‘Treating Customers Fairly’ and the exercise of discretion

May 2024

Treating customers fairly and the new Guideline for participating business

The Hong Kong Insurance Authority (HKIA) places requirements on insurance companies to Treat Customers Fairly (TCF) in a number of its Guidelines including GL10 (Corporate Governance)[1] and GL 16 (Underwriting Long Term Business Other Than Class C)[2]. The Board is ultimately responsible for the fair treatment of customers. In connection with policyholder dividends/bonuses, the Board needs to establish a policy which fulfils the reasonable expectations of policyholders and to be fair and equitable. GL 16 states that policyholders have a reasonable expectation to receive at least a fair proportion, if not all, of the non-guaranteed part of the illustrated benefits.

A new Guideline GL 34[3] (Establishment and Maintenance of Funds in respect of Participating Business) has been issued by the HKIA to provide guidance regarding the matters arising from the adoption of the Hong Kong Risk-Based Capital (RBC) framework. The Guideline considers the opening balance sheet and the segregation of funds. It also includes requirements regarding the Expenses and Charges made to a participating fund and the Allocation of Surplus/Profits. The overarching obligation of the new Guideline is to consider fairness and equity.

Given the new Guideline, it is timely to revisit the exercise of discretion in connection with the operation of participating funds, especially the declaration of bonuses. It transpires the new Guideline has strong similarities with requirements in other jurisdictions, which might help with its interpretation.

Expenses and Charges

Expenses passed to policyholders will need to be fair, equitable and reasonable

New requirements regarding expenses

The new Guideline introduces a requirement that expenses are fair, equitable and reasonable. The Guideline defines this as follows:

“The allocation is considered fair, equitable and reasonable if:

(a) the allocation is in line with the interests of the relevant policy holders;

(b) the costs are necessary to cover the ongoing operations of the fund or sub-fund; and

(c) the costs are justified by the expected benefit to the relevant policy holders.”

Expenses which don’t meet the tests are regarded as an appropriation of profit to the shareholder and subject to different tests (see below).

1. Guidance GL 10 CORPORATE GOVERNANCE OF AUTHORIZED INSURERS https://www.ia.org.hk/en/legislative_framework/files/GL10.pdf
2. Guidance GL 16 UNDERWRITING LONG TERM INSURANCE BUSINESS (OTHER THAN CLASS C BUSINESS) https://www.ia.org.hk/en/legislative_framework/files/GL16.pdf
3. Guidance GL 34 GUIDELINE ON ESTABLISHMENT AND MAINTENANCE OF FUND(S) IN RESPECT OF PARTICIPATING BUSINESS https://www.ia.org.hk/en/legislative_framework/files/GL34.pdf

Permissible expenses

The Guideline gives guidance about the interpretation of permissible expenses, but analysis and judgement will be required:

- **Operating costs: "(may only allocate) … costs which are incurred for operating the fund. This may include a fair and proportionate share of overheads"**

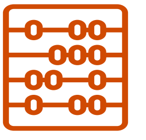
  Maintenance costs would fall within this scope. Acquisition costs may require further analysis, especially where the costs don't relate to the marginal sale of a policy, for example, investments in building distribution channel. (See beneficiary analysis requirement below.)

- **Related parties: "…assess whether such costs are charged at arm's length."**

  Transfer pricing analysis may provide support for intra-group recharges. Investment management fees are captured under this test.

- **Beneficiary: "…demonstrates the expected benefit to the relevant policy holders if incurring such costs. Disproportionate expected benefit to the shareholders versus to the relevant policy holders may cast doubt on whether such costs incurred are genuinely necessary"**

  The Guideline specifically calls out one-off expenses to merit closer attention. Costs of meeting regulatory requirements (IFRS17, HK RBC) are an example of costs which have a stronger argument for passing on a share to policyholders. Examples of other costs needing analysis might include distribution channel investment costs (e.g. agency sign-on fees or bank distribution access fees) and over-run expenses.



