30 September 2021

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To: Chief Executives of all authorized insurers carrying on long term insurance business, Responsible Officers of all licensed insurance broker companies and licensed insurance agencies, and Chief Executives of all authorized institutions

Dear Sirs,

Joint inspection on the use of premium financing to take out long term insurance policies in Hong Kong

The Insurance Authority (**"IA"**) and the Hong Kong Monetary Authority (**"HKMA"**) carried out a joint inspection exercise on premium financing activities in late 2020. The joint inspection, being the first of its kind conducted by the IA and the HKMA together, covered authorized insurers carrying on long term insurance (**"insurers"**) and licensed insurance intermediaries (including banks) carrying on regulated activities in long term insurance (**"insurance intermediaries"**) in Hong Kong.

Premium financing 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 (usually a bank). The customer assigns the life insurance policy to the lender as collateral for the loan. In entering into a premium financing arrangement, a customer incurs the costs to service the loan facility (i.e. interest) in addition to the premium and fees under the life insurance policy, and is exposed to risks associated with the loan facility which may adversely affect the insurance coverage and benefits to be received under the policy.

The areas covered by the joint inspection included:

- 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.

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This circular serves to share the key observations of the IA and the HKMA from the joint inspection and highlights certain areas of concern which we propose to address by providing further detail on the expectations with regards to compliance with the relevant regulatory standards in order to improve customer awareness, protection and outcome.

The insurers and intermediaries inspected were generally able to comply with the minimum regulatory requirements on risk disclosure, including the requirements set out in the Guideline on Underwriting Long Term Insurance Business (other than Class C Business) ("**GL16**") issued by the IA. We consider, however, that improvements could be made on the granularity and adequacy of such disclosure in order to raise customer awareness of the key risks and other matters associated with premium financing arrangements.

In respect of affordability assessments, we found that the impact of the use of premium financing on the customer's ability to afford the life insurance policy was sometimes not adequately taken into consideration as required under the Guideline on Financial Needs Analysis ("**GL30**") issued by the IA. In certain cases, the asset proof provided by customers did not match with the liquid assets disclosed during the financial needs analysis process. This cast doubt on the ability of the customer to afford the life insurance policy with premium financing. In particular, it was questionable whether such customers had sufficient financial resources (without surrendering the proposed insurance policy or any existing insurance policies) to repay the loan under the premium financing facility in full upon request of the lenders.

It was also observed that the use of premium financing was sometimes not appropriately taken into consideration by insurance intermediaries in the course of carrying on their regulated activities, falling short of the expectations on insurance intermediaries in treating customer fairly and providing accurate and adequate information to customers to enable customers to make informed decisions as stipulated under General Principles 2 and 5 of the Code of Conduct for Licensed Insurance Agents and Code of Conduct for Licensed Insurance Brokers. As such, customers who were contemplating the use of premium financing to finance their purchase of life insurance policies may not be sufficiently informed about the potential impact of the financing arrangements on the benefits and the insurance protection under the policies.

Details of the observations of the two regulators can be found in the **Annex** and the relevant findings have been shared with individual insurers and insurance intermediaries for appropriate follow-up actions (where applicable).

In view of these findings, the IA and the HKMA will engage the industry and relevant stakeholders to clarify the expected standards for insurers and insurance intermediaries when carrying on insurance business and regulated activities involving premium financing.

For enquiries about the contents of this circular, please contact:

Julie Zhu, Senior Manager, Long Term Business Division, IA (Tel: 3899 9902)

Candy Tam, Senior Manager, Banking Conduct Department, HKMA (Tel: 2878 1292)

Yours faithfully,

Carol Hui
Executive Director
Long Term Business Division
Insurance Authority

Alan Au
Executive Director
Banking Conduct Department
Hong Kong Monetary Authority

c.c. The Hong Kong Federation of Insurers
The Hong Kong Confederation of Insurance Brokers
Professional Insurance Brokers Association

Annex

Key findings of the joint inspection of the Insurance Authority and the Hong Kong Monetary Authority on the use of premium financing to take out long term insurance policies in Hong Kong

A) Customers' Affordability

Affordability Assessment

1. Premium financing (hereinafter referred as **"PF"**) is in substance a loan with the life insurance policy (hereinafter referred as **"policy"**) being used as the collateral. Customers utilising PF facilities would need to make loan repayments with interests which would invariably reduce the amount of disposable income or liquid assets of the customers when the required repayments fall due or upon the request of the lender. The affordability assessment should therefore take this into account[1].

2. It was observed that, for PF Policies, affordability assessments by some insurers and intermediaries were conducted based on the out-of-pocket[2] premium amount to be borne by customers. Using this practice, instead of assessing the adverse impact that the PF facility would have on a customer's affordability, the PF facility was used to "support" the customer's affordability. It was found that some customers were able to use PF to purchase policies with a level of premium typically in excess of his/her affordability levels, resulting in over-leveraging[3]. In one particular case, the total premium amount of the said policy was found to be over two times the customer's total liquid asset amount.

