

## Malaysia: New Exposure Draft on the management of participating life business – a greater focus on estate management

On 31 December 2021, Bank Negara Malaysia (“BNM”) issued a new Exposure Draft on the management of participating life business (“Exposure Draft”<sup>1</sup>). This update comes five years after the first guidelines on the management of participating life business (“MPB guidelines”) were implemented in July 2016.

The Exposure Draft largely builds on the existing MPB guidelines. Key areas of updates and enhancements include:

- An explicit requirement to conduct an independent review of asset shares every three years, in addition to the current requirements for an independent review of the insurer’s management of participating (“par”) business.
- Requirements related to the uses of the estate in the par fund, including the need for regular assessments of the estate and a requirement to distribute ‘excess estate’.
- Management of small or shrinking par funds.
- Submission requirements of proposed bonus revisions.

This e-Alert summarises the key changes in the Exposure Draft, with a focus on new requirements related to estate management and management of small or shrinking par funds.

### Management of the estate in the par fund

The Exposure Draft outlines the permitted use of the estate as working capital for the par fund, specifically to:

- Alleviate new business strain for profitable new par business;
- Facilitate investment management; and
- Support bonuses in line with Policyholders’ Reasonable Expectations (“PRE”).

We interpret ‘profitable new par business’ as new par policies that the Board reasonably expects to be profitable to the insurer, as opposed to intentionally selling loss-making new

par business. To what extent any cost of capital should be allowed for in such assessments is not exactly clear and may be something that the industry wants to clarify with BNM, or otherwise leave open to each insurer’s interpretation.

Insurers will be required to conduct the following assessments on the par fund estate:

1. **One-off assessment** to confirm the quantification of the estate and ascertain that the estate is not directly attributable to any specifically identifiable groups of policyholders.

As part of the estate quantification, insurers are required to conduct an analysis of movement between asset shares and the estate since the first independent review of asset shares was carried out, supported with a reconciliation of asset shares (and their underlying components) to reported financial statements. We understand insurers will have commissioned their first independent review of asset shares within the last five years, after the implementation of the MPB guidelines in 2016.

If it is discovered that the estate has arisen, at least in part, from any past underpayments to policyholders, then insurers are expected to rectify and make good such underpayments from the estate to current and exited policyholders, with the cost of the rectification exercise borne by shareholders. In this context, “underpayment” has been defined in the Exposure Draft as “a shortfall of payment to policy owners in relation to policy owners’ reasonable expectations, contractual obligations, and prevailing requirements during the time when payments were made”.

We note that the normal smoothing applied in the determination of participating payouts will naturally give rise to under- or over-payments relative to asset shares. We would not expect such differences to fall under the definition of “under payments”, however, the industry may want to seek clarification from BNM on this interpretation.

<sup>1</sup> [https://www.bnm.gov.my/documents/20124/948107/ED\\_on\\_Management\\_of\\_Participating\\_Life\\_Business.pdf](https://www.bnm.gov.my/documents/20124/948107/ED_on_Management_of_Participating_Life_Business.pdf)

This one-off assessment must be submitted to BNM within four months of the financial year-end falling on or after 31 December 2022.

**2. Annual assessment** to ascertain whether the amount of estate to be retained as working capital in the par fund is appropriate and gives due regard to the interests of policyholders. Insurers will also need to consider the ongoing solvency and ensure fair distribution and utilisation of the estate over time.

As part of the annual assessment, insurers will need to project the par fund taking into consideration the expected new business (including the interaction between in-force and new business) and for closed funds, the run-off profile of the policies. The annual assessment will need to be documented in a report that details the methodology and assumptions used to determine working capital and the amount of estate expected to be used as working capital. The report will need to include future projections of the par fund and the projected bonus supportability ratios, which the insurer will use to form an assessment of the estate.

These annual assessments must be submitted to BNM within four months of the financial year-end.

## Distribution of “excess estate”

The Exposure Draft also introduced the concept of “excess estate”, which is defined as the residual estate in excess of that required as working capital in the par fund.

Insurers will be required to distribute any excess estate, while preserving the ongoing solvency of the par fund. Conceptually, this new requirement is similar to requirements that apply to participating funds in the UK<sup>2</sup>. In any proposed estate distribution, insurers will need to give due regard to the interests and fair treatment of policyholders. Any estate distribution needs to ensure gradual and orderly resolution of the estate. Specifically, the distribution of the excess estate must avoid any windfall gain to any group of policyholders.

If the shareholders’ share of any distribution of the excess estate is in line with Para 13.10 of the Management of Insurance Funds policy document (shown below), then insurers will only need to notify BNM of the distribution within four months of the insurer’s financial year-end. The notification must outline the proposed distribution approach supported by the analysis specified in the Exposure Draft, together with the annual assessment on the use of estate as working capital.

### PARA 13.10 OF THE MANAGEMENT OF INSURANCE FUNDS POLICY DOCUMENT: MAXIMUM ALLOWABLE PROPORTION OF SURPLUS OF PARTICIPATING POLICIES ALLOCATED FOR TRANSFER TO SHAREHOLDERS’ FUND

AMOUNT (OR PART THEREOF) OF THE AGGREGATE OF LIFE INSURANCE FUND RELATING TO PARTICIPATING POLICIES (MYR MILLION)	CALCULATION (CUMULATIVE)	MAXIMUM PROPORTION OF SURPLUS
RANGE		
0-300	FIRST 300	20%
301-600	NEXT 300	15%
601 AND ABOVE	ALL EXCEEDING 600	10%

If the proposed distribution of the excess estate does not comply with Para 13.10 of the Management of Insurance Funds policy document (i.e. if insurers want to transfer a higher proportion of the estate to shareholders), then insurers will need to obtain prior approval from BNM. In addition, insurers will need to commission an Independent Review Panel (“IRP”) comprising of actuarial and legal representatives with experience in par fund management, and at least one member representing the policyholders’ interests. The IRP will need to assess if the proposed distribution of the excess estate is appropriate and reasonable, and whether it complies with the requirements outlined in the Exposure Draft. The cost of IRP will need to be met by the shareholders’ fund and cannot be compensated from the estate.

