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Life's not fair, but Life Insurance should be

Improving policyholder fairness through
Hong Kong Participating Business
Regulations

Craig Fyfe

VP, Deputy Chief Actuary

Sun Life

Overview,

The Hong Kong Participating Insurance market is a rapidly growing market fostering innovative product designs. This has attracted global insurers but could be putting policyholders at risk. By its nature, participating insurance is built on trust that insurers will treat policyholders fairly. A competitive growth mentality could place policyholder concerns in the backseat.

The Hong Kong Insurance Authority (HKIA) regulates insurers and protects policyholders. The previous regulatory requirements on participating insurance products were relatively light, but these have been significantly strengthened with the release of Guideline 34: Guideline on Establishment and Maintenance of Fund(s) in Respect of Participating Business, and the HKIA has just released a final draft of an update to this guideline.

This updated regulatory guideline keeps pace with the growth in the Hong Kong market and closes the regulatory gap with other mature global participating insurance markets. Enhancing policyholder protection will benefit the insurance industry and policyholders in the longer-term, but it will lead to shorter-term challenges.

Hong Kong Par Insurance Market Background

Participating Insurance allows the policyholder to participate, along with the insurer, in the gains and losses through the policy's dividends or bonuses. The Participating Insurance market in Hong Kong has seen rapid growth recently. In 2024, long-term business premium was HK\$220 billion, which was up over 20% from the previous year and over 80% of that premium went into Participating products.

The market stagnated over COVID but is seeing a strong rebound. Some of that growth is coming from Mainland Chinese Visitors that are likely attracted by higher Hong Kong interest rates and investment returns, along with the currency options of US and HK dollars.

The market attracts global insurers from North America, Europe and other Asian countries. The previous regulatory requirements were relatively light, which allowed the competitive markets to expand the types of insurance products being offered and illustrating aggressive returns.

The strong market growth, product innovation, and uncertainty regarding participating policyholder treatment from all the global players, is driving the HKIA to strengthen the regulatory requirements. The HKIA has been keeping in step with the growth and advancement in the insurance industry with the financial reporting adopting IFRS 17 / HKFRS 17 in 2023, and a Risk-Based Capital (RBC) regime in 2024. The HKIA has also been developing regulatory requirements specifically targeting participating insurance with the release of GL34, and a final draft of an updated version of GL34 was just released.

Key Sections in GL34

The main regulation issued by the HKIA is the Guideline on the Governance of Participating Business – GL34, which sets the IA's expectations for sound and prudent business practices. It contains a strong emphasis on the fair and equitable treatment of customers. The first release of the guideline was effective July 1, 2024, and there continues to be strong engagement within the insurance industry on implementing the requirements.

Governance

The guideline establishes a governance framework, and the updated version contains an additional component to be added to the framework. The ultimate responsibility for ensuring policyholders receive equitable and fair treatment is with the insurer's Board. The Appointed Actuary plays an advisory role to the Board, and next year there will be the addition of a Participating Business Committee (PBC) to provide independent and objective advice to the Board. The guideline also requires a Board approved corporate policy on the governance of the participating business.

This is an excellent model and shares aspects with other global governance frameworks for participating business. Although there is no transition allowance given, there should be an understanding that compliance with the regulations will take time. Many activities associated with participating business only occur annually, such as updating dividends/bonuses, and sometimes less frequent. If there is a focus on achieving rapid compliance it may result in a surface level implementation and fail to achieve a robust thoughtful result that comes through addressing challenging issues over time.

The Board should look to strengthen the role of the Appointed Actuary from merely providing advice to the Board, to providing strong opinions confirming the various fairness assessments and adherence to the corporate policy. By placing the Appointed Actuary's name and professional designation behind the opinions will help to ensure they are given the proper attention. The Appointed Actuary is closer to the business, thereby putting them in a better position than the Board to ensure compliance and detect issues, as some fairness issues can begin small and grow over time to become more material.

The requirement for creating the PBC is expected next year. This committee provides independent and objective advice to the Board on key matters associated with the Participating Fund. The Board will appoint members of the PBC for fixed terms. The PBC is given a long list of key matters to advise the Board including, Appointed Actuary dividend/bonus recommendations, dividend/bonus mechanisms, fairness of expenses, investment risk and strategy, sales strategy, sales illustrations, and policyholder communications including customer complaints.

