# Asia e-Alert

Milliman

## Indonesia: Understanding the viability of spinning off a Syariah window

### Introduction

Insurance Law 40, enacted in 2014, mandates insurance companies to separate their Syariah business units, or "windows" from their conventional business into a separate entity. This process of "spin-off", is to happen when either:

- the value of the Tabarru' fund and participants' investment funds has reached 50% of the aggregate insurance funds (including conventional funds); *or*
- by October 2024 (10 years after the enactment of Insurance Law 40),

whichever occurs first. In 2016, the Indonesian regulator, Otoritas Jasa Keuangan ("OJK") issued Regulation No. 67/POJK.05/2016 ("POJK 67") to clarify that insurers could spin-off their Syariah windows by transferring their in-force portfolio to either:

- a newly licensed standalone Syariah insurance company; *or*
- an existing standalone Syariah insurer.

As at 31 December 2020, and according to the 2020 Insurance Report published by the OJK, there were 22 Syariah windows and seven standalone Syariah insurers. Shareholders of the entities with these 22 windows must decide whether a sufficient business case exists to spin-off their window into a financially viable standalone Syariah entity. The combination of profits that emerge from the transferring in-force portfolio and the new business sold through existing distribution channels (notwithstanding the higher cost structure required to support the new standalone entity) will determine whether to spin-off, or not.

This decision may be relatively straightforward for the larger windows, and those that have access to established distribution channels. However, this may not be the case for the smaller windows, whose shareholders may have questions such as:

- Is our in-force portfolio large enough to make spin-off feasible?
- What level of new business is needed to achieve scale quickly enough?
- What level of capital is required to support the spin-off entity?
- Can the spun off entity generate sufficient returns to cover expenses and provide adequate returns to shareholders?

### Illustrative Example

In order to illustrate the issues that smaller windows may be considering, we have modelled the financial impact of spinning off a hypothetical Syariah window, which we refer to as "Darussalam Syariah Life". Darussalam Syariah Life is broadly the same size as a 'middle ranking' window based on market statistics as of 31 December 2020. Our model projects the financial statements for Darussalam Syariah Life using the following simplistic assumptions:

- Transferring an in-force portfolio of two regular-premium unit-linked products (one front-end and one back-end loaded) and one single-premium credit life product. The transferring portfolio is assessed to have a value[1] to shareholders of IDR 155 billion, which is effectively the 'Purchase Price' to be paid for the transferring portfolio by the new entity. We assume that no 'net assets' are transferred to the new entity i.e. only assets equal to the liabilities will be transferred. We have assumed there is a further injection of IDR 100 billion on day-one to meet the initial paid-up capital requirement of the new spin-off entity.
- New business will be generated through bancassurance and agency sales channels. Credit life sales are assumed to be 20% of Annual Contribution Equivalent[2] and sold through the bancassurance channel only. Unit-linked sales are assumed to be 80% of Annual Contribution Equivalent and

1 Value of in-force business determined on traditional embedded value basis.

2 Annual Contribution Equivalent = 100% Regular Contribution + 10% Single Contribution

split equally between the two channels. We have assumed product margins that are broadly in line with those observed in the market (before expense overruns).

- Annual Contribution Equivalent is estimated to be IDR 80 billion in the first year after spin-off. Subsequently, new business growth rates are assumed to be 15% p.a. in the first 10 years and 10% p.a. thereafter for unit-linked business sold through agency sales channels. New business growth rates for bancassurance business are assumed to be 25% p.a. in the first 10 years and 20% p.a. thereafter. Credit life is assumed to grow at 15% p.a. in all years. This projection assumes that the expected spin-off of Syariah bank windows will support the growth of the bancassurance channel.[3]
- Commission and operating expenses are estimated to be IDR 250 billion (approximately 60% of total contributions) in the first year after spin-off, increasing by 4% p.a. thereafter to reflect a full standalone company without shared services.[4]
- Non-unit and unit-fund reserves of IDR 3 billion and IDR 350 billion respectively are assumed to be transferred into Darussalam Syariah Life. No qard is transferred on spin-off.
- The Target Capital Adequacy Ratio of Darussalam Syariah Life is projected to be 200% reflecting an internal margin over the regulatory minimum level of 120% subject to IDR 100 billion minimum paid-up capital.

