Best's Market Segment Report

March 29, 2021

Malaysia Non-Life Insurers Maintain Underwriting Discipline Amid Market Challenges

Non-life companies remain resilient while grappling with the impact of the ongoing pandemic and other market challenges

Despite several headwinds including sluggish economic growth, ongoing operating challenges from COVID-19 and regulatory changes, Malaysia's non-life insurance companies have generally continued to report good overall profitability, as well as maintain solid solvency positions. In AM Best's view, the country's non-life segment is underpinned by robust capital adequacy, as well as a track record of consistent underwriting profitability, despite increased competition arising from the phased liberalisation of pricing for major product lines over recent years.

Malaysia's non-life insurance market comprises 26 companies, including 21 general insurers and five takaful operators. In 2019, non-life companies posted combined gross premiums and contributions of MYR 21 billion (USD 5.2 billion), of which the general takaful operators accounted for 16%. The non-life insurance segment has recorded modest expansion in recent years, with a five-year average compound annual growth rate (CAGR) of 2% in terms of gross direct premium (2015-2019). Although the non-life insurance penetration rate in the country (which stood at 1.4% in 2019) lagged behind that of Thailand and Singapore, it is higher than most of its emerging Southeast Asia peers.

The development of the Malaysian non-life insurance market over time has been supported by an established risk-based capital (RBC) regulatory framework and robust oversight from the regulator, Bank Negara Malaysia (BNM). Furthermore, many insurers that operate in the market either have relationships with international insurance groups, or large domestic financial institutions through their shareholding structure, which has helped to drive the maturity of the non-life industry through knowledge exchange, as well as implicit and explicit support from parent organisations.

AM Best classifies Malaysia as Country Risk Tier 3 (CRT-3), categorised by a moderate level of political risk and a low level of economic and financial system risk. However, the US-China trade tensions, oil price volatility, as well as reduced domestic manufacturing and construction activity over recent years have weighed on the demand for commercial insurance in Malaysia.

Non-life Insurance Premiums Declined in 2020 Due to COVID-19

Like most countries around the world, Malaysia's economy has been impacted by the economic fallout from the COVID-19 pandemic. In February 2021, BNM announced that Malaysia's GDP contracted by 5.6% in 2020; the central bank expects the economy to recover in 2021 on the back of improved global demand although GDP growth over the near term is likely to be affected by any future need to reinstate COVID-19 containment measures in the country. Connected with these economic conditions is the expectation that the gross premiums/contributions of Malaysia's non-life insurance segment will have declined by over 1% during 2020. In fact, during the first six months of 2020, reported gross direct premium declined by approximately 3.5% as compared to the same period in 2019. Motor business

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experienced the steepest fall of over 7%, due to stalled new vehicle production and a slowdown in automobile sales during a period that saw a Malaysian Government Movement Control Order (MCO) imposed to assist with containing the spread of COVID-19. Personal accident business including travel insurance, also decreased significantly during the first six months of 2020. In particular, travel insurance sales were severely hit by the ongoing pandemic, with all but essential domestic, regional and global travel paused during the period.

Marine, aviation and transit (MAT) is also a line of business which has seen heightened premium volume fluctuations in Malaysia. Given the country's oil exporting nature, this line of business has in part seen volatility over recent years, emanating from changes in the global demand and pricing for Brent crude oil. Furthermore, the COVID-19 pandemic has driven disruption to global supply chains, manufacturing industries and transport which has resulted in a decline of 1% in premiums from MAT in the first six months of 2020.

Similar to trends observed in many other Southeast Asia markets, the pandemic has supported the demand and raised awareness for health and medical insurance. According to the General Insurance Association of Malaysia, Persatuan Insurance Am Malaysia (PIAM), during the first six months of 2020, health and medical insurance premiums grew by about 3%, as compared to the same period in the year before.

