Capital efficiency: Thriving within minimum capital standards

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Recent market developments have seen the release of the draft version of the Indonesia Insurance Roadmap 2023-2027 that brought to light a staggering increase in the minimum capital requirements for the insurance industry by 2028. The key question on everyone's mind is whether these new requirements are sufficiently robust and if they are aligned with the industry's objectives. In this article, we will offer insights into capital efficiency, which is intrinsically tied to these minimum capital requirements.

As a backdrop, in accordance with Financial Services Authority Regulations (POJK) 67/2016, the Financial Services Authority (OJK), the regulatory authority overseeing Indonesia's financial services sector, has established minimum capital requirements for insurance and reinsurance companies. These requirements currently stand at IDR100bn for conventional insurance companies and IDR50bn for Sharia-compliant insurance companies, with double those amounts mandated for their reinsurance counterparts. The proposal in the Roadmap is to increase the capital requirements by an astonishing amount by 2026 and 2028. These minimum capital standards are part of the Strategic Programme and Pillar 1 of the Roadmap, and are designed to strengthen the companies' capacity to meet their financial obligations and fortify the stability of the insurance industry. While capital management is fundamental to profitability in the insurance sector, it is imperative that companies ensure they can meet their financial commitments effectively.

On the other hand, senior management in the insurance sector grapples with perpetual questions that keep them awake at night: Is our existing capital base adequate? How do we raise capital? Are we optimising our capital efficiently? Do we have robust mechanisms in place to monitor both the sufficiency and efficiency of our capital deployment? It is a topic that piques curiosity – how can we enhance capital efficiency, while complying with the new minimum capital requirements under the Roadmap?

Capital measurement

A company's financial wellbeing can be assessed using a critical metric known as the Capital Adequacy Ratio (CAR). This essential measure is calculated using the following formula:

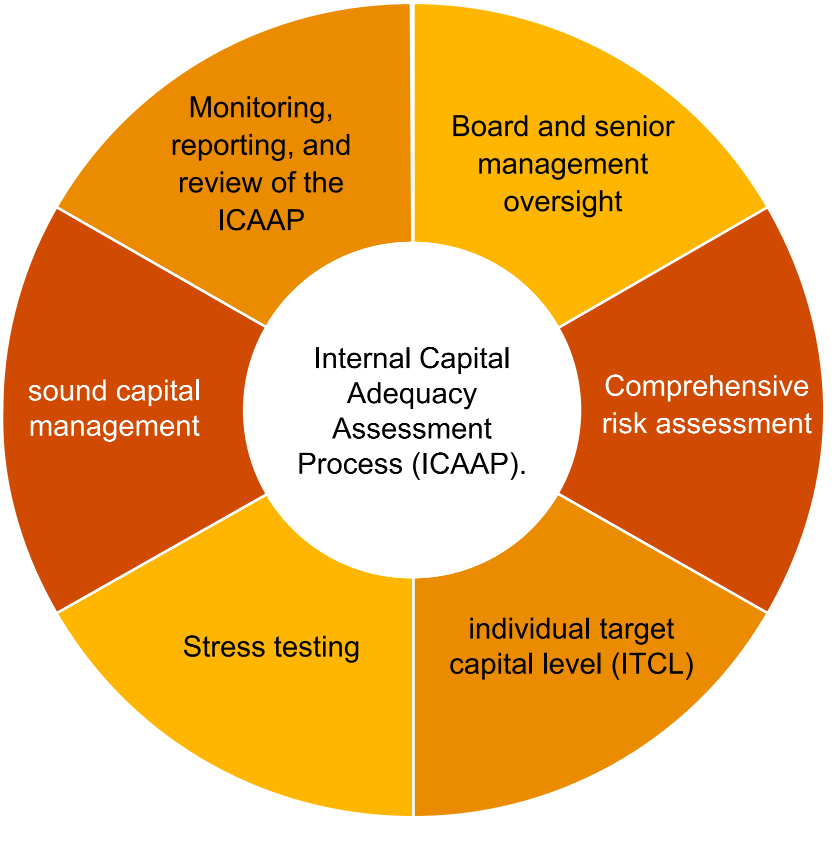
$$Capital\ Adequacy\ Ratio = \frac{Total\ Capital\ Available\ (TCA)}{Total\ Capital\ Required\ (TCR)}$$

Within the framework of Risk-Based Capital (RBC), OJK mandates that companies maintain a CAR of at least 120%. This threshold is set to ensure that companies are operating with a prudent level of capital. However, it is important to note that this 120% CAR is merely the minimum requirement established by OJK. Companies falling below this benchmark will face heightened scrutiny from OJK. Consequently, businesses are motivated to maintain CAR levels above this threshold, as unforeseen challenges could arise in the future, putting their capital adequacy to the test. Therefore, it is imperative for management to continually evaluate and reassess the company's capital adequacy.