Based on these assumptions, the projections assume that Darussalam Syariah Life will have an aggregate commission and operating expense overrun of IDR 650 billion over the first seven years. The magnitude of the overrun reflects Darussalam Syariah Life as a standalone entity without shared services. Additional capital injections of IDR 200 billion in excess of the initial paid-up capital of IDR 100 billion over the first five years are expected to be required, given the commission and operating expense overrun. The projections imply an Internal Rate of Return[5] of 21.3% based on the estimated Appraisal Value in year 10. If the Syariah market grows at 15% p.a., then we estimate that Darussalam Syariah Life would have a 3.7% market share after 10 years.

While this is a simplified illustrative example, such analyses can help companies identify the level of capital that is required and to understand factors that drive this level of capital. These analyses will also help to identify the importance of distribution and related new business volumes (and corresponding growth rates) and how this contributes to the commission and operating expense overrun (and capital) in the near term, prior to the generation of profits in the medium to longer term. The IRR indicates the return that shareholders can expect to receive if the business plan is achieved. Of course, the actual performance will differ to the business plan and hence sensitivity analyses can help indicate the outcome of alternative scenarios.

## Understanding outcome of alternative scenarios

We illustrate this by providing the impact of three alternative scenarios:

- Scenario 1: 25% relative decrease in new business volumes.
- Scenario 2: 25% relative increase in expenses.
- Scenario 3: 25% relative increase in new business volumes with corresponding 15% increase in expenses.

| | TOTAL ADDITIONAL CAPITAL (IDR BN) | ADDITIONAL CAPITAL REQUIRED (YEARS) | IRR | MARKET SHARE |
|---|---|---|---|---|
| BASE CASE | 200 | 5 | 21.3% | 3.7% |
| SCENARIO 1: -25% NEW BUSINESS VOLUMES | 450 | 7 | 13.4% | 2.8% |
| SCENARIO 2: +25% EXPENSES | 600 | 7 | 14.7% | 3.7% |
| SCENARIO 3: +25% NEW BUSINESS VOLUMES AND +15% EXPENSES | 230 | 5 | 23.4% | 4.7% |

3 The new business growth assumptions are for illustrative purposes only. They are not intended to represent our views on market growth.

4 We note that the industry is lobbying to the regulators to allow an arrangement of shared services between the new spin-off entity and the existing conventional insurance entity, at least in the initial years post spin-off. In this paper, we have assumed no shared services post spin-off.

5 The IRR is calculated so that when the value of in-force business is transferred to Darussalam Syariah Life, the initial paid-up capital of IDR 100 billion plus the subsequent capital injections equal the Appraisal Value at the end of year 10. The Appraisal Value is the Embedded Value at the end of year 10, plus 10 times the value of new business written in year 10.

The key observation is that adverse movements in either expenses or new business volumes (Scenarios 1 and 2) will result in higher capital injections for a longer period than the base case. While Darussalam Syariah Life is sensitive to lower new business volumes, it is possibly more sensitive to increases in expenses. Lower new business volumes drive higher capital injections from lower Ujrah collected (i.e. contribution-related and fund-related charges). An increase in expenses results in a projected increase in capital injections from a decrease in profit. The IRR reduces as a result of a lower Appraisal Value at the end of year 10 and higher capital injections for scenarios with both higher expenses and lower sales volumes. The projected market share changes in line with new business volumes since it's measured by Annual Contribution Equivalent.

Scenario 3 illustrates that higher sales volumes with a corresponding increase in expenses result in higher capital injections. This is because the increase in new business strain and expenses under this scenario offsets the positive impact of the higher Ujrah from greater sales volumes. Overall, the IRR improves as a result of a higher Appraisal Value at the end of year 10, despite higher capital injections. The higher projected market share increases consistently with the increase in new business sales.

## Conclusion

In summary, developing credible assumptions around new business volumes and expenses is crucial when assessing the financial feasibility of the spin-off entity, as these factors are the key drivers to expected future profitability and future capital requirements.

As the October 2024 deadline approaches, it is becoming more important for each company to have a well-considered strategy for its Syariah window and the new standalone entity. While some of the larger windows are well advanced in their planning and are at the stage of formally executing and implementing their plans for spin-off, our sense is that many of the smaller windows are behind in their planning. This will not only lead to less time to consider the important aspect of strategy and viability for the spun-off entity but also give the larger entities a greater head start in establishing their new brands and promoting the new Syariah entities.



**CONTACT**

Brian Colgan
brian.colgan@milliman.com

Farzana Ismail
farzana.ismail@milliman.com