Asia e-Alert

# Indonesia: New RBC and Technical Reserves Requirements

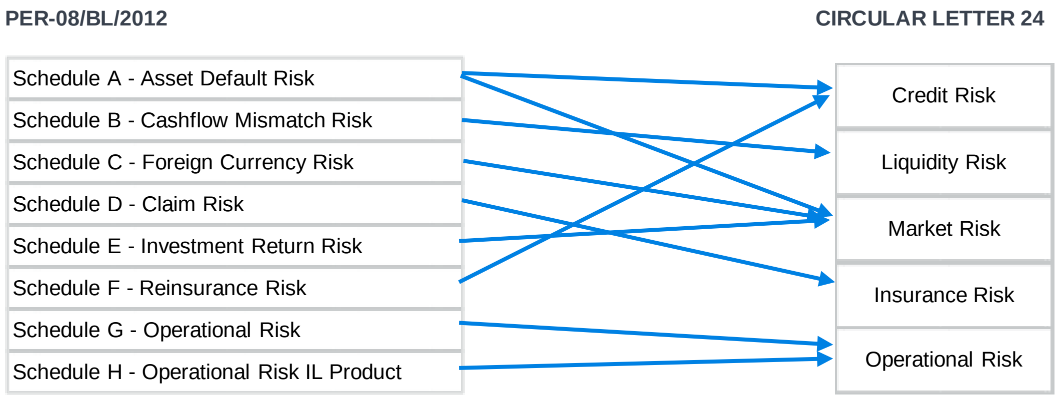
On 13 June 2017 Indonesia's Financial Services Authority (OJK) issued a number of circular letters (SEOJK), to provide clarifications on two regulations, namely POJK No. 71/POJK 05/2016 and POJK No. 72/POJK 05/2016, which were released in December 2016. The new circular letters became effective as of 1 July 2017. In this e-Alert, we highlight and compare changes in the capital and technical reserves requirements as set out in these circular letters. The relevant circular letters discussed in this e-alert are: SEOJK No. 24/SEOJK.05/2017, SEOJK No. 25/SEOJK.05/2017, SEOJK No. 27/SEOJK.05/2017 and SEOJK No. 28/SEOJK.05/2017.

## Risk Based Capital (RBC)

### CONVENTIONAL

Superseding PER-08/BL/2012, SEOJK No. 24/ SEOJK.05/2017 (Circular Letter 24) specifies the new Minimum Risk-based Capital (MRBC) to be calculated as the sum of the risk charges under five specified risk categories, which have been re-categorised compared to the previous regulations as summarised in Figure A below.

**FIGURE A: MAPPING OF RBC COMPONENTS[1] OF CONVENTIONAL RISK UNDER NEW REGULATION (CIRCULAR LETTER SEOJK 2017 NO. 24)**




#### Credit Risk

The components of capital charges for credit risk under the new regulations reflect a combination of risk charges previously included under PER-08/BL/2012, corresponding to Schedule A (asset default risk) and Schedule F (reinsurance risk), with updates to risk charges applicable to certain asset classes.

#### Market Risk

The new market risk covers the risk of changes in the market value of company assets, changes in foreign exchange rates, and changes in interest rates, corresponding to Schedule A (asset default risk), Schedule C (foreign currency mismatch risk), and Schedule E (risk of premium insufficiency due to actual investment returns being worse than expected) under PER-08/BL/2012. In general, the computation of risk charges under the new definition of market risk is similar to that under PER-08/BL/2012, with changes to risk factors applicable to asset-backed securities and real estate investment trusts (REITS), as well as the new risk charge on non-investment properties.

[1] Excludes the guaranteed investment portion for investment-linked products

### Insurance Risk

Similar to Schedule D (risk of claim experience worse than expected) in PER-08/BL/2012, the new insurance risk considers the risk of the failure of a company to fulfil its obligations to policyholders or the insured as a result of inadequate underwriting, pricing, and/or claims management processes.

A new catastrophic risk component has been included and is computed as the reserves held for catastrophic risk, net of reinsurance, multiplied by a catastrophic risk factor, and aggregated over each business line.