Permissible expenses

Analysis will be required to identify the operating costs for the participating business

Fines and redress

The rules will not permit these costs to be charged to policyholders

- **Fines:** The Guideline calls out specific areas of non-permissible charges in this area including:

  a) fines or penalties;

  b) payments to a skilled person (where shortcomings found); or

  c) payments of compensation or redress.

- **Governance:** Policies will require Board approval and annual endorsement of the fairness and equitable treatment by the Appointed Actuary.

We would expect companies will already have policies for the operation of participating business, as required under GL16. The new Guideline may require existing policies to be reviewed. The existing expense analyses may need to be reviewed to explicitly evidence compliance with the Guideline.

New requirements regarding allocation of surplus/profits

The new Guideline sets out the requirements for the allocation of profit including the reasonable expectations of policy holders and also fairness:

"The allocation of distributable surplus/profits arising from the participating business to policy holders and shareholders, as well as among different groups of policy holders, should be: :

(a) fair and equitable;

(b) in line with the reasonable expectations of policy holders;

(c) sustainable; and

(d) compliant with the corporate policy on the governance of participating business as approved by the Board. "

Profit allocation

Fair, equitable and in line with reasonable expectations of policyholders

Requirements for profit charges

The Guideline has been drafted in the light of the wide range of practices in Hong Kong and does not mandate a specific treatment. The requirements link back to fair treatment of customers (which already applies by virtue of GL16 and GL10):

- **Allocation to policyholder and shareholders: "…should ensure a fair balance of risk and reward between participating policy holders and shareholders, and among different groups of policy holders."**

  The Guideline does **not** prescribe a fixed sharing ratio, but it does require a formalised approach. The wording also highlights consideration needed where **"…shareholders are expected to receive a disproportionately high portion of the distributable surplus/profits through elevated fixed or upfront profit charges."**

- **Payouts: "An authorized insurer should strike an appropriate balance between ensuring fair payouts for exiting policy holders and the security of benefits for continuing policy holders in an applicable participating fund."**

  It is not uncommon in Hong Kong for surrender values to target an amount less than asset share for a period.

- **Acceleration in exceptional circumstances: "An authorized insurer should not accelerate the distribution of surplus/profits from an applicable participating fund asymmetrically to shareholders."**

  Where an acceleration takes place the Guideline requires evidence that the distribution of surplus is unlikely to result in a material adverse impact to policyholders including reasonable expectations of policyholders and security. There is a similar requirement in the Guideline to consider changes made since 1 January 2019, which may have had the effect of accelerating a shareholder transfer or changing the opening balance of assets attributed to the opening fund.

Bonus and pricing documentation evidencing the firm's practices will need to be reviewed to firmly evidence the assessment of fair treatment. Customer literature should also be reviewed to ensure it adequately discloses how payouts will be determined.

Lessons from other jurisdictions

The new Guidelines echoes the requirements set out by regulatory authorities in other jurisdictions. For example, the United Kingdom's Financial Conduct Authority[3] (FCA), the Monetary Authority of Singapore[4] (MAS) and The Office of the Superintendent of Financial Institutions[5] (OSFI) in Canada all require fair treatment of customers.

Global practices

While not directly applicable to Hong Kong, overseas practices should be considered for relevance to Hong Kong.

The common root (Insurance Core Principle 19, Conduct of Business) in Hong Kong and the other jurisdictions mean the TCF and PRE (Policyholders' Reasonable Expectations) practices in the other jurisdictions are useful reference points for Hong Kong also. These other practices may provide evidence supporting fair treatment in respect of the same practices applied in Hong Kong. Alternatively, the insurance company may review these other practices and conclude they are less relevant where the facts and circumstances in Hong Kong are different.

UK: PRE and asset shares

The presumption is that PRE is defined in terms of asset shares unless past representations support otherwise

Singapore: acquisition costs

The rules contain extensive requirements regarding the allocation of acquisition-related costs to participating funds.