If the Board deviates from the PBC advice given, the Board will need to inform the PBC, and if the PBC believes the deviation may adversely affect the policyholders, the PBC should inform the Board and the HKIA. The insurer will also be required to publish an annual statement from the PBC, including the members names and whether the PBC is satisfied that the insurer has exercised its discretion fairly and reasonably.

The PBC will be given strong influence, and the insurer will need to choose the committee members carefully. Fairness is neither unique nor immutable, which is why there is an emphasis on judgment. These insurance policies last a lifetime, which means they will see different accounting and regulatory regimes, the introduction of new asset classes, and tax regime changes. The assessment of fairness will need to adjust to these new circumstances. Fairness does not always act in a way that benefits the policyholder, as that would be unfair to the insurer/shareholder. The Board will need to take care in the selection of PBC chairperson and other members to ensure the advice received from the committee is objective and balanced. If the PBC does not have the knowledge, experience and maturity to professionally fulfill the duties of the PBC, there could be practical business issues created for the insurer through unnecessary involvement of the regulator and negative public impressions created through the annual PBC statement.

The insertion of the PBC assessment prior to the Board approvals will impact the timing of the work. The work supporting the Appointed Actuary may be completed just in time to support the Board submissions, but beginning next year the PBC will also need to provide an assessment prior to the Board's approval. This will likely require the insurer's work to be moved earlier to support the time necessary for the PBC's review.

The Appointed Actuary should consider bringing in an external, independent actuary to support their work. The independent actuary could provide an industry perspective to the Appointed Actuary on particularly challenging issues. They could complete periodic detailed reviews of the insurers practices in its adherence to the corporate policy and to GL34 with recommendations. The reviews of the independent actuary could then be made available to the Appointed Actuary and the PBC to support their opinions and recommendations. This would allow the PBC to focus on the material changes and key matters for the participating fund.

Opening Balance of Assets and Liabilities, and the Independent Report

On the effective date of the guideline the insurer is required to identify the assets and liabilities attributable to the participating business, and to have the Appointed Actuary certify the sufficiency of the opening balance of the participating fund. Within nine months the insurer must submit an Independent Report to the IA.

This provides a good starting point to anchor the requirements and build on with future enhancements to the regulations. Although they could not backdate the requirements, there was an assessment to ensure insurers did not accelerate the release of surplus in the previous five years.

Separating the assets and liabilities of the participating fund from the other activities of the insurer provides a greater level of control to ensure policyholders are treated fairly. This is sometimes referred to as “ring-fencing” and helps separate the gains/losses that belong to the participating fund from the gains/losses associated with the business outside the participating fund.

An aspect of fairness that is not considered is the allocation of assets over time. The assets form the main profit source supporting the participating products, but some assets are scarce. The allocation of plentiful government or corporate bonds, and equity indices may not demand an assessment of fairness. However, the allocation of privately sourced assets or real estate could result in unfair practices. An unfair practice could involve starting the participating fund with higher yielding private assets and subsequently removing them to support other products. It could also be unfair to not assign new scarce assets to the participating fund as the participating fund grows or older private assets mature. The Appointed Actuary should consider the fairness of the asset allocation annually in addition to the review of the investment strategy and asset mix.

The Independent Report involves a review of the opening position, and the business practices associated with the establishment of the participating fund. This is a key step to ensure that there is a solid foundation to build on, but it does not provide full comfort on ensuring the ongoing fairness to policyholders.

Fair allocation of expenses

The guideline requires that expense allocations to and within the participating fund must be fair, equitable and reasonable. The insurer may only allocate expenses that are incurred for the operation of the participating fund but may also include a fair proportionate share of overhead costs. The HKIA expects that the basis and justification of the expense allocation be documented within the insurer’s corporate policy, and that the Appointed Actuary should provide an annual opinion on the fairness of the expense allocation.

An annual expense study of the company’s expenses that reconciles to the accounting ledger is the foundation of a fair allocation of expenses. The expenses will need to be broken down into the types and categories of expenses includes whether the expenses are associated with acquisition, maintenance, overhead, claims, and underwriting.