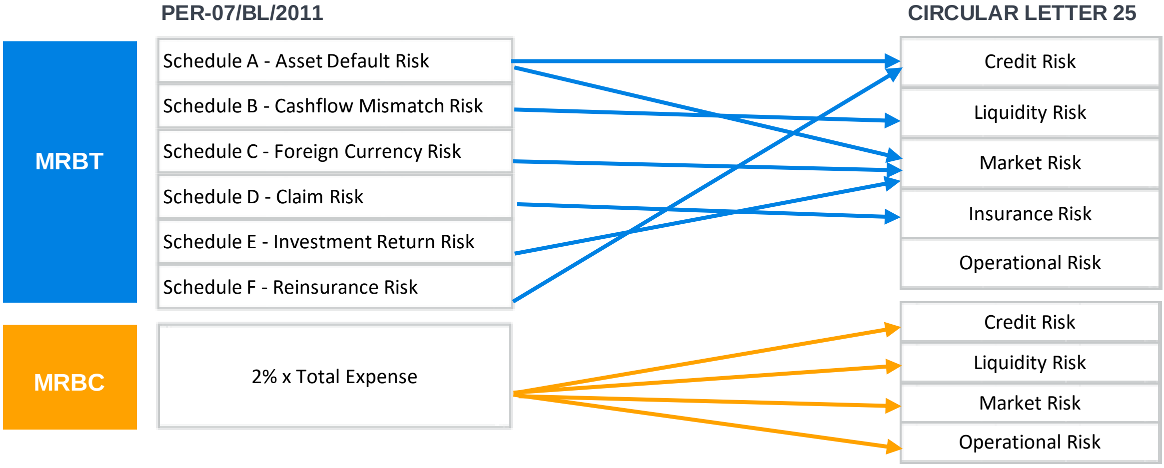
### Operational Risk

The new operational risk charge combines Schedule G (operational risk) and Schedule H (operational risk related to the administration of investment-linked products) in PER-08/BL/2012, with the addition of a new risk factor of 50% on deferred acquisition costs (DAC). Circular Letter 24 also clarifies that the expense data used in the calculation of the operational risk charge must be based on the quarterly financial reports for the four most recent periods.

## SYARIAH

SEOJK No. 25/SEOJK.05/2017 (Circular Letter 25) specifies the minimum risk-based Tabarru' and Tanahud funds (MRBT) and the minimum MRBC for insurers and reinsurers operating under Syariah principles, superseding PER-07/BL/2011. MRBT is defined as the amount of funds needed to anticipate the risk of loss that may arise as a result of deviations in the management of assets and liabilities from the Tabarru' and Tanahud funds. Syariah insurers and reinsurers are required to hold MRBT with respect to the Tabarru' and Tanahud funds, whereas MRBC is to be held with respect to their company or shareholders' funds. The Syariah risk charges have been recategorised as compared to PER-07/BL/2011 and are summarised in Figure B below.

FIGURE B: MAPPING OF RBC COMPONENTS[2] OF SYARIAH UNDER NEW REGULATION (CIRCULAR LETTER 25)




In general, Circular Letter 25 requires a similar methodology as used to calculate the capital requirements for conventional business. A summary of key changes from PER-07/BL/2011 includes:

- The introduction of credit, liquidity, market, and operational risk charges on assets in the company/shareholders' funds. Previously no asset risk charges were applied to company/shareholders' funds.
- The credit risk factors applied to Syariah assets have been updated and are now aligned with the risk factors applied to the equivalent conventional asset classes as specified in Circular Letter 24.
- The liquidity risk charge is calculated by applying a risk factor to the excess of liabilities over assets (segregated by term to maturity), again using a similar approach as used for conventional business. The previous regulation applied a liquidity risk factor to premium allowances.
- The insurance risk requirement for Syariah products with a policy term exceeding one year has been aligned with the conventional approach, which involves holding capital to a 95% level of sufficiency on the contribution provisions at the company level. The insurance risk charge for yearly renewable products or products with a policy term of up to one year is calculated by applying a risk factor to the allowance for unearned contributions.

