

**GUIDANCE NOTE ON
UNDERWRITING CLASS C BUSINESS**

**Office of the Commissioner of Insurance
30 July 2014**

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1 INTRODUCTION

1.1 This Guidance Note is issued pursuant to the Insurance Companies Ordinance (Cap. 41) (“ICO”) and the Insurance Core Principles, Standards, Guidance and Assessment Methodology (“ICP”) promulgated by the International Association of Insurance Supervisors (“IAIS”). Specific references are:

1.1.1 Section 4A of the ICO stipulates that the Insurance Authority (“IA”)’s function is to protect existing and potential policyholders. Section 4A(2)(c) states that the IA shall promote and encourage proper standards of conduct, and sound and prudent business practices amongst insurers.

1.1.2 ICP 19 stipulates that the conduct of the business of insurance should ensure that customers are treated fairly, both before a contract is entered into and through to the point at which all obligations under a contract have been satisfied. ICP 19.0.1 further stipulates that the conduct of insurance business should help to strengthen public trust and consumer confidence in the insurance sector.

1.2 This Guidance Note applies to all authorized insurers underwriting Class C business, or more commonly known as Investment-Linked Assurance Schemes (“ILAS”) business.

2 RELEVANT REGULATORY DOCUMENTS

2.1 Where appropriate, this Guidance Note should be read in conjunction with other relevant codes/circulars/guidance notes issued by the IA or other regulatory bodies, including the

following¹ –

- Updated Requirements Relating to the Sale of Investment Linked Assurance Schemes to Enhance Customer Protection issued by the Hong Kong Federation of Insurers (“HKFI”)
- Enhanced Regulatory Requirements on Selling of Investment-Linked Assurance Scheme Products issued by the Hong Kong Monetary Authority (“HKMA”)
- Guidance on Internal Product Approval Process issued by the SFC
- Handbook for Unit Trusts and Mutual Funds, Investment-Linked Assurance Schemes and Unlisted Structured Investment Products issued by the SFC

3 PURPOSE

- 3.1 ILAS is a hybrid product with both insurance and investment elements. Clients have to bear the associated investment risks but at the same time benefit from some form of insurance protection.
- 3.2 As ILAS are long-term insurance contracts, they normally entail a more complex charging structure and the investments involved do not have the same level of liquidity as other forms of investments. Clients should be fully apprised of the nature of such products, as well as the associated rights and obligations, before they enter into such contracts.
- 3.3 Both the IAIS and the global insurance industry have placed increasing emphasis on fair treatment of customers. ICP 19.2.4 stipulates that fair treatment of customers encompasses:
- developing and marketing products in a way that pays due regard to the interests of customers;
 - providing customers with clear information before, during and after the point of sale;
 - reducing the risk of sales which are not appropriate to

¹ The list is not exhaustive and may be subject to changes from time to time. Insurers have the responsibility to ensure compliance with all the relevant requirements with due regard to their own circumstances.

customers' needs;

- ensuring that any advice given is of a high quality; and
- managing the reasonable expectations of customers.

3.4 This Guidance Note aims to set out the proper standards of conduct and business practices for authorized insurers underwriting Class C business.

4 DUTY OF THE BOARD AND THE CONTROLLER

4.1 It is the duty of the Controller, as specified under section 13A of the ICO, to ensure that requirements set out in this Guidance Note and the relevant ICPs are observed throughout the life cycle of all ILAS policies. It is also the duty of the Board to maintain general oversight over the implementation of measures in compliance with this Guidance Note.

5 PRODUCT DESIGN

5.1 ICP 19.2.4 stipulates that insurers should develop and market products with due regard to the interests of customers. During the product design stage, the insurer should carry out a diligent review to ensure that the product meets the “fair treatment of customers” principle, particularly in the areas set out below.

5.2 Insurance Value

5.2.1 ILAS products should bring insurance value to clients.

5.2.2 Insurers have agreed that effective from 1 January 2015, all ILAS products would provide a minimum death benefit of 105% of the account value. This notwithstanding, insurers are encouraged to provide additional insurance benefits beyond this minimum level.

5.3 Fees and Charges

5.3.1 Fees and charges to be paid by the customers should be fair, commensurate with the insurance protection offered by the ILAS product concerned, and reflect the services/added

value of the insurer.

