Making Indonesia the Leader In Shariah Life Insurance

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It's an exciting time to be an insurer in Indonesia. In 2014, Otoritas Jasa Keuangan (OJK/Financial Service Authority), Indonesia's financial regulator, mandated insurers to separate their conventional and Sharia businesses by 2024 ('spin-off'). Amid calls for more regulatory clarity, Sharia Life Insurance (SLI) players had already started to do so, with Prudential being the first global insurer to split its businesses in 2022.

The Indonesian government has made bold moves to support this initiative, including establishing Komite Nasional Ekonomi dan Keuangan Syariah (KNEKS/National Islamic Finance Committee) and merging three local Sharia banks into Bank Syariah Indonesia, but will this be enough to create a growing, sustainable Sharia economy?

Conditions driving Sharia interest

Among Islamic countries, Indonesia has the largest insurance market at $19.2bn (2018). Yet she remains a sleeping giant in the Sharia space - SLI penetration is just 6% with a market of $890m, while neighbouring Malaysia leads with 15% penetration and a size of $1,189m, despite its insurance market being five times smaller. Premium growth in Indonesia has been a bright spot, with SLI growth outstripping total insurance growth by 1.40%.

Figure 1. Key market metrics for seven Islamic countries

		Total insurance market size 2018 (in million USD)		SLI market size 2018 (in million USD)	Total insurance premium growth 2017-2018	SLI insurance premium growth 2017-2018	SLI penetration (% of insurance market)	SLI penetration (% of GDP)
Indonesia	#1	19,220	#2	890	8.00%	9.40%	6.02%	0.09%
UAE	#2	12,500	#4	270	4.20%	6.20%	2.20%	0.06%
Saudi Arabia	#3	9,500	#3	285	5.00%	-2.70%	3.00%	0.04%
Turkey	#4	6,378	#6	115	20.50%	86.90%	1.80%	0.01%
Malaysia	#5	3,941	#1	1189	1.80%	9.70%	15.00%	0.33%
Pakistan	#6	1,968	#7	20	13.00%	26.10%	<1.0 %	0.01%
Bangladesh	#7	1,464	#5	127	11.10%	9.70%	8.70%	0.05%

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With such remarkable headroom for SLI to develop, it is no surprise that some industry players view the Sharia economy with optimism. To unlock Indonesia's Shariah potential, the government and insurers must take active steps to address critical gaps in regulation and communicate value, or this scenario is unlikely to materialise.

Opportunities to drive SLI in Indonesia

We anticipate five major areas of opportunity where insurers can influence their success in the Indonesian Sharia life insurance market:

<u>Communicate the distinct value of SLI</u>

SLI is intrinsically fair, being built on the principles of risk sharing rather than risk transfer, more common with conventional insurance, and has many consumer-friendly features. These principles are clear to insurers, but are these benefits perceived the same from a customer's perspective?

Today, Muslims make up 95% of SLI customers. However interestingly, only 27% of Muslims purchase SLI for the purposes of fulfilling their spiritual needs, with a majority citing more functional benefits such as lower premiums, higher returns, and better features. In fact, when Muslims purchase life insurance, they purchase Conventional Life Insurance (CLI) over SLI at a ratio of 2:1.

This indicates a limited differentiation between CLI and SLI products in the minds of customers. To succeed, it is critical for insurers to define how SLI can bring differentiated values to the Indonesian customer base. First, insurers can create awareness by encouraging Islamic community-based organisations, such as Muhammadiyah, to educate their members on how to adopt SLI through curriculum development.

Next, there needs to be clear industry branding around SLI inclusivity and applicability for people across all religions. Many customers who prefer CLI over SLI are drawn to its "universal" image, as there is a strong perception that SLI is created only for Muslims. Breaking this mould could mean re-engaging the general public with what SLI stands for, possibly through industry-led campaigns.

