Annex

Practices of AIs and Expected Standards on Life Insurance Policy Replacement

General

AIs and their sales staff are required to comply with all applicable statutory and regulatory requirements relating to life insurance policy replacement, including but not limited to conduct requirements for licensed insurance intermediaries as set out in the Insurance Ordinance ("IO"), in particular sections 90(a) and 90(d); GL27 together with the corresponding Interpretation Notes issued by the IA; and various Codes of Conduct issued by the IA.

For the purpose of this circular, AIs should follow the detailed definition of policy replacement stipulated in Section 5 of GL27 together with the corresponding Interpretation Notes. Throughout this circular, the term "customer" bears the same meaning as "policy holder" or "potential policy holder".

(1) Best interests assessment and advice

Expected standards

Paragraph 5.5 of GL27 requires licensed insurance intermediaries including AIs and their sales staff to:

(a) assess and provide advice to the customer on whether the proposed purchase of a new life insurance policy is in the customer's best interests taking account of the reduction in the total cash value or sum insured under the existing life insurance policy, and any other adverse consequences to the customer arising from the policy replacement;

(b) ask the customer to provide information on his/her existing life insurance policy(ies) so that such assessment may be provided; and

(c) properly document the information provided by the customer during the assessment process, as well as the factors considered, evaluation, the recommendation(s) made by the AI and its staff, and reason(s) for such recommendation(s) as appropriate.

Practice 1

In certain sampled life insurance transactions involving policy replacement, weaknesses were noted in AIs in terms of sufficiency of information obtained on the existing policies of the customers; assessment on the implications on the customers arising from the policy replacement; and documentation on the customer suitability assessment of the policy replacement.

Expected standards

In the sale of a new life insurance policy involving policy replacement, AIs are particularly reminded of the requirements under section 90 of the IO which stipulate, among others, that AIs and their staff should act honestly, fairly, in the best interests of the customer, and with integrity, and have regard to the particular circumstances of the customer that are necessary for ensuring that the regulated activity is appropriate to the customer. The requirements under the Code of Conduct for Licensed Insurance Agents and the Code of Conduct for Licensed Insurance Brokers issued by the IA should also be observed, e.g. Section II and Section VI thereof.

(2) Identifying policy replacement at the point of sale

Practice 2

New life insurance transactions of a couple of AIs involving policy replacement by way of surrender or lapse of the existing policies (previously bought with the AIs concerned) were found not having the enquiries to the customers correctly answered at the point of sale of the new policies, although it was a prevailing regulatory requirement to ascertain whether surrender or lapse, among other things, of an existing life insurance policy had taken place or would take place. As a result, these cases were not identified as policy replacement cases and thus the various implications arising from the policy replacement were not explained to or discussed with the customers concerned.

In respect of the policy replacement cases involving surrender or lapse of the existing policies before the applications for the new policies, although such statuses of the existing policies were available in the internal records of the AIs concerned, which were also made available to their sales staff at the point of sale of the new policies, the AIs concerned did not require their sales staff, in assisting the customers in answering the enquiries, to check against those available records for the statuses of the existing policies that might indicate policy replacement.

Expected standards

In accordance with paragraphs 5.1, 5.4 and 5.5 of GL27, AIs and their staff should take all reasonable steps to ascertain whether the customer is purchasing the life insurance policy as a policy replacement. In addition, AIs should establish adequate procedures and controls to ensure their sales staff check at the point of sale available information in their records for the statuses of existing life insurance policy(ies) of the customer (e.g. information collected from the customer or provided by the issuing insurer(s) if the existing policy(ies) was sold through the AI) to ascertain whether any changes[1] have been made to an existing life insurance policy of the customer prior to the application date for the new life insurance policy, which may indicate policy replacement, and the sales staff should further enquire with the customer and take the steps as required by GL27. In this connection, AIs are expected to check records for such available information for a period of at least 12 months immediately prior to the application date for the new life insurance policy.

For the avoidance of doubt, such checking should be conducted regardless of whether the insurer(s) issuing the existing life insurance policy and the new life insurance policy is the same (i.e. "internal policy replacement") or are different as far as the information is available to the AI, and whether the changes[1] were handled by the same staff.