5.3.2 It would be questionable whether an ILAS product, which only carries minimal insurance content but has high upfront charges or multiple charges, could meet the “fair treatment of customers” principle.

5.4 Sustainability of the product

5.4.1 ILAS products should be sustainable. High level of fees that could deplete a client’s investment notwithstanding a modest growth scenario can hardly be considered as sustainable.

5.5 In considering whether the design of an ILAS product meets the requirements of this GN and the “fair treatment of customers” principle, the IA will look at all relevant factors in their totality, including the product features, insurance elements, added value/services to clients, all fees/charges, surrender penalties, remuneration structure etc.

6 PROVISION OF ADEQUATE AND CLEAR INFORMATION

6.1 ICP 19.2.4 stipulates that insurers should provide customers with clear information before, during and after the point of sale.

6.2 ICP 19.3.4 stipulates that the product development and marketing process should include the use of adequate information on customer needs.

6.3 Insurers should include information on the key product features and risks in all the product documents, including the product brochure, Key Facts Statement and Important Facts Statement / Applicant’s Declaration (“IFS/AD”).

6.4 Product information should be bilingual², clear and succinct, with the use of plain language and legible font size, and should be easily understandable by average clients.

6.5 ICP 19.2.4 further stipulates that insurers should manage the reasonable expectations of customers. Accordingly, projections in

² For the avoidance of doubt, the English and Chinese versions of the product documents can be separated, but BOTH must be available to the clients.

relation to the growth scenarios should not be overly optimistic. Clients should at least be apprised of the no-growth scenario (0%), alongside other growth scenarios, in the benefit illustration statement.

7 SUITABILITY ASSESSMENT

7.1 ILAS products should only be sold to clients with both investment and insurance needs.

7.2 Insurers should endeavour to reduce the risk of sales that do not meet the needs of customers.

7.3 ICP 19.6.2 specifies that insurers should seek the information from their customers that is appropriate for assessing their insurance needs, before giving advice or concluding a contract. This information may vary, but should at least include information on the client's:

- financial knowledge and experience;
- needs, priorities and circumstances;
- ability to afford the product; and
- risk profile.

7.4 Clients' needs must first be properly assessed through the use of Financial Needs Analysis ("FNA") form. ILAS must not be marketed to clients before their needs are properly analyzed.

7.5 Clients that have indicated their insurance needs should then be presented with different insurance options that are available to meet their specific needs and financial circumstances. Examples include:

- clients wanting both insurance protection and "saving up for the future" should be presented with the option of procuring an endowment policy; and
- clients wanting both insurance protection and benefitting from growth in the investment market should be presented with the options of procuring a participation policy or an ILAS policy, and the advantages and risks of both products should be explained in detail. Only in cases where the clients wish to

make the investment decision and are willing to bear the investment risk should ILAS be recommended.

- 7.6 Suitability assessment includes assessing the investment horizon of the potential policyholder, with due regard to the financial circumstances, planned retirement age etc.
 - 7.6.1 Premium payment term – The clients’ age at the time of policy inception as well as his/her target retirement age are relevant to the suitability of the premium payment term. For instance, a policy maturing in 40 years with prolonged redemption penalties would unlikely be appropriate for a 60-year-old client.
 - 7.6.2 Regular premium – It is also necessary to ascertain the client’s ability to pay continuously throughout the policy payment term. For instance, it would not be appropriate to sell a regular premium product to retirees or clients that do not have a stable income.
- 7.7 The suitability assessment should be carried out whenever there are changes to the circumstances of the client, including the scenario where an existing policyholder requests a top-up.
- 7.8 Insurers have the duty to verify all available information, particularly the “Statement of Purpose” section in the IFS/AD, the FNA and Risk Profile Questionnaire (“RPQ”), and assess whether a particular ILAS product is suitable for the client.

8 ADVICE TO CLIENTS

- 8.1 After a client has considered the insurance options, and is beginning to consider an ILAS policy, he/she should also be properly apprised of all the product features, particularly the fees and charges, surrender penalties (if any) as well as the product and investment risks.
- 8.2 After a client has decided to procure an ILAS policy, he/she should be fully apprised of the key products features again, as well as his/her rights and obligations, such as the right to ask for details of the intermediaries’ remuneration, the need to complete the post-sale call, the 21-day cooling-off period etc. The IFS/AD must be duly signed by the client.

