Insurance Intermediaries Qualifying Examination

Investment-linked Long Term Insurance Examination

Study Notes

2024 Edition

PREFACE

These Study Notes have been prepared to correspond with the various Chapters in the Syllabus for the Investment-linked Long Term Insurance Examination. The Examination will be based upon these Notes. A few representative examination questions are included at the end of each Chapter to provide you with further guidance.

It should be noted, however, that these Study Notes will not make you a licensed person for any of the regulated activities under the ***"Securities and Futures Ordinance",*** *or otherwise an insurance specialist. It is intended to give a preliminary introduction to the subject of Investment-linked Long Term Insurance, as a quality assurance exercise for Insurance Intermediaries.*

We hope that the Study Notes can serve as reliable reference materials for candidates preparing for the Examination. While every care has been taken in the preparation of the Study Notes, errors or omissions may still be inevitable. You may therefore wish to make reference to the relevant legislation or seek professional advice if necessary. As further editions will be published from time to time to update and improve the contents of these Study Notes, we would appreciate your feedback, which will be taken into consideration when we prepare the next edition of the Study Notes.

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ANSWERS TO REPRESENTATIVE EXAMINATION QUESTIONS

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NOTE

If you are taking this subject in the Insurance Intermediaries Qualifying Examination, you will also be required, unless exempted, to take the subjects "Principles and Practice of Insurance" and "Long Term Insurance". Whilst the examination regulations do not require you to take those two subjects first, it obviously makes sense to do so. Those subjects lay a foundation for further studies and many of the terms and concepts found in those subjects will be assumed knowledge with this subject.

For your study purposes, it is important to be aware of the relative "weight" of the various chapters in relation to the examination. All chapters should be studied carefully, but the following table indicates areas of particular importance:

Chapter	Relative Weight
1	**2.5%**
2	**20%**
3	**35%**
4	**32.5%**
5	**10%**
Total	**100%**

Calculators brought into the examination venue are subject to inspection. Non-programmable electronic calculators (without cover) may be used in examination, provided that the calculators are battery-powered, silent in operation and with neither print-out nor graphic/word display functions. Please refer to the List of Approved Calculators at "FAQs" on the Website of PEAK Examination Centre at www.vtc.edu.hk/cpdc. Calculators on the List of Approved Calculators can only be allowed to use during examination.

Chapter 1
INTRODUCTION TO INVESTMENT-LINKED LONG TERM INSURANCE POLICIES

1.1 DEFINITION

As specified in Part 2 of Schedule 1 to the ***"Insurance Ordinance" (Cap 41)***, investment-linked long term insurance policies fall within Class C of Long Term Business – Linked Long Term. Linked Long Term Business is defined as the business of effecting and carrying out of insurance on human life or contracts to pay annuities on human life where the benefits are wholly or partly to be determined by reference to the value of, or the income from, property of any description (whether or not specified in the contracts) or by reference to fluctuations in, or in an index of, the value of property of any description (whether or not so specified).

In order to minimise the confusion with the classification of business between Class A (Life and Annuity) and Class C (Linked Long Term), the Insurance Authority has issued a ***"Guideline on Classification of Class C – Linked Long Term Business"*** (GL11), which highlights some of the predominant features of Class C Linked Long Term policies. In GL11, it is stated that a Class C policy must either be a life or annuity contract and possess one or more of the following features:

(a) The benefits of the policy are calculated in whole or in part by reference to the value of, or the income from, specified assets or group of assets or by reference to movements in a share price or other index, whether or not subject to deductions in respect of expenses or charges;

(b) The policyholder is given the options to choose the underlying investment assets from a range of investment fund options; and

(c) The policy is designed in such a way that the policyholder is contractually bound to bear partly or wholly the risk of the investments to which the benefits are linked.

In other parts of the world, investment-linked insurance policies are also known by the following terms:

(a) ***Unit-linked life/annuities***: This is a common term used in the UK. The term "unit-linked" illustrates that the values of the policies are linked to the price of the units.

(b) **Variable life/annuities:** This is the common term used to describe investment-linked business in the US. The term "variable" illustrates that the returns vary with the value of the underlying investment. There are two different types of variable life insurance.

- ***Fixed premium variable life*** is based on whole life. When talking about this product, life insurance practitioners generally drop the "fixed premium" qualifier and refer to the product simply as **variable life**. It provides a fixed premium payment schedule.

- ***Flexible premium variable life*** is based on universal life (a flexible premium derivative of whole life). This product may also be called "**variable universal life**" or "universal variable life." When talking about this product, life insurance practitioners generally retain the "universal" qualifier. It combines the premium and death benefit flexibility of universal life insurance and adopts its feature of unbundling of the pricing factors with the investment characteristics of variable life policies. Variable universal life has increasingly become more popular than variable life, owing to its flexibility.

In Hong Kong, investment-linked annuities are not commonly found. The most popular type of investment-linked insurance product is ***flexible premium variable life insurance*** (also called "variable universal life" or "universal variable life").

1.2 CONCEPT

As mentioned in the previous section, investment-linked insurance policies are insurance policies with its policy value directly linked to the performance of its underlying investment. This may be achieved by formally linking the policy value to units in a special unitised fund run by the life insurer, or linked with the units in a unit trust (or mutual fund). The value of the units is directly related to the value of the underlying assets of the fund. This value may fluctuate according to the performance of the investments concerned.

Investment-linked insurance policies may come in a variety of forms, but there is a common factor. Part of the premiums will be used to purchase units in a fund at the price applicable at the time of purchase. The value of the policy will then fluctuate according to the value of the units allocated to it.

How the investment-linked insurance policies work somewhat differs from the traditional life insurance and annuities. With traditional life insurance and annuity policies, net premiums (i.e. premiums net of the insurer's costs of doing business) once paid will become part of the company's general investments whose earnings help to accumulate cash value, from which policy benefits are paid. The death benefit and cash value of these policies are usually fixed and guaranteed. Under these types of policies, the authorized insurer assumes the investment risk. Where the amount of investment proceeds is more than what is required to fund the insurance contract's guarantees, the difference is added to the company's earnings. Part of such earnings is distributed to the policyholders of participating policies in the form of dividends, and the rest may wholly or partly be transferred to the shareholders' funds. On the contrary, in the case of a deficit (perhaps because of poor investment results), the authorized insurer bears the loss.

However, for the investment-linked insurance policies, net premiums are invested in investment funds accounts that are separated from the company's general assets (separate accounts) and are therefore entirely separated from the insurer's general account liabilities. The policy value, death benefit or annuity payment amounts will vary depending on the performance of these investment fund accounts. With these types of policies, all the investment risk is borne by the policyholder who however does not directly own any of the underlying assets recorded in the accounts. This allows investment gains to be passed through to the policyholders, but it also means that investment losses are borne by the policyholders.

A variety of assets may be used for linking purpose including equities (ordinary shares), fixed income securities (money market instruments and bonds) and a whole range of cash and other security/asset funds.

As these policies are considered collective investment schemes under the definition provided for in the ***"Securities and Futures Ordinance" (Cap 571),*** authorisation has to be sought from the Securities and Futures Commission ("SFC") if they are sold to the general investing public.

Finally, it should be noted that only authorized insurers authorized under the ***"Insurance Ordinance" (Cap 41)*** to carry on Class C business in or from Hong Kong can underwrite investment-linked long term insurance policies.

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Representative Examination Questions

The examination will consist of ***80*** *multiple-choice questions. The majority of the questions will be very straightforward, involving a simple choice from four alternatives. These we may call* ***Type "A" Questions.*** *A selection of the questions (probably between 10% and 15%) will be slightly more complex, but again involving a choice between four alternatives. These we may call* ***Type "B" Questions.*** *Examples of each are shown below.*

Type "A" Question

1. All investment-linked long term insurance policies have to obtain authorisation from which of the following organisations if they are sold to the general investing public:

   (a) the Hong Kong Federation of Insurers;
   (b) the Securities and Futures Commission;
   (c) the Professional Insurance Brokers Association;
   (d) the Insurance Authority.

[Answer may be found in **1.2**]

Type "B" Question

2. An investment-linked long term insurance policy usually serves which of the following objectives:

   (i) protection
   (ii) investment
   (iii) fixed interest income
   (iv) guaranteed final return

   (a) (i) and (ii) only;
   (b) (ii) and (iii) only;
   (c) (iii) and (iv) only;
   (d) all of the above.

[Answer may be found in **1.2**]

Note: *The answers to the above questions are for you to discover. This should be easy, from a quick reference to the relevant part of the Notes. If still required, however, you can find the answers at the end of the Study Notes.*

Chapter 2
INVESTMENTS

Since the value of an investment-linked long term insurance policy depends on the performance of its underlying investment portfolio, in order to fully understand its nature, it is necessary to have a basic knowledge of investment.

Our discussion on the investment topics is covered in two chapters. In Chapter 2, we review the basic concepts of investment with special emphasis on investment objective, risk and return, risk management, factors affecting investment considerations and finally investment advising. In Chapter 3, we give a detailed description of the major types of investment assets including money market instruments, debt securities, equities (shares), financial derivatives, real estate, low liquidity investments, investment funds and insurance products.

2.1 RISK OF INVESTMENT

What motivates a person to invest, rather than spending their money immediately? The most common answer is accumulation of wealth and provision for the future. To increase wealth, a person needs to do something to the savings to make them grow. What a person does with the savings to make them increase over time is investment. Thus, investment is the commitment of money for a period of time in order to derive larger future payments. The definition of investment is ***to sacrifice present value for future value.***

When we talk about investment, most people focus on how much money they can make without any detailed analysis or are even ignorant of the risks involved in the investment. It is imperative for investment advisors to fully understand the concept of risk and help investors define their risk appetite before embarking on investment or giving investment advice. Therefore, we start with a detailed look at risk.

2.1.1 Meaning of Risk

Risk is the possibility of loss or injury. In investment terms, it is the uncertainty associated with the end-of-period value of the investment. Investors are however, more concerned with the downside risk, which represents the possible loss or reduction of the original sum invested – ***financial risk***. In the investment industry, the existence of financial risk means that it is possible for investors to lose money, and that there is no absolute guarantee of capital growth.

Financial risk is often perceived to have increased in recent years. The equity market crash in 1987, the Sterling Pound's exit from the Euro Exchange Rate Mechanism in 1992, the bursting of the bond market bubble in 1994, the Asian markets meltdown in 1997-1998, the 9/11 terrorists attack in 2001, the epidemic of SARS in 2003, the Global Financial Crisis of 2007–2008, the European Sovereign Debt Crisis in 2010 and the Coronavirus Crash in 2020 have all left their marks in the minds of investors. This perceived increase in financial risk, together with a growing awareness among investors of the various techniques and products for managing it, has led to a sharp increase in demand for risk management services.

2.1.2 Types of Risks

Investors are sometimes mistaken by the concept that they can avoid risks by just placing their asset in a bank account. This act however, is still subject to two risks:

- default risk in that the bank they invest in may go out of business; and
- inflation risk in that higher prices of goods in the future will reduce the purchasing power of the saved funds.

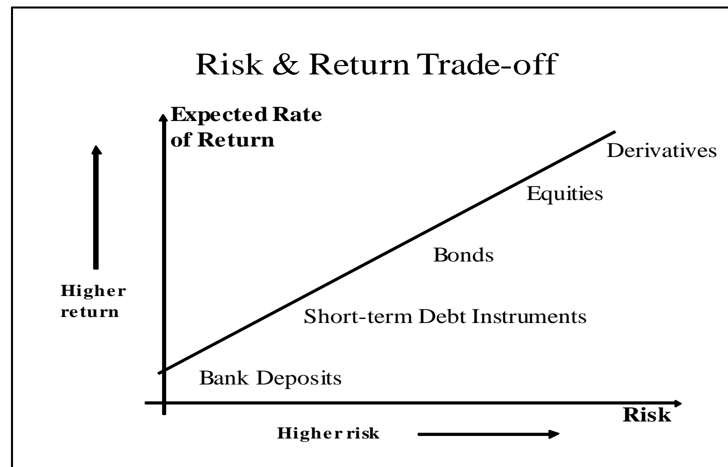
There is an endless list of risk factors in investment to the average investors. The following list covers the more common and important risks:

- ***Market risk*** – basic demand and supply in the market will affect the price of investment instruments. An investor will suffer a loss if he/she has to sell an asset when the price drops below his/her original purchase price.
- ***Company risk*** – negative developments such as the loss of market share or the failure of a new product launch will have an adverse effect on a company's financial status and thus its share price.
- ***Economic risk*** – the possible impact of an overall economic slowdown.
- ***Inflation risk*** – the loss of purchasing power as return on investment does not match the inflation rate.
- ***Default (credit) risk*** – the potential inability of a debt issuer to pay interest and/or repay principal.
- ***Interest rate (price) risk*** – the price fluctuation of certain fixed income investments prior to maturity due to current market interest rate changes.
- ***Liquidity risk*** – the inability to liquidate (sell) an investment or the need to pay a substantial cost to liquidate.
- ***Reinvestment-rate risk*** – the inability to reinvest interim cash flows or a mature investment at the same or higher rate of return.
- ***Exchange (currency) risk*** – a foreign financial investment upon maturity may have to be converted into home currency at a less favourable rate due to foreign exchange rate fluctuation.
- ***Sovereign or Political risk*** – political instability may cause governments to take actions that are detrimental to the financial interest of financial investment instruments in that country.
- ***Operational risk*** – the risk faced by financial institution arising from the operations of the business deal processing, deficiency of information system, ineffective internal management and control system, human errors, etc.

