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Legal Update
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Hong Kong Tightens Controls over Sales of ILAS Products

Hong Kong regulators have tightened regulatory controls over the sale of Investment-Linked Assurance Schemes (ILAS) by imposing further requirements including commission disclosure, Key Facts Statement and customer's declaration, as well as post-sale controls. These new requirements are aimed at enhancing customers' understanding of the risks and features of ILAS in an attempt to better protect customers.

ILAS – the Good and the Bad

ILAS products are life insurance policies with an investment component. As the policyholder, the premiums paid are used by the insurer to invest in a number of different funds. The value of the insurance policy (including Death Benefit) is linked to the performance of the underlying funds and may fluctuate depending on market conditions. The attraction of such products is that they give customers access to a wide range of funds, as well as the flexibility of switching funds without incurring charges of the fund houses. However, the policyholder has no rights or ownership over the underlying funds and his only recourse is against the insurer.

ILAS are long-term products with a long lock-in period. Charges and fees apply in the event of early termination or encashment, and such charges can be quite substantial. ILAS have been popular in Hong Kong for many years, but complaints about the product and the discrepancies in the sales process discovered by the Office of the Commissioner of Insurance's mystery shopping exercise in 2012 have caused concerns. Given the trend towards enhancing financial product regulation both in Hong Kong and globally, Hong Kong regulators have now turned their focus on ILAS.

The Regulators

Currently, there are a number of government and self-regulatory bodies which regulate ILAS. Insurers are regulated by the Insurance Authority (IA) and the Hong Kong Federation of Insurers (HKFI), a self-regulatory body. Brokers are regulated by two self-regulatory bodies, the Professional Insurance Brokers Association (PIBA) and the Hong Kong Confederation of Insurance Brokers (CIB). The new prudential insurance regulator, the Independent Insurance Authority, is expected to be established in 2015.

Banks may act as an insurance intermediary or have an insurance arm which provides ILAS. Banks are regulated by the Hong Kong Monetary Authority (HKMA). Given ILAS is an insurance product, it is not regulated by the Securities & Futures Commission (SFC) but its marketing material must be approved by SFC before it can be offered to the public.

The Sales Process

An ILAS sales process – *before* imposition of the new requirements – involves the following stages:

i. The customer is required to complete a Financial Needs Analysis (FNA) and a Risk Profile Questionnaire (RPQ) to assess suitability for ILAS.

ii. The customer must be provided with various marketing literature including the Key Facts Statement (KFS). The customer must also sign a declaration confirming they understand the features of the ILAS and that they agree it is suitable for their needs (Declaration).

iii. When ILAS is sold through banks, the sales process must be recorded.

iv. While ILAS sold through other means do not need to be recorded, insurers must conduct 'check up' calls after sales to vulnerable customers (such as elderly customers) and risk-mismatch customers (for instance, a customer who wants to purchase ILAS even though it is not suitable for his or her financial needs). Any calls must be made within the cooling-off period, which lasts for 21 days after the policy is issued.

So What's New?

Under the new requirements, there are more controls at every stage of the sales process.

NEW KFS

The KFS is marketing literature that customers must be provided with. The KFS must be approved by the SFC, and must now include the following new information:

- A statement of purpose of investing in the ILAS.
- A total fees and charges disclosure setting out, amongst other things, the total fees and charges as a percentage of the total premium(s).
- More disclosures about long-term features such as upfront-charges, early surrender or withdrawal charges and loyalty bonuses.
- A statement that the intermediary will be receiving remuneration out of the charges the customer pays. The customer can ask the intermediary about the extent of its remuneration.

All existing applications with SFC must comply with the new requirements. All ILAS currently approved by the SFC have until 30 September 2013 to comply with new requirements.

THE DECLARATION

The Declaration to be signed by the customer must now include an Important Facts Statement (IFS). The IFS is to include a statement of purpose plus advice for the customer on the following:

- Cooling-off period.
- No ownership of assets and no guarantee of investment returns.
- Long-term features and fees and charges.
- Risk associated with early termination.
- Statement about intermediaries' remuneration.

INSURERS' CHECK-UP CALLS

It is now a requirement for all insurers to conduct check-up calls to all customers. All calls must be audio-recorded. The purpose of the calls is to ensure that insurance intermediaries have explained the features of the product and that the customer understands the risks of ILAS. The check-up can be conducted at the insurer's office at the point-of-sale or by way of a call within five days after the policy is issued. The insurer must ask the following questions during the check up:

- Did the insurance intermediary perform an FNA and RPQ?
- Did the customer receive and understand the marketing literature explaining the key features of the ILAS and the level of charge and fees?
- Is the customer aware that investment returns are not guaranteed and the value of investments may go down as well as up?
- Is the customer aware that the intermediary will receive remuneration? The customer can ask the intermediary about the remuneration.
- Is the customer's Declaration consistent with his/her understanding?
- Is the customer aware of his/her cooling-off right?

If the customer provides negative or uncertain answers, the insurer must then undertake further investigations including following up with the relevant insurance intermediary. If necessary, the insurer should take appropriate action, such as cancelling the sale.

For ILAS sold through banks, there is no need for the insurer to conduct a check-up call because the banks are required to audio-record salient aspects of the sales process.

DISCLOSURE OF REMUNERATION

The KFS and IFS (included in the customer's Declaration) includes disclosure about the intermediaries' remuneration. The requirements vary slightly depending on the type of intermediary:

- Brokers must disclose that they will be receiving remuneration but do not need to disclose the amount unless the customer asks.
- Banks must disclose monetary and non-monetary benefits.

- Insurance agents (other than banks) must disclose at least the basic commission rate(s) (e.g., the maximum or a range). HKFI and IA are currently discussing further requirements.

In addition, brokers are now required to disclose that they will receive remuneration for all insurance business, but do not need to disclose the amount unless asked by the customer.

Conclusion

There are now heightened requirements at all stages of the ILAS sales process, from disclosure of intermediaries' remuneration to post-sale controls. The enhanced requirements are directed towards improving customers' understanding of how ILAS works – its risks and its features – before they become "locked into" the product. It appears the changes are intended to impose a higher level of discipline – comparable to that which is more commonly seen in a banking environment – on the sales process of the insurance industry. It remains to be seen how the new requirements will impact on sales of ILAS products in Hong Kong and whether they will result in fewer complaints or claims. In the meantime though, insurers and insurance intermediaries are advised to carefully review and bring up to date their ILAS sales practices to ensure compliance.

Contact Us

For inquiries related to this Legal Update, please contact the following person or your usual contacts with our firm.

Tow Lu Lim
Partner
T: +852 2843 4490
E: tl.lim@mayerbrownjsm.com

Jenny Yu
Registered Foreign Lawyer
T: +852 2843 4445
E: jenny.yu@mayerbrownjsm.com

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