[2] Excludes guaranteed investment portion for investment-linked products

- A catastrophic risk requirement is now included as part of the insurance risk requirement.
- An operational risk requirement has been introduced and is calculated as the sum of 1% of general and administrative expenses less education and training expenses, 50% of DAC, 1% of investment-linked funds and 1% of Tabarru' fund investments.

# Technical Reserves

### CONVENTIONAL

SEOJK No. 27 /SEOJK.05/2017 (Circular Letter 27), which supersedes PER-09/BL/2012, provides the latest guidance on establishing technical reserves for insurers and reinsurers. Compared to the previous guideline, PER-09/BL/2012, apart from introducing a new reserve for catastrophic risks for companies that do not have adequate reinsurance coverage, Circular Letter 27 mainly provides additional clarification to the existing requirements for the calculation of technical reserves.

The components of total reserve are outlined in Figure C as follows. Details of the additional clarifications are summarized below.

**FIGURE C: TOTAL RESERVE COMPONENTS (CONVENTIONAL) UNDER NEW REGULATION (CIRCULAR LETTER 27).**

Premium Reserve + Unearned Premium Reserve (UPR) + Reserve for products with investment components + Claim Reserve + Catastrophic Reserve = Total Reserve

## Premium Reserve

Circular Letter 27 provides guidance on the type of products for which premium reserves are required. While investment-linked products have been explicitly excluded, renewable insurance products with a policy term greater than one year are now included.

The maximum reserving discount rate cannot be more than the average government bond yield over the past one year (instead of three years under the previous regulations), although companies may still apply a maximum discretionary adjustment to the discount rate of 0.5%. The bond yields used to determine the discount rate must refer to published yield curves from the Indonesia Bond Pricing Agency (IBPA), and the maturity period of the government bonds used must be in line with or close to the duration of liability cash flows or the remaining policy duration of the relevant in-force policies.

## Unearned Premium Reserve

As was the case with the previous regulations, the premium to be used for the calculation of unearned premium reserve (UPR) under Circular Letter 27 is the gross premium less direct commissions. Different limits on the maximum allowable commission deductions have been introduced based on the type of insurance.

## Reserves for Investment-Linked Products

This section is similar to the Accumulated Fund Reserves component from the previous regulations with an additional reserve for the protection component. There are now three parts to this component:

- An accumulated fund reserve for non-guaranteed benefits equal to the market value of the investment-linked funds at the valuation date
- A reserve for guaranteed benefits equal to the difference between the guaranteed fund value and market value of the investment-linked funds (floored at zero)
- Reserves for the protection component and/or other benefits of investment-linked products

## Claim Reserve

A reserve for approved claims which are not immediately paid needs to be included as one of the components of the claim reserve, in addition to reported but not admitted (RBNA) and incurred but not reported (IBNR) reserves.

## Catastrophic Reserve

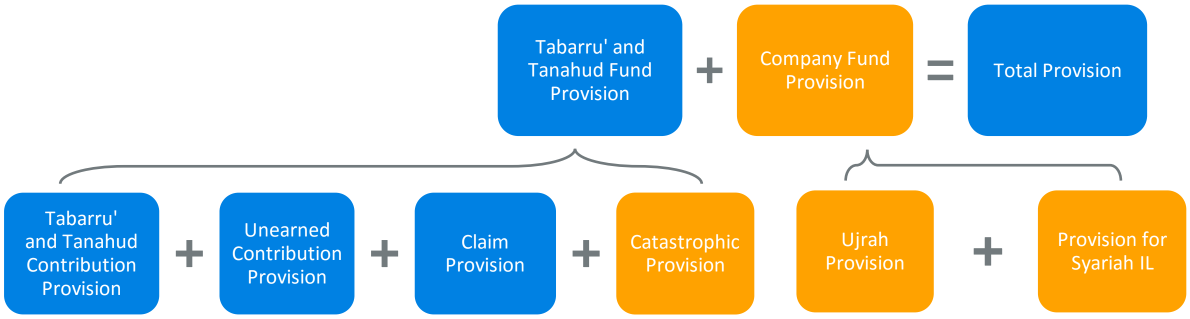
Catastrophic risk has been excluded from the calculation of the unexpired risk reserve (URR) and included as a separate stand-alone reserve. A catastrophic reserve is required for companies that do not reinsure any catastrophe risks and/or if the companies' existing catastrophic risk reinsurance is deemed insufficient.