2.1.3 Risk-return Trade-off

Inevitably, investment involves risk. Any investment involves a trade-off between risk and expected return. As a general rule, the higher the return an investor seeks, the higher the risk he/she must be prepared to accept. The higher return is to compensate for the higher risk of the investment. As such, investors should be aware of the risks and returns of different asset classes in making investment decisions.

The following graph provides a perspective on the relationship between the risks and returns of several investment assets. Please note that the graph is not drawn to proportion but it does give a relative position of the level of risk and expected return of those assets.



2.1.4 Risk Reduction Techniques

There are a few proven techniques for reducing risk in investment. They are diversification, dollar cost averaging, and time.

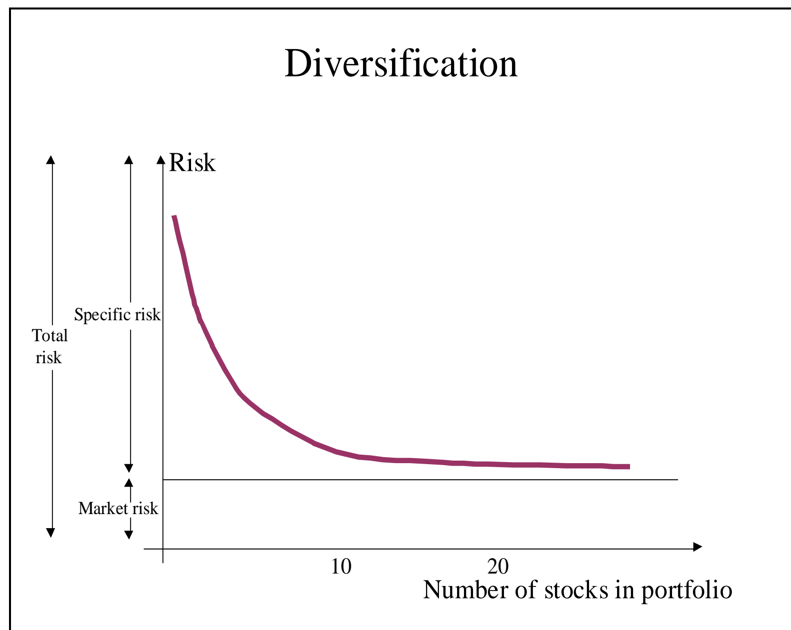
(a) Diversification

Diversification means owning different issues of the same asset class or different asset classes within a portfolio of investment, or investing in different markets, regions or countries. Diversification is a normal practice of investment managers to reduce the risk without substantial reduction in returns. It has been demonstrated that putting assets with low correlation in their return together in a portfolio could reduce substantially the overall risk of the portfolio without giving up return.

Why does diversification reduce risk? This is because normally markets do not all move in tandem and some financial instruments react differently to market movements. That is, one instrument may drop in value but the other may increase in value at any point in time responding to the same market/economic movement. For example, a downturn in the economy will normally lead to a fall in the equity market (economic risk) and at the same time give a boost to the bond market (lower interest rate, higher bond price). Another example is that an increase in oil price is detrimental to energy dependent firms like airlines and manufacturing companies but beneficial to energy producing firms like oil companies. Therefore, if your portfolio holds both types of stock, for example Cathay Pacific and CNOOC, the adverse effect of rising oil price on Cathay Pacific may be reduced by the positive impact on CNOOC.

A "balanced portfolio" – return from investing in a variety of investment assets tends to be less volatile than that from investing in a single asset, because the investor is in effect spreading the risks. Insofar as investment is concerned, one should always avoid putting all eggs in one basket. This is also the underlying concept of investment funds.

The following diagram shows how the total risk of a portfolio decreases when more assets are added into the portfolio.



(b) Dollar Cost Averaging

It is an investor's dream to be able to enter the market at its bottom but nobody knows when a market reaches its bottom. To the contrary, we often see people got caught at the top of the market. Investors want to buy low and sell high but turn out to buy high and sell low.

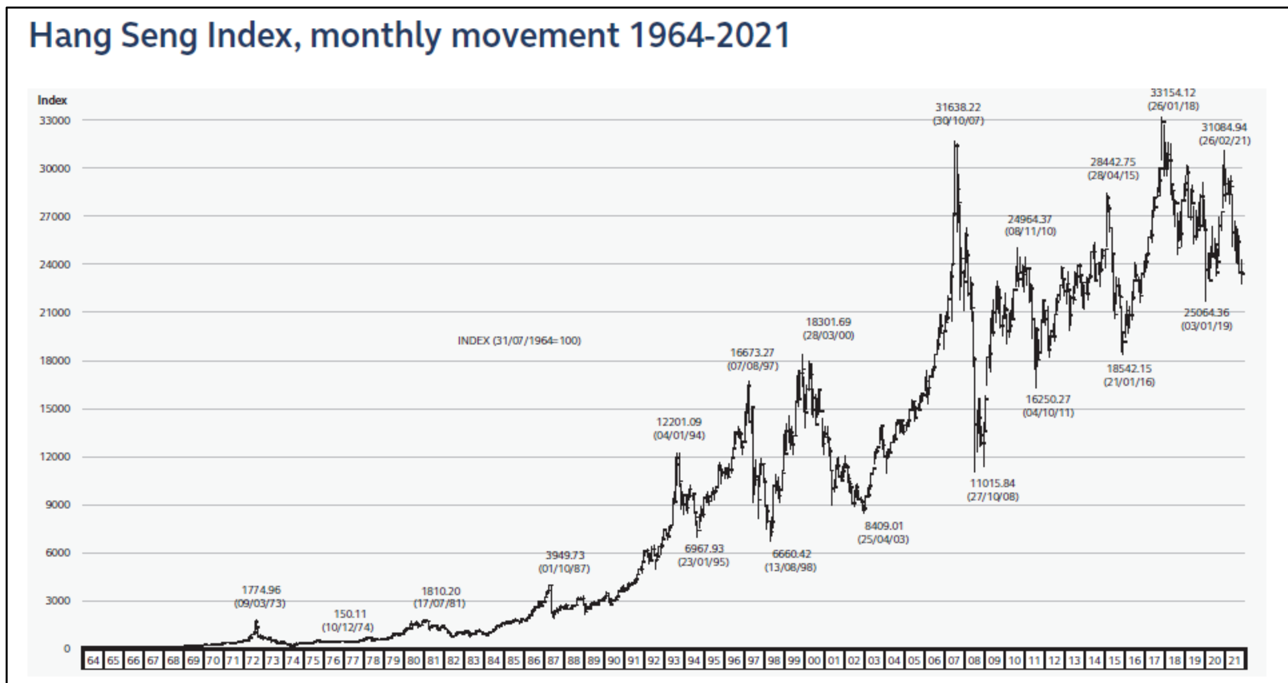
Dollar cost averaging is a technique to prevent investors from putting all their money in the market at the inappropriate time. This involves investing a fixed sum of money at fixed intervals of time. Let us look at the following example. Suppose an investor wanted to invest HKD150,000 in stock A but he/she was not sure whether it was the suitable time to enter the market. He/she therefore decided to split his/her capital into 5 equal sums of HKD30,000 and buy stock A worth of HKD30,000 in the middle of each month. The following table illustrates his/her transaction records.

Date	**Market Price**	**No. of share Bought**
15-Jan	HKD50	600
15-Feb	HKD60	500
15-Mar	HKD40	750
15-Apr	HKD25	1,200
15-May	HKD50	600
Total no. of shares bought		3,650
Average cost per share		HKD41.10

We can see from the table that although at the end of the period the stock price of A was virtually unchanged at HKD50, the same level when the investor started his/her investment, the investor has built up his/her portfolio at the average price of HKD41.10. The reason is that with a fixed sum of investment, the investor bought more shares when the stock price was lower and bought less shares when it was higher, a lower average cost was thus achieved.

(c) Time as a Risk Moderator

Time not only works for investors through the power of compounding (please refer to **Appendix A**) but also helps to dampen the risk of investments. At the Hang Seng Index chart below, we see that the stock market basically follows an upward trend with interim fluctuation. Suppose an investor was unfortunate enough to enter the market at the peak in 1997. If he/she was able to keep his/her position till year 2007, he/she would have a chance to get out with a good profit. However, if he/she was a short-term investor and had to close his/her position in 1998, the story would be very different.



Source: HKEX Fact Book 2021 (P.20)

It must be pointed out that although most stock markets tend to come back and surpass their previous high if investors can stay long enough in the market, the waiting period could be indefinite. For instance, the Japanese Nikkei 225 index – closing at 18,665 on 10 March 2015 - is still way below its record high of 38,957 seen in December 1989. This is yet another example illustrating the importance of "diversification".

2.1.5 Risk Management Process

Having laid down the risk management principles of an average investor, we are going to discuss the risk management process from the perspective of a financial intermediary. The risk management process typically involves four steps: Identification of Risk; Measurement of Risk; Management of Risk; and Monitor of Risk.

(a) Identifying Risk

The business must be fully understood before the risks inherent therein can be identified. For example, a securities broker whose business relies heavily on a few clients is subject to a higher credit risk than a broker which has diverse client mix. If the nature of the business is not properly

understood, the risks identified may be over or under estimated or even incorrectly classified.

In identifying the risk, the management of the business should be aware of the different types of risk discussed in Section **2.1.2** related to its activities such as credit, market, economic or political risks and their possible impacts, etc.

(b) Measuring Risk

The most common method to quantify risk is the concept of volatility of the rate of return of an asset. Volatility is defined as the standard deviation of the rate of return. Historical volatility is a measure of the dispersion of returns around the average of historical returns. It can also be used in a forward-looking manner to calculate the dispersion around the expected return.

(i) **Expected Return**

We may employ scenario analysis to assist us to find out the expected return of a financial asset, e.g. a fund. Firstly we forecast the expected returns of the fund in different scenarios like bull market, stable market and bear market. Secondly, we assign probabilities of occurrence to each scenario. Then the expected return is calculated by:

$r = \Sigma p_i r_i$

Where

r = expected return

p_i = probability of occurring r_i

r_i = return of an expected scenario

(ii) **Volatility**

After finding out the expected return, we can use the formula of standard deviation to calculate the volatility. The higher the volatility, the higher is the risk of the investment.

Volatility = standard deviation = $\sqrt{\Sigma p_i (r_i - r)^2}$

Example:

Find out the expected return and volatility of Fund A and Fund B given the following return scenarios:

Probabilities	Return of Fund A	Return of Fund B
0.2	20%	20%
0.7	25%	40%
0.1	5%	-10%

Expected return of Fund A:
(0.2 x 20%) + (0.7 x 25%) + (0.1 x 5%) = 22%

Expected return of Fund B:
(0.2 x 20%) + (0.7 x 40%) + [0.1 x (-10%)] = 31%

The volatilities of both funds are:

Probabilities	Return of Fund A	$p_i (r_i - r)^2$	Return of Fund B	$p_i (r_i - r)^2$
0.2	20%	0.01%	20%	0.24%
0.7	25%	0.06%	40%	0.57%
0.1	5%	0.29%	-10%	1.68%
		0.36%		2.49%

The volatility of Fund A = $\sqrt{\Sigma p_i (r_i - r)^2}$
= $\sqrt{0.36\%}$ = 6.00%

The volatility of Fund B = $\sqrt{2.49\%}$ = 15.78%

(iii) **Sharpe Ratio**

From the above example, Fund B has a higher return carrying at the same time a higher risk as compared to Fund A. An investor would however be more interested in the question as to which fund gives a higher return for the same level of risk. To answer this question, we need to rely on Sharpe ratio which is the return of an asset over risk free rate per unit of risk undertaken:

Sharpe ratio = (Expected return – Risk free rate) / volatility

Assuming the risk free rate is 5% in the above example:

Sharpe ratio of Fund A = (22 – 5) / 6 = 2.83

Sharpe ratio of Fund B = (31 – 5) / 15.8 = 1.65

Despite the higher absolute return of Fund B, Fund A in fact can give a higher return for the same level of risk.

(iv) **Other Measurements of Risk**

Other major market risk measurement methodologies include:

1. Value at Risk ("VaR"): It is widely adopted as an industry benchmark for risk measurement for banks and financial institutions. It is a measure of the change in value of an investment as a result of changes in market conditions at a specified confidence level. An example of a VaR statement is "The 1-day 99% VaR for the position is HKD1 million". It means that there is 99% chance that the maximum daily loss likely to occur is HKD 1 million.
2. Stress test: VaR only indicates the maximum loss within certain level of confidence. There is still chance of a loss much larger than the VaR figure. Stress test can supplement this shortcoming of VaR by assessing how an investment performs when specific large moves in the market parameters occur.

3. Option sensitivity measures: it measures the option price changes as against changes in other parameters such as time, interest rate, volatility, etc.
4. Duration: it is used to measure the percentage change in bond prices with respect to change in interest rate.

(c) Managing Risk

In order to manage the risk identified and measured in the previous steps, effective risk management policies and procedures must be established.

Risk management is a top-down process and therefore the endorsement of top management is one of the key success elements of risk management policy. The policy must be set out clearly and properly documented. The risk management responsibilities have to be clearly defined and communicated to the staff concerned. Sufficient training has to be provided. The senior management has the responsibility to implement the policy properly and oversee the day to day operations. Effective segregation of duties must be ensured so that risk management functions are independent of any of the business units.

An effective organisational structure is also a prerequisite of successful risk management. A direct reporting line to the senior management is necessary so that anything unusual can be reported and responded to quickly. Adequate resources, competent and experienced personnel must be available for the implementation of the risk management policy.

