UNIVERSITI MALAYA

Insurance Regulation in Malaysia

An Examination of Developments and Philosophy

University of Malaya

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Biodata

Prof. Lee Hock Lock had his early education in Penang at the Anglo-Chinese School and the Methodist Boys' School. He then entered the University of Malaya in Singapore from which he graduated in 1961 with a B.A. (Hons) degree in Economics. He did post-graduate research work in the University of Malaya in Kuala Lumpur for his M.Ec and Ph.D degrees which he obtained in 1968 and 1974 respectively. In 1965, he spent almost a year in Bangkok at the United Nations Asian Institute for Economic Development and Planning, after which he was made a Fellow of the Institute.

Prof. Lee started his working life in 1961 as an Assistant Economist in the Economic Research Department of the Central Bank of Malaysia (Bank Negara Malaysia). He worked there for nine years, the last appointment held being Senior Economist and Head, Division of International Finance in the Department. For about a year in 1964-65, he was seconded by the Bank to serve as its Economic Liaison Officer in its branch in Singapore and also to be attached to the Ministry of Finance, Singapore to undertake project studies for the Ministry.

Prof. Lee left the Central Bank in late 1969 to join the Faculty of Economics and Administration of the University of Malaya as a lecturer. He was promoted to Associate Professor in the Faculty in 1975. In January 1992, he was appointed Professor of Applied Economics. He retired from the University in July of that year but was re-employed on contract, first as Professor and, subsequently, as Professor of Applied Economics until now. He was Chairman of the Divi-

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sion of Applied Economics in the Faculty in 1974-76 and from 1994 until the present.

Prof. Lee's research interests are in the areas of financial regulation; banks and other financial institutions; and economic development. His major publications include the following books: *Household Saving in West Malaysia and the Problem of Financing Economic Development*, Kuala Lumpur, Faculty of Economics and Administration, University of Malaya, 1971; *Public Policies and Economic Diversification in West Malaysia 1957-1970*, Kuala Lumpur, University of Malaya Press, 1978; *Public Policies, Commercial Banks and Other Deposit Institutions in Malaysia: A Study in Resource Mobilization and Utilization*, Kuala Lumpur, University of Malaya Co-operative Bookshop Publications, 1981; *Central Banking in Malaysia: A Study of the Development of the Financial System and Monetary Management*, Singapore, Butterworths, 1987; *Regulation of Banks and Other Depository Institutions in Malaysia: A Study in Monetary, Prudential and Other Controls*, Singapore, Butterworths, 1992.

Prof. Lee has recently completed a book project financed by the Persatuan Insuran Am Malaysia, the Life Insurance Association of Malaysia and the Malaysian National Reinsurance Bhd. The book, to be entitled, *The Insurance Industry in Malaysia: A Study in Financial Development and Regulation*, will soon be published by Oxford University Press.

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Insurance Regulation in Malaysia - An Examination of Developments and Philosophy

by LEE HOCK LOCK

INTRODUCTION

Two interesting events occurred in the past seven months. First, two days before the New Year, more than 2,000 life insurance agents gathered outside the Central Bank of Malaysia in protest. They wanted the government to suspend indefinitely the Bank's guidelines to control operating costs of life insurance companies. Second, in mid-April this year, the government tabled the Insurance Bill 1996 in the House of Representatives, a hefty piece of legislation of 225 sections. The press called it the coming of stiffer regulations for the insurance industry. A pall of gloom soon fell on the industry. There was resigned silence.

These events represent responses to a continuing process which started 35 years ago to seriously tighten controls over the insurance

industry. Culminating in the Insurance Bill 1996, there has now developed a comprehensive and complex system of controls over the operation of insurance companies and their intermediaries. Furthermore, on top of the laws and the amendments that came every few years, there are other forms of regulation such as guidelines and circulars, from the regulator. All these taken together can be very bewildering to the public.

My purpose here this evening will be try to make some sense out of this whole thing. We shall be dealing only with conventional insurers. The regulation of insurance intermediaries and the takaful operators must remain the topic of other lectures.

The principal authority empowered to regulate the insurance industry in Malaysia since 1963 is known by different names at different times of the period: Insurance Commissioner, Director General of Insurance, and Central Bank of Malaysia. For simplicity, I shall call this authority the regulator.

