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To : Chief Executives of authorized insurers carrying on direct long term insurance business

Dear Sirs,

Enhanced controls on premium payments by cashier orders

As part of its ongoing monitoring and supervision, the Insurance Authority (“IA”) carries out inspections to assess the adequacy of the controls and procedures of long term authorized insurers to achieve compliance with the customer due diligence and record keeping requirements in the Anti-Money Laundering and Counter-Terrorist Financing Ordinance (Cap. 615) (“AMLO”). Not unlike a medical-check up, being selected for inspection is not in itself indicative of pre-existing problems, but if potential issues are identified by the IA it enables the insurer to take corrective action. Prevention is, after all, always better than cure.

The direct engagement that the inspection process enables is particularly effective in the field of anti-money laundering and counter-terrorist financing (“AML/CTF”), where the regulatory regime requires insurers to take a risk-based approach (“RBA”) to developing controls. The RBA places responsibility on insurers to design their control systems for their specific business operations (rather than “one-size fits all” controls having to be prescribed by the regulators). The adequacy of an insurer’s controls can then be assessed by the IA in-situ during inspections. Every year, the IA shares general lessons learned via inspections through regular AML/CTF seminars and other training.

On rare occasions, however, in particular inspections the IA will come across an area where the controls observed are so out-of-kilter with the risk they have been designed to mitigate, as to be substantially inadequate to prevent the risk arising and potentially deleterious of wider conduct standards across the insurance market. In these instances, the IA must send a more immediate market-wide message to call out the matter and require timely remediation to be implemented. Such is the case with the controls observed by the IA in recent inspections on premium payments made by cashier orders, as detailed in this circular.

Relevant regulatory requirements

The IA's Guideline on Anti-Money Laundering and Counter-Terrorist Financing ("GL3") provides that an insurance institution ("II") should take reasonable measures to mitigate the money laundering/terrorist financing ("ML/TF") risks associated with transactions involving third party deposits and payments. Failure to do so may result in the II contravening section 23(b) of Schedule 2 to AMLO which requires an II to take all reasonable measures to mitigate ML/TF risk, exposing the II to potential disciplinary action.

GL3 provides the following examples of situations involving third party payments that might give rise to ML/TF suspicion, which should prompt the II to make further investigation and enquiries about the source of funds:

- (a) unnecessary routing of funds or other property from/to third parties or through third party accounts;
- (b) a proposal to purchase by utilizing a cheque drawn from an account other than the personal account of the proposer; and
- (c) any transaction involving an undisclosed party.

Where a policy holder uses an unrelated third party to pay for an insurance policy, the risk arises that the true beneficial owner of the policy or the source of funds is being disguised (this being an obvious ML/TF red flag). Using its RBA, therefore, an II should develop controls and processes to identify payments being made by third parties (rather than the policy holder), validate the relationship between a policy holder and the third-party payor, and ascertain the reason behind the third party making the payment instead of the policy holder.

In previous AML/CTF Seminars¹, the IA has emphasized that insurers should generally not accept payments from unrelated third parties and should thereby implement controls and processes such as transaction monitoring to identify third party payments and consider whether these are suspicious.

AML/CTF controls and monitoring for third party payments also serve a dual function in reinforcing conduct compliance in respect of the risk of payments being made through licensed insurance agents (being third parties vis-a-vis the policy holder). The Code of Conduct for Licensed Insurance Agents provides that a licensed individual insurance agent should not receive payment of premiums unless he or she is authorized to do so by his/her appointing insurer. Where the individual insurance agent is authorized to collect premium by his/her appointing insurer, the agent must handle the payment of premium (and pay it onto the insurer) in strict conformity with the requirements, controls and timing set by the appointing insurer. The individual insurance agent should also safeguard any premiums received and never mix such premium with the agent's personal funds. A cursory glance down the list of disciplinary actions taken by the IA in its short

¹ AML/CTF seminars held in 2017 and 2023

time as a conduct regulator demonstrates how handling of a policy holder's premium by individual insurance agents can expose the policy holder to risks ranging from misappropriation to delays in payment resulting in uncertainties on the effectiveness or even deprivation of insurance coverage. Further, if the agent receives monies involved in criminal proceeds, additional criminal consequences may follow². Hence, the need for the insurer to have adequate controls to identify and prevent these situations arising and thereby have processes in place which identify payments made by policy holders via appointed individual insurance agents (being, with regards to policy holders, third parties).

