Annex

Findings from IA-HKMA joint inspection exercise on premium financing

A) Affordability Assessment

Regulators' expectations:

The Insurance Authority (the "IA")'s Circular[1] (the "IA Circular") sets out the minimum standards in terms of affordability assessment for applications involving premium financing ("PF"). More specifically, Para.2 of the IA Circular requires the assessment to ascertain whether the customer has sufficient financial resources to –

(a) pay at the outset the portion of the premium not financed by the PF facility;

(b) meet all scheduled repayments (including principal and interest repayments) over the entire tenure of the PF facility; and

(c) repay the sum owed under the PF facility if demanded by the lender before maturity of the policy.

Key Observations:

1. Most insurers and intermediaries examined have met the minimum requirements stipulated in Para.2 of the IA Circular when performing the financial needs analysis ("FNA") and made good use of questionnaires to ascertain the customer's circumstances.

2. Having that said, one insurer's underwriting practice did not duly consider the details of the PF facility (e.g. tenor or interest rate) but instead made an assumption that 20% of a customer's declared total liquid asset would be reasonably sufficient to repay any interest payment arising from any PF facility. This practice fell short of IA's expectation as it not only failed to meet Para.2 of the IA Circular, but was also not a prudent way for assessing affordability given that interest rate applicable and loan tenor varies among customers.

3. Likewise, it was found that banks with dual capacity as lenders and insurance intermediaries also assessed PF facilities differently. Most PF facilities were offered in the form of overdraft, revolving loan or term loan (tenor ranging from 1 to 20 years but subject to annual review). Some banks counted interest payment for the entire tenure of the PF facility in their affordability assessment while some counted for only a single year.

[1] "Circular on the supervisory standards and key requirements on the use of premium financing to take out long term insurance policies" issued by the Insurance Authority on 1 April 2022, which came into effect on 1 January 2023.

4. We have also identified a market practice amongst insurers which raises doubt about the customer's affordability. In some of the samples examined, the IA found that if the initially declared financial resources by the customers were insufficient to meet the insurer's affordability criteria, the insurers would request the customers to "reconfirm" their available financial resources or enquire whether they are willing to "revise" their appetite[2] for paying insurance premiums.

5. The IA found that under this practice, customers concerned would generally supplement that they actually had more liquid assets than initially declared and/or increase their appetite to meet the original insurance premiums. In one particular case, the customer, upon receipt of the request from the insurer, amended the declared circumstances for a total of 4 times, increasing the appetite to pay for the PF policy as well as the target saving levels, while proclaiming that more liquid assets were available than originally declared.

6. Although the declared liquid assets in most of the cases will be partially verified[3] by asset proof, the premium paying appetite is a matter of judgment. The above practice raises doubt about the customer's true circumstances, and whether the PF policy recommended remains suitable for the customer. In our view, a more appropriate approach would be for the insurer to "reconfirm" in a more conservative manner, e.g. suggest the customer to reduce the premium to an affordable level.

Good Practices:

7. Several insurers have implemented additional stress parameters when assessing the customer's affordability with respect to PF, for example-

- When determining the loan interest payments, the insurer would add 200bps on top of the customer's declared interest rate to assess whether the customer is still able to meet scheduled repayments under an interest rate rising environment; and

- When assessing the effective loan period to determine interest payments, some customers would declare a one-year tenor of the loan to be used. Given that the loan is an overdraft facility, one insurer would further assess whether the customer is still able to meet interest repayments if the overdraft facility extends beyond the first year and lasts until the breakeven year under the relevant policy.

[2] Generally speaking, the FNA would ascertain how much % of the customer's liquid assets or disposable income that the customer is willing to use to repay insurance premiums, which is regarded as the customer's appetite for paying for insurance.

[3] It is a common practice for the insurers to obtain asset proofs equivalent to the total premium only.

B) Risk of Over-Leveraging

<u>**Regulators' expectations:**</u>

Para.8 to Para.11 of the IA Circular requires insurance intermediaries and insurers to assess whether a customer is with risk of over-leveraging[4], and perform additional measures to safeguard these customers. These include asset and income proof verifications as well as providing justifications for recommending a PF policy to these customers.

Likewise, the Hong Kong Monetary Authority (the "HKMA")'s Circular[5] (the "HKMA Circular") requires banks and their subsidiaries that provide PF facility to take into consideration, among other things, whether the ratio of the loan amount of the PF facility to the customer's existing own financial resources (i.e. the leverage ratio[6]) is within a reasonable level in their credit assessment for cases where a risk of over-leveraging exists. Banks should also ensure that such ratio is disclosed to the customer before the customer accepts the PF facility offer.

