Obligation to place funds in government bonds

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Pursuant to the Financial Services Authority (Otoritas Jasa Keuangan, "**OJK"**) Regulation No.1/PJOK.05/2016 regarding Investment in Government Bonds (*Surat Berharga Negara* or **"SUN"**) for Non-Bank Financial Institutions (the **"Regulation"**), life insurance companies, general insurance companies, pension funds, among others, must commit a certain minimum amount of their investments in SUN (the **"Placement")**.

For life insurance companies, this figure is 20 percent of their total investments which is to be reached by December 31, 2016 (and 30 percent of their total investments by December 31, 2017). For general Insurance companies, the figure is 10 percent of their total investments by December 31, 2016 (and 20 percent of their total investments by December 31, 2017). As indicated in the preamble of the Regulation, the purpose of obliging insurance companies to make such a Placement is to encourage investments by non-bank financial which are in accordance with their long-term liabilities characteristics, and encourage the role of domestic investors in the development in infrastructure.

The timetable for the mandatory Placements is set out in Article 3 of the Regulation. The head of the Indonesian Association of Life Insurance Companies expressed the view on *Bisnis.com* that the supply of SUN was limited and doubted that insurance companies would be able to meet the target for the Placement. He also requested tax relief on any profits for companies that purchased SUN. Foreign buyers also purchase SUN and in fact make up an estimated 28.5 percent of purchases, and this means that supply is tight impacting negatively on yields.

Firdaus Djaelani, the director of Non-Bank Financial Institutions section of the OJK, opined that in order to increase Placement options, the OJK was currently studying the possibility of allowing Placement in State-Owned Enterprises' infrastructure bonds (**SOEIB**), which would count as Placement in SUN.

The OJK stated though that it would first have to ascertain whether the availability of SOEIB was sufficient before giving the green light. If Placement in SOEIB is approved, the OJK would issue a Circular Letter (**CL**) in this regard. Based on the statement of the OJK in the press, SOEIB would therefore have the same status as SUN. However, some questions linger, which will hopefully be addressed in the planned CL: for example, what constitutes SOEIB? Would any bonds issued by a SOE construction company be eligible? Would SOE bonds from non-construction companies be accepted as well? (from Pertamina or PLN, for example). Or will the OJK scrutinize the underlying project and determine if it is an actual infrastructure project (for example, a construction company issuing bonds for real estate development)?

Second, in the case of general insurance companies, could this not lead to a conflicted situation, whereby an insurance company could be investing in an infrastructure project via SOEIB and insuring it at the same time?

Conclusion

The OJK is on the right track: according to international best practices, insurance is by its definition a means to protect members of society and spread out risk over a long period of time, and thus it is best suited to investing in long-term financial instruments. In Indonesia, a situation has developed where insurance does not always prioritize long-term protection but short-term investments, exemplified by unit-linked products. Therefore, there is a risk that an asset maturity mismatch could occur between short-term investment objectives and the longer-term maturity of SUN and SOEIB.

The OJK is right to steer the industry toward long-term investments, such as SOEIB and SUN; nevertheless, there will be a transitional period, and the paradigm shift that is necessary will not happen overnight. Close contact and open lines of communication between the OJK and professional associations will be key to ensuring that the transition is a smooth one.

Update on bancassurance: 'armchair insurance'

MKK insurance team

Bancassurance (or **"BA"**) offers the promise of a solid B2B relationship with two sizeable institutions leveraging off each other's strengths and finding real synergy. Studies have shown that bancassurance can lower costs by 30 to 50 percent by using a bank's existing infrastructure and staff as a platform. As a form of above the line marketing, it is next to none. Over the years, its benefits have been tried and tested.

The bancassurance market in Indonesia has been heating up on the back of a spate of recent tie-ups: Manulife has signed an agreement with DBS, Allianz with Maybank and FWD with Hana Bank. The rationale for these recent moves makes good business sense; it is a truism that people do not buy insurance but rather it is sold to them: agents are needed to sell policies and it is for this reason that the insurance business is slow-going. Agent commissions are high, and there is an elevated churn rate with the training, accreditation, etc. that such an exercise entails. Anecdotal evidence suggests that the proportion of prospecting to selling is 80/20, which is not very time-efficient. Bancassurance allows underwriters to side-step this problem by obliging bank customers to take out their products as a condition to entering into a loan agreement.