Phased De-Tariffication of Motor and Fire

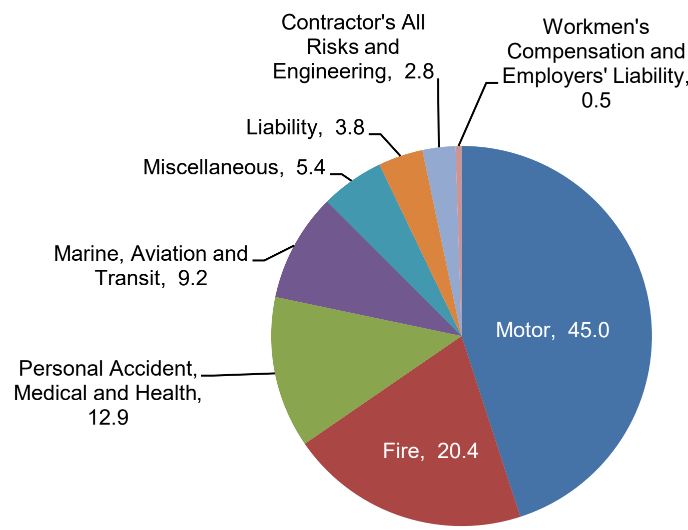
BNM first commenced implementing a programme of changes in July 2016, aimed at the gradual and phased liberalisation of Malaysia's largest non-life product lines, motor and fire insurance. Prior to this, these lines of business were subject to fixed regulatory tariffs. A large part of the motivation for the phased de-tariffication, which remains ongoing, is to enable insurers' greater flexibility and scope to differentiate as part of their product and pricing strategy, and underwriting risk selection. In terms of materiality, during 2019 and the first six months of 2020, these lines of business collectively accounted for over 65% of total gross direct premium (**Exhibit 1**). As such, the approach of implementing these changes gradually is aimed at ensuring the industry and policyholders can appropriately adapt to and avoid significant instability in pricing or performance that has been seen in some other markets when tariffs were withdrawn.

To date, there have been two phases of de-tariffication executed by BNM, which have led to a partial liberalisation of motor and fire business. More specifically, insurers underwriting certain motor and fire products have greater flexibility over their pricing, subject to an upper and lower threshold around the prescribed tariff rates. In the case of motor, insurers are able to set their pricing within a +/- 10% range of the tariff rates, while the range for fire is +/- 30%. A third phase of de-tariffication is also planned, and is

Exhibit 1

Malaysia Non-Life Insurance (ex Takaful) – Gross Direct Premium Break-down, as of 1H20

(%)