Any estate that has been distributed cannot be clawed back to increase the insurers’ working capital in the future.

## Management of small or shrinking par funds

The Exposure Draft outlines additional requirements for par funds that are small, have been on a declining trend, or are expected to shrink to an unsustainable level. For such funds, the Appointed Actuary is expected to conduct regular monitoring and assessment of the key risks within the par fund (e.g. solvency, liquidity, investment risk, etc.). The Appointed Actuary is required to project the par fund for the next five years by number of policies, asset shares, and net liabilities further supported by stress and scenario tests. The Appointed Actuary will also need to outline remedial and mitigating action plans to manage key risks within the par fund in the Financial Condition Report.

<sup>2</sup> COBS 20.2.21: “At least once a year (or, in the case of a non-directive friendly society, at least once in every three years) and whenever a firm is seeking to make a retribution of its inherited estate, a firm’s governing body must determine whether the firm’s with-profits fund, or any of the firm’s with-profits fund, has an excess surplus.”

COBS 20.2.22: “(1) If a with-profits fund has an excess surplus, and to retain that surplus would be a breach of Principle 6 (customers’ interests), the firm should make a distribution from that with-profits fund...”

## Conclusion and next steps

Overall the new Exposure Draft helps to provide further clarity on BNM's expectations of insurers in the management of par funds. Most insurers in the market have experienced a continued decline in new par business sales over the last decade. Thus, developing a run-off plan that protects both the solvency of the par fund and the interests of the par policyholders is essential to avoid a tontine effect in the future<sup>3</sup>. The use and distribution of the estate should be a key element of any run-off plan, alongside other considerations such as investment strategy, expense management, and the use of reinsurance.

The requirement for the one-off assessment to ascertain the sources of the estate may be challenging for some insurers. Estates often build up from surplus that has been retained from historical business, where prudence in times of less sophistication for fund management meant pay-outs of less than asset share on average, which then grows with investment returns. Insurers may have limited historical information and data on which to analyse the evolution of their estates, making it difficult to confidently explain exactly what the sources of the estate have been. If insurers do discover that there have been past underpayments to specific groups of policyholders (relative to what they might reasonably have received at the time of payment i.e. absent 20:20 hindsight), then any repayment exercise is also likely to be challenging for the insurer to manage.

A key challenge for any estate distribution exercise will be in balancing the aim to distribute the estate as quickly as possible, to ensure as many policyholders as possible benefit from the estate, against the need to maintain adequate working capital to manage the fund through its run-off. The estate contributes to the risk capacity of the fund, and absorbs the impact of any substantial changes affecting par funds, at least in the short term. As par funds shrink, the proportionate amount of capital required can increase (as small funds will be exposed to greater volatility), presenting another challenge. To address this issue, one approach deployed in markets such as in the UK, is for companies to allocate estate to policies such that they would receive enhanced terminal bonuses on maturities or death claims, but retain the right to reduce or

claw back these enhancements for in-force policies in the future if necessary (i.e. as a potential management action under adverse circumstances). This effectively keeps the distributed estate of in-force policies as working capital, whilst still allowing it to be distributed to maturing policies, allowing for earlier (and therefore potentially fairer) distribution of the estate. The requirement in the Exposure Draft that prohibits claw back of distributed estate could prevent the deployment of this approach. The industry may want to raise this point with BNM or gain greater clarity on its definition of claw back.

The Exposure Draft also specifies that in determining the distribution of the excess estate, insurers must avoid any windfall gains to any group of policyholders. The industry may want to obtain clarification from BNM whether a more appropriate wording for this objective could be 'to avoid any inappropriate bias to any group of policyholders'. Estate typically arises because investment returns are higher than reflected in asset shares (for example, in retrospect the bonuses paid on existing policies are too low as unrealised gains were higher than expected when actually realised). Any distribution of estate arising from those sources will, by definition, be a windfall for those that ultimately receive it. "Inappropriate bias", however, refers to some classes of policies being credited with a higher share of the excess estate than others. For example, distributing excess estate to policies written in the last few years is likely to be viewed as unfair, as those policies will not have contributed much to the working capital of the fund. These newer policies would also benefit from any future distributions of excess estate, which those about to leave the fund will not.

Par fund management can be complex and challenging. Our consultants have extensive experience helping insurers in the UK and Malaysia with managing run-off issues for par funds. These include issues surrounding estate distribution and reattribution projects, developing run-off plans, and other par fund transformation projects.

For further details on this topic, please contact the authors of this e-Alert, or your usual Milliman consultant.

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<sup>3</sup> A tontine arises when the last policyholders to exit the fund receive an inordinate share of the estate. In the context of a par fund, a tontine may arise when the fund is closed to new policies and some of its surplus assets have been held back from being distributed to its policyholders, often as a result of the fund needing to hold sufficient surplus assets to meet its own capital requirements.



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