Milliman

Syariah Spin-off Readiness Survey: Responses & Inferences

INDONESIA | MAY 2022

Introduction

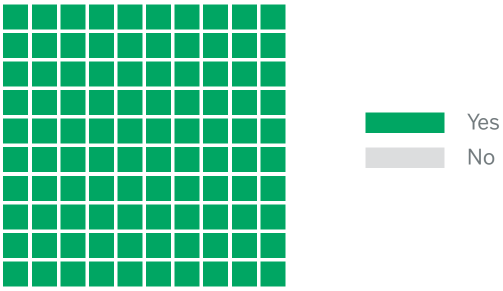
In Indonesia, in order to comply with Insurance Law 40 enacted in 2014, Conventional insurance companies with a Syariah business unit (also referred to as a "Syariah window"), are required to separate or 'spin-off' these windows no later than October 2024. In 2016, the Indonesian financial regulator, Otoritas Jasa Keuangan ("OJK"), issued Regulation No. 67/POJK.05/2016 ("POJK 67") entitled "Licensing and Institution of Insurance Companies and Reinsurance Companies" clarifying that instead of spinning-off, insurers could transfer their in-force portfolio to an existing standalone Syariah insurer. After consultation with, and lobbying from the industry, in November 2019 the OJK released POJK.05/2016 ("draft regulation"), which provides various relaxations to the requirements of POJK 67 to help ease the spin-off process. These include the ability to use shared services (with either the previous Conventional insurer or a Group function for example) for at most three years and being able to gradually increase the paid-up capital to the minimum requirements over a period of two years after spin-off.

Although October 2024 is over two years away there is a considerable amount of work for insurers to do to successfully execute a spin-off strategy. To gauge the extent of insurers' preparedness for spin-off, Milliman carried out a survey in Q4 2021 with the aim of identifying the key issues and challenges facing insurers.

Results of this survey are summarised in this report which reflects responses from 11 windows, capturing the views of small- to large-sized Syariah portfolios. All respondents were direct writers of life insurance business. No reinsurers or non-life companies responded to the survey. We would like to express our gratitude to the 11 respondents for sharing their comments and feedback. We trust that all industry participants will find the results of our survey informative.

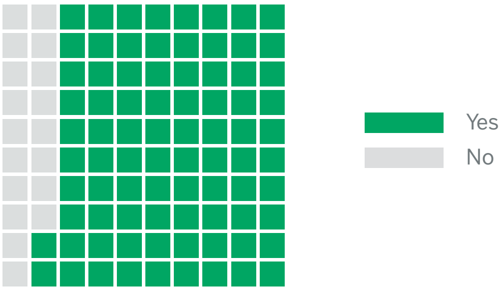
SPIN-OFF READINESS

01 Does your company plan to spin off its Syariah business unit by October 2024?



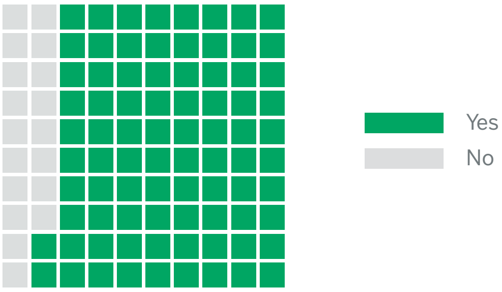
100%

02 Is your company ready to spin off its Syariah business unit by October 2024?



82%

03 Do you think the October 2024 deadline to spin off is achievable?



82%

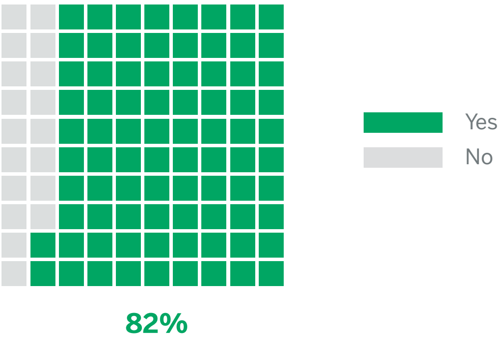
Encouragingly, all respondents plan to spin-off their Syariah unit and none are contemplating exiting the Syariah market. This shows that companies recognise the strategic value and potential growth in the Syariah market. Nine respondents described themselves as being ready to spin-off by the deadline of October 2024. with the same number believing that the October 2024 deadline is achievable.