In any event, if there is any doubt about the customer's affordability, a prudent approach (e.g. rejection of applications from these customers) should be adopted to protect the interest of these customers.

<u>**Key Observations:**</u>

8. In our review, the IA and the HKMA obtained information on all PF policies issued from 1 January to 30 June 2023 which were subject to the new requirements in the IA Circular. It was found that there were <u>no policies issued with risk of over-leveraging</u> based on customers' declaration. In other words, all PF customers in our review period have declared sufficient financial resources in the FNA to pay the policy in full without the use of any PF facility.

9. Most insurers confirmed they would <u>not</u> accept any applications from customers with a risk of over-leveraging while the remaining insurers mentioned they would only consider accepting the application if the additional measures under Para.8 to Para.11 are satisfied.

10. For banks, most of them, as insurance intermediaries, confirmed that they would <u>not</u> accept applications with a risk of over-leveraging. Only one bank represented that approving applications with a risk of over-leveraging would be considered if there is sufficient justification, but no such transaction had actually taken place.

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[4] The risk of over-leveraging exists when loan repayment requested by the lender before maturity of the policy cannot be fully met by the customer's own funds and can only be met using surrender value of the proposed policy.

[5] Circular on "Use of Premium Financing to take out Long Term Insurance Policies" issued by the HKMA on 1 April 2022.

[6] A ratio exceeding 1 means that the customer does not have sufficient asset to repay the loan in full upon lender's request without using surrender value of the proposed policy and is at a risk of over-leveraging.

11. Banks, as lenders, in general conducted credit assessment on PF applications, taking into account the risk of over-leveraging. However, there were cases where banks conducted credit assessment without ascertaining if a risk of over-leveraging existed. For example, a lending bank conducted credit assessment on PF applications solely based on the income proof submitted by the customer and the loan approval decision was simply based on whether the customer's monthly income was adequate to support monthly interest for the PF facility. Such assessment approach cannot determine if the customer has own funds available to pay the policy in full without surrendering the policy. Furthermore, the lending bank did not conduct its own risk of over-leveraging assessment on customers and instead solely rely on the insurance intermediaries to ascertain customers' risk of over-leveraging for PF during the FNA process, which fell short of the HKMA's expectation.

Good Practices:

12. When determining whether a customer is at a risk of over-leveraging, the majority of insurers would adopt a more prudent benchmark than Para.8 of the IA Circular by taking a 10% to 50% haircut on the customer's own funds. Several insurers would apply an even lower benchmark if the customer was identified as a vulnerable customer under GL16.

13. Most bank intermediaries and a handful of insurers would display the leverage ratio to the customers in the FNA form and explain to the customers whether they may be at a risk of over-leveraging.

C) Asset Proof Examination

Regulators' expectations:

Financial evidence checking (asset and income proof examination) is an integral part of the underwriting function of most insurers. It is often used by insurers to verify the financial information disclosed by the customer and also 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.

In general, the customer's financial evidence provided should be commensurate with the assets declared by the customer in the FNA. Para.11 of the IA Circular has also provided guidance over how asset proof verification should be done, including applying reasonable haircuts depending on the conditions and state of the assets and advised against the use of owner's occupied properties as asset proof.

Key Observations:

14. In general, substantial improvements were observed in asset proof verification as compared to our last joint inspection in 2020. From our samples, most underwriters were diligent when examining the financial evidence provided and applied haircut where appropriate.

15. However, there were several isolated cases where the underwriters had fallen short of the level of care expected of a prudent underwriter. For example-

    (a) There was one case where the underwriter accepted owner's occupied property as an asset proof which was explicitly prohibited under Para.11 of the IA Circular; and

    (b) There was another case where the cash value of a life insurance policy was accepted as asset proof, despite the customer explicitly declaring in the "Important Facts Statement – Policy Replacement" of having no intention to utilize cash value of any insurance policies to purchase the PF policy.

Asset proof issued by banks

16. As part of the asset proof verification process, insurers would often receive statements or letters issued by a bank regarding the customer's financial circumstances. These statements or letters not only contain the customer's assets under management but also sometimes provide an overview of the customer's background together with the source of wealth. The information from a bank is often heavily relied upon by insurers as it acts as an independent and reliable source to verify the information provided by the customer.

17. However, in our examination, we found that the reference letters practice of a bank fell short of the regulators' expectation, more specifically-

    (a) In some of the reference letters submitted to the insurer, the background information about the customers was revealed to be incorrect after the insurer performed searches in the Companies Registry.

    (b) In some of the reference letters submitted by the bank to the insurer, the bank would state the customers' wealth not only within the bank but also outside the bank (i.e. in other financial institutions). It was found that the information contained in the reference letters submitted by the bank, including customers' background information and customers' wealth outside the bank, had not been duly verified by the bank issuing the reference letters.

