Participating business: why clear governance matters

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The role of robust governance in the management of participating business

Treating Customers Fairly (TCF) and meeting policyholders' reasonable expectations (PRE) lie at the heart of the management of participating business. Our earlier paper[1] discussed PRE from the lens of communication. Equally important is to consider the corporate perspective. Strong governance and clear documentation of principles and practices help frame clearly what the company wishes to achieve in the management of the participating business. Brief, shallow documentation might have the appeal of affording considerable room for the exercise of discretion, but can leave a gap between how the company manages the book and the views of an informed layperson (the customer view of PRE), introducing the risk for a reversal later. Acknowledging the importance of good governance, the Hong Kong Insurance Authority has started to discuss enhancements to governance. The purpose of this article is to share some perspectives on the topic.

Policies and documentation

Clear documentation is difficult to craft. Given our earlier comments highlighting the difficulties of crafting easily understood documentation[1], these policies and statements of practices will have more of an internal focus. Their goal is to provide a framework for the exercise of discretion in the operation of participating business. These documents form part of the public disclosures in the UK, which has experimented with long-form (detailed) and more customer-friendly versions of the same documents.

Detailed policies should ideally cover the major areas of discretion highlighted in the box below.

Scope of participating governance and policies

Amounts payable and bonuses

Amount payable under a participating policy including the approach to setting bonus rates and the approach to smoothing maturity payments and surrender payments.

Investment strategy

Significant aspects of the firm's investment strategy for its participating business.

Allocation of expenses

Charges and expenses made to participating fund and which costs are charged to the shareholders' business.

Conflicts of interest with shareholders

Equity between the policyholder fund and any shareholders

Conflicts of interest with other policyholders

Volumes of new business and arrangements on stopping taking new business

Mutualisation of interests with different generations of policyholders

1 From promises to performance: The power of clear and transparent communication in insurance policies
https://www.pwchk.com/en/industries/financial-services/insurance/publications/from-promises-to-performance-sep2023.html

Example regarding the allocation of expenses

Highlighting just one example of the sorts of issues a company may need to address in its policies, we will briefly touch on expense allocations. Setting a policy to determine the apportionment of expenses between policyholders and shareholders can be difficult. The box highlights some of the issues

Expense allocations

- maintenance or acquisition expense overruns
- distribution-related payments for industrial recruitment of agents or access payments to banks
- shareholder financial reporting costs, such as the implementation of IFRS17
- related-party transactions including service companies and asset management companies

It's almost impossible to contemplate every future eventuality in a policy document. The operating environment and the business model could vary over the long period of time in which participating business is managed. Formulation of high-level principles may be the most direct way to approach this. For example, consideration of which party (policyholder or shareholder) is expected to generate the primary benefit from the expense; is the expense under the control of management; and is the aggregate expense broadly in line with that assumed in the policyholder illustrations? The policies will need to be detailed enough to provide a framework for management and to demonstrate the fair treatment of customers.

Participating business committees

The final aspect of governance is oversight. Management of an insurance company might be rightfully concerned about expense and lengthier decision-making processes if another committee were introduced; however, the experience of other markets is more positive. The UK and the Indian regulators introduced oversight of the exercise of discretion for participating business and separately for the oversight of workplace defined contribution retirement benefits.

The committee's role is to ensure the interests of the policyholders are appropriately considered. Acting in an advisory capacity (the Board of Directors retains responsibility for the decisions made), a committee may consider compliance with the firm's documented practices and whether the various conflicts of interests between different groups of policyholders and with the shareholders have been effectively addressed. The committee will consider bonus declarations, management actions and costs charged to the respective funds.

While some actuarial membership is inevitable, the experience from overseas is that the membership may include a range of backgrounds including investment and other professionals. Further, the UK guidance is that larger and more complex firms should have independent committees and not rely on non-executive directors of the firm.

The Hong Kong Insurance Authority has started to discuss with the industry on how such committees could be adapted to work in the Hong Kong context, which is a positive development for customers.

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