Capital Management Framework

Insurance companies worldwide conduct assessments of capital adequacy and efficiency through the application of a capital management framework, often referred to by various names, one of which is the Internal Capital Adequacy Assessment Process (ICAAP). This comprehensive framework typically consists of board and senior management oversight, comprehensive risk assessment, individual target capital level (ITCL), stress testing, sound capital management, and monitoring, reporting, and review of the ICAAP.

The ICAAP framework can be summarised as follows.



Component	Scope
Board and senior management oversight	Approval by the Board of the insurer's risk tolerance and capital management framework. Senior management is responsible for developing and implementing ICAAP effectively.
Comprehensive risk assessment	The risk The risk assessment must provide a comprehensive evaluation of the insurer's risk profile and the quality of its risk management. This assessment should extend beyond the confines of the RBC framework, encompassing considerations such as liquidity risk, group risk, and catastrophe risk. The insurer's risk profile depends on (1) the size and complexity of the business, (2) growth and expansion strategies, (3) the nature, scale, and complexity of asset mix, and product offering, composition, and market segments. The risk management quality depends upon several critical elements: (1) the quality of Board and senior management oversight and overall governance processes, (2) the adequacy and appropriateness of policies and procedures, (3) the appropriateness of organisational and incentive structures, (4) the effectiveness of internal control functions, such as internal audit, financial control, and compliance and risk management, (5) the adequacy of supporting systems infrastructure for business and control functions, (6) the effectiveness of monitoring of risk exposure and escalation processes, and (7) the adequacy of resources and staffing, with appropriate expertise and experience.
ITCL	The ITCL is set by considering the capital requirements required to face the adverse scenarios and is measured through stress testing. The ITCL should be above 120%, the level set by the regulator. The ITCL should provide a robust threshold in the management of an insurer's capital adequacy, and a breach of the ITCL will trigger management responses to restore capital to this level. The ITCL must be set to take into account the ability to keep CAR above 120% upon occurrence of adverse scenarios throughout projections within a certain period of time.
Stress testing	By aligning the assumptions with the results of the comprehensive risk assessment, stress tests should be performed by generating and selecting adverse scenarios with their likelihood and impact based on the insurer's risk profile, quality of risk management, and operating environment. The projections should incorporate all future changes in risk profile arising from the business plan and operational activities over the period of projection, taking into account the prevailing business and economic environment, emerging trends, and historical adverse movements. The scenarios and degree of stress are different between one insurer and another.

Component	Scope
Sound capital management	The capital planning process must be dynamic and forward-looking from the insurer's risk profile, adjusted based on the ITCL, the results of stress tests, capital instrument definitions. The capital management plan (CMP) must have a list of thresholds as triggers for clear corrective actions (specific, actionable and realistic) to maintain the capital level at all times on each threshold.
Monitoring, reporting, and review of the ICAAP	Proper monitoring is required so that the insurers are able to track changes in the risk profile, risk management activities, operating environment and financial position. This process should be performed regularly considering how new experiences, emerging trends and changes to the business and operating environment impact assumptions, methods, and results of risk profile and quality risk management, stress tests, ITCL, and CMP. This process will ensure any potential breaches of thresholds are reported to the Board and senior management immediately.

Optimising capital efficiency through robust Capital Management Frameworks

The proper implementation of a capital management framework plays a pivotal role in ensuring a company can accurately quantify the risks it faces and the amount of capital needed to mitigate them. Such an approach is invaluable for charting the company's strategic course and planning for future growth, encompassing critical decisions such as dividend distributions and entering capital-intensive projects and investments, all while remaining prepared to weather unforeseen challenges.

In situations where the company's current capital falls below the ITCL, insurers should first activate a well-thought-out capital management plan to restore the capital position. This prudent step is taken before resorting to the less-favoured alternative, which is capital injection – a move often met with resistance from shareholders. Restoring capital is essential not only for the company's sustainability but also for upholding the security of policyholders and fostering confidence in the market. We can also conclude that meeting minimum capital requirements does not guarantee the adequacy of the company's minimum capital.

On the other hand, in cases of overcapitalisation, injecting further capital by raising the minimum capital requirement could inadvertently lead to capital inefficiency. Overcapitalisation typically occurs when insurance companies underwrite lower-risk, lower-volume business. In such instances, the insurer may already meet the required capital, and raising this threshold would compel a re-evaluation of the business strategy and risk appetite. This might involve underwriting more substantial volumes of business or accepting higher risks, all in an effort to deploy the surplus capital effectively. Prior to any strategic changes, it is essential to employ a comprehensive capital management framework, providing a means to assess the impact and gain a clearer understanding of capital adequacy.

We fully appreciate and support the Roadmap and its objectives, as they have the potential to enhance trust within the insurance sector. This Roadmap will bolster various aspects of the insurance industry, including its services, security, management, quality, and overall system. In conclusion, the insurance industry stands to gain from the implementation of a capital management framework such as ICAAP, a framework that seamlessly complements minimum capital requirements and enhances insurers' overall capital efficiency.

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