Asia e-Alert

Milliman

Indonesia: New regulations impacting unit-linked business

Introduction

On 14 March 2022, the Indonesian Financial Services Authority (OJK) published 'OJK Circular Letter number 5/SEOJK.05/2022 (SEOJK)' outlining the new regulations for unit-linked business in the Indonesian life insurance market. The regulations were issued after two draft versions of the SEOJK were circulated to life insurers in 2020 and 2021 for industry feedback.

The SEOJK was drafted with the backdrop of numerous customer complaints and disputes pertaining to unit-linked policies. Consequently, the SEOJK seeks to enhance the level of transparency and protection accorded to unit-linked policyholders.

The SEOJK constitutes an almost entirely new set of requirements compared to the superseded 'Decision of the Chairman of the Capital Market and Financial Institution Supervisory Agency number KEP-104/BL/2006,' which previously regulated unit-linked products in Indonesia.

This e-Alert highlights the key changes in the new regulations on unit-linked business. It is neither intended to be an exhaustive list of all the changes resulting from the SEOJK nor a generally applicable set of interpretations of it. In particular, we note that there is uncertainty in many aspects of the SEOJK, which is highlighted and discussed below. The full SEOJK is available here.

Key change 1: Higher minimum capital

Section II of the SEOJK outlines a higher minimum capital requirement for companies planning to sell unit-linked products for the first time. Conventional insurance companies wishing to sell unit-linked business are now required to hold a minimum capital of IDR 250 billion (approx. USD 17 million), while Syariah insurance companies are required to hold IDR 150 billion (approx. USD 10 million). This is considerably higher than the IDR 150 billion and IDR 100 billion (approx. USD 7 million), respectively, as specified in the previous guidelines.[1]

The new requirement may provide a more stringent barrier to market entry, especially for smaller companies. Companies that have previously obtained OJK approval to sell unit-linked products are exempted from this new requirement, and thus it is likely that existing players will continue to dominate this space. However it is unclear how Syariah spin-off entities would be impacted by this requirement.

Key change 2: Increased minimum sum assured

Section III defines the new requirement for minimum sum assured. The table below shows a comparison with the previous regulations 'KEP-104/BL/2006.'

Premium Type - Currency	New regulations SEOJK5/2022	Previous regulations KEP-104/BL/2006
SP - IDR	Max(IDR 100 million; 125% SP)	Max(IDR 15 million; 125% SP)
SP - non IDR	Max(IDR 500 million; 125% SP)	Max(USD 1,500; 125% SP)
RP - IDR	Max(IDR 100 million; 5x Annual RP)	Max(IDR 7.5 million; 5x Annual RP)
RP - non IDR	Max(IDR 500 million; 5x Annual RP)	Max(USD 750; 5x Annual RP)

Notes:

1) *SP = Single Premium; RP = Regular Premium*
2) *Premium is defined as basic premium*
3) *1 USD = 14,434 IDR (Source: xe.com, as of 3rd June 2022)*

The increase in the minimum case size is likely to result in a profile shift of unit-linked policyholders towards the more affluent segment.

Key change 3: Banning guarantees

The new SEOJK forbids any form of investment guarantees in the unit-linked policy, such as a minimum investment return on the unit fund. Banning such guarantees is expected to increase transparency and make it clearer that policyholders would bear

[1] POJK No. 67/POJK.05/2016 concerning "Business License and Institutions for Conventional & Syariah Insurance and Conventional & Syariah Reinsurance Companies."

the investment risk in unit-linked products. This is expected to address some of the mis-selling risk observed in the market.

Key change 4: Removal of waiting period

In Section III, waiting period is now only applicable to customers who opt to not undergo a medical check-up during the underwriting process.

The removal of waiting period is likely to increase the anti-selection risk. There may also be repercussions in the reinsurance space. It is unclear whether reinsurers will re-price their rates given the increased risk which would ultimately result in higher overall premiums borne by policyholders.

Key change 5: Active premium holidays

The new regulations specify that premium holiday is only allowed upon policyholder's request (i.e., "active premium holiday"). Such a request must be made at least 30 days before the premium holiday takes effect.