The selection of the unit cost expense base will support the allocation of the expenses to the participating fund and across the policies. Ideally, there should be a cause-and-effect relationship between the unit cost expense base and the type of expense, but this may need to be balanced with what is practical. Some typical units include \$ per policy, % of commission, % of premium, per claim, and bps on asset share.

The selection of these unit cost expense bases can directly impact the fairness and appropriateness of the expense allocation within the participating fund. If you were faced with two different blocks of business within the same participating fund, where one was made up of smaller mass market insurance policies, while the other was associated with high-net-worth larger policies. If the cost to administer one large high-net-worth policy was dramatically more than the cost for the smaller policy, then selecting a \$ per policy approach for allocating the expenses between these policies would lead

to the smaller policies cross-subsidizing the larger policies. This would be unfair, but the fairness could be improved by considering using a bps on the asset share, or by using a combination of bases.

Fairness may require changes over time. This could be the result of the participating fund growing or running off, or if new types of products are added to the participating fund. Continuing to allocate expenses as they were allocated in the past does not indicate that the allocation is fair. It is also important to note that an improvement in the fairness of the allocation may not indicate that the prior allocations were unfair. Fairness is something that requires ongoing management and review, which is supported by the annual Appointed Actuary fairness opinion on the allocation of expenses.

Assessing consistency can help in applying fairness. The company may be selling both participating and non-participating policies. A comparison of the expense allocations between these types of products may help in ensure fair treatment of participating policies. It would be expected that there would generally be consistency in the application of the expense allocation methodology and principles over time. There should also be consistency in the allocation of expenses to the participating account and the resulting changes to each policies expense assumption used in the setting of the dividend or bonus scales.

There may be unique circumstances that arise from time to time that require specific judgment to be applied in the appropriateness of the expense allocation to the participating fund and within the fund to the policies. If these circumstances arise, it would be advisable to ensure that the issue is highlighted to ensure it receives proper consideration from the Appointed Actuary, PCB, and the Board. There may be multiple ways of handling the situation in a fair manner, and in reviewing the selection made it may be helpful to consider whether the approach is unfair and why.

If the participating fund is starting up or experiencing a period of rapid growth, there may be a higher level of expenses to support that growth. It would be inappropriate for the first policy sold to bear the entire cost of the start-up. It may also be inappropriate to assume that the shareholders will completely fund the start-up costs. Judgment will be required to ensure a fair allocation of these costs to and within the participating fund, and across time.

One-time costs arise periodically, and it may be appropriate for the participating fund to bear its fair share of those costs. They could arise from the implementation of new accounting standard (e.g., IFRS 17), or a required overhaul of an aging administration system. The company may decide to keep these costs at a corporate level, but it may be appropriate to consider if an allocation of these costs to the participating fund would be fair.

You may be faced with a situation involving a merger, acquisition, or divestiture. The payment made or received in these circumstances is often associated with the shareholder profit and it would be unlikely that it would fair to allocate these to the participating fund. However, there may be impacts to the expense unit costs that could directly impact the participating fund. If the company acquired or sold a portion of the company it could lead to a corresponding decrease or increase in the expense unit costs leading to either less or more expenses being allocated to the participating fund. Management has some control over the level of expense, and it may take management some time to adjust the expense unit costs following a divestiture.

Although not stated explicitly in the guideline, taxes are generally included when considering the fair allocation of expenses. Shareholder income taxes are generally excluded from the allocation, but taxes associated with premium, or investment income would be included. Taxes can take many forms, and this may change over the life of the policy, and it would be advisable to consider whether policies would participate in taxes should there be a change tax regime.

The guideline requires a corporate policy to set out clearly the basis and justification for the expense allocation that is to be endorsed by the Board. It would be advisable to keep this Board approved document at a higher level covering the principles of the expense allocation methodology and then have supporting guidance covering the details of the implementation of the methodology. Changes to

the practical details of the expense allocation are likely more frequent and at a level that the Appointed Actuary is likely better positioned to manage rather than the Board. This would reduce the number of expected changes to the corporate policy and ensure that changes to the policy receive greater attention.