THE INSURANCE INDUSTRY UP TO 1960

From the time when insurers first set foot in this country in the late 18th century to about 1960, life was very simple for the insurers. Until 1915, there was almost complete laissez-faire. The growth of foreign trade increasingly raised the demand for general insurers. These came out via the agency houses which represented them. These insurers were genuinely here to do business. In any case, the close connection of the agency houses with London ensured that these insurers were well-known names. Life insurers were mostly patronised by the expatriate community. The links of the expatriates with London further ensured dealings only with insurers of repute. Also contributing to the simplicity of the environment was the absence of any consumer movement then to champion the rights of the consumers of insurance products.

By about the early years of the 20th century, the governments of the day began to feel a bit uneasy about the virtual laissez-faire situation for this growing financial service. Yet, they could not see the need to do much. And so they settled for some token legislations to cover only life and fire insurers. Very simple requirements were made under these laws. Life and fire insurers had to maintain statutory deposits with the authorities, provide for regular audits and, submit annual accounts to the registrar of companies. In addition, life insurers had to maintain insurance funds separate from their other activities and undertake actuarial investigations into their financial condition every five years.

Laws covering these matters for life insurers were passed in the Straits Settlements in 1915, the Federated Malay States in 1924, and Johore in 1934.[1] For fire insurers, the laws were passed in the Straits Settlements in 1917, the Federated Malay States in 1918 and Johore in 1934.[2] Following the establishment of the Federation of Malaya in 1948, these laws were consolidated into a single piece of legislation for life companies and another single piece of legislation for fire companies.[3] In the Borneo territories, only British North Borneo had similar laws.[4]

RATIONALE FOR COMPREHENSIVE REGULATION OF INSURANCE INDUSTRY

The laws and regulations that came after 1960 and, especially after 1963, are of a different nature. They interfered with free market forces. It would be interesting to dwell a little on why this change was made.

The primary reason is that the insurance industry belongs to that special category of financial institutions whose functioning and well-being are vital to the well-being of the nation. The industry with its many facilities touches on virtually all aspects of daily life. It is difficult to conceive of an economic activity which is not dependent on it. And it is inconceivable for modern life to have its comforts, convenience and security without it.

For a modern government, the choice is quite clear about the treatment it should accord the industry. It cannot leave the industry to sink or swim in the midst of free market forces. Too much is at stake and too many parties are involved, especially the multitude of consumers of insurance products.

Shortly after the Federation of Malaya gained independence in 1957, the government felt that the laws governing the insurance industry have become inadequate and irrelevant. It wanted a piece of legislation comprehensive enough to empower it to control and supervise all insurance activities so that the Federation would have a strong industry that would make its rightful contribution to the newly emerging economy. Following a request made to the Australian government under the Colombo Plan, an expert S.W. Caffin, then Commonwealth Actuary and Insurance Commissioner of Australia, was made available to the Federation to formulate and recommend comprehensive legislation to regulate the country's insurance industry. On the basis of his recommendations, the Federation government worked out the Insurance Act 1963.[5]

THE "MUSHROOM" INSURERS AND REGULATION

As the Insurance Act 1963 was being prepared, the urgency and necessity for a comprehensive law of control were deeply impressed on the government. This was caused by the entry and proliferation of the so-called "mushroom" life insurance companies from the second half of 1960. They were called "mushroom" companies because they sprang up in large numbers within a short time, like mushrooms overnight. These "mushroom" companies issued life policies at rates of premiums which were not actuarially calculated and with no reference to the age and health situations of the insured. Moreover, these had very small capital resources and little or no experience in insurance business. All these condemned them as pseudo insurers. By January 1962, as many as 56 "mushroom" companies were doing business in the Federation.

Right from the start, the government knew that these "mushroom" companies were heading for disaster. And so it decided to nip the problem in the bud. But under the existing insurance laws, it was totally helpless. Parliament had to pass three pieces of ad hoc legislation to deal with these companies. One imposed a barrier to entry into the life insurance industry in the form of a minimum capital requirement.[6] Another made it a requirement for premiums chargeable by a life company to be actuarially adequate and for its affairs to be run on sound insurance principles.[7] The third empowered the authorities to liquidate the "mushroom" companies.[8] All these eventually cleaned up the industry of the "mushroom" companies.

The episode of the "mushroom" companies taught the government a good lesson. It demonstrated that the existing regulatory framework was an open invitation for trouble in the insurance industry. That nothing serious ever assailed the industry over the past 50 years before the "mushroom" companies did was merely sheer good luck and, perhaps, also the lack of enterprising opportunists to exploit the situation. In particular, the "mushroom" affair drove home the following points: (a) There cannot be allowed free entry into the insurance industry. (b) The authorities must be empowered to ensure proper conduct of the insurance business.