[1] For example, surrender / partial surrender, withdrawal of policy values, taking out of a policy loan (including automatic premium loan), use as a collateral to obtain a loan facility, suspension or cessation of premium payment, exercising of premium holiday, reduction of premium payable, lapse, conversion to reduced paid-up insurance, and conversion to extended term insurance.

(3) Monitoring policy replacement after point of sale

Practice 3 An AI performed monitoring to track policy replacement in respect of cases involving surrender of the existing life insurance policies after the applications for the new life insurance policies whilst the customers had answered at the point of sale of the new policies that they did not so intend to surrender their existing policies. However, the scope of such monitoring process was limited as it only covered existing policies surrendered within 14 days after the applications for the new policies, and that both the applications for the new policy and surrender of the existing policy were handled by the same sales staff. This was unsatisfactory because a considerable number of the policy replacement transactions of the AI fell outside the scope of the monitoring process since the surrender of existing policies took place beyond 14 days after the new policy transactions and that the applications were handled by different staff. *Practice 4* Sales staff of an AI did not identify at the point of sale of a considerable number of new life insurance policies that the customers would have their existing policies surrendered or lapsed after the applications for the new policies. The AI did not even have any monitoring processes in place to keep track of policy replacement transactions after the point of sale.

Expected standards

For cases not considered to be policy replacement cases upon the application for the new life insurance policy based on the answers provided by the customer to the enquiries, in addition to the measures under Section (2) above, AIs should have proper procedures and controls in place to monitor whether any changes[1] have been made to an existing life insurance policy of the customer after the application for the new policy that may indicate policy replacement by making use of information available to the AI. If so, AIs should look into the case and take appropriate follow-up actions taking into account relevant factors. To this end, the monitoring should cover any such changes[1] which were made during the 12 months immediately following the application date for the new policy irrespective of whether the changes[1] were handled by the same staff and whether the case was internal policy replacement.

(4) Internal controls and management supervision

Apart from the observations cited in Practices 2 to 4 above, it was noted that some of the sampled life insurance transactions, although not being identified by the sales staff as policy replacement cases at the point of sale of the new policies, were actually suspicious and displayed high conduct risk.

Practice 5

A sales staff of an AI handled three life insurance transactions but the customers soon had their existing policies surrendered or lapsed within few days after the applications for the new policies. In one transaction, the new and existing policies were even identical products.

Practice 6

A sales staff of an AI sold a new life insurance product to a customer shortly after the customer had an existing policy of the identical product lapsed with considerable loss as the cash value received from the existing policy was substantially less than the total premium paid.

Practice 7

A sales staff of an AI handled a customer's application for surrender an existing life insurance policy on the ground that the relevant policy was not the type of product required by the customer. As a result, the customer suffered a loss since the cash value he received from the surrender was substantially less than the total premium paid. Nevertheless, the same staff sold a new life insurance policy with the same product type to the same customer two weeks later.

Practice 8

In an AI, handling of policy replacement transactions was concentrated in certain sales staff and branches. In addition, there were a number of such transactions where the same staff also handled the applications for the surrender of the existing life insurance policies for the customers.

Practice 9

The management information system ("MIS") of an AI, which had been distributing life insurance policies issued by two insurers, only covered policy replacement transactions involving policies issued by the same insurer. In other words, the AI's MIS did not cover replacement transactions where the existing and the new policies were issued by different insurers notwithstanding that the AI was an intermediary of both insurers, and that the customers might suffer losses from policy replacement involving life insurance policies of these two insurers.

Practice 10

It was common that the MIS reports of AIs on policy replacement were produced only based on the responses provided by the customers to the enquiries during the applications for the new life insurance policies, rather than on cross-checking with records available to the AIs about any changes[1] made to the existing policies that might indicate policy replacement.

Expected standards

AIs should ensure they have a framework of adequate processes, controls, reviews and oversight to effectively identify and monitor any changes[1] to an existing life insurance policy which may indicate policy replacement and take appropriate actions. Under such framework, the control functions of business units and independent compliance functions, among other risk control parties, and internal audit functions of AIs should be involved. Such framework should ensure compliance with statutory, regulatory and internal requirements, including but not limited to the measures set out in Sections (2) and (3) above.