(d) Monitoring Risk

Finally, an internal system should be in place to regularly monitor the risk management process. It can be done either by internal or external auditors in order to assess the effectiveness of the system. Appropriate revision or enhancement can be made if necessary. Similar to the risk management policy, the monitoring system must be clearly set out and properly documented.

2.1.6 Financial Risk Management in Hong Kong

(a) Risk Management Systems and Processes

The regulatory bodies in Hong Kong play a key role to ensure that high standard of risk management system and processes are implemented in financial institutions of Hong Kong. There are different regulatory frameworks in place to govern the risk management of different types of financial institutions such as authorized institution, brokerage house, investment fund company.

Hong Kong Monetary Authority (“HKMA”)

The authorized institution is governed by the HKMA. The HKMA has issued various guidelines as contained in the HKMA’s Supervisory Policy Manual to the industry which are either minimum standards or best practices in risk management.

The regulatory approach undertaken by the HKMA is called risk-based supervisory approach which is based on the recommendation of the Basel Committee on Banking Supervision. It seeks to determine whether authorized institutions have appropriate systems of risk management and internal control. The objective is to provide an effective process to monitor and assess the safety and soundness of authorized institution on an on-going basis.

The HKMA implemented the **CAMEL rating system** since 1995 which is an international recognised framework for assessing **Capital adequacy**, **Asset quality**, **Management**, **Earnings** and **Liquidity**. The overall rating is expressed through the use of a numerical scale of 1 to 5 in ascending order of supervisory concern. The risk-based supervision provides the supervisory process with the necessary framework to factor the risk profile of an authorized institution into the CAMEL system.

All in all, the HKMA has identified four basic elements contributing to a sound risk management environment:

- active Board and senior management oversight;
- organisational policies, procedures and limits that have been developed and implemented to manage business activities effectively;
- adequate risk measurement, monitoring and management information systems that are in place to support all business activities; and
- established internal controls and the performance of comprehensive audits to detect any deficiencies in the internal control environment in a timely fashion.

Securities and Futures Commission ("SFC")

The SFC is the statutory body responsible for regulation of the securities and futures industry and facilitating and encouraging the development of these markets. The SFC also adopted risk-based regulation to the securities and futures industry. It means identifying and then focusing its attention and resources on the areas where it perceives to be of highest risk. The ultimate aim is to encourage intermediaries and market participants to develop a compliance culture.

The SFC has a range of regulatory tools such as regulatory programmes, policy projects and compensation schemes. These tools are either diagnostic, monitoring, preventative or remedial in nature:

- Diagnostic tools to identify and assess risks: For instance, the Intermediaries Supervision Department, which requires registrants to submit monthly financial resources returns, uses a set of assessment indicators to assess the financial risk exposure of registrants. The Licensing Department uses diagnostic tools in order to identify applicants for licences who could pose an unacceptable risk to investors.
- Monitoring tools to monitor and track identified risks: For instance, the Enforcement Division carries out market surveillance to gather evidence in relation to market crime. The Intermediaries Supervision

Department uses both desktop and field reviews to identify instances of intermediaries' misconduct.

- Preventative tools to prevent or limit risks: For instance, the Investor Education and Communications Department provides education programmes that help investors become more aware of their rights and about how to protect their investments.

- Remedial tools to respond to risks that have arisen: For instance, where intermediary misconduct has been proven, disciplinary sanctions may be imposed. Finally, the investor compensation scheme is another example of a remedial tool used as a response when an intermediary fails and causes loss to investors.

(b) Risk Management Techniques

We are going to look into some practical risk management techniques that are encountered in the day-to-day risk management operation.

(i) **Marking to Market**

It is the process to revalue the collateral value of a client to reflect the current market value. For example, a futures broker should mark its clients' open position regularly to ensure that margin calls would be made if the clients' margins fall short of the maintenance margin. Frequent marking to market should be performed especially when there is a dramatic move in the market.

(ii) **Limit Setting**

Market risk exposure of a financial intermediary can be limited by setting trading limits. For example, position limit is the maximum open position a client of a securities broker may take. More detailed limits such as intraday and overnight limits can also be set. Stop-loss limit is also a common technique to limit the loss by liquidating a position when a pre-defined loss level has been suffered.

(iii) **Hedging**

The impact of future adverse price movement can be minimised by hedging with the use of derivative. For instance, if a fund manager expects a short-term downward correction in the market, he/she may sell short stock index futures in order to hedge against any potential decline in the portfolio value. When the stock market drops, the gain from the short stock index futures contracts will "offset" the loss in value of the portfolio.

(c) Past Experience

We have discussed some incidents of financial downturn in section **2.1.1**. They illustrate the utmost importance of risk management. Some other recent examples further confirm this.

(i) Barings

The collapse of Barings Bank in 1995 overnight was a classic example of operational risk. A trader in Barings had undertaken unauthorized dealing activities in futures. He was however able to conceal them because he was responsible not only in trading, but also in settlement of the transactions. By the time it was discovered, the bank had already lost billions of dollars.

The incident highlights the importance of segregation of duties in the risk management processes and procedures. The business unit (the dealing department) must be separated from the risk management unit (the settlement department) such that any irregularities in dealing can be identified much earlier.

(ii) Asian Financial Crisis in 1997-1998

Due to the impressive economic record of the East Asian countries, the region has attracted large inflows of capital from foreign investors in the 1990s. Unfortunately, the funds were not invested efficiently but lent to family members or political affiliated parties by the banks. The funds ended up with poor returns and defaults from borrowers were surging. When the foreign investors started withdrawing funds by selling off assets in the region, speculative attack on the regional currencies were launched.

This is not only a case of wrong assessment of credit risk by the banks in evaluating the chance of default by the borrowers, but also the ignorance of the importance of risk management. Moreover, the extreme interest rate and exchange rate movement caused by the crisis has posed severe market risk to financial institutions. Some local securities houses collapsed in the event, seemingly due to underestimation of the market risk at the time.

(iii) Global Financial Crisis of 2007–2008

The global credit market was hard hit in 2008 following the peaking off of real estate market in the US by the end of 2006. New purchasers were warded off by the unsustainable level of property price. At the same time, default rate of property mortgage increased. Market began to lose confidence in those firms which had been active in lending to the property purchasers. Following the collapse of Bear Stearns in March 2008, market confidence continued to deteriorate and the bankruptcy of Lehman Brothers in September 2008 finally triggered the global credit crunch. It illustrates again the importance of risk management. Any wrong assessment of default risk and market risk may lead to collapse of seemingly unassailable financial institutions.

(iv) European Sovereign Debt Crisis in 2010

It is a multi-year debt crisis that has been taking place in the European Union since the end of 2009. Several eurozone member states such as Greece, Portugal, Ireland, Spain and Cyprus were unable to repay or

refinance their government debt or to bail out over-indebted banks under their national supervision without the assistance of third parties like other eurozone countries, the European Central Bank ("ECB"), or the International Monetary Fund ("IMF").

In fact, the catastrophe was mainly caused by a sudden cessation of foreign capital into countries that had substantial deficits and were heavily dependent on foreign lending, i.e. a balance-of-payments crisis. The situation was worsened by the inability of states to resort to devaluation (reductions in the value of the national currency). Besides, a lack of fiscal policy coordination and financial regulatory centralization among eurozone member states triggered the concerns regarding the solvency of banking systems or sovereigns were negatively reinforcing. The crisis has had significant adverse economic effects and labour market effects, with unemployment rates in Greece and Spain reaching 27%, and was blamed for subdued economic growth, not only for the entire eurozone, but for the entire European Union.

(v) Coronavirus Crash in 2020

It was a considerable and sudden global stock market crash that began on 20 February 2020. Moreover, it was the fastest and the most devastating fall in global stock markets since the Wall Street Crash of 1929 as the Dow Jones Industrial Average ("DJIA") tumbled more than 30% from 9 March 2020 to 16 March 2020. The coronavirus disease 2019 ("COVID-19") was first identified in December 2019 in Wuhan, China, which is currently the most impactful pandemic since the flu pandemic of 1918, has decimated the global economy. As of 19 November 2020, more than 56.1 million cases have been confirmed, with more than 1.34 million deaths attributed to COVID-19. The outbreak of the disease not only has plummeted the financial markets, but also has caused social and economic disruptions to an extent similar to the Great Depression. Besides, it has led to the widespread of food and necessity shortages exacerbated by panic buying, affecting hundreds of millions of people.

(d) Looking Ahead

The Hong Kong banking system has remained largely intact under the global credit crunch in 2008. This is possibly attributed to the growing awareness of risk management in the industry.

However, the collapse of Lehman Brothers has led to the Minibond crisis in Hong Kong. This further demonstrates that a financial institution should not only focus in managing financial risks. Other risks such as legal risk, reputation risk and systemic risk are equally important. Both the HKMA and the SFC has taken initiatives related to the offering and selling of investment products. To this end, the Insurance Authority ("IA") has also issued a set of guidelines relating to the selling of investment-linked long-term insurance policies for better consumer protection (see section **4.13.1** for details).

2.2 INVESTMENT CONSIDERATIONS

After we have gained a basic understanding of risk in investment, it is time for us to move on to other factors that have to be taken into consideration before making investment decision.

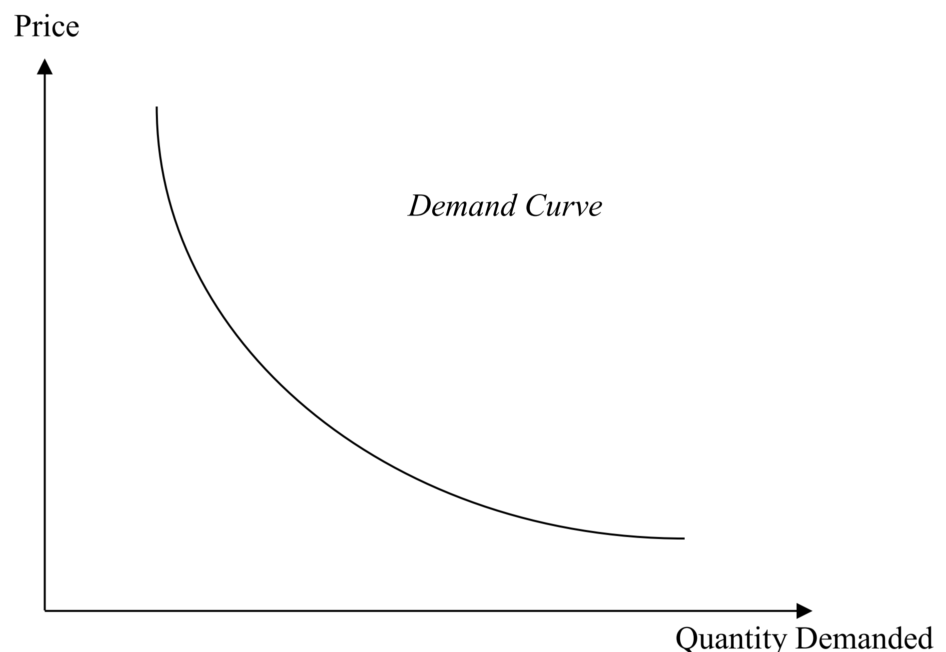
2.2.1 Basic Economics

Economics is the study of how individuals make choices under the constraint of limited resources and of the results of those choices for society. For example, the market for oranges consists of buyers and sellers. Buyers (individuals) determine the quantities to purchase at different prices and the sellers determine the quantities to produce at different prices. The interaction among buyers and sellers determines the market price and quantity of oranges traded in the market (society).

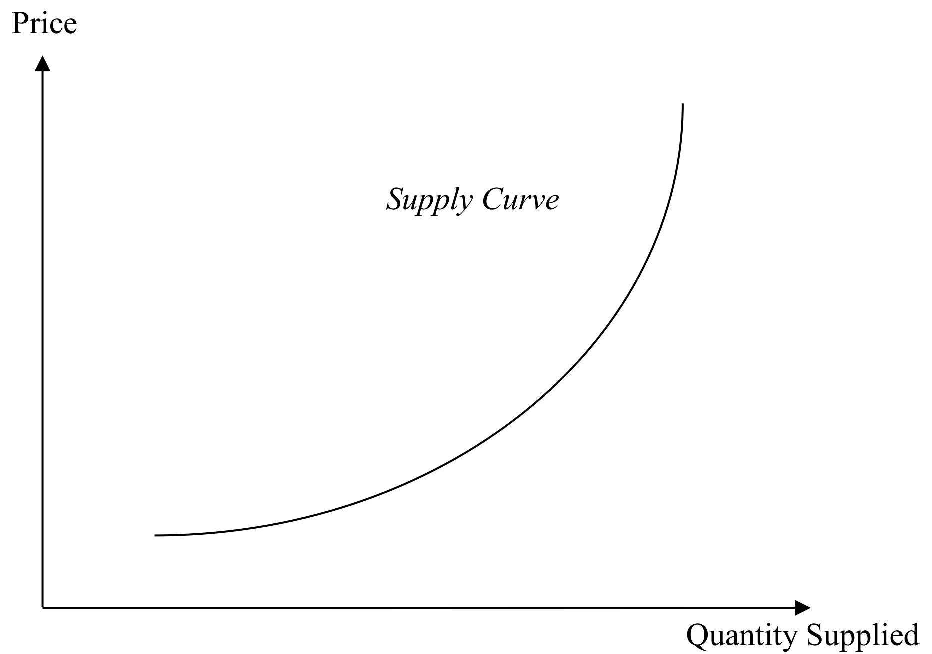
(a) Demand and Supply

Demand curve is a graph showing the quantity of a good that buyers are willing to buy on the x-axis at each price on the y-axis. The quantity demand is normally downward sloping with respect to price. This inverse relationship is attributed to the substitution effect and the income effect.