INSURANCE REGULATION FROM 1963

The Caffin-pioneered piece of comprehensive legislation, the Insurance Act 1963, became law governing all insurance activities from 1963. At short intervals during the next 33 years, amendments were made to this Act, many extending significantly the scope and direction of regulation. In mid-April this year, the Act and all its amendments have been tidied up, rewritten, augmented, rearranged, liberalized in some aspects, tightened up in others and, presented anew as the Insurance Bill 1996. In addition to the law, there are the many guidelines and the circulars which supplement it. All the developments over the past 33 years have contributed to the build-

ing up of a regulatory framework for the insurance industry that today has touched on almost all the important aspects of insurance operations.

It is not possible for this evening's lecture to deal with all the regulations that have crept into the law, guidelines and circulars. There are too many of them. I propose to discuss only what I consider the five most important areas the post-1963 regulatory system has focussed upon. These are:

i) Barriers to free entry into the insurance industry.

ii) Insurer solvency.

iii) Other measures towards safe and sound insurers.

iv) Safeguarding the rights of consumers of insurance products.

v) Public policy through insurance regulation.

(i) Barriers to Free Entry into the Insurance Industry

Possibly the most fundamental measure of control imposed by the Insurance Act 1963 and its amendments is the putting up of barriers to free entry into the industry. It takes the form of a *requirement* for all who wish to undertake insurance business in Malaysia to be *registered.* When the Insurance Bill 1996 becomes law, *licensing* will replace registration but the effects will be the same.

Registration effectively puts an end to free entry into the insurance industry. Since 1963, two types of considerations govern the registration of an insurer:

a) its ability to meet certain qualifications; and

b) the nature of the prevailing policy conditions.

Perhaps the most important of the qualifications for entry is being able to meet the minimum capital requirement. It was RM1 million initially for either life or general insurance business and RM1.5 million

for both classes of business. These sums are small by today's standard but they were substantial in those days. They have been raised substantially since then. Coming 12 years later was the requirement to maintain a solvency margin — but more of this later. With certain exceptions, the entrant would have to be either a registered company or a co-operative. However, all insurers will have to be public companies when the Insurance Bill 1996 becomes law. These qualifications have successfully shut out the pseudo insurers.

There is little documentation about the policy environment governing registration that existed in the past 33 years but from what may be gathered, the following have been important policy considerations:

a) There was a definite policy to foster and encourage local insurers, especially from the 1970s. As late as 1972, 80 of the 93 registered insurers (86%) were foreign- incorporated.

b) The New Economic Policy was implemented in the insurance industry from 1975. The Policy has certain requirements on equity for the Bumiputra community, other Malaysians and, foreigners and these have been an inhibiting factor.

c) The insurance industry was considered by the regulator to be over-crowded, even as late as 1980.[9] With that, the policy was not to register new companies, unless there were special requirements such as for foreign reinsurers.

d) The regulator decided that the locally-incorporated companies and those that emerged from restructuring under the New Economic Policy be given a fair period of time to consolidate and grow. This was another reason to discourage new insurers.

(ii) Insurer Solvency

The maintenance of insurer solvency can be regarded as the primary reason for regulation. An insurer receives premium payments from a policyholder today in return for its promise to pay benefits at some future date — as when the risk insured against materializes or when the policy concerned matures. The value of this promise depends wholly on the insurer's ability to pay when the time for it comes i.e. it depends on the insurer's solvency.

An insurer will fail to meet this obligation if it becomes insolvent. This can give rise to very serious consequences for the insured, their dependents or persons in a third party. Furthermore, insolvency must also mean the end of the road for an insurer as it can continue to exist only on the fragile confidence of the public in its ability to deliver on its promises. Even more serious, a failure by one insurer to meet its liabilities can cause widespread anxieties and even loss of trust among the public in insurers as a whole. In extreme circumstances, runs on insurance companies have been known to occur just as there have been runs on banks.[10] All these consequences of insurer insolvency can cause irreparable damage to a nation's economy in view of the widespread role of insurance in modern life.

Fundamental though the issue of insurer solvency is for insurance regulation, it may come as a surprise that in Malaysia significant measures to promote insurer solvency came rather late — 12 years or more after the Insurance Act 1963.

In 1975, the most conspicuous of the solvency measures was introduced — the solvency margin. The use of the solvency margin rests on one simple principle namely, that it is not sufficient for an insurer to be just solvent i.e. to be in a situation where it has just enough assets to meet its liabilities. The solvency margin requires that an insurer should have a *specified amount of surplus of assets* over its liabilities at all times. This is to permit appropriate action to be taken before the actual solvency of the insurer is endangered. This surplus is called the prescribed solvency margin.