18. The insurer using these bank reference letters also fell short of the IA's expectation in terms of heavily relying upon some ambiguous wordings in the letter (e.g. wealth in other banks), with no official bank statements or certificates further verified.

Broker memo issued by the broker

19. It was noted from certain insurance applications via a broker that when the insurer asked for asset proof regarding the customer's financial circumstances, broker memo issued by the relevant broker was provided. However, it was found that the broker did not verify nor keep any supporting documents of the client information (such as level and source of wealth and income) stated in the broker memo. More alarmingly, in a couple of cases, no record of the broker memo itself was maintained by the broker.

D) Disclosure

Regulators' expectations:

Para.12 to Para.14 of the IA Circular sets out the disclosure requirements to be made by intermediaries and insurers in relation to the customer's use of PF including, among others, the "Important Facts Statement – Premium Financing" ("IFS-PF") which provides key risks and important disclosures for customers to make an informed decision regarding their use of PF and also documents evidence whether the intermediary had made recommendations and solicitations involving the use of PF. The customer is required to duly complete, sign and date the IFS-PF prior to policy issuance.

Key Observations:

20. In our review, almost all insurance applications involving the use of PF had duly completed the IFS-PF prior to policy issuance. Having that said, several isolated instances had been identified where the standard fell short of our expectation:

    (a) A few insurance applications were found with IFS-PF not duly completed prior to policy issuance due to operational oversight by the underwriters; and

    (a) In another instance, we found that the IFS-PF appeared to be tampered with. More specifically, the tick box where the customer declares whether the intermediary had made recommendations and solicitation involving the use of PF was whited out.

21. Some banks, as lenders, used mobile banking applications to accept customers' loan applications for PF. The key facts statement of PF was incorporated into the mobile banking application for customers to click in and read. However, a bank allowed the customers the option to skip this important risk disclosure section when applying for the PF application through the mobile banking application. Even though the risks related to PF were brought to the attention of the customers through the IFS-PF by the licensed intermediary, the lending bank was reminded to advise customers to read and understand the information in the key facts statement before applying for facility, and also obtain customers' acknowledgement that they have done so when submitting the PF applications.

22. After the rise of interest rate in the second half of 2022, some banks had relied on clauses embedded in the terms and conditions in loan agreements to change the basis of interest rate (e.g. from HIBOR-based and Prime-based interest rates to the Cost of Fund of the bank) of PF facilities. Nonetheless, the change of basis and the determination of the applicable interest rate of the facilities had not been set out clearly in product documents and drawn to the attention of the customers. A circular had been subsequently issued by the HKMA on 16 October 2023 to remind banks of the need for proper disclosure, and to clarify the disclosure requirements of interest rate when providing PF facilities to customers.

Good Practices:

23. In addition to the IFS-PF as required, some banks, as insurance intermediaries, made available PF related key facts statement/ product information sheet, on which additional risk disclosure was shown to illustrate the financial implication of using PF, i.e. the actual benefit receivable of a policy financed by PF would be less than the amount indicated in benefit illustration.

E) Sales Practice

> **Regulators' expectations:**
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> General Principle 6 of the Code of Conduct and GL30 require intermediary's regulated advice to be suitable for the customer taking into account the customer's circumstances. GL30 further requires suitability assessment to precede any recommendations.
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> Similarly, Para.7 of the IA Circular rode on that principle and reminded intermediaries to restrain from giving regulated advice recommending the use of PF, unless sufficient information in relation to the customer's circumstances (including details of the proposed PF facility) is obtained.

Key Observations:

24. In our review, we have observed several instances of inappropriate sales practices, giving doubts as to whether customers' suitability assessments were properly carried out by the intermediaries prior to providing regulated advice, namely:

    (a) A few situations were observed where the preparation of benefit illustration documents had preceded the suitability assessment. In one case, the customer, being a visitor from Indonesia, has yet to arrive in Hong Kong. However, it was found that the intermediary had already liaised with the insurer about customer's discount and arranged the pre-printing of the benefit illustration documents for a specific insurance product; and

    (b) A few insurers and intermediaries were not aware that without obtaining the details of the PF facility (e.g. the customer has refused to provide said details in the IFS-PF), the intermediaries should not make any recommendations or solicitations involving the use of PF.

F) Monitoring against Inappropriate Sales Practices:

Regulators' expectations:

Para.21 of the IA Circular requires insurers, licensed insurance agencies and licensed insurance broker companies to have proper controls, procedures, and adequate supervision to ensure their staff, licensed individual insurance agents and licensed technical representatives are complying with the requirements in the IA Circular as well as their internal policies governing the sales practices.