In March 2022, Prudential announced that it had become one of the first life insurers to have received regulatory approval to spin-off its life Syariah window, with the establishment of PT Prudential Sharia Life Assurance.

The exact definition of "ready" remains open to interpretation. However, the draft regulations require the new Syariah standalone company to be launched and fully operational within 30 days of receiving approval from the OJK (as per the draft regulation to update POJK 67).

CONDUCTING THE VIABILITY OF SPINNING OFF A SYARIAH WINDOW

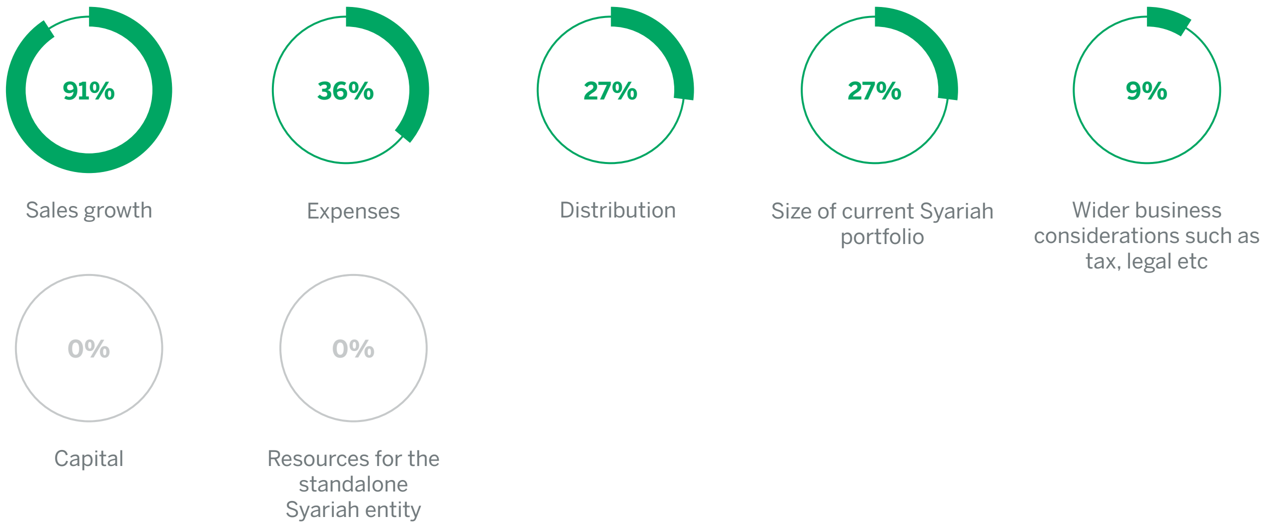
04 Has your company conducted a feasibility study on spinning off your Syariah window?



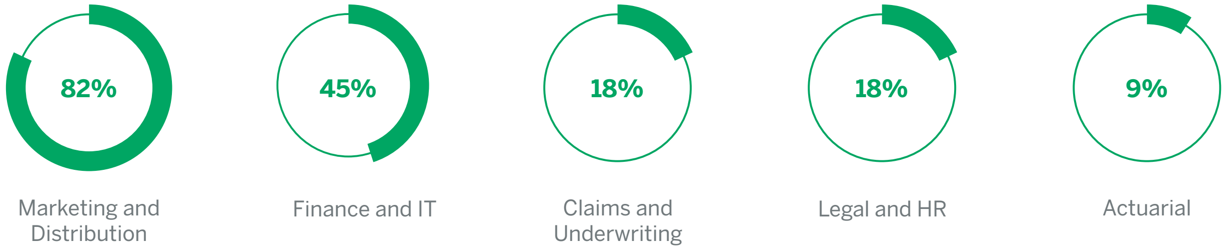
*A feasibility study is a key part in determining whether the new standalone Syariah entity is financially viable, or not. Companies should allow for sufficient time to conduct the feasibility study and for it to be sufficiently reviewed and challenged before moving onto the next stage of analysis. A good feasibility study would help insurers to assess the projected capital requirements of the standalone entity, and the expected level of profitability. Varying key drivers of risk such as expense levels and new business sales volumes would help companies understand the impact of these risks on capital and profitability. Further details on understanding the viability of spinning off a Syariah window are in the e-Alert available **here**.*