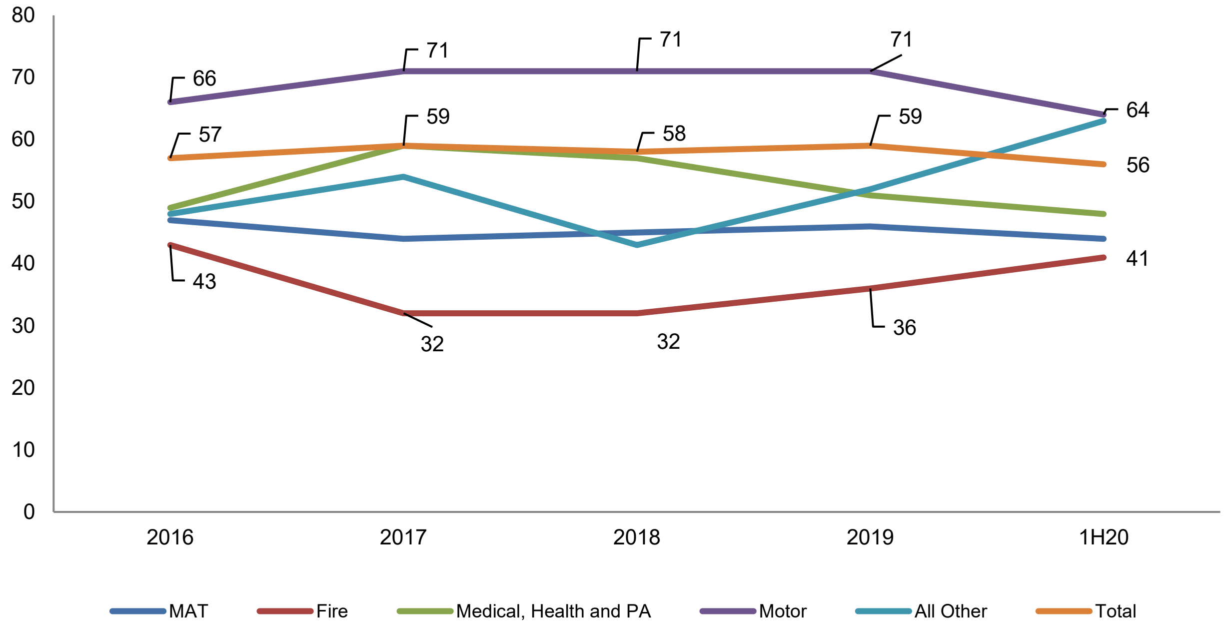


Source: Bank Negara Malaysia

Exhibit 2

Malaysia Non-Life Insurance (ex Takaful) – Historical Net Incurred Loss Ratio

(%)



Note: Net incurred loss ratio is calculated as a ratio of Malaysian general insurers' net incurred claims over earned premium income.
Source: Bank Negara Malaysia

expected to further enhance the market's liberalisation. However, this was postponed until the end of 2021.

Since the implementation of the phased de-tariffication, AM Best notes that Malaysia's non-life segment has seen a slight uptick in pricing competition, and this has placed some pressure on underwriting margins albeit insurers generally remain profitable. For motor insurance, the loss ratio has increased from 66% in 2016 to about 71% in 2019 (**Exhibit 2**), as insurers have experienced greater pricing competition, as well as various other performance challenges. Notably, the claims severity for motor-related bodily injuries has been climbing due to rising medical inflation (which has been growing at a double-digit rate); claim costs have also been driven up by increased litigation expenses associated with liability claims and fraud, as well as the impact of the Civil Law (Amendment) Act 2019.

Fire insurance is a key driver of the non-life segment's overall underwriting performance, although the growth of this line of business has slowed since 2017, along with a climbing loss ratio. Over this period, many non-life companies have begun offering discounts on premiums or widened coverage scopes for certain sub-sets and risk categories which have exhibited historically good loss experience (such as small-medium sized enterprises). These steps have been taken generally as a means of reflecting underlying profitability of accounts and to support retention of profitable business amid increased competition from other insurers in the liberalising market.

In general, the market has shown a level of discipline in responding to the transition from a tariffed market to a liberalised pricing market to date. However, AM Best notes that as the transition to an increasingly liberalised environment continues, there is likely to be increased competition over pricing and risk selection, which may further dampen underwriting margins as compared to historical levels.

Digital Transformation Catalysed by Liberalisation and COVID-19

AM Best is of the opinion that the government's phased liberalisation coupled with the disruption borne by COVID-19, have helped to accelerate the digital transformation of Malaysia's non-life insurance segment. To remain competitive and to access customers in an increasingly digital world, non-life insurers in Malaysia have focused on several initiatives including enhancing data and pricing capabilities, developing innovative products, automating claim processes, and expanding distribution online. While agency distribution remains the dominant source of business generation for this market, the online channel has grown rapidly, albeit from a small base, over the last two years. AM Best expects this channel to continue expanding robustly as more companies emphasise the benefits of digital distribution and servicing, and dedicate greater resources to digital advancement to boost sales, diversify as well as differentiate themselves against peers amid tougher competition.

However, the increasing digitalisation of the non-life market also raises companies' exposure to cyber risks and data protection issues. As such, BNM has sought to encourage digitalisation in the insurance industry cautiously, and has issued various new guidelines and policies on dealing with digital business, technology and anti-money laundering among other aspects. Although these regulatory developments seek to ensure the protection of consumer welfare, it may also potentially lead to some limitations and restrictions to insurers' business development and digitalisation efforts over the near term.

Overall, AM Best expects the use of technical solutions, digital methods to interacting and transacting with policyholders and, more generally, innovation as part of the insurance landscape to feature high on the list of ongoing strategic considerations of executive management teams of Malaysian non-life insurers over the medium term.

