Nor Shamsiah Mohd Yunus: Innovation in a disruptive era

Remarks by Ms Nor Shamsiah Mohd Yunus, Governor of the Central Bank of Malaysia (Bank Negara Malaysia), at the Malaysian Insurance Institute (MII) Summit "Innovation in a Disruptive Era", Kuala Lumpur, 28 September 2018.

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I would like to congratulate the Malaysian Insurance Institute for organising this summit. This is my inaugural engagement with the industry and it gives me great pleasure to be able to address all of you today. In line with the theme of this conference, my remarks today will cover three things:

1. Firstly, the role of insurance within the context of key developments that are shaping our economy;
2. Secondly, how the Bank views and is responding to innovation in the insurance sector; and
3. Finally, some perspectives on our regulatory and supervisory focus moving forward.

Role of insurance in an economy

Insurance plays a core function in the modern economy and the financial system. There is a positive relationship between economic growth and insurance development. This is borne out by studies which have shown that more developed markets have a higher share of insurance in the economy.

The role of insurance in the economy is worth restating, particularly given the economic and social challenges that we face today. A core purpose of insurance is providing protection against individual and business risks through risk transfer and pooling. This improves individual welfare, and supports consumption and investment activities. The effects are more pronounced among lower income groups and micro- and small businesses that are disproportionately impacted by events such as the death or incapacitation of a breadwinner, or business disruptions. Insurance and takaful therefore play a critical role in reducing inequality. This is key and growing risk can be seen in economies that are becoming more prosperous, *and* at the same time more divided.

A well-developed insurance sector also contributes to wider economic efficiency and resilience. At a time where global developments can have a far greater impact on domestic economic performance, it is important for countries including Malaysia, to continue to develop our growth potential through further diversification into new and higher value-added economic activities. Insurance facilitates this by allowing businesses to take risks, without which we cannot have innovation. It also enhances access to financing. This is possible because insurance has the ability to pool, assess and assume risks that are outside the expertise and capacity of banks or businesses themselves to bear. Such examples would be weather-related crop and property insurance, key people risks or product liabilities. Premiums that are paid for insurance also act as strong incentives for businesses to improve risk management, which in turn, increases business resilience.

Of course, insurance also plays a key role in the development and resilience of our financial markets. In these recent episodes of heightened market volatility, insurance and takaful companies, alongside banks, have had an important stabilising effect on markets.

Placed in this context, it is sobering to note that for Malaysia, insurance merely accounts for 1.7% of GDP and only 5.8% of financial assets. Clearly, there is significant, untapped potential for the industry to increase its broader economic impact, and feature much more prominently in Malaysia’s growth story. However, this cannot happen unless the industry steps up its game and takes a more strategic view of its role in the economy – working much more proactively across the industry and with relevant bodies and agencies.

Take insurance penetration. It has been sluggish. Over the past few years, penetration (in terms of total premiums to GDP) for the industry remained low at 4.8%. Less than 40% of Malaysian citizens own a life insurance or family takaful policy. For the working population aged between 20 and 59 years old, this is higher at about 50%. There are at least another around 8 million working-age individuals and over 700,000 micro enterprises in Malaysia that need protection. Of these around 3.7 million are from the Bottom 40 income group.

Another pressing issue is the role of the industry in supporting a sustainable and comprehensive healthcare system in Malaysia. Health expenditure is around 4.6% of GDP. In fact, the Malaysian medical and health insurance market has the highest average gross medical inflation. It was around 15.4% in 2018. It is expected to continue rising. The industry plays a key role in helping contain costs and to align the consumers and medical industry towards preventive care measures. This will reduce the burden of individuals in society, especially those less privileged.

Further, the world's population is ageing and Malaysia is not far from this. An ageing population will put pressure on growth and the social protection system. Insurance will have a role to play in ensuring the life, health and pension needs of society are met in a sustainable manner.

These demands on the industry are far from trivial and will not be met without strong leadership, a longer-term view on investments in capacity, and a relentless focus on quality standards and operational efficiency. Yet, today these conditions remain hampered by what is still a fragmented industry.
It is therefore timely, if not *more urgent*, for institutions to consider synergistic partnerships to achieve the scale and competitive edge to lift performance and break into new markets. Our economy is in need of transformational change in the insurance sector – not incremental ones. To achieve this, we believe there is room for further consolidation in the industry.

Technology and innovation

Let me turn to our views on innovation.

This industry has no shortage of evidence of its ability to seize opportunities provided by technology to improve itself. In the United States in the 1950s, the life insurance industry was one of the first and largest commercial users of the computer during its formative years. The data processing power of the computer allowed the industry to design new products, scale up operations and increase efficiency.

Fast forward to today, we are at the brink of another great technological revolution and disruption. Artificial intelligence, big data and robotics will reshape the way we live, work and play. In many ways, the industry is in a prime position to seize the opportunities arising from these technologies given that the ability to manage risks remains the single most compelling proposition of insurance.

For example, e-hailing services have become part and parcel of modern life. Many of the drivers do not benefit from generic motor insurance products. Perhaps usage-based or pay-as-you-drive insurance policies would be better suited for these consumers. Technology such as telematics could also be adopted to incentivise drivers to good behaviour. Artificial intelligence and blockchain can be utilised to enhance the efficiency of the claims settlement process.

As a service industry, it is important for insurance companies to address the user experience. From our extensive engagements with the public, many Malaysians still find purchasing insurance too much of a hassle. Products are perceived to be too convoluted, complicated and non-transparent. We are taking this very seriously, particularly given the measures we have taken to encourage the use of plain language coupled with clear and concise disclosures.