KEY CONCERNS ON THE SPIN-OFF

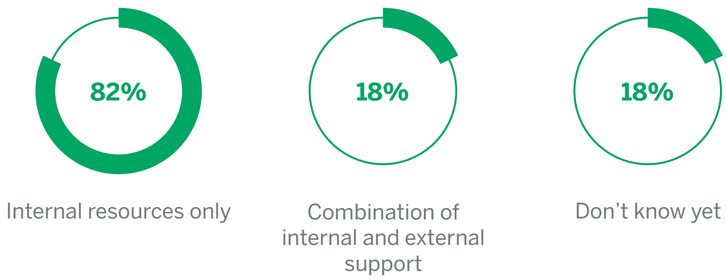
05 What are your top two concerns in Syariah spin-off?



06 In terms of resources, which are the top two business functions do you anticipate to be your biggest concern under the standalone spin-off Syariah entity?



07 What resources and support do you plan to use in the spin-off process?



The survey identifies 'sales growth' and 'expenses' as respondents' top two concerns. This is followed by concerns on the 'distribution' and 'size of the current Syariah portfolio.' While resources does not come across as a top two concerns, we suspect that this will still be one of the key issues for new 'spun-off' entities, given the general shortage of resources in Indonesia. The ability to share services with the conventional business over the first three years may however put less pressure on resources, at least in the initial years following spin-off.

In terms of business functions, respondents are most concerned with the front office sales-related functions, as well as finance and IT. This is quite natural given they involve direct touchpoints with the customer and are fundamental parts of the sales process. The scarcity of skilled and experienced human resources in the Indonesian market will make it challenging for companies to hire adequate resources for their finance and IT teams in the standalone Syariah entity. Companies will also need to check that other back-office functions, such as actuarial and legal, have sufficient resources bearing in mind the OJK's minimum function requirements.

The majority of respondents plan to use internal resources only. While this may be a cost-effective way of spinning-off the business unit, companies may also wish to consider the value of an external independent review of the work conducted such as the feasibility study, business plan, product strategy etc. In addition, external support can also help minimise the pressure on existing resources, who would also have 'Business As Usual' workload in addition to managing the spin-off.

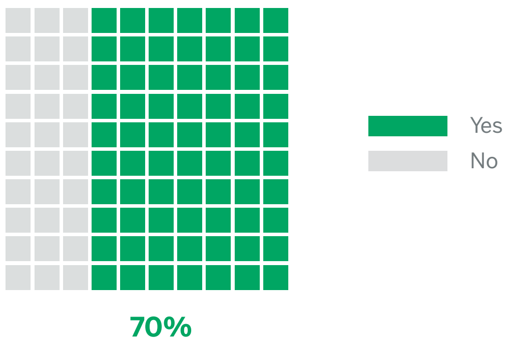
KEY CHALLENGES OF SPINNING-OFF

08 What are your top two concerns in Syariah spin-off?

Respondents identified the need 'to develop sufficient scale quickly' and 'uncertainty in future sales growth' as the two largest challenges followed jointly by 'uncertainty in legislation' and 'challenges in distribution' as their top three challenges. Companies will either need to achieve scale before spinning-off, or quickly afterwards, to benefit from economies of scale, avoid expense overruns and deliver sufficient returns to shareholders. This is consistent with the earlier survey result whereby 'sales growth' is identified as the top key concern for many respondents.