Finally, insurers should stress the key tenets of SLI around ethicality and social impact. Globally, the importance of ESG (Environmental, Social, and Governance) has soared and now touches virtually every sector. Insurers should take the opportunity to harmonise the positioning of SLI products with ESG principles, especially towards ESG-conscious customers and corporations.

<u>Reach the underinsured and uninsured</u>

Indonesia remains highly underpenetrated in terms of life insurance - our statistics show that around 60% of people in Indonesia do not have a life insurance policy, with most coming from lower income groups (<IDR 11m). At the same time, SLI purchases are highly centred on the affluent (>IDR 25m).

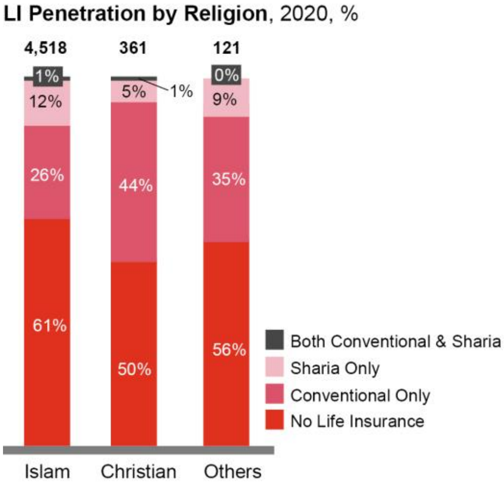

Figure 2. Life Insurance (LI) Penetration

Evidently, there is an opportunity to bring SLI to the uninsured, whereby arguably, it would deliver the most social value. First, insurers could explore direct channel led distribution of simpler products with no advisory requirements, to provide more affordable options for customers. Community-based channels such as Nahdlatul Ulama are an ideal channel to do so with its sizable membership, but this would need to be accompanied by suitable incentives for the cooperative.

Next, digital has drastically changed customer engagement and commercial delivery models. In particular, the pandemic has driven customers to become more attuned to transacting online. Internet penetration in Indonesia remains high and continues to rise dramatically, making this a key channel to reach the uninsured. Insurers can capitalise on this by creating digital applications, to provide ease of transaction and transparency.

Build a lean operating model

As SLI businesses become standalone entities, it is critical for them to scale quickly to ensure their continued existence. These businesses need to run a flexible operating model as they find their feet - leveraging on the shared resources on their CLI parent to keep costs down and build new revenue streams quickly. Regulators can facilitate this through supportive transition frameworks, in-line with Sharia-compliant processes. As the SLI businesses grow, such supporting connections can be gradually reduced as necessary.

Partnerships will be a key lever to help SLI players build scale. Bancassurance within commercial banks can be a powerful channel to bring SLI products to the wider market but this may require strong regulatory backing. Sharia banks such as BSI can also offer effective product-line synergies, especially to customers who purchase Sharia products end-to-end for more spiritual reasons.

Finally, strong distribution channels and a robust route-to-market strategy must be developed. This includes establishing and leveraging customer communities such as Muhammadiyah and Nahdlatul Ulama, as well as exploring the development of intermediary capabilities such as insurance agents and brokers.

Develop a strong talent pool

Agents are a crucial channel for SLI products, constituting around 44% of channel share. However, the number of SLI licensed agents still lags behind that of CLI agents, constituting around 36% less than CLI agent volume. Many of these licences are dual, which means a further loss in SLI agent volume if the draft Fatwa on restricting agent-duality becomes regulation. Scaling the SLI economy will require more SLI agents to be certified, well as become incentivised to sell SLI products, possibly through structural commission revisions and proprietary customer access.

A careful evaluation of agent productivity is also key. Customers indicated that the top consideration for purchasing SLI products is the agent's knowledge of Sharia-related concepts. Understandably, for these Sharia customers, conversion requires more than just product knowledge, which is typically what agents are trained in. Insurers can work with religious organisations such as Dewan Syariah Nasional-Majelis Ulama Indonesia (DSN-MUI/National Sharia Board-Indonesian Ulama Council) and associations like Asosiasi Asuransi Syariah Indonesia (AASI/Indonesian Sharia Insurance Association) to provide broader exposure to Islamic finance concepts.