Without going into details, the prescribed solvency margin is based on the minimum capital requirement (or, for foreign insurers, the prescribed surplus of assets over liabilities in respect of their Malaysian business). From 1978, an attempt was made to relate the size of the margin for a general insurer to the volume of the insurer's business as reflected by its premium income but the capital requirement (or the surplus for foreign insurers) remained the minimum. The Insurance Bill 1996 envisages the imposition of a separate solvency margin for each class of insurance business to take account of the large differences between life and general insurance.

Insurer solvency needs *constant monitoring* by the regulator. Regular inspections of insurers and special investigations are the means used for this purpose. However, there was no legal provision for *regular inspections* of insurers in Malaysia until 1983. But during the period 1963-83, the regulator had powers to require an insurer to provide him with any information pertaining to its business. On the other hand, the powers to undertake a special investigation were already in place by 1963. Anyway, this is not the same as having powers for regular inspections.

The nature of the *reinsurance arrangements* of an insurer can determine its risk exposures and hence its solvency. It was only from 1975 that the regulator was empowered to inspect the adequacy and appropriateness of an insurer's reinsurance arrangements and to tender advice. The Insurance Bill 1996 will enable the regulator to go further namely, to require an insurer to rectify any shortcomings in its reinsurance arrangements.

Claims reserving has been and continues to be a problem area in efforts to promote solvency. By itself, the process of claims reserving is already technically difficult and subjective. But on top of that, many Malaysian insurers were found to practise improper claims reserving and some unscrupulous insurers were noted to have abused the process. To make for better claims reserving practices, two sets of guidelines have been issued by the regulator to all insurers.[11] Furthermore, the Insurance Bill 1996 will enable the regulator to

require insurers to undertake additional actuarial evaluations to assist him in his supervision work here.

Finally, the Malaysian insurance law has been equipped with certain provisions not commonly found in solvency regulations elsewhere. These provisions recognize that insolvent insurers are not total "write-offs" and that every effort should be made to rehabilitate them, if possible. These provisions, which became available from 1991, offer two sets of actions that may be taken by the regulator. The first set operates largely within the framework of an insolvent insurer's management. It may entail an order to the insurer to cease certain activities or it may require the removal of certain employees and/or directors coupled with their replacement by others. The second set of actions entails a total change in the insolvent insurer's management. Here the regulator or his appointee will assume control of the insurer and carry on its business until a turn around has been effected. In lieu of this, the regulator may apply to the High Court to appoint a receiver or manager to manage the whole or a part of the insurer's business.

Two insolvent general insurers have been put under these rehabilitation provisions in 1991. These were the Mercantile Insurance Sdn Bhd and Pan Global Insurance Sdn Bhd, the largest and second largest motor insurers respectively. Mercantile Insurance Sdn Bhd was taken over by the regulator but it still went under because its shareholders refused to inject the required fresh capital to correct its huge solvency deficiency. Pan Global Insurance Sdn Bhd was merely subjected to a revamp of its management and was salvaged.

(iii) Other Measures towards Safe and Sound Insurers

While measures to ensure insurer solvency provide the major focus for all regulatory activities, other measures have also been taken to assist the development of a strong and healthy insurance industry generally. Most of these measures, like those concerned with sol-

vency regulation, only emerged many years after the Insurance Act 1963, prompted no doubt by the experience gained and the rise of fresh problems in the industry.

Among the measures to promote safe and sound insurers, possibly the most significant are those that contribute to the development of *management of competence and integrity* for each insurer. It has often been found that a common cause for the problems of troubled insurers has to do with poor or dishonest management. In Malaysia, formal attention was accorded to ensuring management of competence and integrity for insurers only about 15 years after the Insurance Act 1963.

The following are developments towards this end:

a) From 1978, the regulator's approval is required for appointments of managing director, director, principal officer and controller. The grounds for disqualifying holders of such appointments were clarified and laid down from 1983.

b) From 1978, the regulator was empowered to call on an insurer to remove a director or a member of its senior management if he considered that its management was conducting its business in a detrimental manner. From 1991, the regulator's powers were enhanced when he can from then on directly remove such persons and replace them by others. Alternatively, the regulator or his appointee may directly take over the insurer's business and run it until the situation changes, as noted earlier.

c) By the early 1990s, the regulator has commenced to impose an annual minimum expenditure target for staff training on all insurers, this being 1% of an insurer's wage bill in 1990 and rising to 4.5% in 1994.

Measures to promote *financial prudence* among insurers constitute another important approach to promoting safe and sound in-

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surers. Besides being exposed to risks from liabilities arising from its insuring activities, an insurer is also exposed to another important source of risks namely, those arising from the manner it invests the resources of the insurance funds. From 1975, the regulator was empowered to ensure that the assets held in the insurance fund of an insurer are safe, suitable and stable.