IMPACT OF REMOVING THE 80% CAP ON FOREIGN OWNERSHIP

09 Do you think removing the 80% cap on foreign ownership helps companies in spinning-off?

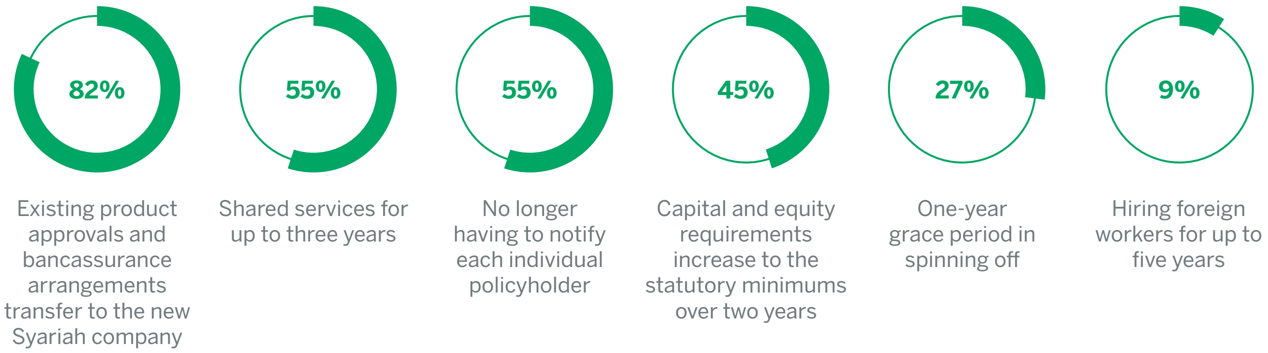


Government Regulation PP No. 14/2018 stipulated a maximum limit of 80% equity ownership by foreign investors in non-listed insurance companies. Insurance companies would be exempt from this 80% limit through "grandfathering" if the level of ownership exceeded 80% before PP No. 14/2018 came into force in August 2018. Up to year 2020, the regulations did not allow for the grandfathering to apply to the spin-off Syariah entity. This issue was a major area of concern amongst grandfathered firms before the issuance of Government Regulation PP No. 3/2020, which clarified that grandfathering could now be passported into the new Syariah insurer. If a grandfathered insurance company spins off its Syariah window, then the new standalone Syariah company will also be exempt from the 80% foreign ownership cap. Hence a majority of respondents agreed that the removal of the 80% foreign ownership cap (via grandfathering) helps insurers to justify the rationale for spin-off.

THREE ADVANTAGES AND DISADVANTAGES OF OJK'S DRAFT REGULATIONS

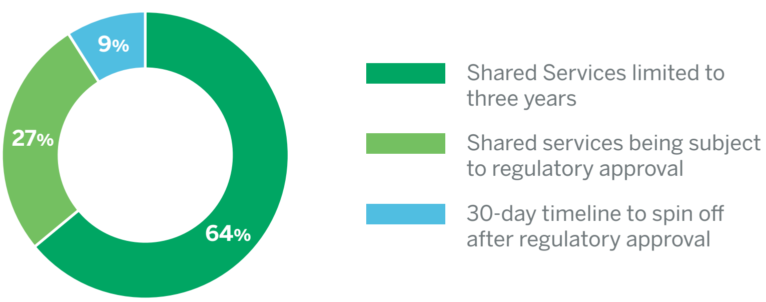
OJK's draft regulation to update POJK 67 has certainly helped to alleviate some of the challenges of spin-off. The respondents' thoughts on the advantages of this draft legislation are summarised below:

10 What do you consider to be the top three advantages of the draft regulation, issued in Nov 2019, to update POJK67?



The main advantages identified by the respondents relate to the operational aspects, with the top advantage voted by respondents to be the ability to transfer existing product approvals and bancassurance arrangements from the conventional company to the new standalone entity. This is followed by the ability to share services for up to three years, which helps with controlling expenses and minimising resource needs in the initial years. The removal of a need to notify each policyholder of the spin-off was also selected as one of the top three key advantages.