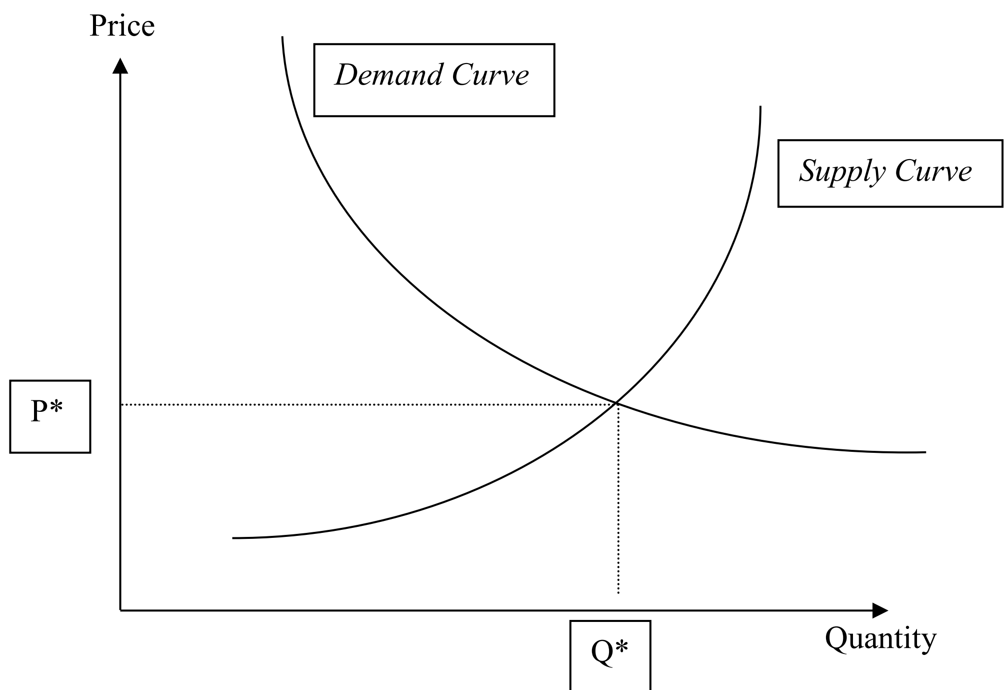
When oranges are getting more expensive, buyers may switch to apples or other fruits that substitute for orange and consume fewer oranges. This is the substitution effect. Moreover, the price increase reduces purchasing power and buyers cannot afford to buy as many oranges as before: the income effect. The quantity demanded can be illustrated in the following demand curve.



Supply curve is a graph showing the quantity of a good that sellers are willing to sell on the x-axis at each price on the y-axis. The supply curve is normally upward sloping. The assumption is that sellers would be more than happy to sell or produce additional oranges, so long as the price received is higher than the additional costs of supplying or producing them. This can be illustrated in the following supply curve.



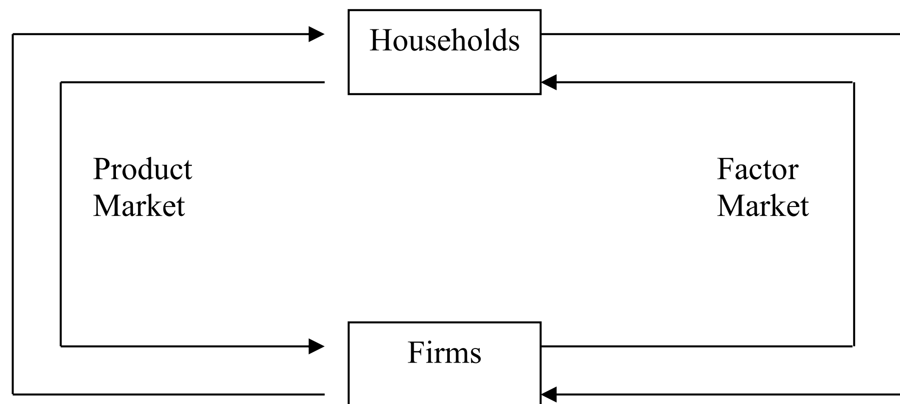
The demand curve intercepts the supply curve at the equilibrium price and equilibrium quantity where buyers are happy to purchase and sellers are happy to supply the equilibrium quantities at the equilibrium price. The equilibrium price (P*) and the equilibrium quantity (Q*) are shown in the following graph.



However, there are factors other than price that would affect the equilibrium such as incomes, tastes, population, expectations, and the prices of substitutes and complements. These factors may shift the demand curve leftward or rightward. For example, when the general income of a society increases, the quantity demand of oranges at each price level will increase. The demand curve will be shifted to the right and the equilibrium price and quantity will therefore increase.

(b) Economic Sectors

An economy in its simplest form consists of only two sectors: the household sector and the business sector. The household sector buys goods and services supplied by the business sector. It also supplies labour (factor services) to the business sector in return of wages. These two sectors can be illustrated in the following diagram:



However, the above model excludes the government sector and foreign sector. The government sector receives taxes from the household and business sectors; and spends money to fulfil its economic, political and social objectives. The foreign sector trades (export and import) goods and services with the domestic economy.

More importantly the simple economy assumes that there are no savings in the economy thus ignoring the finance sector. It includes the financial intermediaries and institutions through which funds are transferred from people who have an excess to those who have a shortage. The different sectors mentioned above can either be a lender-saver or borrower-spender.

(c) Money and Banking

The finance sector is to facilitate the transfer of funds or money. Money has three principal uses: medium of exchange; a means of holding wealth; and a unit to measure value.

Money as defined by the HKMA is classified as:

- M1: The sum of legal tender notes and coins held by the public plus customers' demand deposits placed with banks.
- M2: M1 plus customers' savings and time deposits with banks plus negotiable certificates of deposit (NCDs) issued by banks held outside the banking sector.
- M3: M2 plus customers' deposits with restricted licence banks and deposit-taking companies plus NCDs issued by these institutions held outside the banking sector.

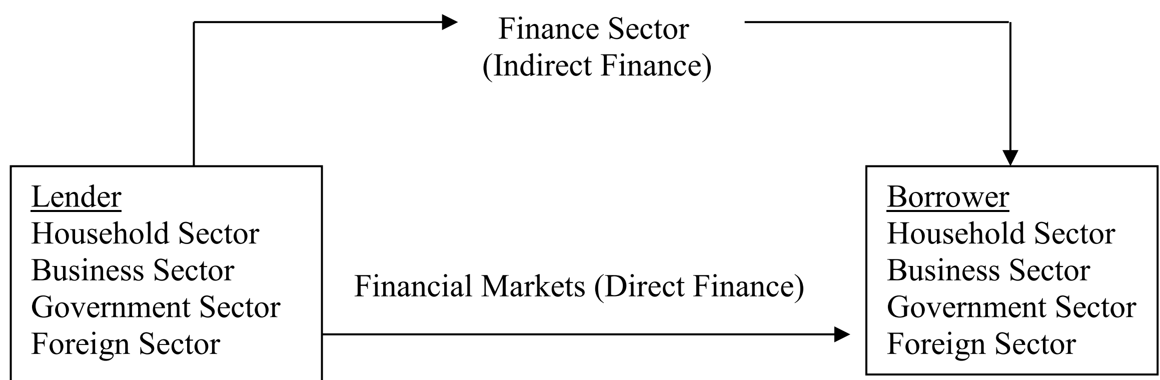
The banking system plays the most important role in the finance sector by extending credit to borrowers and using funds raised from depositors. The main reasons why we need the banks to facilitate the money market are as follows:

- Specialisation: banks specialise in evaluating the quality of borrowers whereas individual savers do not have the expertise to determine the credit standing of potential borrowers.
- Investment: banks help saver accumulate wealth and direct their savings toward higher return and more productive investments.
- Payment: banks facilitate payments of account holders with the use of current accounts, remittances and credit cards.

2.2.2 Global Economy

(a) Flow of Funds

The excess of funds of different economic sectors can flow towards those who are in need either directly or indirectly. Direct finance refers to the borrowers obtaining funds directly from lenders. In this situation, the amount of lending, return and risk profile of lender and borrower match each other. Indirect finance occurs when the funds flow through the finance intermediaries from the lender to the borrower. It happens when the risk and return of borrower and lender do not match. The intermediaries are therefore compensated for assuming the risk by adding a fee (brokerage or commission) on top of the interest charged. It can be shown in the following figure:



(b) International Capital and Investment Flows

A financial market does not exist on its own. There are always investment opportunities across the borders which furnish international capital and investment flows. The globalisation of financial market allows countries with higher productive investment opportunities and lower domestic savings to fill the gap by attracting capital inflows from countries with higher savings and lesser investment opportunities. Moreover, an investor can easily diversify his investment portfolio by holding financial assets in different countries. It results in more efficient use of financial resources.

However, it is worth noting that international capital flow is a double-edged sword which may cause global financial market instability. The economic crisis in one country may easily spread to other markets. For example, the global financial markets were put under severe stress due to the credit crunch in the United States in 2008. The problems of the US banks' balance sheets have brought cross border lending to emerging markets to a halt by the US banks. Furthermore, overseas investors holding assets in the US also experienced asset degrading which would end up reducing consumption in the domestic economy.

(c) Global Market

Due to the integration of the global financial market, Hong Kong is one of the participants which are greatly influenced by their trading and investment partners. In examining factors affecting the Hong Kong economy, it is important to consider its relationship and interaction with the US and the Mainland of China.

Chinese Economy

The Mainland of China plays a key role in Hong Kong's economy and financial markets. By virtue of its close proximity to the Mainland, Hong Kong is perfectly situated for trade with it. For many years, Hong Kong has served as the gateway for foreign investment in the Mainland by providing financial, management and technical expertise.

The entry to the World Trade Organization in 2001 has set the stage for even greater economic expansion in the Mainland which has since further opened up to global trade and capital flows. The Closer Economic Partnership Arrangement ("CEPA") was rolled out in 2004, which provided Hong Kong with additional and exclusive benefits for access to the Mainland economy.

Impact of the US Economy on Hong Kong

The US is one of the major trading and investment partners of Hong Kong. In 2021, exports of goods to the US made up 6.2% of Hong Kong's total exports, seconded only to the Mainland of China. As regards direct investment, US investors accounted for 2.3% of direct investments in Hong Kong by market value at the end of 2021.

Moreover, the Hong Kong dollar is linked to the USD operating under the currency board system. As a result, the interest rate in Hong Kong tends to move in tandem with the US interest rate. For the above reason, the US economy has a direct impact on that of Hong Kong.

Regional Influences

In considering the global financial market's impact on the Hong Kong economy, one should not lose sight of the regional influences. Hong Kong is one of the leading economies in Asia and international fund managers interested in Asian markets would likely allocate a substantial part of their investments in Hong Kong. As a result, any instability of the regional economies and their currencies would lead to capital outflow from the region and inevitably from Hong Kong. An obvious example was the Asian Financial Crisis in 1997 which was triggered by the devaluation of the Thai Baht, with the Hong Kong dollar being attacked by speculators in the ensuing chain of events.

2.2.3 Economic Factors Affecting the Financial Markets

The performance of financial markets is subject to the domestic and global economy. As the well-being of an economy is reflected from different economic factors and indicators, it is important to have a good understanding of them in order to gauge the financial market.

(a) Gross Domestic Product ("GDP")

The ultimate measurement of an economy's performance is its gross domestic product. It is the market value of the final goods and services produced in a country during a given period. There are three methods to calculate GDP, namely, the production method, the income method and the expenditure method.

The expenditure method is by far the most popular one. It assumes that all the final goods and services that are produced in a country in a given year will be consumed by household, business, government and foreign sectors. These four sectors consume the final goods and services in four different types of expenditures: consumption by households, investment spending by firms, government purchases and net exports.

(b) Economic Cycles

Over time, an economy's output may increase more rapidly in some years than in others. As measured by the real GDP, a country's economic performance will tend to fluctuate by way of a cycle throughout history. This is known as the economic cycle which has four phases generally:

1. Expansion: The real GDP increases rapidly during period of expansion where profits and wages start increasing and unemployment rate falls. This also leads to higher prices.

2. Peak: The economy expands until the peak occurs. The real GDP is at a maximum and inflation is a threat to the economy.

3. Recession: It is the contraction phase of the economy after the peak. Output and employment fall. It would become a depression if the recession prolongs such as the Great Depression in the 1930s.

4. Trough: Employment and profits are at the minimum at the trough stage of the economic cycle and after which comes a new economic cycle again.

(c) Government fiscal and monetary policies

A government by deploying different policies can stabilise the economy to a certain extent. The right policy mix may bring an economy out of recession or prevent it from overheating. Fiscal policy refers to decisions on the government's budget as to how much the government spends and how much tax it collects. The logic behind fiscal policy is straightforward: the government increases purchase of goods and services, which are components of GDP, would directly boost the GDP. Furthermore, increasing spending by the government sector may increase the income of the household sector which will fuel further consumption by the private sector.

Monetary policy is the action by the government to influence the money supply in the economy so as to affect the market interest rate. During a recession, the central bank should lower the interest rate by increasing

money supply, which would in turn stimulate investment and thus GDP. On the other hand, in order to prevent the economy from overheating, the central bank should raise the interest rate thus reducing investment and GDP. Monetary policy can be done through open market operation, control of reserve requirement or discount rate and intervention of foreign exchange market.