First, from 1975, an insurer may be prohibited from making investments of certain types or it may be required to realize a part or the whole of such investments. The availability of this power should help to avoid undesirable situations such as in the U.S. where many insurers invested large amounts in junk bonds. Second, from 1978, important restrictions have been imposed on loans and advances made from insurance funds. These restrictions are to ensure that such loans and advances are well secured; that the insurer's own shares are not used as security; and that the loans and advances are not channelled to the insurer's own directors, director-interested companies and, companies related to the insurer.

Another area of prudential control entails the introduction of measures to ensure the security of the assets in insurance funds — that they are kept separate from other assets; are not mortgaged or pledged; and are in proper and accessible custody. Most of these requirements came after 1975.

Finally, the regulator has been compelled to take direct action to *control costs* in recent years to foster a more safe and sound insurance industry. Two major items of expenditure of insurers have engaged the attention and concern of the regulator. These are commission payments and management expenses.

The payment of high commissions to agents has long been used by insurers as a major means to appropriate for themselves an increasing share of the market in sectors where competition has been fierce. In life insurance, there was also the problem arising from the manner commissions have been paid which did not encourage persistency of policies.

The industry itself recognized the need for joint action among the insurers themselves to deal with the issue of commission payments. But the results of such joint actions taken in the 1980s have been limited. On management expenses, the insurers did not act. But the regulator considered that these were unduly high and merited action.

In view of these, the regulator decided to intervene directly via guidelines to control both commission payments and management expenses. It felt that more reasonable and realistic levels for both of these major items of expenditure are prerequisites for a strong industry. The first of these guidelines, issued in 1990, was directed at the general insurers.[12] The second of these, issued in late 1995, was directed at the life insurers.[13] The latter caused the vociferous demonstration of life agents outside the Central Bank seven months ago but the authorities have remained firm.

(iv) Safeguarding the Rights of Consumers of Insurance Products

Consumers of insurance products in Malaysia, especially individuals, are a disadvantaged lot when these are arrayed against insurers. They are not organized and hence they have never been a force of much influence. This situation is further aggravated by the lack of a strong consumer movement in the country. The insurance laws that were enacted from early this century to 1962 paid no regard whatsoever to consumers' rights. Whatever rights the policyholders have enjoyed then were those accorded to them by the insurers on their own volition and in the manner they saw fit.

The Insurance Act 1963 was a turning point. For the first time, protection of policyholders' rights was written in the insurance law of the country. Admittedly, the areas initially covered were few. These have since then been considerably augmented by the various amendments to the Act that came after. Furthermore, the Insurance Bill 1996 has brought in many more provisions for consumer protection.

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It would be too time consuming to examine each of the measures for consumer protection individually. Suffice it for me to indicate the broad areas into which the provisions have developed. As of today, six broad areas of consumer protection have found their way into the regulatory framework.

(a) Towards Fairer Terms for Consumers in Insurance Contracts

Insurers always have the upper hand over policyholders when it comes to insurance contracts. In many countries, laws have therefore been passed to safeguard the rights of the weaker policyholders and Malaysia has done likewise beginning with the Insurance Act 1963.

There are now *provisions to safeguard policyholders against financial losses* e.g. entitlement to a surrender value for life policies after a specified period; non-forfeiture of a policy after it has been in force for a minimum period; entitlement to conversion to a paid-up life policy; etc. Furthermore, there are now also *provisions to protect a policyholder against avoidance or cancellation of his policy* on grounds of inaccurate or questionable information supplied, under certain circumstances. A third category of provisions accords a life policyholder *the right to return a policy* he finds unacceptable shortly after issue and to get a refund of the premiums paid.

(b) Preventing Exploitation of Consumers of Insurance Products

Consumers of insurance products face possible exploitation in the insurance market. There have now been introduced measures to minimize the use of false or deceptive means by insurers or their intermediaries to induce purchase of their products. Another group of measures has been introduced to protect the small and unsophisticated policyholders under the home-service business.

(c) Ensuring Reasonably-Priced Insurance Products

Prices of insurance products have strong public interest elements. Most obvious are the compulsory insurance policies required by law to be taken by certain groups e.g.: third party motor insurance and insurance for workmen's compensation. Since 1963, the Malaysian regulator has taken upon himself the task to arbitrate on the fairness of prices of general insurance products to consumers as well as their implications for insurer solvency, whenever there have been proposals to raise premiums. Over the past 33 years, approval for changes in premium rates was granted only once each by the regulator for the motor and fire sectors. Consumer interest was evidently an important consideration.