The regulator steps in

The regulatory environment has not always been auspicious for BA. In 1933 the Glass-Steagall Act in the US prohibited banks from selling insurance to avoid systemic risk in the economy, but in 1999 the Act was repealed. In Indonesia there was also a speed-bump on the road when the KPPU, perhaps looking to the "25 percent rule" for BA in Korea, ruled that BA was a monopolistic practice, as it limited customer choices. KPPU stated it was contrary to Article 19A of Law no. 5 of 1999 on Prohibition of Monopolistic Practices and Unfair Business Competition. However, the ruling of the KPPU against BRI was overturned on January 26, 2016 by the Supreme Court, and this has given the green light once again to BA dealings.

The OJK, however, has wisely chosen to heed the spirit of the KPPU's admonitions by issuing a Regulation and two Circular Letters on BA in order to accommodate the concerns of the anti-monopoly agency.

It has categorized BA activities into three categories, (1) referrals, (2) distribution and (3) product integration and has ruled that banks must give customers three choices for referrals to pre-empt any accusations of monopolistic practices.

Given the foregoing, one would conclude that the BA is now an open playing field, and every insurance company in Indonesia of any size will be scrambling to enter into a lucrative bancassurance contract. But is BA the simple proposition that it seems to be? Can commercial success really be achieved with the stroke of a pen?

Analysis of the market

Let's take a moment to consider the vital underlying base of the market, the policyholders, to better understand the anatomy of BA and the implications of making BA a vital part of one's distribution network. Indonesians have traditionally tended to rely on family support networks in times of trouble, but as society becomes more and more urban and diffuse, they are finding that their traditional lines of support are not sufficient to accommodate their needs and account for all the risks in modern life. It is for this reason that more and more people will seek insurance and what better way to sell it to them through BA, the selling of insurance as a bundled product which will benefit the client and provide comfort to the bank in case of decease of the loan holder. It follows logically that it is an easy 'sell' since it is a pre-condition to entering into the loan agreement and benefits both parties. On the surface it seems like an efficient and safe strategy to follow.

However, even if bancassurance plays to Indonesians' reticence with regard to taking out insurance by forcing them to do so, insurance companies should not be too smug about it; customers are becoming more and more savvy and if the insurance products they are obliged to buy don't reap the expected benefits or if they are not competitive, customers will complain to the OJK or vote 'with their feet' and be more careful when choosing a bank to take a loan from. With the advent of the internet, customers research products and their range of choices on the net before committing to anything. In addition, another factor that insurance companies have not considered is that they could be cannibalizing their own profits since they are in essence taking clients away from their own agents and brokers.

In addition to eating into their agents' and brokers' commissions, underwriters risk losing their competitive edge. After all, agents provide a vital intimacy to the insurance relationship; they serve as on the ground ambassadors and educators for insurance and have direct interaction with policy holders. BA outsources that function at its own peril. The idea of orchestrated success through a remote marketing arrangement leaves an underwriter critically exposed. It is important to have people on the ground and the agency force is constantly evolving and adapting to the rapidly shifting market landscape. It is dangerous to take away one's scouts and point men and plant one's flag in quicksand via a long-term agreement with a high upfront payment. It seems counter-intuitive on many levels. Underwriters should be very wary if they think they can negotiate success through a B2B contract. For certain it is an important piece of the puzzle, but by no means is it the whole picture. No one would suggest turning down a system of automatic referrals, but no real service provider worth his salt would build a business solely on this either for the reasons mentioned above.

Evolving field

Finally, BA in Indonesia is still an evolving field. The efforts of the KPPU to limit or even place an outright ban may not be over. The OJK and the KPPU may not yet have had the final word on the matter. A senior commissioner of the OJK has opined negatively on upfront payments for BA agreements and called them "unhealthy" because they undermine the financial health of an underwriter by squandering funds that should be earmarked for policyholders on forward-looking B2B agreements.