In circumstances where suspicious non-compliance with requirements, high risk areas, or other exceptions were identified, follow-up actions (including review of the transactions and follow-up with the customers concerned) should be taken in a timely manner to ascertain whether the non-compliance is substantiated; whether interests of the customers had been prejudiced; and whether there were any issues of concerns in sales management (e.g. putting undue pressure on sales units or sales staff, adopting a sales incentive scheme or sales targets that easily bring(s) about improper conduct of sales staff, lack of oversight of the AI's or sales staff's compliance with applicable statutory and regulatory requirements as well as the AI's internal requirements) or staff conduct (e.g. inducing a policyholder to replace an existing life insurance policy with another life insurance policy by misrepresentation or other fraudulent or unethical means).

Any identified prejudiced interests of customers should be promptly addressed with remedial actions, and any issues found in sales management or staff conduct should be properly dealt with. Breaches of statutory or regulatory requirements; prejudiced customer interests; and issues in sales management or staff conduct should be timely escalated to the management, and reported to regulators in accordance with established requirements. As appropriate, they should also be promptly reported to the board of the AI.

To facilitate controls, reviews and oversight relating to policy replacement, AIs should have in place comprehensive and effective MIS. Among others, the MIS should be able to identify (i) at what time the changes[1] to the existing life insurance policies were made vis-a-vis the application dates for the new life insurance policies; (ii) products of the existing and new policies involved; (iii) frequency and concentration of occurrences at different levels (e.g. staff, branch, business unit and so on) etc. for control and monitoring purposes as well as for identifying suspicious or high risk transactions, and potential issues in sales management or staff conduct relating to policy replacement.

The mystery shopping programmes of AIs should cover testing of policy replacement.

(5) Incentive systems and feedback mechanisms

Practice 11

A 6-month incentive programme of an AI rewarded frontline sales staff with additional bonus scores for remuneration on new life insurance transactions provided that certain criteria were met, of which one criterion specified that the customer should not be holding a policy of the same category at the point of sale. This arrangement might provide incentive for frontline sales staff to induce or suggest a customer to surrender an existing policy, thereby giving rise to policy replacement, or to ignore acting in the best interests of customers. In one life insurance transaction sampled in the HKMA's on-site examination where the AI awarded the sales staff with the additional bonus scores under the said incentive programme, an existing life insurance policy of the customer had been lapsed within 12 months prior to the customer purchasing an identical product. Furthermore, the existing policy was still within the reinstatement period. It was not evident how the sales staff had taken such fact in the sale process of the new policy to perform the customer best interests obligation. The AI removed such criterion in designing its incentive programme after the HKMA's on-site examination.

Practice 12

It was noted that an AI would not pay commissions to the sales staff for the sale of new life insurance policies, or would even claw back any paid or payable commissions to the sales staff if, within 12 months prior to or after the applications for the new policies, the customers had any existing policies surrendered, lapsed, with premium payment amount reduced, or on premium holiday. The above arrangement was considered one of the useful practices in reducing conduct risks relating to policy replacement.

Expected standards

AIs should properly design their incentive systems such that proper risk culture and business conduct of staff are encouraged and incentivised, and that improper risk taking and misconduct are deterred. In particular, AIs should ensure that sales targets are not formulated in such a way that they would likely put undue pressure to sales management or sales staff, or give rise to misconduct or undesirable behaviours of sales staff. Specifically, insofar as policy replacement is concerned, the design of an AI's incentive system on the sale of life insurance products should take into consideration circumstances conducive to policy replacement that is to a customer's disadvantage.

In addition, AIs should design and put in place effective feedback mechanisms, such as escalation policies including whistle-blowing mechanisms, for timely reporting of any suspected misconduct or malpractices in relation to policy replacement so that appropriate follow-up actions can be taken. AIs should also foster an environment that protects and supports their employees in reporting any suspected misconduct or malpractices they come across.

(6) Staff training

Practice 13 In interviews with sales staff of AIs, it was found on several occasions that some of them failed to provide a full account of the changes[1] to an existing life insurance policy that might indicate policy replacement, or assess whether the policy replacement was in the best interests of customers.

Expected standards

In addition to establishing adequate policies and procedures, AIs should provide sufficient training to relevant staff, including sales staff and control functions, to ensure that they have sufficient understanding of the definition of and the statutory, regulatory and internal requirements relating to policy replacement.