Clearly, these measures have not had the desired effect. There is an urgent need for the industry to design a more positive customer experience. For example, quality engagements with first-time buyers and the underserved will go a long way in closing the huge protection gap which remains our most important priority right now.

We will also be looking more closely at the experience with direct distribution channels to date. We would like to see greater impact from direct channels, including online or mobile platforms, in supporting higher insurance penetration. Today, the Millennials and iGeneration expect significant technological innovations in the entire chain of insurance experience – from product comparisons, purchase, claims, and customer support. The industry cannot ignore this fact as they will become the key customer segment in the near future. Further attention also needs to be given to the role of shared infrastructure to support insurance undertakings, building further on the fraud and motor insurance databases.

From the Bank's perspective, our aim is to facilitate innovation in three main ways. First is by lowering the barriers to innovation and competition. This is achieved by providing an environment through the regulatory sandbox for the industry, including non-insurance firms, to test innovations without costly regulatory reprisals. It also allows the Bank to appropriately tailor our rules to better suit innovations as we too, learn from observing the solutions that are tested in the sandbox.

Second is through proportionality. We aim to better reflect proportionality in our regulatory framework. For insurance, we expect that this will be mostly targeted at conduct rules where a more proportionate approach could be taken to reduce compliance costs for insurers to introduce innovative solutions in areas where we believe the risks to consumers are low.

The third area of focus will be to develop a more coherent approach, particularly across agencies, for ensuring legal and regulatory compatibility with new innovations in insurance. This includes addressing issues that may arise in legal constructs, for example*, smart contracts, liability issues associated with robo-advice or driverless cars,* and strengthening defences against cyber threats and abuses by criminal elements.

Regulatory framework and priorities: Laying the foundation for a stable and well-developed insurance sector

My third message today relates to the regulatory priorities and framework to ensure the stability and development of the insurance sector. Stability and development are not two contradictory goals.

Since the supervision of insurance was brought under the Bank's ambit in 1988, the industry has come a long way. Building on the stronger foundations in the industry, in the more recent period, we have embarked on a broad range of reforms to further develop the full potential of the industry to better serve the economy.

One of the recent significant policies we have put in place is the Life Insurance and Family Takaful Framework (LIFE Framework), which was introduced in 2015. One of the three core pillars of the LIFE Framework is to promote product innovation while preserving policy value.

At its core, the Framework places significant emphasis on product suitability assessments in the delivery of insurance products. These developments that we observe in the offering of investment-linked products have at times been at odds with this emphasis. With more than two-thirds of new premiums generated from such products in 2017, and an environment of heightened financial market volatility, a key concern for the Bank has been with the complexity of products offered, and the level of understanding of the investment risk, which is borne entirely by consumers. From our observations, the safeguards in place within insurers over product design, disclosure levels and suitability assessments continue to reveal gaps.

In this regard, the Bank has consulted the industry on potential enhancements to be made to our requirements on investment-linked insurance businesses to address some of these gaps. We expect to finalise the requirements to the Minimum Allocation Rate (MAR) shortly to protect the account value of consumers; more robust suitability tests to improve policy persistency; and enhancements to sales illustrations.

The other key reform has been the Phased Liberalisation of Motor and Fire Tariffs which started in 2016. The Bank is currently assessing the outcomes of the second phase as we prepare to launch into the next phase of liberalisation. We are encouraged to see the positive response from the industry and the positive impact on the diversity of products available to consumers. Over the coming months, we will be able to form a clearer view on the market impact of premium rate adjustments. This will allow us to consider further flexibilities in the pricing bands. We hope that this in turn will drive further product innovations in addition to expanding capacity going forward.

Internationally, developments in global regulatory and accounting standards will also see corresponding changes in the domestic regulatory environment. A key development has been the ongoing work by the IAIS to establish a risk-based global Insurance Capital Standard. It is the Bank's intention to align domestic regulations with international standards to promote the resilience of the industry. However, we will always do so with a careful consideration of domestic specificities.

The Bank trusts that the industry will continue to ramp up its preparation towards full implementation of the IFRS 17 in 2021. In the next two years, the Bank will be reviewing the valuation and capital standards for solvency reporting. This will take into account the potential areas of alignment with international solvency and accounting standards. The results from the quantitative tests and feedback from industry engagement will be valuable inputs for these upcoming reviews.

As you are no doubt aware, these standards are inherently very complex. As the industry prepares for them, there is a need to strengthen capacity and arrangements – both at the institution and industry levels – to support implementation. This includes ensuring effective organisation and coordination of technical work at the industry level through the actuarial and industry associations. The Malaysian Insurance Institute also needs to further develop its capacity to support what will almost surely be an increase in demand for effective and relevant technical training in these areas.

Conclusion

Let me conclude. The insurance industry is no stranger to innovation. The history of insurance is a success story of innovation in action. One of the earliest application of insurance is found in the ancient Code of Hammurabi. Simple insurance contracts were also commonplace in Greek and Roman civilizations for maritime trade. The insurance premium, a concept at the heart of the industry, was first observed in historical records in the 14th century in Northern Italy.

The innovative spirit and ingenuity associated with insurance offers great promise for the industry to remain relevant, flourish and contribute to the development of the nation in the times to come. The late Steve Jobs once said that "*Innovation distinguishes between a leader and a follower*." As our economy continues to grow and transform, I would urge the industry to provide leadership in demonstrating responsible and inclusive innovation.