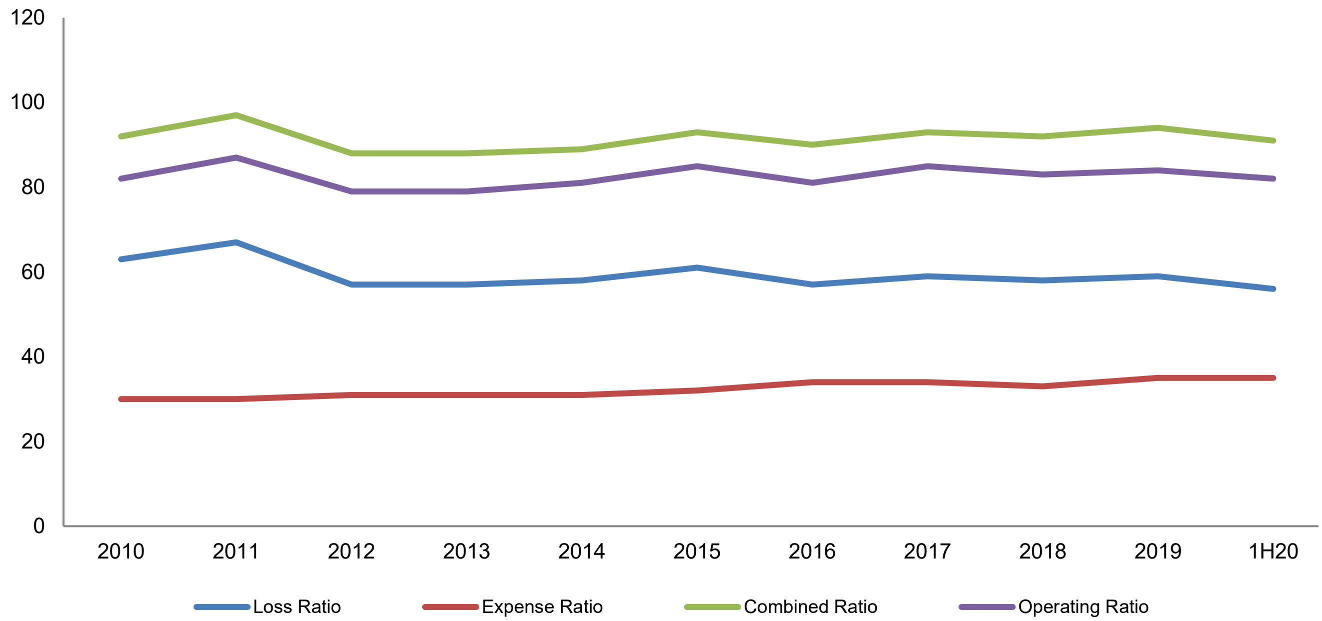
Overall Profitability Remains Resilient Despite Challenges Ahead

In terms of underwriting performance, Malaysia's non-life segment has historically outperformed several of its peers in Southeast Asia. The segment (excluding takaful) has consistently delivered favourable results, with a 10-year average combined ratio of 92% and operating ratio of 83% (2010-2019), thanks to generally robust pricing in non-motor lines of business and a relatively benign natural catastrophe environment (**Exhibit 3**).

During the first six months of 2020, some lines of business, including motor and health, benefitted from a reduction in general activity (such as reduced road traffic and visits to clinics and hospitals) and therefore lower loss experience. AM Best also notes that most standard travel policies in Malaysia that were in force when the pandemic hit included coverage exclusions for infectious diseases. As such, non-life companies were not subject to any major rise in claims. The aforementioned factors led to some improvement in loss ratios during the first six months of 2020, as compared with the same period in 2019.

Investment income also remains a key contributor to the overall earnings of Malaysian non-life insurers, which have recorded an average yield of around 5% over the past decade. AM Best notes that most market participants have prudent investment strategies and allocate a large proportion of assets to cash and deposits, as well as government and corporate bonds. However interest rates have been falling in recent years, with the BNM policy interest rate remaining at a low of 1.75% in January 2021.

Exhibit 3
Malaysia Non-Life Insurance (ex Takaful) – Underwriting and Operating Results (2010-1H20)
(%)



Source: Bank Negara Malaysia

In response to these investment conditions and in an attempt to achieve a level of yield enhancement, AM Best notes that some companies have shifted part of their asset allocations from cash and deposits to alternative instruments including exchange traded funds and unit trusts.