Inspection observations on controls relating to third party payments made by cashier order

In recent inspections we have observed a practice whereby insurers accept premium payment by policy holders by cashier order³, with controls in place that seek to prevent such cashier orders being used to make third party payments. Such controls rely on a threshold approach. If the cashier order amount exceeds the threshold which the insurer has set, the insurer will require production of valid payment proofs to conclusively identify the purchaser of the cashier order as the policy holder. For cashier orders below the threshold amount, however, the insurer (as its control) will request the policy holder to sign a declaration confirming the cashier order has been purchased by the policy holder with the policy holder's funds. Some insurers also require the servicing individual insurance agent to witness the policy holder's signature on the self-declaration.

There is nothing inherently wrong with such threshold approach as a control process. However, if the thresholds are set too high and not accompanied by regular sample testing of cashier orders falling under the threshold, it may result in the controls being circumvented and undermined.

The IA has observed a practice of insurers setting such thresholds at significantly high levels (e.g. US\$300,000), with limited to no testing of the veracity of the self-declarations for the resulting large number of (high value) cashier orders under the threshold. In its inspections, the IA took samples of the cashier orders under the thresholds which were accompanied by policy holder self-declarations. Based solely on information that the insurers held, the IA inspectors were easily able to identify a significant number of such cashier orders that had not actually been purchased by the policy holder (despite being self-declared as such). Rather, the cashier orders had been purchased by third parties and the insurers had failed to identify this. The number of such cashier orders purchased by third parties (accompanied by what were, in effect, false self-declarations) were, in certain cases, so alarmingly significant, that it was clear that the high thresholds set and lack of testing under the threshold, had rendered the insurer's controls substantively ineffective, as demonstrated by the ease with which such controls were being circumvented.

² Under the Drug Trafficking (Recovery of Proceeds) Ordinance (“DTROP”) and the Organized and Serious Crimes Ordinance (“OSCO”), a person commits an offence if he deals with any property knowing or having reasonable grounds to believe it to represent any person's proceeds of drug trafficking or of an indictable offence respectively. The highest penalty for the offence upon conviction is imprisonment for 14 years and a fine of \$5 million.

³ Some insurers use the term “bank drafts” interchangeably.

Further, in the case of many of the cashier orders identified by the IA as having been purchased by third parties (rather than policy holders), the third parties who had purchased the cashier orders were the insurer's own appointed individual insurance agents i.e. the same persons who had witnessed the erroneous self-declarations signed by the policy holders. In addition to AML/CTF non-compliance issues, this raised issues of potential breaches of the IA's Code of Conduct for Licensed Insurance Agents having occurred (and gone undetected by the relevant insurers). Indeed, in assisting policy holders to procure insurance policies with false self-declarations, the insurance agents were putting the legal effectiveness of the policies being purchased at risk.

Expectations on controls and procedures to prevent cashier orders being used to make unidentified third party payments

As stated, the approach to AML/CTF compliance encouraged in GL3 is a risk-based one, which empowers and places the responsibility on insurers to use an RBA to craft controls specific to their respective business operations. So as not to undermine the RBA, the IA refrains from prescribing specific "one-size fits all" compliance controls to be adopted. On this occasion, however, the IA has direct experience of identifying cashier orders for third party payments in its inspections which the insurer in question had failed to identify. The IA did this using information in the possession of the insurer. Further, it was clear that, in order to remediate the matter, direction from the IA was requested (and needed) by the insurer on how to set the threshold and generally strengthen its controls (rather than it being able to come up with an alternative set of controls itself using the RBA). To be fair and transparent to other insurers, therefore, (and to ensure this matter can be remediated expeditiously if other insurers have the same issues) the IA hereby shares the expectations given by its directions below.

If an insurer accepts premium payment by cashier orders and adopts a "threshold approach" as part of its control system as outlined above to control the ML/TF and related conduct risk of such cashier orders being used to make unidentified third party payments, as a general benchmark the IA would expect such control system to have the following minimum features:-

- (a) **Threshold** - In terms of threshold, the insurer should do full and conclusive checks on any cashier order exceeding **HKD400,000 (or USD50,000 equivalent)**. Full and conclusive checks should also be carried out on a cashier order as payment for an insurance policy if, together with other cashier orders used to make payment for same policy in the same year, the total amount exceeds HKD400,000 (or US\$50,000). "Full and conclusive checks" means identifying the purchaser of the cashier order by obtaining valid payment proof e.g. the cashier order purchase receipt, purchaser's bank statement, back page of cashier order containing pre-printed texts by issuing bank certifying purchaser's identification information, etc..