(d) Interest rate

Interest rate is in essence the price of holding money which is determined by the demand and supply of money. The higher the market interest rate, the greater the cost of holding money as people would prefer the alternatives to money such as deposits and bonds. For countries which have control over their monetary policy, the money supply is controlled by the central banks. However, Hong Kong is operating under a linked exchange rate system. It is the local interest rate rather than the exchange rate which is adjusted to cater for inflows and outflows of funds. As a result, Hong Kong has effectively surrendered its control over money supply in return for a stable exchange rate against the US dollar.

(e) Exchange rate

The exchange rate between two currencies is the amount of one currency that can be traded for the other. Under a flexible exchange rate system, the exchange rate is not officially fixed but changes in accordance with the market force of demand and supply for the currency. Most developed countries nowadays adopt flexible exchange rate system. Some currencies are however fixed against another currency under a fixed exchange rate system. The linked exchange rate system of the Hong Kong dollar is a good example.

(f) Inflation

Inflation is a measure of the annual percentage rate of change in the general price level. Higher inflation will bring about lower purchasing power of money.

The price level is distinguished from inflation in that the former is the overall level of prices at a particular point in time as measured by a price index like the consumer price index.

Furthermore, the increase in price of one particular goods does not necessarily lead to inflation. The monetarist economists argue that if the money supply is constant, the price increase in one good will leave lesser amount of money to consume some other goods and thus lower the price in other goods. In short, the price increase in one goods is offset by the decrease in others in such situation. It will only result in the relative price change without affecting the general price level.

Deflation occurs when there is negative inflation. This normally happens during the recession phase of the economic cycle. It is different from disinflation which refers to a decrease in the inflation rate.

(g) Unemployment rate

Unemployment rate is expressed as a percentage of the number of unemployed divided by the labour force. One must therefore first ascertain the size of the labour force which is defined as the total number of employed and unemployed people. According to the definition of the Hong Kong Census and Statistics Department, the employed are those aged 15 and over who have been at work for pay or profit during the 7 days before enumeration or who have had formal job attachment. The unemployed population consists of those persons aged 15 and over who fulfil the conditions of: having not had a job and having not performed any work for pay or profit during the 7 days before enumeration; having been available for work during the 7 days before enumeration; and having sought work during the 30 days before enumeration.

(h) Globalisation and Technology

The global financial markets are integrating with the assistance of technology advancement such as computer network. Most international financial markets are accessible around the world so that any investment markets or assets are not restricted to the domestic investors but open to all global investors. Transmission of funds can also be done instantly which further facilitates settlement of financial transactions. These developments may increase the transaction volume of the financial markets.

The internet has also greatly improved the transparency of financial markets. Besides the traditional financial news provider such as Reuters and Bloomberg, there are a lot of up-to-date news and information on global markets which can be accessed via the internet.

As discussed above, the international mobility of funds has its advantages and disadvantages. While this will help economic growth, some of the capital flows are bound to be speculative and volatile. As a result, a domestic economy may be vulnerable to the attack of hot money.

2.2.4 Investment Objective and Risk Tolerance

The first step of investment should be the formulation of an investment objective. When being asked about their investment objective, most investors would say they want to make money. And when being asked about how much they would want to make? The typical answer is the more the better. However, such answers are not good enough.

An investment objective must be specific and realistic, taking into consideration the investor's personal needs, risk tolerance and investment constraints. A person's investment return objective may be stated in terms of an absolute or relative percentage. For example, the investment objective is to achieve an average annual rate of return of 15%, or 1% above the inflation rate, for the next 10 years. Also, it may be stated in terms of a general goal, such as capital appreciation, capital preservation or current income.

In setting an investment objective, risk tolerance is the most important consideration. As we have seen in the risk reward trade-off discussion, huge risk accompanies high

return. An understanding of the level of risk tolerance is needed before a realistic investment goal can be set.

Risk tolerance is the largest amount of loss that an investor is willing to take for a given increase in the expected return. Each investor is said to have a risk tolerance factor, i.e. the extent to which he/she is prepared to risk a loss on his/her investment in return for chances of an enhanced return. An investor who prefers an investment with less risk to one with more risk, assuming that the two investments offer the same expected return is known as a risk-averse investor. One standard way of classifying investors, in relation to their risk tolerance is:

(a) ***Conservative***: such an investor is more concerned with capital protection than with high rates of return. He/she may also be described as risk averse, i.e. not a gambler ready to play for high stakes.

(b) ***Aggressive***: such an investor is much more ready to accept risk and to improve chances of enhanced returns. This necessarily involves variations of return and in the short-term at least could involve losses.

(c) ***Balanced***: the happy medium, where a degree of risk is acceptable, but where protection of capital remains important.

In general, different stages of life also influence risk appetite. As age increases, the investor's investment strategy will usually adjust to fit new goals and circumstances. On the other hand, the ability of a person to take risk also affects the level of risk tolerance. Generally, higher net worth investors have higher risk tolerance than lower net worth investors.

Many tests have been developed to help investors to evaluate their risk tolerance. Investors should take such a test to get a better understanding of their tolerance levels before investing.

2.2.5 Other Investment Constraints

Apart from investment objectives and risk tolerance that set limits on risk and determine the return objective of investment, some other factors also influence investors and need to be considered before making their investments. These factors are:

1. Liquidity requirement;
2. Time horizon; and
3. Tax considerations.

(a) Liquidity Requirement

Liquidity refers to the ability of an investor to sell the asset quickly without having to make a substantial price concession.

An example of an illiquid investment asset would be an antique item. An investor who owns a piece of Tang dynasty porcelain may have to settle for a relatively low price if the item has to be sold within an hour. If the sale could be postponed long enough for a public auction to be set up, undoubtedly a much higher price could be obtained.

Alternatively, an investor who has to sell HKD1,000,000 worth of HSBC common stock within an hour will probably be able to receive a price close to the price that other sellers of HSBC stock recently received.

Investment plan must take into account of the liquidity needs of an investor. A young investor with a long-term investment goal probably has very low liquidity need while a retiree living on pension would need regular cash flows. The latter should have part of his/her portfolio in liquid securities such as money market instruments.

(b) Investment Time Horizon

This is the time period within which the investor intends to make the investment. This is dependent upon the investor's investment objectives, age and current financial condition. Most investment instruments can generally be classified under the following time frames:

- Short term up to 1 year
- Medium term from 1 to 5 years
- Long term over 5 years

As have been discussed previously, time is an offsetting element for risk. One of the proven risk control strategies is for the investor to ignore short-term fluctuations in value (not being overly enthusiastic or overly concerned) and focus on the long term. History shows that the longer an investor stays invested, in general, the less likely that he/she will experience a negative return.

Investors with short investment time horizons should avoid risky investments because assets may have to be liquidated at an unsuitable time. Investors with long investment time horizon normally have greater risk tolerance because any shortfalls or losses can be recovered from returns in subsequent years.

It should be noted that using investment-linked insurance policies, is usually of a long-term nature, compared to the direct purchase of stocks and bonds.

(c) Tax Considerations

Personal taxes are based on an individual's or family's taxable income. In Hong Kong, returns on investment are not normally subject to personal taxation (capital gains or investment income tax). Since February 2006, estate duty has also been abolished in Hong Kong. However, for investors who are subject to foreign tax jurisdiction, it is worthwhile to consult tax advisors for tax planning.

2.2.6 Investment Advising

(a) Retail Investment Advising

Investment advising refers to the process of providing investment advices to the clients. There is a fine distinction between investment advising and financial planning. The latter is a process in which a financial planner evaluates a client's financial needs such as insurance, retirement, investment, etc. in order to meet the client's overall financial objectives. Investment advising however focuses on the investment objectives and needs of the clients and provides investment advices on investment products, investment strategies and so on.

The development of the retail investment advising market in Hong Kong in the last decade has been fast. The retail banks and independent financial advisors have taken a leading role in promoting the service of investment advising. At the same time, the improvement in living standards and demand for high quality personal financial services are also strong driving forces.

(b) Investment Advisors

The work of an investment advisor is very demanding. Owing to significant differences in the nature, features and risks of investment products and the personal circumstances of clients, an investment advisor should take in account different factors in order to provide appropriate and suitable investment advices:

(1) Knowing the client: the investment advisor must seek information about the client's financial situation, investment experience and investment objectives. It includes the client's investment knowledge, investment horizon and risk tolerance, etc. Preferably, the information collected should be fully documented and updated on a continuous basis to see if there is any change of circumstances of the client.

(2) Understanding the investment products: the investment advisor should have a thorough understanding of the investment products including the structure of the products, the level of risk, fees and charges, the relative performance, liquidity, etc.

(3) Providing reasonable advice: the investment advisor must ensure that the risk-return profile of the investment product matches the personal circumstances of the client to whom it is recommended.

The investment advisor should also provide all relevant information to the clients to assist them to make an informed decision. The reasons of recommendation should be properly documented for future reference.

Given the complex nature of work, an investment advisor needs to have all-round knowledge not only in financial market but also in economics, laws, asset management and risk management. But the above is only technical knowledge. An investment advisor is also expected to have excellent communication skills to take care of the psychological well-being of the clients. For example, he/she must be able to raise personal matters with the clients in a non-offensive manner and to convey bad news in poor market environment.

Most important of all, an investment advisor must build up trust and confidence from the clients by acting ethically. Different regulatory bodies or professional association may have issued their only code of ethics. Some basic ethical principles include integrity, honesty, due diligence, avoidance of conflict of interests, confidentiality competence, etc.

2.2.7 Summary

As explained above, an advisor who is advising on a client's investment portfolio must be concerned with the client's investment needs and objectives and understand the client's level of risk tolerance, constraints and other unique circumstances in order to advise and recommend on the appropriate investment portfolio.

In the selling of investment-linked policies, an insurance intermediary should clearly communicate to the client features and benefits of the insurance policy. The understanding of the various types of investments as well as their related risk and return structures will thus facilitate the communication of relevant and correct information to prospective clients as well as assist in the early identification of the type of products that a prospective client may require.

Most authorized insurers/brokers have devised their own set of questionnaires to assist their agents/technical representatives in the collection of relevant client information for the above noted purpose. Such information includes nationality (tax purposes), number of dependents, cash flow, investment objective and preference, current asset portfolio and insurance coverage. Please refer to section **4.13.1** for a more detailed discussion on this topic.

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Representative Examination Questions

Type "A" Questions

1. Which of the following is the correct sequence of risk management process?

   I. Management of risk
   II. Identification of risk
   III. Monitor of risk
   IV. Measurement of risk

   (a) II, IV, I, III.
   (b) I, II, III, IV.
   (c) II, III, I, IV.
   (d) II, III, IV, I.

[Answer may be found in **2.1.5**]

2. An investment fund has the following return scenarios. What is the expected return of this investment fund?

Probabilities	Return
0.6	25%
0.4	5%

   (a) 15%.
   (b) 17%.
   (c) 20%.
   (d) 25%.

[Answer may be found in **2.1.5**]

3. Why does the economy of the US have a direct impact on that of Hong Kong?

   (a) The US is one of the major trading and investment partners of Hong Kong;
   (b) The interest rate in Hong Kong is the same as that of the US due to the linked exchange rate system;
   (c) The US stock market is a global financial market;
   (d) None of the above.

[Answer may be found in **2.2.2**]

Type "B" Questions

4. Which of the following statements about diversification in investment is/are true?

   (i) It eliminates the risks of investing in stocks in a portfolio.
   (ii) It helps spread the investment risk by investing in different categories of investment in a portfolio.
   (iii) It involves purchasing different types of stocks and investing in stocks of different countries.
   (iv) It reduces overall risk of a portfolio to an investor without sacrificing the return substantially.

   (a) (ii) only;
   (b) (iii) and (iv) only;
   (c) (ii), (iii), and (iv) only;
   (d) (i), (ii), and (iii) only.

[Answer may be found in **2.1.4**]

5. Which of the following are the principal uses of money?

   (i) Medium of exchange
   (ii) A means of holding wealth
   (iii) A unit to measure value

   (a) (i) and (ii) only;
   (b) (ii) and (iii) only;
   (c) (i) and (iii) only;
   (d) all of the above.

[Answer may be found in **2.2.1**]

6. Which of the following economic factors have impact on financial markets?

   (i) Monetary policy
   (ii) Gross domestic product
   (iii) Risk free rate
   (iv) Unemployment rate

   (a) (i) and (ii) only;
   (b) (i), (ii) and (iv) only;
   (c) (ii) (iii) and (iv) only;
   (d) all of the above.

[Answer may be found in **2.2.3**]

[*If still required, the answers may be found at the end of the Study Notes.*]

Chapter 3
INVESTMENT ASSETS

Investment assets are usually grouped into different asset classes according to their common characteristics. Each type of investment asset has its own particular potentials and drawbacks. The following is a list of the most common asset classes that we will discuss in some detail in the following sections:

1. Money Market Instruments
2. Debt Securities
3. Equities
4. Financial Derivatives
5. Real Estate
6. Low-liquidity Investments
7. Investment Funds
8. Life Insurance and Annuity

3.1 MONEY MARKET INSTRUMENTS

Money Market Instruments include highly liquid debt securities with maturities of less than one year. There are two categories of money market instruments, namely, bank deposits and negotiable short-term debt instruments.

3.1.1 Bank Deposits

This means simply placing the money with a "bank" for term or demand deposits. In Hong Kong, only financial institutions authorized by the Hong Kong Monetary Authority are allowed to accept deposits from the public and use the proceeds to make consumer or commercial loans. These institutions are classified as licensed banks, restricted licensed banks, and deposit taking companies. Hong Kong has a strong and solid banking system which makes banks in Hong Kong a very safe place to put our money. The rate of return, derived from interest payments, for bank demand deposit is normally the lowest when compared to other investment assets, reflecting the relatively low risk and high liquidity nature of this class of asset.