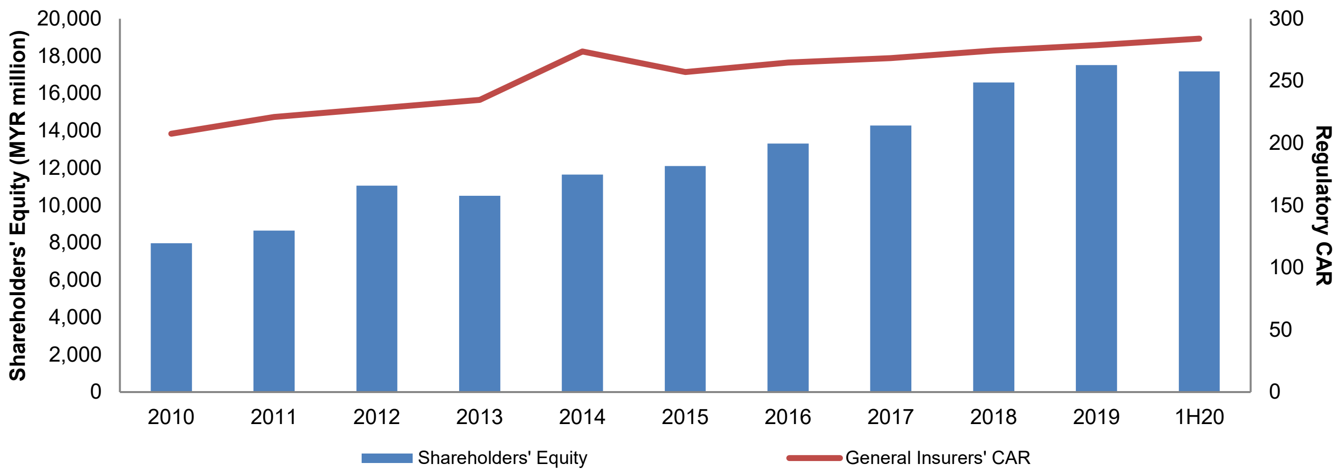
The investment risks associated with these alternative investments will be subject to the underlying composition of the funds, which often include a combination of money market instruments, bonds and equities. AM Best notes that the pandemic environment has driven a heightened level of investment volatility over the past 12 months. Notwithstanding this, the country's main stock market index, FTSE Bursa Malaysia KLCI, has recently rebounded to pre-pandemic levels. Further capital market volatility does however remain a risk and is likely to be dependent on the ongoing global and regional development and management of the pandemic. In response to these market conditions, AM Best expects the segment's non-life insurers to continue to closely monitor their underlying risk exposure to various investment classes, and where appropriate, adjust and refine their portfolio allocation as part of their risk management approach.

Robust Capital Adequacy Underpinned by Appropriate Risk Management

AM Best views the capital adequacy of Malaysia's non-life insurance segment to be healthy, albeit this varies by individual company. Total non-life insurers' shareholder equity grew at a CAGR of approximately 8% over the past five years (2015-2019), attributed to positive retained earnings supported by both underwriting and investment results.

Under BNM's RBC framework, the industry's capital adequacy ratio has been on an increasing trend over the past ten years, and has remained solid during the recent market turmoil borne by the COVID-19 pandemic. As of 30 June 2020, the capital adequacy ratio for the general insurance sector was 284%, compared to 278% as of 30 December 2019 (**Exhibit 4**). This is

Exhibit 4
Malaysia Non-Life Insurance (ex Takaful) – Regulatory Capital Adequacy Ratio (CAR)
(%)



Source: Bank Negara Malaysia

also well above the statutory minimum capital adequacy ratio level of 130% that individual insurers are required to adhere to as part of BNM's solvency regulations. Insurers in Malaysia are also required to maintain an Internal Capital Adequacy Assessment Process (ICAAP) and conduct stress tests periodically. Amid the COVID-19 pandemic, non-life companies were required to perform additional stress tests with scenarios prescribed by the regulator to ensure their solvency levels provide sufficient resilience to this unprecedented situation. AM Best has also conducted COVID-19 stress testing for all of its rated companies, including those rated in Malaysia, with most companies exhibiting sufficient available capital buffers to absorb potential shocks while maintaining solid risk-adjusted capitalisation.