(d) Ensuring Availability of Insurance Cover for All

Rate regulation however has given rise to problems of availability of insurance cover for all in the motor insurance sector. Furthermore, the continually rising claims ratio and other costs in the motor sector have generally made motor insurance an unattractive line of business and this further aggravated the problem of supply. All these were manifested in the following forms: difficulties of high risk vehicles getting cover; unreasonable or arbitrary loadings on premiums; and, insurers reducing or avoiding involvement with motor insurance business.

To ensure availability of cover for all at regulated prices, the regulator was forced to regulate even more: getting insurers organized into high risk motor insurance pool; controlling insurers' loadings on premiums via guidelines;[14] and, since 1991, compelling selected insurers to increase their motor business by a specified percentage.[15] But such measures at ensuring availability of cover can be viable only temporarily. The real solution must rest in controlling claims and costs — a very difficult exercise indeed.

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(e) Minimizing Problems for Users of Insurance Products

Consumers of insurance products often face a wide range of problems in their dealings with insurers. Many insurers have found it convenient to overlook or are insentitive to the situation and needs of the small policyholders or their beneficiaries.

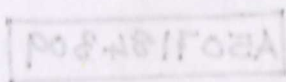
Possibly the most notable measure here was when the regulator undertook on a formal basis to receive and examine all complaints from policyholders and the public about their dealings with insurers and to take appropriate action where necessary. These complaints may touch on matters such as delays in settling claims, rejection of claims without valid reasons, delays in approving repair work on damaged vehicles, etc.

Another notable measure taken enables payment of policy moneys by insurers to beneficiaries of small policies without probate or letters of administration.

(f) Compensating Policyholders and Other Claimants of Insolvent Insurers

Not many people are aware that a fairly satisfactory legal framework is already in place since 1975 to provide for funds to be set up to meet the liabilities of insolvent insurers. These are the insurance guarantee scheme funds for general and life insurance business. There are provisions to limit the amount of payment and the categories of eligible claimants. The funds were originally intended to be financed by levies on all insurers but from 1994, it has become possible to tap other sources of funds e.g. borrowings.

So far such a fund has been established only for general insurers, the reason being possibly because insolvency has affected only general insurers.



(v) Public Policy through Insurance Regulation

There is one other important development. Since 1963, insurance regulation in Malaysia has also been used as a means to implement certain goals of public policy. Three areas may be identified:

a) Assisting in domestic financing of the economy.

b) Implementing national policy on ownership and control; and

c) Fostering a robust and mature domestic insurance industry.

In connection with the first area, it should be noted that insurance companies are not merely suppliers of insurance services. They are also mobilizers of funds in the course of providing these services. These funds become substantial as insurance activities expand. When S.W. Caffin studied the industry in the early 1960s, he found that virtually the whole of each insurance fund was invested in foreign assets.[16] He then made one very important recommendation which was accepted by the government. He called for a matching of all local liabilities of insurance funds with local assets, the pace to be determined by the availability of suitable local assets.[17] Though the underlying rationale for this recommendation was basically for prudential reasons, it meshed in perfectly with the general policy of the young Federation government to induce more domestic use of the funds mobilized by the country's financial institutions.

Thus, when the Insurance Act 1963 was enacted, insurers were required to invest at least 55% of their insurance funds in specified local assets by 1966. Over the years, this minimum proportion has been raised: to 75% by the end of 1972 and then to 80% by 1975. The point is that the continuing acceptance of this principle will in the course of time lead to a channelling of all funds mobilized by insurers into domestic investments in respect of their local liabilities.

Then came a measure of even greater significance for domestic financing. Insurers were directed to invest a specified portion of the resources of their insurance funds in medium and long-term Malaysian government securities. It is well known that proceeds from these securities are used to finance the country's public development expenditures under the five-year development plans. The developmental benefit of this measure is therefore even more.

Initially, insurers were required to hold at least 20% of their insurance funds in Malaysian government securities from 1972. This proportion was then raised to 25% from 1982.

The Insurance Bill 1996 is silent on the continuation of these two requirements but it still confers on the regulator the power to require insurers to invest their funds in such a manner or in such a place as it may prescribe.

The second area insurance regulation in Malaysia has been used to give expression to public policy is on ownership and control. As a means to deal with the long-standing problem of economic imbalance among racial groups, the New Economic Policy was implemented during 1971-90. The Policy has two objectives, the first being to eradicate poverty among all Malaysians and the second being to restructure society to eventually removing the present identification of race with economic function and location. Efforts to pursue the second objective entailed, among other things, the restructuring of equity ownership in the modern sectors and the restructuring of employment.