"[bancassurance means] giving an upfront fee before there is any guarantee that the cooperation will be beneficial to the insurance company," stated Bpk Dumoli in a seminar entitled, "*Bancassurance in our Country*" in Jakarta, June 12, 2014. "*In the future, these sorts of practices [upfront fees] will be prohibited to protect the solvency of the insurance company's financial management to fulfill its obligations to policyholders"*. (Source: http://www.hukumonline.com/berita/baca/lt539972719a875/ojk-akan-melarang-upfront-fee-dalam-kerjasama-bancassurance?fb_comment_id=717158624996561_981498058562615)

Conclusion

Although BA upfront payments have never been subject to regulation, underwriters would be wary before committing to BA agreements given this looming regulatory risk. In general, before entering into long-term arrangements, underwriters should carefully consider all risks inherent in this form of 'armchair insurance' and the many complex considerations and financial and tactical points that are part and parcel of a BA arrangement. Some assume that with the BRI decision of the Supreme Court, the KPPU has "shot its bolt", but this may not be the case. *It remains an evolving field with all the risks this entails.*

Bancassurance: gambit in mid-game

MKK insurance team

The Life Insurance Association (AAJI) hopes to register over 650,000 agents representing various life insurance companies all over the archipelago. But the OJK has much greater ambitions: the regulator targets 10 million agents, a number which it considers optimal, considering the country's massive insurance potential. According to AAJI, around 44 percent of premium income comes from insurance agents. One must wonder then why bancassurance (**BA**) is so often in the news these days, as major life companies clinch mega deals with banks to market their products. Obviously, hopes are high for bancassurance, and deals are often pushed by offshore parent companies that hold great store by the potential of BA.

What is interesting is that the KPPU and OJK have both been making moves on the bancassurance monopolistic practices issue; not in tandem but perhaps in sequence, like two players in a game of chess. The stakes are high in the insurance sector, as there are over 1,000 existing BA agreements, and an unfavorable ruling could cause great losses. Moves are carefully considered and, as an old chess saying goes, "the mistakes are out there, just waiting to be made". Just as gambits are played by grandmasters hoping to win a reputation for themselves, BA agreements are made hoping to reap great rewards: a winning BA deal can bring in millions of dollars in new business. Regulatory risk is very high, as both the KPPU and the OJK are scrutinizing this area of activity.

KPPU has sought to liaise closely with the OJK on the BA issue. With regard to BA agreements involving unit-linked products, the KPPU made its policy recommendations to the OJK on June 24, 2014 where it opined that since there was no exclusive dealer or market leader in this field, the KPPU did not view that a breach of Article 15, No. 5/1999 had occurred. A bank recommending unit-linked products of an insurance company seemed, as a result, to not raise any red flags. However, the KPPU indicated to the OJK that limiting customers to only one choice potentially contravened the spirit of the anti-monopoly law. The KPPU thus sought the OJK's cooperation in regulating the appointment of insurance firms in BA agreements to ensure that the process was fair and transparent.

Soon after, in November, 2014, the KPPU moved to annul a B2B agreement among private parties in a bancassurance agreement, namely BRI and local insurers and fined BRI, BrIngin Life and Eka Life Rp25B, Rp19B and Rp13B, respectively. According to the bancassurance agreement, lenders of BRI were obligated to take life insurance policies from either BRIngin Life or Eka Life. BRI designated these insurers following a 2002 tender for life insurance partners. The KPPU viewed the content of the BA agreement as a monopolistic practice according to the definition set out in *The Competition Law of 1999*; consumers had no choice in their selection of insurance policies as a result of the exclusive BA agreement between BRI and the participating insurance companies.

In this case, the KPPU did not look so much to the principle of market share (BRI did not have a dominant market share, nor did the parties to the BA deal) but to the principle set out in *Bank Indonesia Circular No. 12/35/DPNP* that lenders should have a choice of at least three insurance providers with respect to BA agreements. It is also possible that the KPPU looked to a similar decision in Korea, which also called BA arrangements into question over concerns of monopolistic practices and set a limit of 25 percent for the bancassurance share an insurance company could hold in a bank's bancassurance portfolio. BRI appealed the KPPU's decision, stressing that it had in fact conducted a tender in 2002, and BRIngin Life and Eka Life had been the winners: other companies had been invited but did not meet the bank's standards and conditions. The Supreme Court agreed with BRI and though a 2016 decision, accepted the arguments of BRI, thus reinstating the BA agreement and nullifying the fines and earlier KPPU ruling.