## SYARIAH

SEOJK No. 28/SEOJK.05/2017 (Circular Letter 28) provides guidance on establishing technical provisions for Syariah insurers and reinsurers, superseding SEOJK No. 10/SEOJK.05/2015. Circular Letter 28 has added a requirement for holding a provision for the Syariah operator fund, with respect to Ujrah as well as for Syariah investment-linked products that guarantee the investment principal amount.

The circular letter provides greater clarity in the definitions and provides suggestions on how the Syariah operator may want to calculate the provision. Similar to conventional, a catastrophic provision has also been added.

**FIGURE D: TOTAL PROVISION COMPONENTS (SYARIAH) UNDER NEW REGULATION (CIRCULAR LETTER 28).**




Key details are as follows:

### Tabarru' and Tanahud Contribution Provision

Circular Letter 28 provides greater clarity, definitions, and examples of products in scope in the Tabarru' and Tanahud contribution provision. Tabarru' and Tanahud contribution provisions are required for products that have a term exceeding one year and are non-renewable at policy anniversary, with similar requirements for the discount rates to be used as applied to conventional business.

### Unearned Contribution Provision and Unexpired Risk Provision

For Syariah products that have a term of up to one year or are annually renewable, Circular Letter 28 specifies that the total Tabarru' provision must be the greater of the unearned contribution provision (UCP) or the unexpired risk provision (URP). The URP must be calculated from the average claim rate from the past three years of experience.

### Claim Provision

The claims provisions under Circular Letter 28 have been brought in line with the conventional claims reserves in Circular Letter 27, and now include provisions for RBNA, IBNR, and approved claims which are not immediately paid.

### Catastrophic Provision

Similar to Circular Letter 27 for conventional products, Syariah operators need to hold an additional catastrophic provision if catastrophic risks are not reinsured and/or the existing catastrophic risk reinsurance is deemed insufficient.

### Ujrah Provision

The Ujrah provision has been introduced in Circular Letter 28. It is an additional provision on top of the Tabarru' and Tanahud provisions and is calculated differently for various types of products.

- For products with a policy term up to one year or that have a term exceeding one year, are annually renewable, and do not provide additional benefits from the Syariah operator fund, an unearned Ujrah provision is required.
- For non-yearly renewable products with a policy term exceeding one year, or yearly renewable products with a policy term exceeding one year and that provide additional benefits from the Syariah operator fund, an Ujrah provision is required which takes into account all future acceptances and expenses of the Syariah operator at a 75% confidence level. The assumptions used to calculate the Ujrah provision must be consistent with those used in calculating the Tabarru' provision.

## Conclusions

The alignment of regulatory standards for Syariah business to that currently used for conventional business has certainly raised the bar for Syariah players, with the aim of ensuring that Syariah players are well-capitalised and able to support the expected growth of this sector. The new capital requirements for Syariah business are likely to encourage Syariah players to offer more 'RBC-friendly' products, such as investment-linked takaful (similar to the trend seen in the conventional space).

For conventional business, industry players would perhaps be relieved, to a certain extent, that the new regulations have not really introduced significant changes as compared to existing framework. Instead the regulations provide more explicit guidance on the requirements for reserving and capital standards, thereby closing some of the gaps that have been open to interpretation. The requirement for a catastrophe reserve is a relatively new concept in the region (maybe following Singapore where it is part of the proposed RBC2 framework), although further guidance is required as to how it should be quantified. For products which are reserved using the gross premium valuation methodology (GPV) basis, companies may expect to see higher volatility in the GPV reserves as there is no longer the smoothing effect from using a 3-average basis when determining the valuation interest rate.

Overall the announcement of the Circular Letters reflects the regulator's initiative in progressing the governance of the insurance industry, which will help to ensure that the life insurance industry continues to expand in a sustainable manner.

# Contact details

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