Fair treatment in other jurisdictions

The FCA requires a firm to believe its payouts to customers are fair. The presumption is that asset shares should form the basis of payouts unless the firm's representations to policyholders suggest otherwise. The rules require ranges to be set (the range should contain 100% of the asset share), but it does permit deductions from the asset share to be made for surrenders to defray unrecovered costs and market value adjustments.

In connection with expenses, the UK requirements[6] echo the new Guideline. Some insurance companies in Hong Kong levy guarantee charges to policyholders. The FCA permits guarantee charges to be made provided the guarantee charges should not be significantly larger than the cost of providing the guarantee. However, such guarantee charges would accumulate in the ring-fenced funds and not be a direct source of revenue to the shareholder.

Notice 320[7] published by the MAS is prescriptive in connection with expenses. There are specific restrictions regarding one-off costs including sign-on fees for agents and financial advisors and charging corporation tax to the participating fund. In connection with over-runs, the firm must take prompt action to mitigate the situation to the satisfaction of the Authority.

Authority requires independent review of the expense allocation methodology at least once every three years. In addition, the MAS requires disclosure to customers of the average expense ratios for the participating business.

4. Conduct of Business Sourcebook:https://www.handbook.fca.org.uk/handbook/COBS/20/?view=chapter
5. Notice 320 Management of Participating Life Insurance Business https://www.mas.gov.sg/regulation/notices/notice-320
6. Participating account management and disclosure to participating policyholders and adjustable policyholders – Guideline (2023) https://www.osfi-bsif.gc.ca/en/guidance/guidance-library/participating-account-management-disclosure-participating-policyholders-adjustable-policyholders
7. COBS 20.2.23 : "A firm must only charge costs to a with-profits fund which have been, or will be, incurred in operating the with-profits fund. This may include a fair proportion of overheads."
8. MAS 320: 8J. "An insurer must ensure that any charge or expense allocated to the participating fund is fair and reasonable."

The exercise of discretion by the Board of Directors

Exercise of discretion

Effective decision-making requires an appropriate process and the outcome should not be perverse.

Hong Kong and the United Kingdom are common law jurisdictions. Hence, understanding of previous judgements in the United Kingdom may still be relevant in Hong Kong in connection with the exercise of discretion. There are many references to PRE in the judgements[9,10,11]. The established consensus is that PRE for each company will be shaped by the Articles of Association, past bonus practice, communications to policyholders and the current practice of the industry.

The Board of Directors will generally have wide discretion in the setting of bonus rates; however, their position is not completely unfettered. While courts of law are reluctant to over-turn the exercise of discretion, effective decision-making[12] requires the decision-maker to follow an appropriate process (considering relevant information and not having regard to irrelevant factors) and reaching a conclusion that is not perverse (not reach a decision no reasonable decision-maker could make in the circumstances).

There are examples of how Directors can overstep in the exercise of discretion. Equitable Life[11] was a major provider of participating savings contracts in the UK. Their established practice was to set bonuses for maturing policies in line with asset shares. Over time, annuity options in some contracts became onerous due to falling interest rates and increased longevity. The company introduced a differential bonus practice to effectively negate the additional cost arising from the application of the annuity option. This practice was challenged in the courts. On appeal, it was concluded that the Board of Directors were not entitled to use a differential bonus policy in this way.

9. Axa Equity & Law Life Assurance Society Plc v. Axa Sun Life Plc [2001] EWHC Ch 29 (11th January, 2001)
10. Needler Financial Services v. Taber [2001] EWHC Ch 5 (31st July, 2001)
11. Equitable Life Assurance Society v. Hyman [2000] UKHL 39
12. Associated Provincial Picture Houses Ltd v Wednesbury Corporation [1947] EWCA Civ 1

How can we help?

Our team comprises insurance professionals with extensive experience of participating business:

Expense analyses

Policyholder communications

Asset share frameworks and bonus rate criteria

Contact us

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