3. While most insurers and intermediaries would check their internal systems to verify whether customers had any existing / inforce policies for which the customers were paying premium, it appeared that none of the insurers or intermediaries would assess whether such inforce policies were in fact serving as collateral assigned or acquired via PF. As these policies are often single pay or the total premiums are already prepaid upfront, these policies would be shown as being "fully paid" in the insurer's system, whereas in fact there could still be outstanding interest-bearing loan(s) to be repaid. The loan repayment obligations under the PF facilities used to purchase these existing / inforce policies should therefore have been taken into account in the affordability assessment for the new policies under consideration.

4. For intermediaries which were also the lending banks, it was observed that some did not take into account the total interest payments for the entire tenure of the PF facility in the affordability assessments, despite having access to the details of the PF facility.

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[1] This is a requirement under Paragraph 6.11 of GL30, which took effect on 1 April 2021 after the expiry of the transitional period.

[2] Generally speaking, in a PF arrangement, the customer would only pay a small portion of premiums not funded by the PF facility (e.g. 10%). This is referred to as the "out-of-pocket" premium portion.

[3] Under these circumstances, if the lender requests early repayment of the loan in full, the customer would not have sufficient liquid assets to repay the loan. To cover the outstanding loan and interest, the lender may exercise its right to effect a surrender of the policy to the detriment of the customer.

5. Despite the deficiencies above, certain good practices were also identified during the joint inspection –

   (a) Some intermediaries have established an internal threshold for affordability and would not proceed with an insurance application if the total premium of the proposed policy, together with total interest payments under the PF facility, exceeded a certain percentage of the liquid assets or disposable income of the customer (e.g. 50%). This had a positive effect in discouraging over-leveraging via PF.

   (b) A few intermediaries have tailored their financial needs analysis (hereinafter referred as **"FNA"**) forms or added a supplementary section to obtain details of the PF facility from the customer and assess the adverse impact it will have on the customer's affordability. One intermediary would even explicitly request a confirmation from the customer that he/she has sufficient cash to make any repayments for the PF facility before proceeding with the insurance application.

   (c) In addition to ascertaining the percentage of disposable income which the customer intended to utilise for premium payments, some insurers and intermediaries would also ascertain the percentage of liquid assets the customer was willing to use and take that into account in the assessment.

Evidence supporting affordability

6. As part of the insurers' financial underwriting procedures and customer due diligence controls, most insurers would require financial evidence (i.e. asset proofs) to ascertain their customers' source of funds for premium payments. This procedure serves as an additional check to verify that the customer has sufficient assets, at the point of sale, to meet premium payments or repayments under the PF facility (including the principal and interest on the loan). The following matters, however, were identified during the joint inspection –

   (a) While most customers would declare having sufficient liquid assets in the FNA form for the proposed policy, when asset proof / source of funds verification was performed, some customers failed to demonstrate their source of funds were actually from the declared liquid assets. In most of these cases, it was observed that the market value of non-liquid assets (e.g. owner's occupied properties), cash value of other life insurance policies and assets held under joint accounts would be used to support the proposed policy.

   (b) Many insurers would obtain a declaration from banks to ascertain the customer's asset under management, especially if the bank was also the selling intermediary. It was found that some insurers would accept the declaration even if the bank did not provide the exact information requested.

   (c) Some insurers had found during asset proof verification that customers had undisclosed liabilities (e.g. loans / overdrafts / mortgages), but chose to omit these liabilities in the affordability assessment.

B) Risk Disclosure

Risk Disclosure Practices

7. As PF involves customers assigning their rights and benefits under the proposed policy as collateral in order to receive financing from the lender, the customers should fully understand the relevant risks, limitations and consequences arising from collateral assignment before purchasing a policy through PF. The risk disclosure practice and the level of disclosures were found to vary substantially amongst insurers and intermediaries.

8. A few insurers merely notified the customer of the risks and limitations of PF / collateral assignment after issuance of the policy and effective date of assignment. The risk disclosure statement did not require signature from the customer to acknowledge his/her understanding.

9. An insurer was found with operational deficiency in its risk disclosure practice. A significant number of PF policies were issued without obtaining the required PF risk disclosure form properly signed by the customers.

10. One insurer had embedded the minimum collateral assignment risk disclosure into the policy proposal as a generic risk disclosure, rather than providing the risk disclosure to the customer when he/she had acknowledged his/her intent to utilise premium financing.

11. While the majority of insurers required / expected the intermediaries to explain the content within the insurers' risk disclosure form to the customers, the relevant form did not require the intermediaries to sign off that they had complied with such procedures. As a result, some intermediaries were not aware that they were required by the insurers to explain the relevant risks to the customers as revealed by the joint inspection.

