whether to adopt a similar model for Malaysia will depend on various factors, including an assessment of its ability to accurately capture and quantify risk exposures and the development of deep and liquid capital markets for risk in Malaysia.

### Recommendation 4.24:

**Remove investment restrictions**

To allow insurers more flexibility to optimise their returns on capital allocations, the minimum required percentage of investments in Malaysian Government papers and maximum limit on investments in investment-grade bonds for the purpose of meeting the solvency margin requirement will be removed.

### Recommendation 4.25:

**Expand the role of the existing ombudsman**

In a more deregulated market, the long-term supervisory focus will shift towards observing market conduct and acting on breaches of regulation. This will require the strengthening of consumer protection regulations and wider avenues for consumers to seek recourse in the case of misconduct by an insurer, agent, financial planner or adviser. To

achieve this, the role of the existing Insurance Mediation Bureau will be extended to encompass a broader ombudsman function (with avenues for appeal) which includes counselling, advising and adjudicating in disputes between policyholders and their own or third party insurers. Consumers will also be able to obtain general support and assistance in dealing with insurers and insurance intermediaries.

**Recommendation 4.26:**

**Introduce 'best advice' regulations**

To raise the professional standards of intermediaries, 'best advice' regulations, which hold intermediaries liable for their advice on sales of life and general insurance products will be introduced. The regulations will apply to tied agents, company representatives, brokers, IFAs and financial planners.

The regulations will require an intermediary to obtain sufficient information about a client to enable him to render best advice on financial products to meet the needs of the client. Under 'best advice' regulations, a tied agent or company representative is bound not to sell any product that he knows to be unsuitable for a client. Where he does not have a suitable product in his portfolio to meet the client's needs, he should refer the client to another company or intermediary. The regulations will also provide avenues for a consumer to take action and seek compensation against an intermediary that did not render him best advice.

**Recommendation 4.27:**

**Strengthen regulations on unfair trade practices**

In a more competitive market environment, regulations on unfair trade practices will be strengthened to ensure fair competition and market conduct. Regulations will be introduced to prohibit insurers from engaging in any unfair trade practices, including misrepresentations through false or misleading statements, entering into any agreement to commit any act of boycott, coercion or intimidation resulting in a market monopoly, making or permitting any unfair discrimination that is not properly justified between policyholders and knowingly committing or performing as a general business practice unfair claims settlement practices.

## III. Stimulating Innovation Through Progressive Liberalisation

**Recommendation 4.28:**

**Allow new insurance licences for innovative players**

As a major stimulus to innovation by incumbent insurers, a limited number of new licences in specialised lines of business will be considered for new players with innovative value propositions. In addition to creating value for consumers with new products and potentially more efficient service levels offered by new players in the market, their entry will also drive incumbent insurers to improve their performance and invest in research and development and business strategies that will lead to greater efficiency and innovation in the industry. New licences will be issued selectively. Only concrete

proposals which demonstrate real value propositions that are feasible will be considered for approval.

**Recommendation 4.29:**

**Allow financial and non-financial institutions to buy direct insurers**

Subject to satisfactory progress being made in the consolidation of the insurance industry, new acquisitions of shares in insurers by financial and non-financial institutions will be considered (currently restricted to encourage mergers and acquisitions among insurers). This is expected to create business synergies that will further increase the level of insurance penetration in Malaysia.

**Recommendation 4.30:**

**Open up the reinsurance industry fully to foreign competition**

Given the nature of the reinsurance industry globally, and the enormous economies of scale needed, the development of a domestic reinsurance industry is neither feasible nor desirable. The admission of foreign reinsurers into the domestic market has helped to enlarge national capacity, facilitate the transfer of technical expertise to the domestic industry and contain reinsurance premium outflows. Retention levels in Malaysia have increased significantly over the last decade, particularly in the general insurance sector. Licences will therefore, be offered to new foreign entrants for the conduct of professional reinsurance business in Malaysia in addition to the number already offered and issued under the World Trade Organisation (WTO) Agreement.

**Recommendation 4.31:**

**Increase caps on foreign equity**

Malaysia's commitments under the WTO Agreement currently limit foreign equity in insurers to 30% for new foreign shareholders and 51% for original foreign owners of insurers. To promote the development of new product offerings and technical skills in the industry over the long term, the foreign equity limit for new entrants will be relaxed. However, the liberalisation of ownership by new foreign entrants will be sequenced accordingly to follow the development of a core of strong domestic insurers.

## Approach to Implementation

While the recommendations adopt a market-driven approach towards capability building, performance improvement and industry consolidation, the transition towards the end game will be carefully managed to ensure that Malaysian consumers have access to products and services meeting international standards and at competitive prices.

The recommendations will be implemented in phases under a managed transition plan over a period of ten years. The transition path, designed to minimise instability in the industry and ensure rapid but sustainable reform, is being initiated with measures to strengthen the performance of incumbent insurers and encourage industry consolidation. Liberalisation of the insurance sector will follow once incumbent insurers are adequately strengthened to participate in the new business environment

expected to emerge following liberalisation. The ultimate goal will be to provide world-class products and services to Malaysian consumers while maintaining stability in the domestic industry.

Besides phasing in the transition, specific reviews of the development of the industry will also be undertaken to assess the extent to which the recommendations under each phase have been achieved. A task force will be formed to undertake the reviews. The task force will perform reviews (based on objective criteria and benchmarks which will be developed for this purpose) of the progress of the industry as a whole as well as that of domestic institutions on an individual and group basis. In addition, the task force will also recommend remedial measures where progress is found to be less than satisfactory. Based on these reviews, the pace at which subsequent measures under the Masterplan should be implemented will be determined, taking into account the interests of consumers and the industry.