Update on latest regulatory requirements for insurance products and insurance-linked securities

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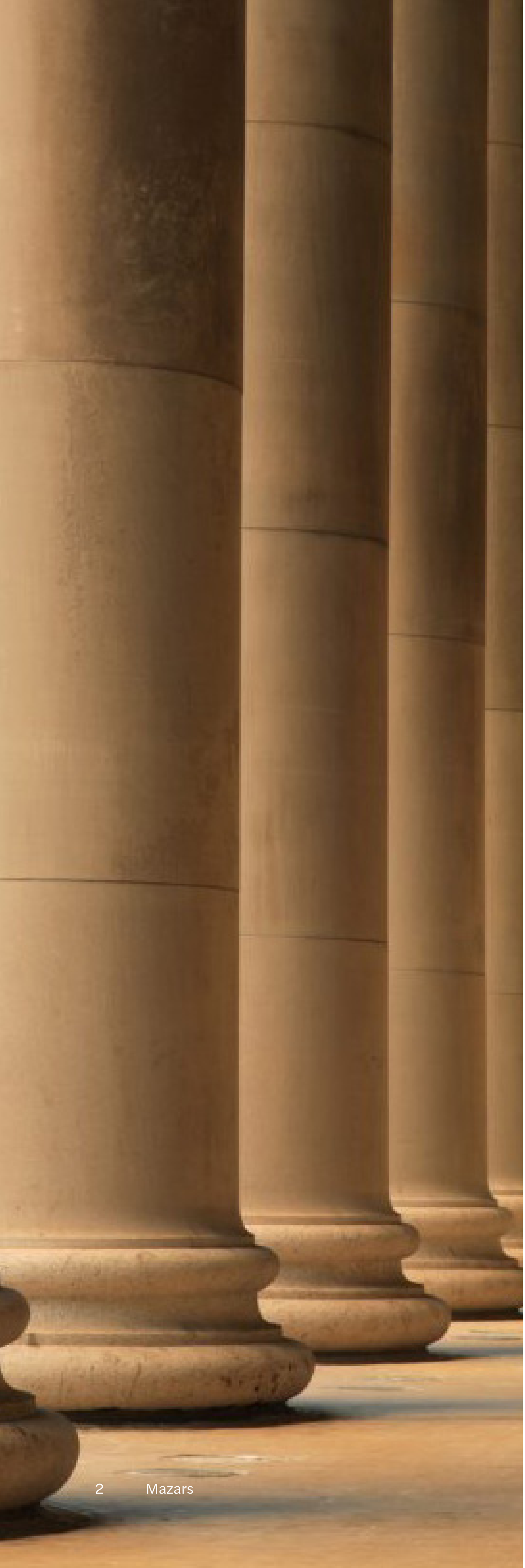

Background

To enhance customer protection in the Hong Kong financial industry, the Hong Kong Monetary Authority ("HKMA"), the Securities and Futures Commission ("SFC") and the Insurance Authority ("IA") (collectively the "Regulators") have recently conducted a series of reviews and inspections over the industry's selling practices of various insurance products and insurance-linked securities and highlighted areas of concerns and their respective regulatory requirements and expectations.

This publication provides a high-level summary of the key regulatory expectations from the Regulators on these specific investment and insurance products offering in Hong Kong, namely:

- **Insurance-linked securities;**
- **Premium financing;**
- **Qualifying Deferred Annuity Policy;**
- **Voluntary Health Insurance Scheme; and**
- **Tax-Deductible Voluntary Contributions.**

The key highlights from the Regulators are summarized as follows:

A. Insurance-linked securities ("ILS") and related products

ILS are financial instruments which can be used by insurers or reinsurers to transfer insurance risks to the capital markets by way of securitization. A typical type of ILS is catastrophe bonds.

The structure and valuation of ILS are usually complicated and with limited market liquidity. Investors could possibly suffer a substantial loss of their capital upon the occurrence of predefined trigger events (e.g. natural disasters or other catastrophes).

On 11 October 2021, the HKMA and the SFC, in consultation with the IA, jointly issued a circular on distribution of ILS and related products to provide guidance to intermediaries on offering or selling of ILS.

Given the heightened risks of these products, the target investors of ILS should have sufficient knowledge and sophistication to understand the associated risks of these products. Under the cirular, the sale of ILS and financial products backed by ILS issued in Hong Kong (i.e., repackaged products) or those which derive their values from ILS issued in Hong Kong as underlying assets (i.e., derivatives) should be restricted to **eligible ILS investors** such as governments, insurance companies, banks, and regulated corporations carrying on the business of provision of investment services with a minimum investment size of US$250,000 or equivalent. Intermediaries should appropriately identify the target investors of ILS and related products by considering any selling restrictions on ILS issued in Hong Kong and outside Hong Kong as well as the structure and risks of these products.

ILS and related products are complex products and intermediaries should comply with the relevant suitability obligations and regulatory requirements in terms of product due diligence, suitability matching, client disclosure and staff training.

B. Premium financing ("PF")

PF is an insurance funding arrangement whereby a customer purchases a life insurance policy and finances the payment of the premiums under the policy using a loan facility provided by a lender, of which the policy is assigned to the lender as collateral for the loan facility.

The IA and the HKMA conducted a joint inspection exercise on PF activities in late 2020, covering areas including suitability and affordability assessment, distribution and selling process, disclosure of risks and other important matters and processing of policy services such as assignment and maturity.