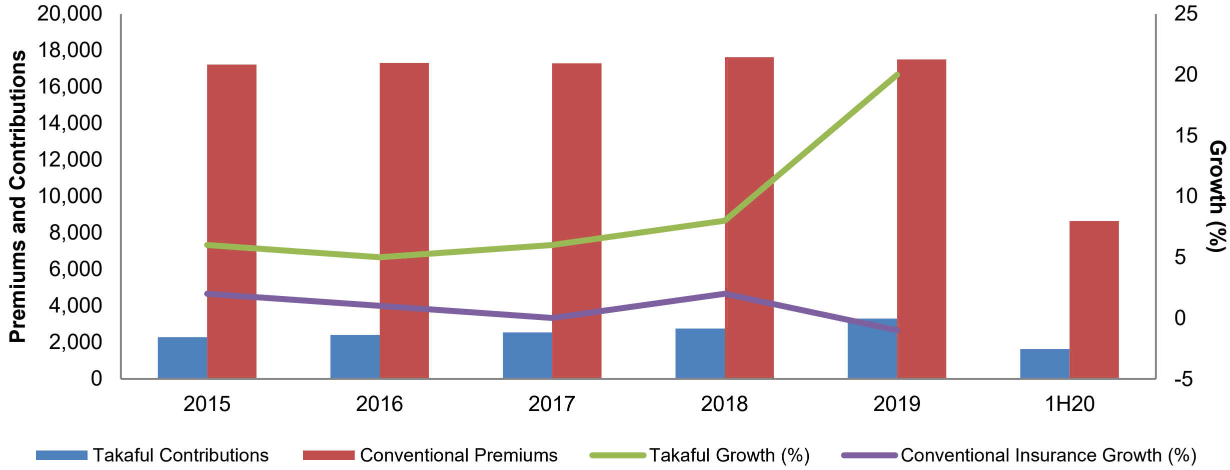
General Takaful Growth Potential

In contrast to the muted growth observed in the conventional insurance segment over recent periods, the general takaful sector in Malaysia has expanded robustly with a five-year CAGR of 10% (2015-2019) (**Exhibit 5**). Similar to its conventional counterparts, general takaful operators are regulated by BNM under a RBC framework.

The operating performance of the general takaful segment has historically lagged behind conventional general insurance companies, in part due to these operators typically having higher expense ratios, greater focus on retail lines business, and a surplus-sharing arrangement between participants and takaful operators. Nonetheless, the gap between non-life insurers' and general takaful operators' operating performance has narrowed during the first half of 2020. Looking ahead, the general takaful segment's performance, similar to conventional counterparts, is expected to face some increased pressure in underwriting results in the face of the ongoing de-tariffication of motor and fire business.

Although the general takaful segment is relatively small and highly concentrated with only four active operators (and the largest operator accounting for about half of the market), AM Best is of the view that this sector in Malaysia will likely continue to exhibit stronger growth as compared to conventional business. This certainly in part reflects the relatively low base and level of penetration that the sector is growing from; nonetheless, there is an expectation of strong growth potential for participants in this area. Growth is expected to be aided by the

Exhibit 5
Malaysia Non-Life Insurance –
Conventional Insurance Premiums and Takaful Contributions
(MYR million)



Source: Bank Negara Malaysia

country's significant Muslim population (60%), as well as the increasing appeal of takaful products due to the surplus-sharing concept.

Future Prospects

Prospectively, AM Best notes that the Malaysian non-life insurance segment continues to face a number of headwinds, including muted economic growth as the pandemic lingers, increasing underwriting competition amid phased de-tariffcation, as well as a low interest rate environment. Non-life insurers operating in this market are expected to continue to manage and minimise the impact of these headwinds on their business profiles, earnings and capital adequacy through a combination of business strategy refinement, increasingly sophisticated underwriting risk selection and appropriate risk management. Leading insurers are also expected to leverage innovation and the increased use of digital solutions to advance their capabilities and competitiveness against other market participants.

Overall, while AM Best expects a gradual thinning of underwriting and operating performance margins over the medium term, operating results are expected to remain profitable. Future operating profitability is also expected to continue to support capital growth through retention of earnings and therefore support the maintenance of robust capital adequacy metrics from the segment.

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