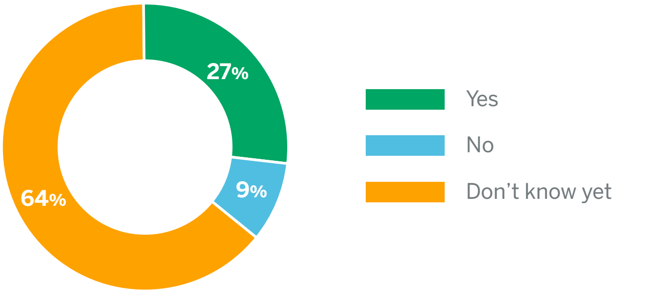
11 What do you consider to be the main disadvantage of the draft regulation, issued in Nov 2019, to update POJK67?



While the ability to use shared services is seen as an advantage of POJK67, the three-year time limit is seen as the main disadvantage of POJK67, as understandably insurers would like to use shared services for a longer period. Obtaining regulatory approval for the shared service was voted as the second main disadvantage. It will be important for companies to plan for contingency measures if approval for shared services is not granted by the OJK. Respondents did not view the 30-day timeline upon receiving regulatory approval to complete the spinning off the Syariah unit (including the portfolio transfer to the standalone Syariah entity) to be a key concern compared to the draft regulations around shared services.

ACQUIRING ANOTHER SYARIAH PORTFOLIO

12 Will your company consider acquiring another Syariah portfolio to develop to scale?

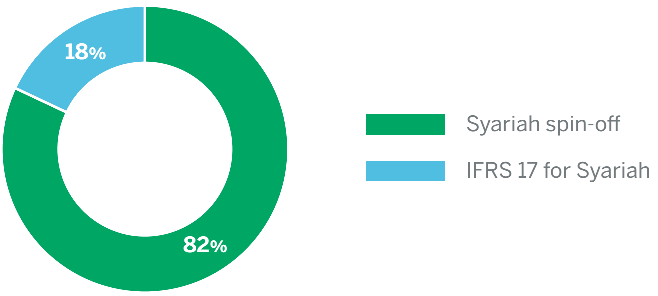


Acquiring another Syariah portfolio is one way for companies to achieve scale quickly. Most respondents appear to be relatively undecided on whether acquisition would be considered in the future. The top key concern in pursuing this option is the quality of the acquired business, followed by the acquisition price and the time and effort required during the acquisition process. It is highly advisable for potential acquirers of portfolios to conduct a full due diligence exercise to understand the quality of the business acquired and its underlying risks. The quality of the portfolio can also have an impact on the acquisition price.

13 What are your top two concerns acquiring another Syariah portfolio?

SYARIAH SPIN-OFF VS. PSAK74/IFRS17

14 Which of the following is a bigger concern and challenge for you?



The survey identifies spin-off as a bigger concern than IFRS17 for Syariah. The deadline to spin-off is October 2024, which is less than three months before 1 January 2025 - the effective date of PSAK74, which is the Indonesian equivalent of IFRS17. Companies that intend to spin-off their Syariah window should prepare to implement PSAK74 as much as possible given the expected savings for progressing while part of the Conventional company. The decision is less clear for companies that choose not to spin-off. Given the portfolio will no longer be on the company's books on the effective date of PSAK74, then it makes sense not to invest the time and effort in implementing PSAK74. However, this results in the risk of non-compliance if the insurer is unable to sell the portfolio before PSAK74 is implemented.

Conclusions

Overall, the survey indicates that existing Syariah players recognise the opportunities that exist in the Syariah market in Indonesia. While most companies have started work in developing the business case for spin-off, the results of the survey indicate that the majority of companies still have work to do in order to decide whether to spin-off or not, and to develop strategies on how to quickly grow and build scale following spin off.

Milliman is well-positioned to support you in conducting feasibility studies and business planning given our knowledge of the Syariah market in Indonesia and recent projects helping companies with spin-off requirements. Our local expertise is complemented by our significant experience of Takaful business in Malaysia and Middle East.

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Milliman is among the world's largest provider of actuarial and related products and service. The firm has consulting practices in life insurance and financial services, property & casualty insurance, healthcare, and employee benefits. Founded in 1947, Milliman is an independent firm with offices in major cities around the globe.

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CONTACT

Brian Colgan
brian.colgan@milliman.com

Farzana Ismail
farzana.ismail@milliman.com