- 8.3 Insurers have the duty to put in place a proper mechanism to ensure full understanding of the above by the client, as evidenced in the IFS/AD.

9 APPROPRIATE REMUNERATION STRUCTURE

- 9.1 ILAS products are susceptible to mis-selling and aggressive selling. In addition, they can be used as vehicles for fraudulent acts and money laundering activities.
- 9.2 Insurers have the duty to ensure that the remuneration structure for their intermediaries do not create misaligned incentives for the intermediaries to engage in the aforesaid activities. For instance, an overly high commission in the initial years of the policy term, coupled with a short clawback period, may create such misaligned incentives.
- 9.3 Accordingly, indemnity commission, or any standing arrangement that offers advance payment of commission, is strictly prohibited. Insurers should only pay commission on an earned basis. Commission payable should also spread over an appropriate duration to encourage good after-sale service and duly reward long term relationship between intermediaries and policyholders.
- 9.4 Cases of mis-selling, aggressive selling, fraud and money-laundering often surface after the expiry of the clawback period. Insurers should therefore put in place an appropriate clawback period to address this particular risk. In addition, to deter such activities, a clawback mechanism must also be put in place to fully recover all commission paid in proven fraud / money laundering / mis-selling cases.

10 AVOIDANCE OF CONFLICT OF INTERESTS

- 10.1 ICP 19.7 requires insurers and intermediaries to ensure that, where customers receive advice before concluding an insurance contract, any potential conflicts of interest are properly managed. ICP 19.7.5 further stipulates that conflicts of interest may be managed in different ways as relevant to the circumstances, for example, through appropriate disclosure and informed consent

from customers.

- 10.2 In regard to intermediaries' remuneration, insurers should follow the formulation stipulated by the IA in calculating the remuneration for each product and distribution channel. The presentation format and wordings should follow IA's template.

11 CLIENTS' INVESTMENTS AND ASSETS

- 11.1 Insurers are required to strictly follow the investment instructions of policyholders in the allocation of premiums received. Any deviation must be based on sound actuarial principles and subject to the agreement of the IA.
- 11.2 Insurers are also reminded to strictly follow the requirements under section 22, 22A and 23 of the ICO regarding segregation and application of assets.

12 POST-SALE CONTROL

- 12.1 ICP 19.2 stipulates that insurers and intermediaries should establish and implement policies and procedures on fair treatment of customers. They should have proper control systems in place to achieve fair treatment of customers and monitor that such policies and procedures are adhered to.
- 12.2 The proper sales process flows is set out in the flowchart at the Appendix. It involves completion of the FNA, confirmation of needs, comparison of different insurance options, completion of the RPQ, explanation of the key product features and completion of the IFS/AD.
- 12.3 To reaffirm clients' understanding of the ILAS policy that they have procured, and that they are fully aware of their rights and obligations under the ILAS policy, insurers are required to make audio-recorded post-sale confirmation calls to all ILAS clients within 5 working days of the date of policy issue. The content of the call should follow the HKFI's template.
 - 12.3.1 Insurers should appoint a separate quality assurance team to make the post-sale calls.

- 12.3.2 Insurers should use their best endeavours to make the post-sale calls, attempting different times of the day and different days of the week.
- 12.3.3 Insurers are encouraged to adopt additional measures such as on-site recording at the service centre or immediate "dial-in" to or from the call centre for clients who are visitors or who may be difficult to reach.
- 12.3.4 In the event of unsuccessful calls, a confirmation letter should be sent to the clients, alongside an email/SMS alert that draws the attention of the clients to the importance of the confirmation letter.
- 12.4 Insurers are required to put in place an effective mechanism to identify possible cases of intermediaries abetting clients to evade the control measures, such as high frequency of clients opting out or deviating from the RPQ process, or having high rate of unsuccessful post-sale calls.
- 12.5 Insurers should have in place proper documentation systems for quality control and future monitoring. Apart from the policy documents and the IFS/AD, records of the post-sale calls, confirmation letters and the email/SMS alerts, as well as control reports in respect of measures in 12.4, should also be kept properly.
- 12.6 Insurers should, during the underwriting process, reject applications for ILAS policies if any of the requirements above are not met.

13 COMMENCEMENT

- 13.1 This Guidance Note shall come into effect on 1 January 2015.

Selling Process of Investment-Linked Assurance Scheme ("ILAS") Products