Distribution of Profit/Surplus

The guideline requires the insurer to establish a clear framework for allocating distributable surplus/profits that is fair and equitable, in line with policyholder reasonable expectations, sustainable, and compliant with the Board approved corporate policy. The allocations to policyholders include any payment of cash dividends/bonuses, terminal dividends/bonuses, or permanent additions to the policy in the form of reversionary bonuses. There should be a fair balance of risk and reward between policyholders and shareholders, and between policyholders. There should also be a fair balance between ensuring a fair payout to exiting policyholders and the security of benefits for continuing policyholders. An insurer should not asymmetrically accelerate the shareholder distribution of profits unless it is unlikely to result in a material adverse effect on the security of the policyholders.

The distribution of profits is the true test of fairness for the policyholder. The approval of the dividend/bonus recommendation by the Board provides good oversight, but consideration should be given not only to the dividends/bonuses that are to be paid or made available in the next year, but also to the dividend/bonus projections that are included in the in-force policy illustrations made available to policyholders. By their very nature, these illustrations require numerous assumptions and are not guaranteed, but they do provide a strong influence in shaping policyholder reasonable expectations (PRE).

Although not mentioned explicitly, dividend/bonus recommendations typically employ some form of smoothing. Smoothing generally provides policyholders a level of stability in their participating product and is common within the industry and forms part of the PRE. The Appointed Actuary should establish clear rules and procedures associated with the smoothing mechanisms to ensure the smoothing is not excessive.

The requirement that the insurer not accelerate the distribution of profit asymmetrically compared with the policyholders could lead to challenges on the interpretation and application. Consider a participating product that only offers the policyholder a terminal bonus. In this situation the policyholder only receives their share of the profits on surrender or death. However, the shareholder may have had to provide capital coverage over the life of the policy and should be compensated for the cost of capital. An accounting standard like IFRS 17 should ensure that the insurance contract liability provides adequate security to the policyholder for the guaranteed benefits, while still enabling the shareholder a reasonable pattern of profit.

Having a fair balance of risk and reward between the shareholder and policyholder as a regulatory requirement will be difficult to determine. Often the shareholder product charges, which establish the balance, are set through the pricing and product design process. The Appointed Actuary would then either need to opine on each product launch on the fairness or establish guidance providing practical principles to follow. More mature markets may rely on market competitiveness to bring about a risk return balance between shareholders and policyholders. If a product is too favourable to the shareholder, then a competitor is more likely to introduce a comparable product that is more balanced and thereby take market share.

The establishment of dividend classes can help ensure fairness among different groups of policyholders within the participating fund. Dividend classes separate some of the different risk types that could be present within a participating fund. For example, some participating products may contain significant exposure to equity risk, while other products may contain very limited exposure to equity risk. Having these two different types of products in different dividend classes can be helpful in

minimizing cross-subsidization. An assessment of fairness among policyholders can also be done across time by ensuring intergenerational fairness and avoiding a tontine, where policies who leave either early or are the last to survive receive a disproportionate amount of the profits of the fund.

Role of the ASHK

Earlier this year the Actuarial Society of Hong Kong issued Actuarial Guidance Note 11: Participating Fund Management in consideration of HKIA Guideline 34. This is an important step in providing guidance to Appointed Actuaries in fulfilling the requirements laid out in GL34. This guideline will likely need to be updated as HKIA reissues an updated Guideline 34 and as the industry gains experience with fulfilling the requirements laid out in the guidelines. The ASHK will play an important role in bringing greater industry consistency in practices associated with participating funds, being a source of education, and facilitating industry discussions. A strong industry improves the trust that policyholders can place in their insurers, and participating products are built on trust.

Conclusion

The introduction of GL34 is a significant step forward in strengthening Hong Kong's regulatory regime and improving the fairness that policyholders should expect from the Hong Kong insurance industry. The industry will face some key challenges over the next few years including staying current with rapidly changing regulatory requirements, enhancing and documenting governance practices, selecting the PBC and integrating the committee into the workflow, and educating the industry participants on fairness considerations and aligning industry practices. While these challenges will be difficult to implement, they will form a strong foundation for the continued growth and development of the Hong Kong participating insurance market.

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