The pattern of equity ownership in the insurance industry in the early 1970s was sharply unbalanced, as elsewhere, with negligible holdings by the Bumiputra community, low holdings by other Malaysians and, very substantial holdings by foreigners. And so, beginning from 1975, equity restructuring targets under the Policy were imposed on the industry on a company basis, these being 30% of the insurer's total equity for the Bumiputra Community, 40% for other Malaysians and 30% for foreign interests. The requirements continued under the National Development Policy. Between 1975-

95, a total of 43 branch offices of foreign insurance companies have restructured into 33 locally-incorporated companies which gave cognizance to the targets on equity under the Policy. Eight more foreign insurers remained to be restructured and they are working towards it.

Control may also be exercised via employment and the New Economic Policy also sought to alter control through employment restructuring, particularly at the managerial and supervisory levels. Focus was directed at the employment of Bumiputra individuals which have been under-represented in the insurance industry. However progress here has not been too encouraging with regard to the managerial and supervisory categories but there has been a notable increase of Bumiputra staff generally.

The Insurance Bill 1996 will introduce further control over ownership of insurance companies when limits will be set on the size of shareholdings. This is to prevent dominating and undesirable shareholders.

Fostering a robust and mature insurance industry constitutes the third area insurance regulation has been used for public policy purposes. Three objectives may be identified here. The most obvious is to give all encouragement and help to the growth and expansion of the domestic insurers. These have emerged in significant numbers only from 1975, assisted no doubt by the New Economic Policy. The second objective concerns the need to deal with a long standing weakness of the industry namely, the tendency of insurers to send out large portions of their premium income abroad for reinsurance purposes. There have been provisions introduced in the law to compel local insurers to underwrite more of the risks usually reinsured abroad. Since 1975, ships and aircraft registered in Malaysia and property located in Malaysia have been required to be insured with insurers within the country unless otherwise permitted. The Insurance Bill 1996 will add to this list the insurance of third party liabilities of residents in Malaysia. The third objective concerns the need to build up the capacity of insurers in Malaysia

to handle large and specialized risks. To this end, guidelines have been issued in 1993.[18] But much more remains to be done.

SOME BROAD OBSERVATIONS ON INSURANCE REGULATION IN MALAYSIA

Having examined these major developments in the regulatory framework for the Malaysian insurance industry, perhaps there is one more thing I should do before I wrap up this lecture. Let me share with you some of my thoughts and observations about this whole question of insurance regulation in Malaysia.

a) First, allow me to deal with the question everyone will now be wanting to ask following the advent of the Insurance Bill 1996: "What else can we expect to see in the future?" Here I think your answer is as good as mine. But I am sure almost every one here will agree with me that the really important provisions for regulating insurers are already in place. We now have a sufficiently adequate regulatory framework. I do not see any justification for major additions in the foreseeable future.

b) Second, notwithstanding that statement, I believe some important changes will still have to be made to the regulatory framework. I refer to the need for some fine tuning to be applied to the framework. One change that needs to be made as soon as possible concerns the solvency margin. Our earlier discussion has indicated that the solvency margin for life insurers is not yet tied to the volume of business of the insurer. This is a major omission. To correct the situation, we may relate the required solvency margin for a life insurer to its total assets. Total assets of the life insurer would be a more suitable basis for reference than premium income in view of the longer term nature of the life business. Perhaps, even more important is that serious consideration be given and efforts made to improve the adequacy of the solvency

margin as a regulatory instrument for all insurers. The magnitude of the solvency margin should be related also to the risks borne by each insurer. In other words, an insurer exposed to higher risks should be required to maintain a larger solvency margin.

Third, from a reasonable man's point of view, there are already enough legal powers for the regulator to do much. But the availability of extensive legal powers for the regulator is one thing. A regulator having also the necessary expertise and manpower to effectively use these powers is another. Among other things, the Malaysian regulator does not appear too strong in the area of regular inspections and special investigations of insurers. Early warning signals appear to have been occasionally missed. For example, the cases of the Mercantile Insurance Sdn Bhd and Pan Global Insurance Sdn Bhd revealed that their insolvencies were at a fairly advanced stage before the regulator decided to act. Perhaps, the regular inspections have not been carried out at close-enough frequency and depth. The point is that there have not been enough experienced examiners in relation to the number of insurers. It would also be helpful if the regulator can develop and use early warning indicators to monitor the financial conditions and problems of insurers in between the regular inspections.