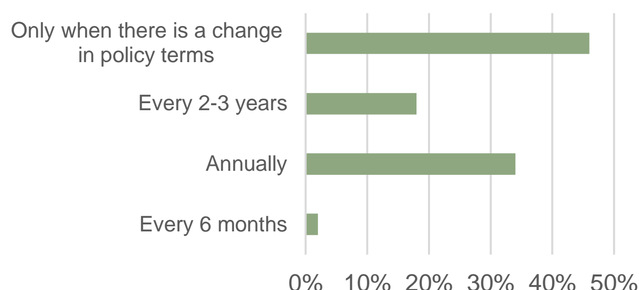
The regulation, however, does not specify how insurers should treat passive premium holidays, i.e., when a policyholder stops paying premiums without notifying the insurer and there is still a non-zero fund value. It is unclear whether such policies ceasing to pay premiums without policyholders' requests should be treated as premium holiday or if they need to be terminated immediately. If the latter, this will result in a material increase in lapses, which could have a negative impact on companies' business performance.

Key change 6: Premium adequacy

The new regulations state that insurers need to assess whether the premiums of a unit-linked policy are expected to be sufficient to sustain the policy throughout the policy term. Such tests must be carried out at the following stages of the policy: (1) at policy inception, (2) periodically during the policy term, and (3) upon specified policy modifications (e.g., when a policyholder adds new riders, exercises premium holidays and partial withdrawals, or if sum assured or coverage is increased). This new requirement is similar to the measures introduced in Malaysia in 2019.

The regulations do not specify how frequent such premium sustainability tests should be conducted during the policy term – only that they need to be performed periodically. In Malaysia where there are similar requirements, such tests must be applied at least annually. As shown below, based on our industry survey, 45% of the respondents view that the premium adequacy test should be performed only when there are policy modifications, while 35% voted that it should be performed annually.

The new regulations require companies to assess sustainability of the unit-linked premium periodically post-sale. In your view, how often should sustainability tests be done?



This new requirement for premium adequacy tests increases the operational requirements of selling and maintaining unit-linked portfolios. Unit-linked products in the market are commonly structured as 'whole of life' with policy durations of up to age 80 to 100. However the premiums of such policies are often inadequate and future top-ups are usually required to sustain the policy for the entire term. Under the new regulations, premium amounts for such policies may need to increase substantially to comply, and this is likely to make them prohibitively expensive. In Malaysia, when similar requirements were introduced, there was a shift towards shorter policy term products, with a guaranteed renewability feature, as a solution to comply with this premium adequacy requirement.

It is also noted that the regulations do not specify the rate of investment return that insurers should use in the premium adequacy test and how it relates to the rate assumed in the policy sales illustration.

Key change 7: Minimum premium allocation

There is a newly prescribed minimum portion of premiums or contributions that must be allocated to form the cash value of the policy. These portions are presented in the table below:

Premium Year	1-3	4-6	7-10	11+
Basic regular premium	60%	80%	95%	100%
Basic single premum / top-up regular premium / top-up single premium	95%			

These limits were not present in the previous regulations, and thus it has been common for life insurers to allocate far less than the newly prescribed limits. While these limits serve to better protect the cash value that the policyholders are entitled to receive, they also reduce the flexibility for insurers in designing unit-linked products and incentive structures for their distribution channels.

The higher minimum premium allocation will also result in an increased new business strain. We anticipate the strain to be more significant for Syariah business compared to conventional business – a consequence that is also widespread in Malaysia – given that expenses and commissions are typically paid by the shareholders' fund, thus limiting the ability of insurers to support this strain from any potential surplus in the risk fund.

Key change 8: Investment limits

Sub-section D of Section IV mandates a number of new restrictions on the investment strategy for unit-linked business, which were not present in the 2021 Draft SEOJK. For 74% of our industry survey respondents, the new rules on investment are one of their top three areas of concern within the new SEOJK.