- (b) **Sampling** - For cashier orders below the threshold in (a) but exceeding HKD120,000⁴ (or USD15,000 equivalent), an insurer should conduct regular **random sampling** of all cashier orders received. As to sample size and regularity of such sampling, the insurer may devise this using its RBA. The samples taken should be checked for any indications that they have been purchased by persons other than the persons who purported to purchase them (i.e. if they have been purported or represented, by self-declaration or otherwise, as having been purchased by the policy holder or third parties that are acceptable to the insurer, the insurer needs to seek to verify that this is indeed the case based on information in its possession). Such checks should include ascertaining whether there is any information to suggest that the cashier order might have been purchased by any of the insurer's appointed individual insurance agents (being checks that the insurer can make based on the information available to it⁵). If the sampling results show a pattern of cashier orders being purchased by unrelated third parties (and not declared as such), the insurer should devise additional controls, based on its RBA, that would appropriately mitigate the risk of unidentified third party payments.
- (c) **Record keeping** - The insurer should keep a complete control log to record all available information on all cashier orders used to make payment under insurance policies, irrespective of the distribution channels through which the insurance policies are sold and the channels through which the cashier orders are received. The control log should contain sufficient information for each payment transaction to aid the sampling work referenced in (b) above including, at minimum: policy number, policy holder's name, amount of single/annualized premium of the insurance policy, payment amount, issuing date of cashier order (if available), credit date of cashier order in insurer's bank account, issuing bank of cashier order (if available), payor of cashier order (if available), bank account number from which the cashier order is drawn (if available), name and licensed number of servicing and witnessing insurance agent (if applicable), and whether payment proof/declaration form is obtained.
- (d) **"Red Flags" and reporting** - As part of its ongoing transaction monitoring for suspicious transactions, the insurer should include red-flags to identify potential circumventions of its controls (e.g. (i) splitting a premium payment into several transactions, to bring each transaction below the threshold of HKD120,000/USD15,000; (ii) situations where cashier orders drawn from the same bank account/purchased by the same payor are used to pay for premium of different and unrelated policy holders). Suspicious transaction reports should be filed to Joint Financial Intelligence Unit if there are grounds for suspicion of ML/TF.

⁴ According to AMLO, a financial institution (e.g. authorized institution) is required to carry out CDD measures in relation to a customer before carrying out for the customer an occasional transaction involving an amount equal to or above HKD120,000 or an equivalent amount in any other currency, whether the transaction is carried out in a single operation or in several operations that appear to the financial institution to be linked. Occasional transactions may include, for example, purchase of cashier orders. Since a financial institution is not required to carry out such CDD measures for occasional transactions below HKD120,000, an authorized insurer should not be required to include cashier orders below HKD120,000 in its random sampling.

⁵ For the avoidance of doubt, insurers should closely collaborate with the designated banks which receive premium payment on their behalf to obtain copies of cashier orders and other relevant documents if information therein can facilitate the requisite assessment. Insurers should also cross-check whether the bank account from which the cashier order is drawn corresponds to the bank accounts of its insurance agents known to the insurers.

The findings and outcomes of steps taken by the insurer in line with the above controls should be properly documented along with documentary proofs (conclusive checks on cashier orders above the threshold; methodology, records and conclusions of sample checks below the threshold; control log of payments made by cashier orders; and records of ongoing transaction monitoring conducted). This information should be made available to the IA on request during inspection or as part of its ongoing offsite monitoring.

Note that the above controls are a benchmark for the IA's minimum expectations where the insurer adopts a "threshold approach". Insurers can adopt stronger controls if preferred (for example either not accepting payment by cashier order at all, or only accepting payment by cashier order of any amount with full conclusive checks to identify the purchaser of the cashier order). However, if currently the insurer accepts cashier orders and uses a threshold approach for its controls process, and that approach does not meet the expectations set out in (a) to (d), the insurer should make the requisite enhancements **by 30 June 2024**.

Finally, the IA reiterates that, through the RBA, the responsibility and autonomy is supposed to lie with the insurer to set appropriate and adequate controls, monitoring and processes suitable for its operation. That is the skill-set and responsibility demanded of the various control functions in an insurer (hence the name "control functions") and the various lines of defence that form part of the insurer's compliance and control system. Every time the IA has to be directive on specific controls it expects to see in order to ensure standards and practices are maintained in the market (as in the case of this circular), this goes against RBA. We therefore ask management and control functions of insurers and all persons performing a role in the lines of defence in insurers, to keep in mind the importance of their respective roles and the performance of their duties. This is imperative to maintaining a high integrity insurance market based on robust and practical compliance.

Should you have any enquiries regarding the above, please contact Mr. Dickson Chui at 3899 9716, Mr. Steven Ho at 3899 9752, or Mr. Raven Chan at 3899 9754.

Yours faithfully,

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