It should be noted that term or fixed deposits usually carry higher rates of return than demand deposit as a trade-off for lower liquidity. Early uplift of term or fixed deposit is subject to heavy penalty.

3.1.2 Negotiable Short-term Debt Instruments

These are short-term (typically maturing in less than 1 year), highly liquid, low-risk debt instruments issued by governments, banks and large non-financial corporations. They play an important role in the short-term investment and borrowing activities of most financial institutions.

Although most investors would hold such instrument to maturity, most of these instruments are negotiable which means that an investor may sell it to another investor in the secondary market if he/she needs the funds before maturity. Investors with substantial funds may invest in such money market instruments directly, but most do so indirectly via money market accounts at various financial institutions.

Most short-term debt instruments are sold on a discount basis, meaning that investor pays a price lower than the face value of the instrument and gets repaid at the face value. For example, a 182-day (26-week) Hong Kong Exchange Fund Bill (EFB) with a face value of HKD500,000 selling at a yield of 3.75% p.a. will cost an investor HKD490,822.30 (being HKD500,000 / (1 + 3.75% x 182/365)). So, the investor who pays HKD490,822.30 for purchase of the EFB will receive back HKD500,000 after 182 days and earns a rate of return of 3.75% p.a.

Major short-term debt instruments include:

- Government Bills;
- Short-term Certificates of Deposit; and
- Commercial Papers.

(a) Government Bills

These are short-term debts issued by the government to finance their expenses. Examples are US Treasury bills ("US T-bills") and Hong Kong Exchange Fund bills ("EFB"). Investing in such bills is literally the same as lending to the government. As the risk of default by the government is extremely low or even regarded as default-risk free, such instruments command the lowest yield among similar instruments. Minimum denomination of US T-bills is USD10,000 and that of EFB is HKD500,000. They are issued and traded on a discount basis with maturities of 4, 13, 26 and 52-week.

(b) Short-term Certificates of Deposit ("CDs")

These are negotiable short-term time deposit certificates issued by commercial banks evidencing a deposit of a fixed maturity of less than 1 year. Most CDs are issued in amounts of HKD500,000 or HKD1,000,000.

The yields on CDs are usually higher than government bills of similar maturity. This is because commercial banks are considered to have a higher possibility of default than the government. The less liquid secondary market and the tax implication are also negative for the investors.

(c) Commercial Papers ("CPs")

These are unsecured promissory notes issued by top-rated financial and non-financial companies with maturities of under one year. CP is a low-cost alternative to bank borrowing. The rates of return on commercial papers typically exceed other comparable term money market instruments rates, reflecting its higher liquidity risk and default risk. However, these are still relatively low in comparison with the interest rates of other corporate fixed income securities, such as corporate bonds.

In the US, the dollar amount of commercial paper outstanding exceeds the amount of any other type of money market instruments except for Treasury Bills, with the majority being issued by financial companies such as bank holding companies as well as companies involved in sales and personal finance, insurance, and leasing.

3.1.3 Advantages and Disadvantages of Money Market Instruments

This class of investment instruments is more suitable for short-term safe haven purpose pending longer-term move and have the following **advantages**:

- low risk;
- provide a reserve for emergencies;
- accumulate funds for specific future purposes;
- principal will not change, sometimes insured; and
- high liquidity.

On the other hand, such instruments do have some **disadvantages** such as:

- low return (inflation risk);
- fluctuating yield (reinvestment-rate risk);
- default risk (for non-government issues); and
- large denomination.

3.2 DEBT SECURITIES

3.2.1 Investing in Debt Securities

Debt or fixed income securities are a group of investment instruments that offer a fixed periodic return with maturities of over one year. This is typically a security document or certificate showing that the investor has lent money to the issuer, which is usually a company or a government, in return for fixed interest income and repayment of principal at maturity. Debt securities can be regarded as companies or government borrowing from the market and the returns are based on the credit worthiness of the respective borrower.

Debt securities generally stress current income although there is also opportunity for appreciation in value. If there is an active secondary market, they can be bought and sold at any time before maturity. However, if the secondary market is very inactive, the investor's money is tied up for the full life span of the security.

Debt securities fall into two general categories:

1. Debt obligations such as bonds; and
2. Preferred Shares (see section **3.2.14** for details).

The debt securities market can be categorised in different ways. Firstly, it can be divided into the primary and secondary market. On the primary market, new issues of debt securities are offered to the public for the first time. For example, the Exchange Fund Notes ("EFN") issued by the Hong Kong Monetary Authority can be subscribed to by investors through tendering on the primary market. Primary issues for corporate bonds are usually organised by financial intermediaries such as lead manager and underwriters.

Trading of the already issued debt securities are transacted on the secondary market which is predominately an over-the-counter ("OTC") market. OTC market is an informal network of market participants such as brokers and dealers who negotiate sales of securities with each other. It is not a standardised market as opposed to an exchange market in that the trade specifications such as contract size, settlement date, etc. are subject to the parties' negotiation. However, since 2000, EFN have also been listed on the Stock Exchange of Hong Kong.

Bonds are debt instruments issued by corporations or government organisations and are usually long-term in nature (above 1 year up to 30 years or more).

These are characterised by a promise by the issuer to pay the bondholder (investor) two types of cash flows. The first type of cash flow involves the payment of a fixed dollar amount periodically, until a specified date. The second involves the payment of a lump sum on this stated date. The periodic payments are known as ***coupon payments***, and the lump sum payment is known as the bond's ***principal***.

There are different types of institutions/organisations issuing debt securities in the market.

(a) Supra-nationals Bonds

These are issued by multilateral organisations such as the International Bank for Reconstruction and Development (commonly known as the World Bank), the Asian Development Bank and the International Monetary Fund. Bonds issued by such organisations carry very high quality with minimal default risk.

(b) Government Bonds

These are financial instruments used by the government to borrow money from the public. They are the safest type of investments, carrying almost no default or credit risk because interest payment and repayment of principal are guaranteed by the government. Because of its credit quality, government bond yields are usually the lowest among fixed income securities of similar maturity periods. In the US, they are called Treasuries (US Treasury Notes and Treasury Bonds), and the debt securities issued by the Government of the Hong Kong Special Administrative Region are known as Exchange Fund Notes.

(c) Government Agency Securities

These are used by corporations owned or sponsored by government such as the Hong Kong Mortgage Corporation, MTR Corporation Limited, and the Airport Authority Hong Kong to raise capital in the bond market.

(d) Municipal Bonds

States or local governments of many large countries also issue bonds to finance their budget. Repayment of debts relies either on the taxing ability of the local government or revenue from some public projects. Municipal bonds carry a higher risk than the government bonds.

(e) Corporate Bonds

Corporate bonds are medium or long-term debt obligations of private or public corporations. Such bonds may be secured by certain assets or unsecured. Bonds issued by corporations fall into many categories. Corporate issuers range from large well known multi-nationals to smaller companies. The nature and risk of corporate bonds could be very different.

3.2.2 Par Value

The par value, also known as face value, maturity value or redemption value, is the amount the issuer agrees to repay the bondholder at maturity. Bonds can have different par values.

3.2.3 Convertibility

For certain type of bonds, the investor may have a right to choose whether to receive the par value or something else, typically the common stock of the issuer or of some other company. This type of bonds is called ***convertible bonds***. These are corporate bonds issued with a right granted to the investors, enabling them to convert the bonds into a specified number of ordinary shares at a pre-determined price and specified date, on or before the date the bond matures. The conversion right is intended to make the issue more attractive to the investors, especially if the bond is unsecured. Convertible bonds generally pay a fixed rate of interest, which is less than the interest on a non-convertible bond because of the value of the convertible feature.

3.2.4 Coupon Rate

This is the interest rate the issuer promises to pay the investor. Coupon payments are calculated by

$$\text{Par value x coupon rate x fraction of a year}$$

e.g. a bond with a coupon rate of 8% p.a., a par value of HKD10,000 and paying interest semi-annually will pay the bondholder HKD400 coupon payment every 6 months. The coupon payment is calculated by

$$\text{HKD10,000} \times 0.08 \times \tfrac{1}{2} = \text{HKD400}$$

Coupon rate can either be fixed for the whole life of the bond or floating, i.e. the coupon rate is reset periodically based on certain reference rate. Most bonds are fixed-coupon bonds with the coupon rate fixed at the issuance and the bondholders will receive coupon payments determined by this rate no matter how the interest rates change after the bond is issued.

3.2.5 Term to Maturity

Most bonds have a fixed maturity when the issuer will repay the money to the bondholder. Some investors view bonds with a maturity between 1 and 5 years as short-term, 5 and 12 years as intermediate or medium-term and over 12 years as long-term. Bonds issued in Hong Kong rarely have original maturity longer than 10 years while in the US, the maturity for long-term bonds is typically 30 years.

3.2.6 Pricing of Bond

(a) Time Value of Money

Fundamental to the pricing of debt securities is the concept of time value of money. It is the relationship between the value of dollars today and that of dollars in the future.

Future value is the amount that an investment will yield after earning interest. For example, an investor deposits HKD100 in a bank today and the deposit interest rate is 5% compounded annually. After a year, the future value of the deposit will be:

$$\text{Future Value (FV)} = \text{Principal (P)} \times [1 + \text{interest rate (r)}]^{(t)}$$
$$= \text{HKD}100 \times (1 + 5\%)^1$$
$$= \text{HKD}105$$

Present value is the amount today of a future cash flow. Let us find out how much an investor needs to deposit in a bank now to yield HKD100 at the end of one year if the interest rate is 5% per year. The present value can be found by discounting the future value at the market interest rate (r):

$$\text{Present Value (PV)} = \text{Future Value} / (1 + r)^t$$
$$= \text{HKD}100 / (1 + 5\%)^1$$
$$= \text{HKD}95.24$$

The above example shows that HKD100 a year later is worth only HKD95.24 today. This is why people say a dollar today is more than a dollar tomorrow.

(b) Interest Rates

Interest rates in the context of debt securities are the costs of borrowing of the issuers. This is reflected in the coupon interest rate as specified in each issue of debt securities. Most of the debt securities have fixed coupon rate which means that the cost of the issuer is constant despite of changes in market interest rates. As opposed to fixed interest rates are floating interest rates which are more common to mortgage lending which is linked to a pre-determined benchmark such at prime rate or Hong Kong Interbank Offer Rate.

However, coupon rate does not necessarily equal to the actual return of a bondholder. It is more common for an experienced bond investor to purchase the bond in the secondary market after it was issued. It follows that the investor may not hold the bond for its entire life span and may not entitle to all coupon payments. The return of the investor is measured by the required rate of return or yield which is the effective interest rate taking into account of the holding period of the bond by the investor.

For the purpose of bond pricing, all interest rates are based on compound interest which assumes that all interest income earned is reinvested at the same interest rate.

(c) Calculation of Bond Price

The value of a bond is the sum of present values of all future cash flows generated from the bond discounted at the yield. The expected future cash flows include the coupon payments and the final principal repayment.

For example, a bond has a par value of HKD100 with 2 years to maturity. The coupon rate is 2% paid annually. An investor requires a rate of return of 5% pa. It means that the investor will receive HKD2 coupon payment one year from now; and HKD2 coupon payment and HKD100 repayment of principal two years from now. The maximum price the investor would be willing to pay for the bond would be the total of present value of these cash flows discounted at the yield of 5%.

$$P = 2 / (1.05) + 2 / (1.05)^2 + 100 / (1.05)^2$$
$$= HKD94.42$$

3.2.7 Price and Yield Relationship

When a fixed-coupon bond is issued, the coupon rate is normally set according to the prevailing market condition and the creditworthiness of the issuer at the time of the issuance. Once a bond is issued, it may change hands in the secondary market at the market price. Over time, the prices paid by each subsequent investor, the number of coupons to be received and the time till maturity are different from each investor. The net rate of return of the investors taking into account of the market price, par value, coupon interest rate and time to maturity is called **yield**. As time passes, the overall level of interest rates and the creditworthiness of the issuer may change reflecting the macroeconomic condition and the performance of the issuer. New buyer of the bond may require a yield that is comparable to similar instruments in the market (market yield) which is different from the coupon rate of the bond.

A bond with a coupon rate that is higher than the market yield looks attractive to the new buyer if it is sold at a price equal to the par value of the bond. However, the holder of the bond would surely not be willing to sell the bond at its par value. To make a transaction possible, the bond should be sold at a price higher than the par value. We say the bond sells at a **premium**. For example, a HKD10,000 par value 5-year bond issued by ABC Corporation bears a coupon rate of 10%, an investor willing to lend 5-year money to the company for a yield of 8% would be willing to pay a price higher than HKD10,000 for the bond.

Conversely, if the market yield is higher than the fixed coupon rate, the bond will only be sold at a price lower than the par value. We say the bond sells at a **discount**. In the previous example, an investor who demands a 12% yield for buying ABC Corporation's bond would not pay HKD10,000 to buy it. In order to sell the bond, the seller has to offer it at a price lower than HKD10,000.

Only when the coupon rate equals to the yield required by the market, the bond will be sold at the same price as the par value. We say the bond sells ***at par***.

Market Yield = Coupon Rate	**==>**	**Bond sells at Par**
Market Yield > Coupon Rate	**==>**	**Bond sells at Discount**
Market Yield < Coupon Rate	**==>**	**Bond sells at Premium**

From the above discussion, we can further conclude that there is an inverse relationship between market yield and the price of a bond. When interest rate (market yield) goes up, bond price will come down and vice versa. This relationship is referred to as the **Law of Fixed Income** by some market players.