On 30 September 2021, the IA and the HKMA jointly issued a circular to share the key observations from the inspection and highlighted areas of concern in:

(i) Customers' affordability:

Some customers were found to use PF to purchase policies with a level of premium typically in excess of their affordability levels and resulting in over-leveraging. Besides, the evidence in supporting their affordability is general not adequate;

Key highlights

B. Premium financing ("PF") (Continued)

(ii) Risk disclosure:

A few insurers merely notified the customers of the risks and limitations of PF or collateral assignment after issuance of the policy and effective date of assignment. Besides, some PF policies were issued without obtaining the required PF risk disclosure form properly signed by the customers. In addition, the description of risks varied amongst insurers and some of the risk descriptions adopted by insurers were found to be inadequate;

(iii) Sales practice & intermediaries training:

The sales practices adopted by intermediaries were inappropriate, such as leveraging own materials with terms of "No Risk", "The Best Fixed Deposit", to mislead customers for PF. Besides, it was found that there was inadequate training provided to intermediaries on the risks related to PF;

(iv) Assignment of Policy:

The customers' signatures on the Notice of Assignment was found to be significantly different from the signatures in the policy documents, and the Notice of Assignment lacked key information on the policy to be assigned;

(v) Cooling-off:

The right to cancel the proposed policy within the cooling-off period was often assigned to the lender prior to policy issuance. However, insurers did not update the corresponding cooling-off notice to reflect the change in circumstances, which was found to be misleading and confusing for the customers. Besides, interests on the PF facility were charged once the loan was drawn down even though the cooling-off rights were subsequently exercised. However, such interest charge was not communicated to the customers at the point of sale;

(vi) Policy benefits disbursement:

Complaints were identified about late penalty interests being imposed on the customer arising from the turn-around time in disbursement of funds by different insurers.

C. Qualifying Deferred Annuity Policy ("QDAP"), Voluntary Health Insurance Scheme ("VHIS") and Tax-Deductible Voluntary Contributions ("TVC")

QDAP is a government certified scheme that can provide policyholders with a steady stream of income after they retire while the premiums are eligible for tax deductions.

VHIS is a government certified scheme that aims to provide better access to private healthcare and to enhance consumer protection for medical insurance while the premiums are eligible for tax deductions.

TVC is a new type of contributions under the MPF system. Scheme members can open a TVC account under the MPF scheme and make TVC directly to the account without involvement of their employers while the contributions are eligible for tax deductions.

On 14 September 2021, the HKMA issued a circular to share the key observations identified from the desktop review of the practices of authorized institutions ("AIs") in selling QDAP and VHIS products and their referral arrangement of TVC.

Before recommending insurance products to a customer, AIs are required to perform appropriate suitability assessment in relation to the customer's circumstances and have in place policies and procedures to comply with the relevant specific regulatory requirements on suitability assessment.

For long term insurance products that are exempt from or not subject to the financial needs analysis requirement and individual medical insurance including VHIS products, AIs are required to perform proportionate and reasonable suitability assessment in relation to the customer's circumstances before recommending the products to a customer.

AIs should have policies and procedures in place to require their staff to provide adequate disclosure and explanation of the nature, and key features and risks of QDAP and VHIS products to the customers during the selling process.

Regarding TVC referral arrangement, AIs should ensure that the customer's consent and signature are obtained before transferring a customer's personal data to the relevant MPF principal intermediary. AIs should also provide the details of the referral arrangement in written form to customers during the referral process, such as the role and involvement of the AI, its relationship with the relevant MPF principal intermediary, and any remuneration receivable. Proper records of the referral process should be maintained by the AIs.

AIs should be mindful that in selling tax deductible products, they should ensure the selling practices adopted by their sales staff will not give undue emphasis on the tax deduction feature of a product to avoid distracting customers' attention from the suitability, features and risks of the product itself.

How can Mazars help?

At Mazars, we have extensive experience working with the diversity of financial services players. We assist major financial institutions including brokerage houses, asset managers, insurance intermediaries, investment and corporate banks, retail and private banks, central banks, and national regulators in dealing with business and regulatory issues with impacts, domestic and international.

Mazars is here to assist you in complying with the relevant regulatory requirements. Depending on the scope, coverage and specifics of your needs, our services for the investment and insurance sector would typically involve one or more of the following:

How can Mazars help?

A. Regulatory reviews and advice	
I.	Review and provide compliance advisory on your firm's
▪	policies and procedures,
▪	processes and controls, and/or
▪	governance and supervision.
II.	Provide observations and recommendations to assist you in complying with the regulatory requirements and expectations, as well as common industry practice.
III.	Provide pre-inspection advice or reviews.

B. Design and implementation of policies and procedures	
I.	Provide advice / assistance in designing and implementing enhancements to the compliance manual, including governance framework, selling practices as well as risk disclosure procedures for insurance products and insurance-linked securities.

C. Training and insights	
I.	Provide training and education for staff, the board, senior management and compliance team for the regulatory requirements on insurance products and insurance-linked securities.
II.	Provide ongoing insights into how peer firms are dealing with the regulatory requirements of insurance products and insurance-linked securities and any common challenges encountered along the way.

We also take on special projects and ad-hoc mandates. We are flexible in our approach and offerings. Please feel free to contact us with any enquiries.

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