Fourth, sometimes it appears that the regulator is being pressured to achieve too much at one go and this has resulted in the imposition of even more regulation at the end of the day. A good example is what the regulator attempted in the motor insurance sector. It has tried to regulate on affordability and costs at the same time. When a cap has been put on premium prices and the efforts made at controlling costs were slow in showing results, problems on the availability of insurance cover for all became inevitable. As a consequence, the regulator had to introduce more regulations e.g. to control loadings on premiums; to compel se-

lected insurers to underwrite more motor policies; etc. But these latter measures cannot be a lasting solution. In situations such as these, it would be better if the regulator can insist and operate on the basis of a more realistic set of priorities to govern the types of action to be taken.

e) Fifth, the process of regulating used so far can certainly do with more participation by the industry. There should be more and closer consultation between the regulator and the industry; more transparent revelation of the regulator's intentions; and more willingness on the part of the regulator to take the industry into its confidence. Apparently these conditions have not been met in many instances. The most recent example has been the tabling of the giant Insurance Bill 1996 in the House of Representatives in April. The industry was generally caught by surprise by some of the provisions in the Bill. And there was no hint even in the latest annual report of the regulator issued in March this year that such a hefty Bill was on the way. I believe that more involvement of the industry in the regulatory process will lead to more effective regulations and, just as important, to better compliance.

f) Finally, it seems to me that we are fast approaching the point of very heavy regulation for the insurance industry. Today, the regulator's presence can be felt almost everywhere in the industry. For many years now, insurers have been subjected to legislation of rapid and unending growth. When the Central Bank of Malaysia became the regulator from 1988, there was added to the expanding legislation a growing list of guidelines and circulars which are in effect extensions of the law. Undeniably, many urgent and important matters about the industry are being taken care of by all these. But there are certainly other matters which should perhaps better be left to the insurers themselves or which need not be so closely regulated.

Regulation is costly business for both the regulator and the regulated. It is not the case of the more, the merrier. And it is needless for me to also add that there must be enough room given to the industry to allow for creativity and innovations. Therefore, for the good of the industry, a fresh approach to regulation appears necessary for the coming years. Efforts should commence as soon as possible to work towards a regulatory framework that will be more selective. But this is likely to be one of the hardest tasks we can ever ask of the regulator. Recent experience has not been encouraging. The regulator has done very little in this direction although it was presented with a great opportunity when the Insurance Bill 1996 was being worked out.

FOOTNOTES

[1]These are: Life Insurance Companies Ordinance 1915 (SS Cap 153); Life Assurance Companies Enactment 1924 (FMS Cap 60); and Life Assurance Companies Enactment 1934 (Johore Enactment No. 129).

[2]These are: Fire Insurance Companies Ordinance 1917 (SS Cap 152); Fire Insurance Companies Enactment 1918 (FMS Cap 59); and, Fire Insurance Companies Enactment 1934 (Johore Enactment No. 130).

[3]These are: Life Assurance Companies Ordinance 1948 and Fire Insurance Companies Ordinance 1948.

[4]These are: Life Assurance Companies Ordinance 1951 (North Borneo Cap 71) and Fire Insurance Companies Ordinance 1951 (North Borneo Cap 46).

[5]See S.W. Caffin, *Report upon Insurance Legislation for the Federation of Malaya*, Canberra, Commonwealth Government Printer, 1960.

[6]Life Assurance Companies (Amendment) Act 1961.

[7]Life Assurance Act 1961.

[8]Life Assurance (Compulsory Liquidation) Act 1962.

[9]See *Annual Report of the Director General of Insurance: 1975*, p. 43 and *1980*, p. 193.

[10]A run on an insurer can take the form of a very large number of policyholders going for surrenders of policies and policy loans as well as allowing their policies to lapse.

[11]These are "Guidelines on Accounting for Insurance Business" (JPI/GPI 3) and "Guidelines on Mathematical Estimation of IBNR Claims Provision" (JPI/GPI 12).

[12]"Guidelines to Control Operating Costs of General Insurance Business" (JPI/GP 2).

[13]"Guidelines on Operating Costs of Life Insurance Business" (JPI/GPI 6 [Revised]).

[14]See "Guidelines on Motor Premium Loadings" (JPI/GPI 4).

[15]*Annual Report of the Director General of Insurance: 1991*, pp. 75-76; *1993*, p. 81.

[16]S.W. Caffin, *op. cit*, pp. 5, 8 and 10.

[17]*Ibid*.

[18]See "Guidelines on the Scheme for Insurance on Large and Specialized Risks" (JPI/GPI 11).

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