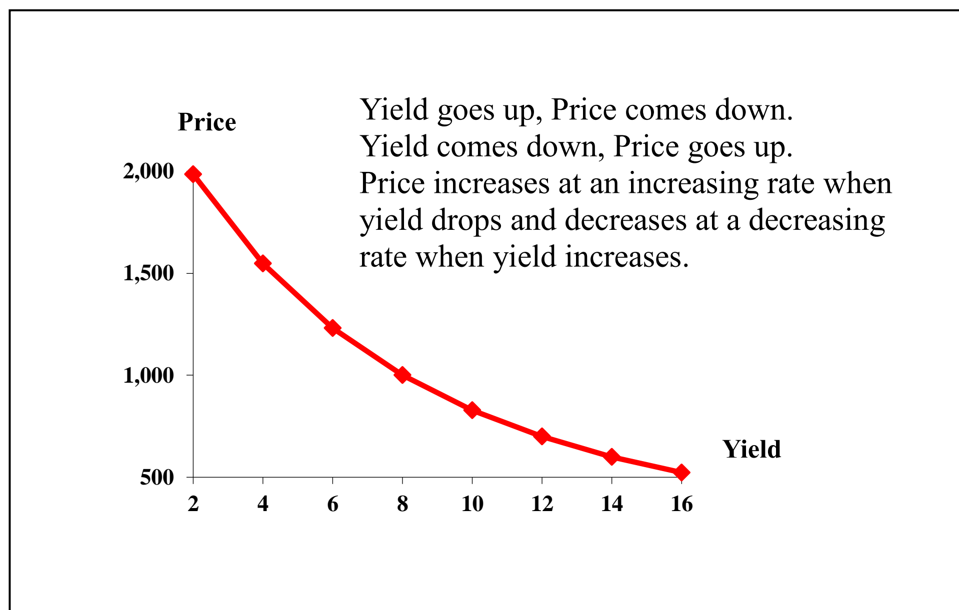
The following table shows the prices of a 20-year bond under different market yield levels. The relationship is also plotted in a graph.

Price-yield Relationship

We have here a 20-year, 8% coupon bond ($1,000 per value), what is the price of the bond under different yield levels?

Yield (% pa)	Yield Change (%)	Price ($)	Price Change ($)	Price Change (%)
2	-6	1,985.09	437.97	28.31
4	-4	1,547.12	315.93	25.66
6	-2	1,231.19	231.19	23.12
8	0	1,000.00	0	0
10	2	828.36	-171.64	-17.16
12	4	699.05	-129.31	-15.61
14	6	600.07	-98.98	-14.16
16	8	522.98	-77.09	-12.85

Price-yield Relationship



Apart from the inverse relationship between market yield and bond price, we can also observe some interesting relationship from them.

1. The magnitude of change in the bond price for a 2% increase in market yield (from 8% to 10%) is not the same as that for a 2% decrease in yield rate (from 8% to 6%). A decrease in market yield will raise the bond's price by an amount that is greater than the corresponding fall in the bond's price for an equal sized increase in the market yield.

2. This is a convex curve, meaning that when market yield drops, the bond price will increase at an increasing rate and when market yield increases, the bond price will decrease at a decreasing rate.

3.2.8 Yield Curve

As explained above, an interest rate is the cost charged to a borrower for the utilisation of funds for a certain period of time or the return of the lender for postponing current consumption to a later date. Generally, an interest rate is composed of three elements:

(a) the real risk-free rate: the return from investing financial securities with no default risk;

(b) inflation expectation: the compensation for expected loss in purchasing power due to inflation;

(c) risk premium: the compensation to the lender for bearing the default risk of the bond issuer.

Investors would generally have different risk premiums and inflation expectations for debt securities with different maturities. Therefore, there are usually different interest rates for different maturities and such relationship can be depicted by a yield curve which is a graphic representation of the relationship between the level of interest rate and the corresponding maturity.

Yield curve can be of different shapes:

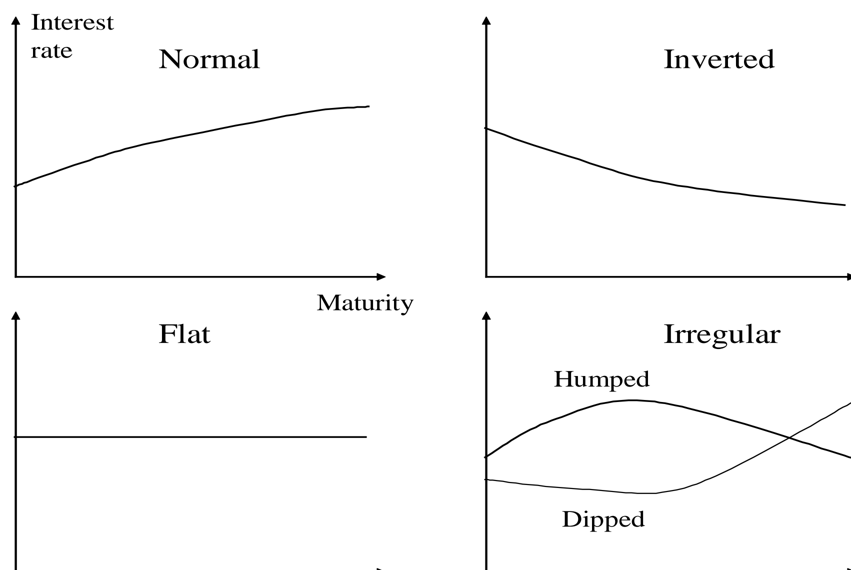
(a) A normal or positive yield curve: it is the most common yield curve. The longer the maturity, the higher the interest rate.

(b) Inverted or negative yield curve: the longer the maturity, the lower the interest rate. It reflects that the market expects lower interest rate in the future.

(c) Flat yield curve: interest rates for all maturities are at similar level which is a reflection of stable interest rate expectation.

(d) Irregular yield curve: any yield curve of any shape other than the above.

The shapes of the different yield curve are shown in the following graphs.



3.2.9 Marketability

This refers to how easily the investor can sell the bonds without having to make a substantial price concession, in other words, the liquidity. Because most bonds are bought and sold in dealer markets, bonds that are actively traded will tend to have lower bid and offer spreads than those that are inactive. Accordingly, bonds that are actively traded should have a relatively lower yield to maturity and a higher intrinsic value than bonds that are inactive.

3.2.10 Bond Ratings

These are alphabetical designations attesting to the investment quality of bonds issued by corporations (rating agencies) which specialise in providing ratings of the creditworthiness of corporations and bond issuers. Such ratings are often interpreted as an indication of the likelihood of default by the issuer. This is a prerequisite for many US debt issuers and may directly affect the issuing price. Debt issuers will have to submit their financial data to the rating agencies in order to get a rating. The two most widely accepted rating agencies are Standard and Poor's Corporation ("S&P") and Moody's Investors Service, Inc. ("Moody's").

A broader set of categories is often employed, with bonds classified as being of either investment grade or speculative grade. In general, investment grade bonds are bonds that have been assigned to one of the top four ratings (AAA through BBB by S&P; Aaa through Baa by Moody's). In contrast, speculative grade bonds are bonds that have been assigned to one of the lower ratings (BB, Ba or below). Sometimes these low-rated securities are called high yield bonds or junk bonds.

Bond Ratings

Moody's	S&P	Description
Investment Grade		
Aaa	AAA	Maximum safety
Aa	AA	High-grade, high-credit quality
A	A	Upper-medium grade
Baa	BBB	Lower-medium grade
Speculative Grade		
Ba	BB	Low grade, speculative
B	B	Highly speculative
Caa	CCC	Substantial risk, in poor standard
Ca	CC	May be in default, very speculative
C	C	Extremely speculative
	CI	Income Bonds that pay no interest
	D	Default

3.2.11 International Markets

Bonds may be classified according to the market where the bond was issued. There are different legal and regulatory issues guiding the issuance of such bonds which may have different implications for the issuers and investors.

Domestic bonds are bonds issued in the domestic currency by corporations domiciled in the same country. **Foreign bonds** are bonds issued in the currency of the country by foreign corporations. There are many interesting names to denote such issues. **Yankee bonds** are USD bonds issued in the US market by foreign corporations. **Samurai bonds** are Japanese Yen bonds issued in Japan by corporations domiciled outside Japan. Formal application and approval from regulatory bodies are needed for the issuance of these bonds.

Eurobonds are bonds issued in the currency of one country but sold in other national markets. For example, a bond issued by a US corporation that is denominated in USD (or any currency other than Euro) and sold in Europe would be referred as a Eurobond. The major advantage of investing in the Eurobond market is that it is neither regulated nor taxed.

3.2.12 Advantages of Bond Investment

This is more suitable for longer-term investment and carries advantages such as:

- low to moderate risk;
- liquidity, ready market available;
- higher return than money market instruments;
- capital preservation;
- regular and determinable income; and
- hedging through derivative products available.

3.2.13 Disadvantages of Bond Investment

- high denominations – some bonds may have high denominations that are not affordable for average investors;
- price risk – fluctuation in interest rates;
- inflation risk – fixed interest rate;
- liquidity – some bonds may not have a ready secondary market;
- no participation in company profits;
- no right of voting;
- possibility of default by issuer; and
- sophisticated trading techniques may be involved.

3.2.14 Preferred Shares (Preference Shares)

Preferred shares, representing an ownership interest in a corporation, give the investor a right to a fixed dividend provided enough profit has been made to cover it. Unlike investors who own a corporation's common shares, preferred shareholders have no voting right but are entitled to be paid the dividends due to them first, before ordinary shareholders can be paid their dividends.

Preferred shareholders also have priority claims on company assets in case of company liquidation. One point to note is that preferred shares are not very common in Hong Kong.

The benefits of investing in preferred shares are similar to those of bonds. Preferred share dividends are usually paid at a fixed rate. However, they differ from bonds in that although the income is fixed, they are not interests and may not be paid if a company does not make profits. They also differ from ordinary shares in that dividend will not be more than the fixed rate even if exceptionally high profits are made. As preferred shareholders are not entitled to the full earning potential of the company, the price of the share will typically have only limited opportunity for capital appreciation.

3.3 EQUITIES

3.3.1 Investing in Equities

(a) What is Equity

Ordinary share, or common stock, represents equity, or an ownership interest in a corporation. This is perhaps the widest known type of financial instruments. It is a residual claim, meaning that creditors and preferred shareholders must be paid as scheduled before ordinary shareholders can receive any payment. It allows investors the opportunity to participate (share) in the long-term growth of a public company. In the liquidation of a corporation, ordinary shareholders are in principle only entitled to any value remaining after all other claimants have been satisfied.

Transactions made in listed securities in Hong Kong are cleared through the Central Clearing and Settlement System ("CCASS"), which is a computerised book entry clearing and settlement system. Transactions are electronically recorded on brokers' (or investors') stock account balances in CCASS, without the need for the physical movement of share certificates.

On purchasing stock, an investor can request to receive the physical scrip to give evidence of his/her ownership. This can be registered in his/her own name with the share registrar. If the certificates are lost, getting replacement certificates is both a time consuming and costly process. Alternatively, the investor can entrust the shares to his/her bank or broker for safe custody; and the latter will usually deposit the shares in CCASS. Note however that with this method of safekeeping, CCASS only recognises the bank or broker as the direct holder of the securities.

The investor can also open an investor account in CCASS for custody of his/her stocks, though trading of shares still requires to be made through a bank or a broker. In this way, the investor will have direct control over his/her share holdings.

(b) Why Raise Equity

A company can raise funds either by debt financing or equity financing. As opposed to debt financing for which cost of borrowing is fixed as represented by the coupon rate, equity financing is more flexible as its costs depend on the amount of dividend paid out which is a matter of discretion of the board of directors. It is therefore generally believed that equity finance is cheaper than debt financing.

In the event of liquidation, debt investors have priority over equity investors to get paid. Therefore, equity finance has also the advantage to spreads the risk of investment amongst investors.

In the case of obtaining equity financing by listing on an exchange, a company can secure longer term access to capital. After raising funds from the primary market for the first time, it can always go back to the market for future fund raising. It is in particular important during economic hard times when debt finance is costly due to credit crunch. For example, during the Global Financial Crisis of 2007–2008, a few blue chips companies in Hong Kong have raised funds by private placement or rights issues. However, it is important to note that whether a listed company can raise

further funds from the market is subject to the willingness of the shareholders to take up the rights.

3.3.2 Methods of Raising Equity

There are different ways to raise funds in the equity market:

(a) Initial Public Offering ("IPO")

When a privately owned company is to be listed on the stock market, it will issue stocks to the public which is called an IPO.

A private company will seek advice from investment bankers as to the feasibility of going public. In Hong Kong this role is played by a ***sponsor*** which is an SFC registered intermediary. The sponsor conducts due diligence to see if a company is qualified for listing. It will then facilitate the company to list on the Stock Exchange of Hong Kong ("SEHK") by lodging the application and preparing all supporting documents.

After the listing application is approved by the SEHK, the new issuer has to provide the public with a prospectus which is a detailed description of the company and the listing matters of the shares to be issued. It will include business plans, the latest financial statements, the prospects of the company and the proposed use of the funds to be raised.

Then the new issuer may appoint a ***lead manager***, who is an investment bank primarily responsible for organising the marketing of the new issues of shares. Normally, the lead manager will form a syndicate with other underwriters to assist with the distribution of the new shares. In order to raise interest among the investing public of the shares underwritten, the lead manager will organise road shows to publicise the offering. For example, potential investors such as funds managers and securities analysts will be invited to luncheons where they can meet the management of the company.