Key Observations:

25. In general, insurers examined have established dashboards and/or risk indicators to identify whether inappropriate sales practices may have taken place amongst their intermediaries. For insurers whose internal practice prohibits their intermediaries from making solicitation or recommendation involving the use of PF, our review also suggests that their underwriters have duly verified this prior to each policy issuance.

26. Having that said, improvements can be made particularly to the intervention levels and frequency of review set by some insurers. For example:

    (a) It was found that one insurer would set the intervention levels at an aggregated level (e.g. agency channel as a whole) rather than at the individual intermediary level. In other words, the insurer would not look into any inappropriate sales practices unless its entire agency channel had collectively triggered the risk indicators.

    (b) One insurer had set the review frequency to be on a yearly basis, which is relatively long as compared to the monthly or quarterly intervals set by other insurers.

Good Practices:

27. It was found that one insurer would conduct post-sale calls if the customer declares that solicitations or recommendations involving the use of PF had taken place. The purpose of the call was to confirm with the customer the details of the sales processes and to identify whether inappropriate sales may have taken place.

G) Training

Regulators' expectations:

Para.7.7(a) of GL16 and General Principle 4 of the Code of Conduct emphasize the importance for intermediaries to have a good understanding of the nature, features and risks associated with the relevant regulated activity. An intermediary's competency is also crucial in reducing the risk of sales that do not meet the needs of customers.

Para.18 and Para.19 of the IA Circular also outline the importance of training on PF and set out the expected standards for insurers, licensed insurance agencies and licensed insurance broker companies.

Key Observations:

28. Generally speaking, insurers examined have developed training materials for their intermediaries and made it mandatory if the intermediary wishes to engage in PF related activities.

29. Based on our review, the training materials examined generally covered the new requirements including affordability assessment, risk of over-leveraging, IFS-PF, and outlined the insurer's internal policy with respect to solicitation and recommendation involving the use of PF.

Good Practices:

30. Some insurers have made use of quiz to verify the competency of their intermediaries with respect to the new requirements as well as risks associated with PF.

31. A couple of insurers have made good use of information contained in the "IA's thematic webpage for premium financing" to enhance their training materials. The insurers also encouraged their intermediaries to visit the IA's webpage to further their knowledge and competency.

H) Other Operational Matters

Assignment of Policy

Regulators' expectations:

ICP19.2 emphasizes the importance of fair treatment of customers and requires authorized insurers and insurance intermediaries to embed this principle into their business culture. Likewise, GL10 Para.10.1 to 10.4 sets out the minimum requirements for authorized insurers with respect to their servicing of customers, which among others, requires the insurer to exercise due care and diligence before the establishment of the insurance contract and until all obligations under the insurance contract have been satisfied.

The notice of assignment ("NoA") is an integral part of a PF arrangement as it outlines the extent of rights and benefits the customer is willing to assign to the lending bank as collateral. As the recipient of the NoA, an insurer is expected to examine the notice carefully before effecting the assignment. At a minimum, the insurer should verify the authenticity of the assignment (e.g. verifying the customer's signature and policy number against its internal systems) as well as keep a copy of the notice to avoid potential disputes.

Key Observations:

32. With respect to policy assignment, it was found that one insurer had relied solely on the confirmation from the lending bank that the policy assignment had taken place. It did not independently verify the authenticity of the assignment nor keep any copies of the NoA. As such, the insurer was unable to provide the relevant documents for review upon IA's request. The above practices fell short of the due care and diligence an authorized insurer should exercise when handling a customer's request.

I) Cooling-Off

Regulators' expectations:

The right to cancel the proposed policy within the cooling-off period prescribed in GL29 is often assigned to the lender as part of the PF arrangement. The IA Circular requires insurers to update their cooling-off notice to reflect the change in circumstances.

Likewise, the HKMA Circular also requires banks to be mindful of imposing any conditions and/or costs on the customer before the expiry of the cooling-off period which may deter the customer from exercising the cooling-off right.

Key Observations:

33. A couple of insurers examined did not update their cooling-off notice in accordance with Para.20 of the IA Circular either because they were not aware of the requirement or had some form of operational oversight.

34. Most banks only charged the interest incurred and did not impose additional conditions or costs on customers if the policy was cancelled during the cooling-off period. Some banks also required customers to pay a small percentage of loan amount as set-up fee, administrative fee, or break-fund fee. Such fees were usually disclosed to customers through term sheet, fees schedule or Terms & Conditions of the banks. Banks are reminded that such fees should be properly disclosed to customers prior to entering into the PF facility and should not deter customers from exercising the cooling-off right.