Adequacy of Risk Disclosure

12. Some insurers' disclosure form / statement only covered the risks and limitations illustrated in Paragraph 6.8 of GL16 (i.e. interest rate risk[4], rights that the assignee may exercise, risk of release of information to the assignee). Other important and relevant items such as key terms / risks were not properly brought to the attention of the customers. For example –

    (a) Definition of PF and that the PF arrangement is not part of the insurance policy contract.

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[4] The interest payment under the PF facility may lower the actual benefit to be received from the customer, and hence reduce the actual return. In particular, if the interest rates applicable to the facility exceeds the rate of return generated by the insurance policy, the customer would suffer financial loss.

(b) Customer may be subject to various risks (e.g. exchange rate risk, credit risk[5], early surrender risk[6], death benefit risk, risks of non-guaranteed benefit, risk of duration / payment timing mismatches, etc.) as a result of the use of the PF arrangement, which may result in financial loss or reduction in benefits.

(c) Impact on customer's rights to cancel the policy within cooling-off period.

13. It was also found that the description of risks varied amongst insurers and some of the risk descriptions adopted by insurers were found to be inadequate.

14. Similar issues were also noted in some banks as intermediaries, as they did not explain adequately the risks, features and limitations of PF to customers at the point of sale, despite also being the providers of the PF facility.

C) Other Practices

Sales Practice & Intermediaries Training

15. Certain inappropriate sales practices were identified. In one instance, an agent was found to have bundled the PF arrangement together with the insurance policy and advertised the bundle as if it was a banking product. The agent also used its own marketing materials with terms such as "No Risk", "The Best Fixed Deposit", which were found to be misleading to the customers.

16. A few cases were noted with the intermediary recommending a particular product because the product is eligible for PF and would "enhance" the return for the customer. However, the intermediaries had not first ascertained the details of the PF facility, the rights that may be assigned under the policy, or the implication on the customer's suitability before making such recommendation. It is also worth highlighting that some intermediaries had internal rules to prohibit their staff from proactively introducing PF services, but these internal rules were not strictly followed.

17. It was observed that although PF was generally considered by insurance intermediaries to be a payment option for customers, the actual impact of PF facilities was not fully taken into account by the intermediaries in the course of their regulated activities. Consequently, a customer would not be made aware that the actual benefit receivable under a policy financed by PF might be less than the recommendation provided by the insurance intermediary regarding the level of target savings amount or the insurance protection attainable within the target protection period, since part of the benefit payments would be offset by the repayment of the PF facility. This shortfall could be significant especially in circumstances where the size of the loan under the PF facility is a relatively large portion of the total premium payments under the policies concerned. Without highlighting the shortfall, a customer might not fully understand the impact of using PF on the actual benefit receivable of an insurance policy and thus the customer

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5 The lender may request the customer to repay all outstanding loan and interest on demand at its discretion, especially due to adverse changes in credit rating or default of the relevant insurer.

6 There is a risk if the lender / assignee exercises its right to surrender the policy, the benefits receivable under the policy may be substantially less than the sum of total premium paid, interest expenses incurred and early repayment penalty, especially in the early years of the policy.

might not be in a position to make an informed decision subsequently on the proposal to finance his/her premium payments under an insurance policy by using PF.

18. In general, it was found that there was inadequate training provided to intermediaries on the risks related to PF. In one of the product training materials examined, the insurer had over-emphasised on the leveraging benefits of PF to its intermediaries and had failed to highlight the significant losses the customer might also suffer if the policy were to be terminated / surrendered during the early years. Relevant risks related to PF were not adequately explained in the training materials.

Assignment of Policy

19. As part of the PF process, the policy would be assigned to the lender as collateral via a written consent from the customer (often formalised as a letter to the insurer, entitled "Notice of Assignment"). Deficiencies were observed in the processing of assignment by some insurers. In particular –

    (a) the customer's signature on the Notice of Assignment was found to be significantly different from the signatures in the policy documents, yet the policy was still assigned; and

    (b) the Notice of Assignment lacked some key information on the policy to be assigned, yet an insurer had still processed the policy assignment in the absence of such information.

Cooling-off

20. It was found that the right to cancel the proposed policy within the cooling-off period was often assigned to the lender prior to policy issuance. However, none of the insurers would update the corresponding cooling-off notice to reflect the change in circumstances, which was found to be misleading and confusing for the customers.

21. It was also observed that interest on the PF facility was charged once the loan was drawn down even though the cooling-off rights were subsequently exercised. However, some banks as intermediaries did not inform customers of such interest charge at the point of sale, despite being aware of this information as the PF facility providers.

Policy Benefits Disbursement

22. The turn-around-time for policy benefits disbursement varied amongst insurers, depending on the relevant terms of the insurance policy or service pledge, which could range from several days to a couple of weeks after policy maturity. Some complaints were identified about late penalty interest being imposed on the customer arising from the turn-around time in disbursement of funds by insurers.