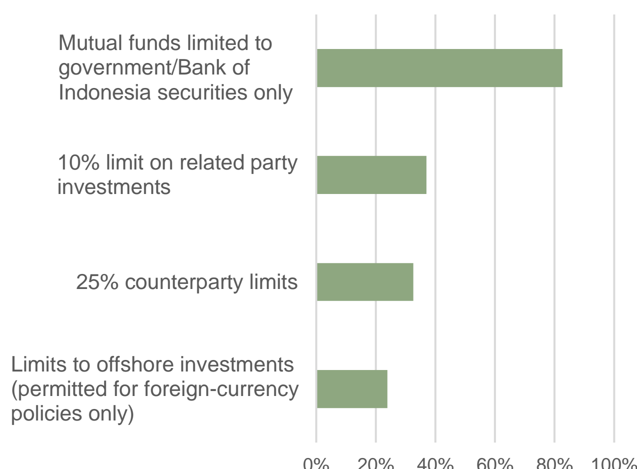
Paragraph 6 of the SEOJK prescribes a 10% cap on investments in Related Parties and a 25% cap on investments in a single counterparty. In addition, Paragraph 8 of the SEOJK requires sub-fund mutual fund investments to consist entirely of assets in government or Bank Indonesia securities, while Paragraph 9 states that sub-fund offshore investments are only permissible for foreign currency-denominated, unit-linked policies.

Currently, many insurers allocate significant assets into various types of mutual funds, such as equity funds, with various underlying assets such as equities, properties, and corporate bonds. As investments in these underlying assets through mutual funds are no longer permissible, one option is for insurers to access these asset classes through direct investment.

However, direct investments would require a higher level of investment expertise and would likely increase investment expenses. In addition, smaller funds would find investment diversification harder and could restrict access to some asset classes (e.g., property).

Many insurers are currently offering offshore funds for their unit-linked policies.The prohibition of offshore investments for Rupiah-denominated, unit-linked policies would limit policyholders' choices and result in less diversification of investments. Rupiah policy assets are now limited to local assets and hence exposed to higher concentration risk. On a positive note, this also means the elimination of currency risk on insurers' Rupiah business.

Based on our market survey, the top two key concerns by the industry on the new investment rules are the restrictions applied on mutual funds (limited to government and Bank of Indonesia securities) and the 10% limit on investments in Related Parties. The new rules on mutual funds in particular, signify a fundamental change as they limit insurers' access to other asset classes such as equities, properties, and corporate bonds.



The new restrictions on investments are expected to have a direct impact on investment return assumptions adopted by insurers when pricing unit-linked business. An increase in investment expenses, combined with more restricted asset classes, will put downward pressures on future investment returns, thus making unit-linked more expensive and less attractive.

Given the new limitations on mutual funds, insurers are exploring the usage of discretionary funds as a potential solution. However, unlike mutual funds, discretionary funds are not unitised. This may present an additional complexity for insurers to develop and maintain the daily unit pricing, which can be an onerous task.

Key change 9: Marketing process and sales disclosures

The new regulations focus on strengthening the sales process at the point-of-sale. Section V.A.6 mandates agents to document their marketing communications with prospective unit-linked policyholders through either an audio or video recording. Subsequently during the freelook period, Section V.D of the SEOJK mandates insurers to conduct a welcoming call to confirm whether the prospective policyholders have been offered the product by the agent and have received adequate explanation on the products features, fees, benefits, exclusions, and risks by the agent.

It is noted these new requirements are only applicable to unit-linked policies, thus for policyholders who would be less willing to cooperate with the recording and welcoming call requirements, they may be more inclined to purchase traditional policies which have a simpler sales process.

The mandatory requirements to have the audio/video documentation and the welcoming call require insurers to enhance their systems and resources to enable compliance,

resulting in higher operational costs. The regulation is not clear as to whether all recordings must be reviewed by the company at the point of sale, or only upon any disputes.

There are also various enhancements to the sales disclosures which are intended to improve product transparency. Section V.G stipulates the new presentation of sales illustrations. The major changes include limits on the investment returns assumed in the sales illustration with the aim to provide a more realistic projection of cash value development. The new regulation requires sales illustrations to show three scenarios with the following maximum rates of investment return (net of tax), varying based on the fund type.

Fund Type	Maximum Investment Return Assumption (%)		
	Negative	Zero	Positive
Money Market	-1	0	5
Fixed Income	-1	0	7
Equity	-1	0	10
Balanced/Mixed	-1	0	8

The older regulation only mandated the insurer to use “Low”, “Medium” and “High” investment return assumptions without specifying the maximum rates, leading to overly optimistic sales illustrations relative to the actual fund performance. In contrast, the new regulation requires insurers to annually update the positive investment return to reflect the actual performance of the funds. The zero and negative return illustrations will show the potential variability of returns thus providing some protection to policyholders from a possible misunderstanding on investment risk. Nevertheless such disclosures will also make it more difficult for insurers to sell unit-linked products.