Despite the foregoing, in a show of cooperation with the KPPU, the OJK passed a regulation and two circular letters on BA to pre-empt any concerns over anti-competition practices. OJK Circular Letter No. 32/SEOJK.05/2016 ("**CL 32**") was issued by OJK on 30 August 2016. CL 32 addressed the role of insurance companies in a BA agreement and OJK Circular Letter No. 33/SEOJK.03/2016 ("**CL 33**") was issued by OJK in September 2016 to address the role of banks in BA arrangements.

Both institutions pledged to work closely together to create a regulatory market for BA which is fair, transparent and competitive. To this end, the OJK and the KPPU now meet once every three months to discuss common issues in finance and insurance. The two agencies share data on companies' market shares and on dominant players and signed a MoU in this regard on July 15, 2014. Consistency in laws and smooth coordination between these two bodies is meant to ensure that BA will develop in a healthy and competitive manner.

The regulatory landscape for BA has been indelibly defined by the moves we described above. Because BA is an evolving area of law with various parties and more than one regulator involved (banks, insurance firms, OJK-Banks as the banking regulator, OJK-IKNB as the insurance regulator, KPPU and BI), caution is the name of the game, and skilful players would do well to look ahead before making touching a piece to move it.

It is clear from the above information on OJK/KPPU cooperation that the decisions of KPPU reverberate through those of OJK, as the insurance regulator strives to echo the concerns of KPPU in its regulations and CLs. Insurers should strive to avoid scrutiny by the regulator by taking measures to comply with the spirit of the law.

There is an old chess adage that, "*in every mistake, there is one part that is correct*". This is not meant to be a consolation for making a bad move, but a warning: just because a justification can be found for making a move *does not make it the right move*. The decision to enter into a BA agreement must only be made after considering commercial and legal aspects on various levels in what is a rapidly-evolving business and regulatory environment.

The Paper Fortress: Barriers to entry for life insurance firms

MKK insurance team

In this short note, we would like to examine the barriers to entry into the life insurance market in Indonesia in light of the sea change in the business environment that took place in Indonesia after the advent of the New Insurance Law of 2014. Shifts in the life landscape have also come about on the back of technological advances and social change. Is it now easier or harder to enter the Indonesian life market? Since many well-established names dominate the life insurance industry, it is a given that establishing a new insurance company is not an easy task. We will see in this note that it is a long and winding road but not an impassable one.

Barrier number one: access to capital

The established leaders in the life field have access to large amounts of capital, and there is no shortage of liquidity these days, especially in Asia, where the spectacular rise of China and Asean has led to large capital accumulations and markets for every type of insurance product. A life insurance company must be well-established to enter Indonesia: it requires an 'A' rating, and a letter is required from its home regulator attesting to its financial soundness, but these are minor considerations, as other factors are more daunting. Obtaining a new license may be difficult, as the life market is bursting at the seams with many well-established players. Acquisition seems to be the way to go. Many local companies are mere shells: they are undercapitalized, and the *Single Presence Policy* as well as every-increasing RBC levels is meant to trigger mergers and acquisitions; such activity has not really begun in earnest, however.

Now that the wave of Japanese entrants buying minority stakes in companies is over, there still remains a large number of local life insurance companies that are undercapitalized. Many firms are unable to comply with the RBC requirements due to economic conditions and internal liquidity issues. This opens the door to opportunity for foreign players; they can buy their way in, if the price is not too onerous, and through acquisition gain exposure to the Indonesian market. There are cross-winds, nonetheless. The recent rise in nationalism is at cross-purposes with this obvious solution, and the hesitation of numerous international players to enter the market indicates that either the barrier to entry is too high or that other conditions are not yet auspicious.

Barrier number two: information

Information has always been a barrier to entry into a market: formulation of policies depends on sophisticated modeling based on the expertise of actuaries and long years of company experience. The information revolution has eroded this barrier, now that information is readily available and more and more information is in the public domain. There are service companies that offer a complete package of software and databases for the insurance industry. While at one time insurance companies had to hire programmers to laboriously create propriety software, it is now readily available for a fee. The battle is not only about harnessing tech, but also in determining how it will be harnessed and what role it will play.