Level the playing field on compliance, tax and investments

Regulators have committed to supporting the development of the Sharia economy and will benefit from taking an insurer's perspective, in ensuring an equitable SLI system. Imbalances in how CLI and SLI are managed need to be addressed; at the minimum, SLI should not have more onerous regulatory compliances than CLI.

SLI players should advocate being able to fulfil their financial health requirements at the company level instead of having to separately manage Tabarru fund solvency. Incentives should also be put in place to ensure SLI-related compliance expenses are equitable with CLI, for instance not having to pay OJK and DSN-MUI fees.

Next, costs in relation to taxation should be examined, especially if they stem from double taxation. For example, zakat payments on SLI funds could be made a part of existing income tax payments or recognised through tax credits. Ujrah could be recognised as part of overall premiums, so that they do not incur VAT. Transactions that have been split up due to Sharia-compliance should not incur tax on each transaction.

An open conversation on regulatory challenges will be key and overall benefits to the Sharia ecosystem must be made clear to all stakeholders. This may mean reassessing the way insurers currently engage with authorities, whereby insurers could collaborate to take a more active, incisive approach on Sharia regulations.

Investment asset classes will also need to be reviewed, to support the development of Sharia insurers. In Indonesia, the level of Sharia-compliant assets has historically been low, limiting the options available for SLI players to drive returns.

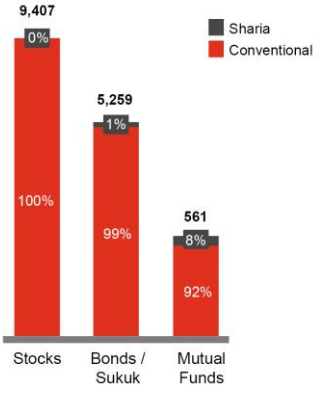

Figure 3. Sharia and Conventional investment classes asset value (in trillion Rupiah). June 2022, Source: OJK

As SLI players look more broadly for returns, alternative investment classes such as real estate and infrastructure finance may become possible sources of long-term cash flow. This will require a more robust Sharia investment approval framework from regulators, as well as the creation of more Sharia-compliant instruments in the capital markets. Clearly, the success of this initiative rests on the financial community as a whole and is not limited to insurers.

Managing regulatory challenges arising from the spin-off

Although OJK has provided further clarity on issues such as foreign ownership and capital requirements since announcing the spin-off, insurers still need to carefully navigate regulatory potholes of risk value and profitability destruction.

For instance, unforeseen expenses arising from asset transfers, VAT on shared services, and investment redemption could occur as the spin-off company becomes a separate legal entity. Ownership structures remain grey as it is unclear whether existing CLI (conventional life insurance) companies in Joint Ventures with multinationals can be considered domestic shareholders. A draft Fatwa is also in place that may restrict insurance agents from being dual-licensed - most agents would understandably pick the option that provides them with greater commissions.

Even within the existing regulations, different compliance requirements between CLI and SLI create a need for insurers to adapt the way they operate the spin-off. CLI premiums are not regulated, whereas SLI Ujrah is capped at 50% of the contribution (for non-ILP). SLI players need to maintain solvency ratios on each Tabarru fund, on top of company solvency, reducing their return on equity.

Without the resources of a conventional insurance business, some SLI businesses might find themselves unable to fully cover their costs. Clearly, there is a need for both regulators and insurers to engage in further dialogue to ensure the Sharia model is sustainable.

Your PwC Indonesia Contacts:

Please feel free to contact our Legal Specialists.

Herry Setiadie
herry.setiadie@pwc.com

Winston Nesfield
winston.nesfield@pwc.com

Paul Francis
paul.francis@pwc.com

John Dovaston
John.j.dovaston@pwc.com

Krishnan Prashant
krishnan.prashant@pwc.com

www.pwc.com/id

PwC Indonesia

@PwC_Indonesia

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