Section V.G.2.i stipulates that sales illustrations must disclose all amounts and timings of fees charged to the policyholders. This includes the cost of insurance (COI) and the cost of riders (COR), which are not usually published, to provide more transparency to the policyholders. However, the SEOJK is silent on the disclosure requirements of COI/COR in the event of repricing during the policy term, and whether a revised sales illustration needs to be shared with the policyholders at that time.

Transition

Policies already in-force as at the SEOJK effective date are permitted to retain their terms and conditions. For new business, insurers will have a 12-month period to implement the changes with the exception of the following key changes which are effective immediately:

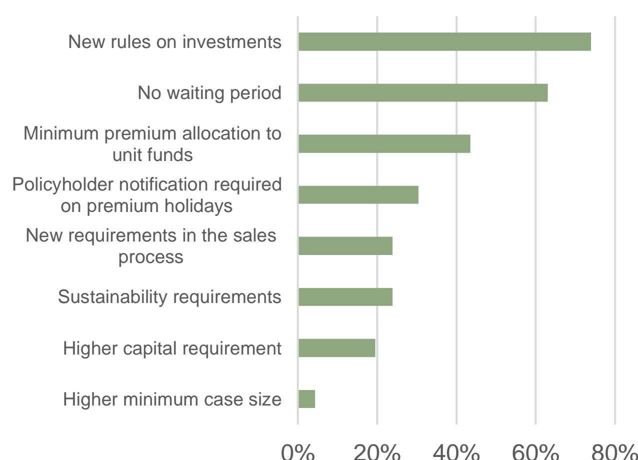
- waiting periods (Paragraph III.D.3)
- premium holidays (Paragraph III.D.4)
- general asset-liability management (Paragraph IV.A)
- investment strategy (Paragraph IV.C)
- investments in related parties (Paragraph IV.D.6)
- OJK report of investments in related parties (Paragraph IV.D.23)
- publishing of NAV (Paragraph V.I)
- account value development report (Paragraph V.J)

Existing funds that currently do not comply with the new investment rules (e.g., investment limits, mutual funds with underlying assets other than government or Bank of Indonesia securities, offshore investments) do not need to be adjusted to comply. However, for the limits on investments in related parties and single counterparties, the proportion of the existing fund currently invested in these parties cannot be increased further above the permissible limits.

Given that the new guidelines are effective immediately, many companies will be facing practical and operational challenges (e.g., resources) to comply with immediate effect, thus giving rise to non-compliance risk.

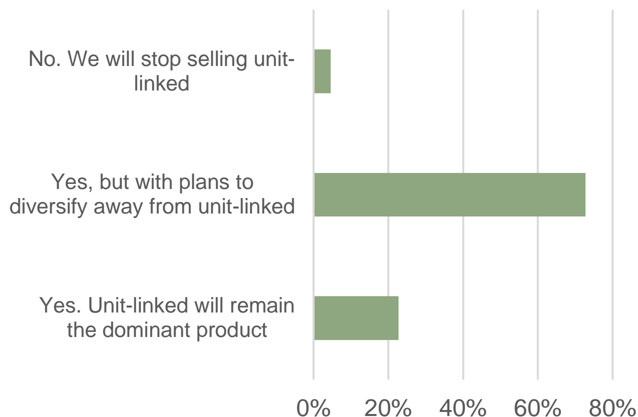
Conclusion

While the new regulation is intended to protect policyholders and improve transparency, it has also created several areas of concern for industry players. Based on our market survey the top three key areas of concern are the new rules on investment (74%), the removal of waiting period (63%), and the requirement for minimum premium allocation to unit funds (43%).



Overall, life insurers selling unit-linked products in Indonesia would need to review their product strategy, considering the impact of the new regulations on new business sales and operational costs of selling and maintaining unit-linked

business. Based on the market survey, around 73% of the respondents believe that their companies will continue to sell unit-linked business, but would plan to diversify to other product lines.



Ultimately, the resulting increase in the minimum case size for unit-linked policies means the product will only be accessible to more affluent policyholders. The new and stricter rules on the sales and management of unit-linked products are expected to have a significant impact on the Indonesian life insurance landscape.

If you would like to discuss this further, please reach out to the authors of this e-Alert listed below, or your usual Milliman consultant.

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milliman.com

CONTACT
Farzana Ismail
farzana.ismail@milliman.com

Joshua Winata
joshua.winata@milliman.com

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