Barrier number three: distribution

Distribution is a major piece of the puzzle. Agents have always been an expensive though necessary means to getting one's product out to the public. And the public is quickly becoming more and more tech savvy, and transactions and shopping are inexorably shifting online. Photography went digital at a certain point, leaving photo developing studios such as Kodak without a viable service anymore; telecoms are also going digital, as calls can be placed over the internet and they are going from being challenged by the internet to eventually merging with it. Digitalization is also blurring lines in the insurance industry. Already there is already considerable overlap. Information is the heart of insurance. At its very core, the real value of any insurance firm is its data, and millions of dollars are invested in building data centers to protect their business. Digitalization not only offers control and manipulation of company data, but it also provides new channels of distribution.

Not only is technology changing the insurance industry, but it is also shaping it in unexpected ways. Digitalization facilitates collection and evaluation of data and is sometimes complementary and sometimes disruptive. For example, data centers are a boon for accumulating and collating data, but they may soon be made obsolete with the advent of cloud technology; As for micro-insurance, it was thought that it would be disruptive, but as it turns out, it is not the next Uber some thought it would be: its role is complementary at best but still unclear in the bigger scheme of things.

The recent wave of Indonesian bancassurance deals seems to turn away from web-based solutions and rely on long-term expensive distribution agreements with brick and mortar banking partners. A bancassurance strategy gives the advantage to large established players that have the means to enter into such agreements. If this strategy turns out to be effective, it will definitely be a barrier to new entrants since (1) they may not have the capital to enter into such agreements and (2) the choice of bank partners is becoming increasingly narrower.

Given the very low level of insurance penetration in Indonesia, the means of distribution is one of the key battlefields. In Indonesia it is a truism that "insurance is not bought but sold", and bancassurance leverages very strongly off that fact. This makes bancassurance a very compelling channel and micro-insurance less so.

Paper barrier

One of the only remaining barriers is clearly regulatory: the OJK will not give out a license to every company that requests it and even a major player will not find itself automatically welcomed with open arms. Buying into the market through acquisition is one strategy that may be successful, but the life market is already very crowded and what's more crowded with foreign players. A foreign life firm will thus have to craft a very compelling strategy to make a successful entry.

The dominant position of established players is basically only protected by regulation, without which new players could conceivably push in and take over market share through disruptive means. Digitalization poses challenges because it means that consumers have more options available to them, and it is relatively easy to compare various products and their benefits: consumers are becoming more and more sophisticated and demanding.

This poses challenges, and we must also be ready for a new wave of life insurance entrants playing by new rules. But this presents us with opportunities as well: micro insurance is a new form of insurance that offers the means to sidestep agents with the promise of increased efficiency. Micro-insurance would seem to meet the OJK's triple goal of diversification, deepening of the financial system and of financial inclusion. However, the margins are very small in micro-insurance, and one wonders if it is not becoming simply a form of CSR. Query whether it will be abandoned or instead re-invented (there is surely an opportunity to be seized here).

Perhaps a savvy new entrant could use it as the gateway to enter the market, employing micro-insurance as political leverage to obtain a license and then as a platform to build its business upon. Another strategy to ride the tech wave would be to take advantage of the government's wish to onshore data centers. An adept life firm could play the data center card with great skill and make it a key bidding factor in setting up insurance operations in Indonesia.

Conclusion

We can conclude that barriers are no longer a monolithic 'wall' to be scaled, but what we have before us is a rapidly-changing landscape. The regulatory barrier to entry is perhaps the most onerous. To gain the approval of the regulators, it is in finding solutions to current challenges that an entry model should be crafted.

As a final word, existing players would do well to revisit their business model and strive to ride the tech wave, lest they be left in its wake. Let's face it: no policyholder would consider entering into a policy without first looking it up on the internet as to its pluses and minuses and examining its reputation to determine whether 'they keep their promises'. In this new low-barrier paradigm, every player in the life insurance industry must re-think its business model, clients, employees and the ever changing market itself.