An ***underwriter*** is usually an investment bank or a brokerage company which undertakes the risk of the new issue. Under a typical underwriting arrangement, in the event that the IPO is under subscribed, the underwriters have to take up the shares unsold.

The listing requirements are governed by the Listing Rules of the SEHK. Since there are two trading platforms on the SEHK, namely the Main Board and the Growth Enterprise Market ("GEM"), there are two sets of Listing Rules applicable.

Investors should refer to the Listing Rules for the full and complete requirements of listings. Generally, to qualify for listing on the Main Board, an applicant must satisfy one of the following tests: (1) the profit test; (2) the market capitalisation/revenue/cash flow test; and (3) the market capitalisation/revenue test. For example, under the profit test, a new applicant must have a trading record of not less than three financial years under substantially the same management. There must be ownership continuity and control for the most recent audited financial year. Profit attributable to shareholders must, in respect of the most recent year, be not less than HKD35 million and, in respect of the two preceding years, be in aggregate not less than HKD45 million.

There are also other general requirements such as the expected market capitalisation. At the time of listing, it must not be less than HKD500 million and the expected market capitalisation of its securities held by the public at the time of listing must not be less than HKD125 million.

GEM was established in November 1999 to provide capital formation opportunities for growth companies of all industries and sizes. Therefore, generally the listing requirements of the GEM are less stringent than that of the Main Board. For example, unlike the Main Board there is no profit requirement. However, the new applicant must have a positive cash flow from adjusted operating profits (before changes in working capital and taxes paid) of not less than HKD30 million in aggregate for the two financial years preceding the issue of the listing documents. The market capitalisation requirement is only at least HKD150 million.

For avoidance of doubt, the above are not meant to be exhaustive and one should refer to the respective Listing Rules for the full and complete requirements of listing.

(b) Private Placements

It takes place when the shares are issued to a specific class of investors. Normally, only professional investors such as mutual funds or high net worth clients are eligible to subscribe to shares through private placement. This is contrasted with IPO where shares are offered to the general public.

(c) Equity Warrants

An existing listed company may raise funds by issuing warrants which grant the holder the right to purchase shares of the company at a pre-determined price before a deadline.

(d) Rights Issues

Rights issue is also a popular method to raise funds for existing listed companies. It refers to a listed company raising funds by inviting existing shareholders to subscribe to new shares in proportion of their existing shareholding. As the name suggest, rights issue represents a right of the shareholders who are not obliged to subscribe to the new shares offered. A shareholder has three options: (1) subscribing to the shares offered; (2) selling the rights to others who would like to subscribe to the shares; (3) doing nothing. In the last two cases, the shareholders will have their shareholding diluted.

For example, an investor has 1,000 shares in Company A which has just announced a “1 for 4” rights issue. For every 4 existing shares, the investor may subscribe to one additional share. So, the investor has the right to subscribe to an additional 250 shares (1,000 / 4). Generally, the offer price of a rights issue or subscription price is at a discount to the existing market price. For example, the market price of Company A is HKD1 and the subscription price may be HKD0.75.

Following the above example, the value of your shareholding before rights issue is HKD1,000 (1,000 shares x market price at HKD1). The cost of rights issue is HKD187.5 (250 shares x offer price at HKD0.75). After the rights issue, you will hold 1,250 shares (1,000 + 250) and the value of your

investment should be HKD1,187.5 (HKD1,000 + HKD187.5). Therefore, the theoretical value per share after right issue, or ex-rights price is HKD0.95 (HKD1,187.50 / 1,250 shares). In other words, the theoretical value of the rights is HKD0.2 (ex-rights price at HKD0.95 – subscription price of HKD0.75).

3.3.3 Why Invest in Equity

The greatest advantage of the corporate form of organisation is the limited liability of its shareholders. In Hong Kong, ordinary shares are generally fully paid and non-accessible, meaning that ordinary shareholders may lose their initial investment but not more. That is, if the corporation fails to meet its obligations, the shareholders cannot be forced to give the corporation the funds that are needed to pay off the obligations. However, as a result of such a failure, it is possible that the value of a corporation's shares will be negligible; i.e. the investor will suffer a total loss of his original investment.

As with other types of investments, the total return is important. Shareholders have two ways of gaining: by selling the shares at a higher price than that at which they were purchased, and from dividends paid by the company. However, shareholders may suffer capital loss due to a fall in share price. Also, second line or smaller stocks may be illiquid; i.e. difficult to sell.

A successful company will probably pay an increasing dividend on its shares each year. The price of its shares is also likely to rise, so the return will include both dividend income and capital gains. If a company is unsuccessful, the value of its shares is likely to decline. Share prices on stock markets can change rapidly. In general, equities are considered riskier than money market instruments and bonds.

Earnings, not dividends, are the source of a corporation's value. Some of the commonly used terms in the analysis of stock value are outlined as follows:

1. **Price Earnings Ratio (or PE Ratio):** A corporation's current stock price divided by its past 12-month earnings per share.
2. **Return on Equity:** The earnings of a corporation divided by its book value.
3. **Dividend Yield:** The current annualised dividend paid on a share, expressed as a percentage of the current market price of the corporation's common stock.
4. **Payment Ratio (or Pay-out Ratio):** The percentage of a corporation's earnings paid to shareholders in the form of cash dividends.
5. **Retention Ratio:** The percentage of a corporation's net earnings that are not paid to shareholders but instead are retained for future expansion.

3.3.4 Bonus Issue

A listed company may offer shares to the existing shareholders for free as a result of capitalisation of profits. It is similar to rights issues except that the new shares are free of charge.

Using the above example, instead of rights issues it is now a "1 for 4" bonus issue announced. Similarly, the value of the investment before bonus issue is HKD1,000 and the total number of shares held thereafter is 1,250. However, this time the value of the investment after the bonus issue is same as that of before, i.e. HKD1,000, because the bonus issue is free of charge. Therefore, the theoretical price of the share after bonus issue is HKD0.8 (HKD1,000 / 1,250).

3.3.5 Dividend

Payments made in cash to shareholders out of the earnings of a company are termed dividends. In Hong Kong, these are typically declared semi-annually by the board of directors and are paid to the current shareholders of record at a date specified by the board known as the dividend date.

Corporate management may use dividend changes as a signalling device, raising or lowering dividends on the basis of its assessment of the corporation's future earnings. Share prices will change according to the investors' perceptions of each company's performance and prospects.

Compiling a list of shareholders to receive the dividend is not as simple as it seems, because for many corporations the list changes almost constantly as shares are bought and sold. Those shareholders who are to receive the dividend are identified by the use of an ex-dividend date.

Because of the time required to record the transfer of ownership of common stock, the Stock Exchange of Hong Kong specifies an ex-dividend date that is two business days prior to the date of record. Investors purchasing shares before the ex-dividend date are entitled to receive the dividend in question; those purchasing on or after the ex-dividend date are not entitled to the dividend. The same principle applies to rights and bonus issues.

3.3.6 Stock Exchange of Hong Kong ("SEHK")

(a) Basic Structure and Functions

The SEHK was set up in 1980 with a view to consolidating the then four stock exchanges and was in full operation after 1986. All along only companies with proven track records could go listed on the SEHK. It was until 1999 the GEM was established to facilitate equity financing by emerging companies and the original exchange is referred as the Main Board. The Hong Kong Clearing and Exchanges Limited ("HKEX") wholly owns the SEHK and GEM and is itself a listed company in Hong Kong. It is aimed to provide an efficient and transparent regulatory framework to facilitate the raising of capital and trading of securities in Hong Kong.

Different types of securities apart from equity are now listed on the SEHK:

- derivative warrants with underlying assets of ordinary shares, market indices, foreign currencies or a basket of shares;
- equity linked instruments (investors are in essence writing an option on the underlying stock);
- exchange traded funds ("ETFs") which represent a portfolio of securities designed to track the performance of an index;
- debt securities such as the Exchange Fund Notes ("EFN") issued by the HKMA;
- the Pilot Programme whereby a number of securities listed on the National Association of Securities Dealers and Automatic Quotations ("NASDAQ") and the American Stock Exchange ("AMEX") were also listed on the SEHK.
- callable bull or bear contracts track the performance of underlying assets without requiring investors to pay the full price required to own the actual asset.

- real estate investment trusts (“REITS”) aim to deliver sources of recurrent income to investors through focused investment in a portfolio of income-generating properties such as shopping malls, offices, hotels and service apartments in Hong Kong and/or overseas.
- the inflation-linked retail bond, also known as iBond, is launched by the HKSAR Government. For example, the latest iBond due 2024 has a minimum denomination of HK$10,000 and a term of three years. The semi-annual interest payments are linked to average annual inflation in Hong Kong, subject to a minimum interest rate of 2.00%.
- inline warrants are a type of structured product that entitles the investors to receive a pre-determined fixed payment at expiry. Inline Warrants may be issued with a lifespan of six months to five years. They may be bought and sold prior to their expiry on the cash market of HKEX. At expiry, settlement is made in cash only.

(b) Major Features

The Hong Kong stock market plays a leading role in the world equity market. According to the statistics of World Federation of Exchanges, as at the March of 2023, the Hong Kong stock market was the 7th largest market in the world by “domestic market capitalisation” in USD. It was the 4th largest market in Asia.

At the end of April 2023, there were a total of 2,602 companies listed on the Main Board and the GEM combined. Their total market capitalisation was HKD 35,855 billion. (Source of data: Hong Kong Exchanges and Clearing Limited)

(c) Primary and Secondary Markets

Similar to the debt market, the equity market can also be divided into primary and secondary market.

The primary market is one when a company goes listed and new shares are issued for the first time. New capital from the public will be raised by the company. It is an exercise between the company and the investors. The procedures to raise funds on the primary market have been discussed in Section **3.3.2**.

On the other hand, the secondary market refers to the transaction between buyers and sellers of the shares of the already listed company. No funds are raised by the company irrespective of the price and trading volume of the company’s shares in the secondary market.

The secondary market of equities in Hong Kong is transacted at the third generation of the Automatic Order Matching and Execution System (AMS/3) which connects investors, Stock Exchange Participants, and other market participants and the central market through ecommerce facilities. All orders of securities transactions on the SEHK must be placed on the AMS/3 for matching and execution. The AMS/3 has made placing order electronically through internet or by mobile phone possible whereby investors can place order via either Online Trading Service Channel, Proprietary Network Service Channel or Brokers’ Proprietary Channel.

3.3.7 International Markets

Due to the mobilisation of investment, the performances of other major international equity markets have a significant impact on the Hong Kong stock market due to globalisation.

(a) US Market

There are many stock exchanges in the US. The most familiar ones are the American Stock Exchange, the NASDAQ and the New York Stock Exchange. Due to the close ties between the US and Hong Kong in terms of the linked exchange rate and the export and import markets, the economy of the US as reflected in the US stock market may have a significant impact on that of Hong Kong. Since the US and Hong Kong are in different time zones, the Hong Kong market opens after the US market was closed. As such the volatility in the US market will be largely reflected in the Hong Kong market upon opening.

In November 19, 2020, the Pre-opening Session (from 9:00am to 9:30am) was introduced by the SEHK whereby all Exchange Participants may place orders into the AMS/3 before the market opens at 9:30am. It has the benefit of preventing significant price fluctuations when the market formally opens.

(b) European Markets

The economic and political union of 27 member states primarily in Europe brought about by the European Union ("EU") and also the use of a single currency of Euro has strengthened the economic power of the European markets. In accordance with the statistics of the International Monetary Fund, the EU's GDP for the year 2022 based on purchasing-power-parity (PPP) share of world total was 14.56%.

As of March 2023, the most prominent stock markets in Europe are the pan-European stock exchange of Euronext, the London Stock Exchange in the UK and the Deutsche Börse in Germany.

(c) Asian Markets

According to the statistics of World Federation of Exchanges, as at the end of March 2023, the Shanghai Stock Exchange in China was the largest market in Asia by "domestic market capitalisation" (in USD). The second largest market was the Tokyo Stock Exchange in Japan and the third was Shenzhen Stock Exchange in China.

Other key players in Asian stock markets are Hong Kong, India and Korea.

(d) China Market

The Mainland of China has two stock exchange markets, one in Shenzhen and the other in Shanghai, which are regulated by the China Securities Regulatory Commission ("CSRC"). The first ever legislation governing the Mainland securities market is the Securities Law which came into effect in 1999.

The Shanghai Stock Exchange was established in November 1990 followed by the Shenzhen Stock Exchange in December 1990. Both markets trade A and B shares. A-shares are accessible by Mainlanders alone (until the launch of the programmes introduced below), whose transactions are settled in the local currency. B shares are now open to both domestic citizens and foreign investors, whose transactions are settled in US dollars (in the Shanghai Stock Exchange) and in HK dollars (in the Shenzhen Stock Exchange).

The Mainland stock market has gradually been opened to foreign investors. In 2003 the Qualified Foreign Institutional Investor programme ("QFII") was launched to allow approved foreign investors to trade A shares. Given the increasing number of H shares listed in Hong Kong, the impact of the Mainland market on Hong Kong is getting more and more significant.

In April 2014, the Securities and Futures Commission ("SFC") and the CSRC made a Joint Announcement regarding their in-principle approval for the development of a Pilot Programme called the Shanghai-Hong Kong Stock Connect, for the establishment of mutual stock market access between the Mainland and Hong Kong. Commencing on 17 November 2014, the Shanghai-Hong Kong Stock Connect has created for the first time a feasible, controllable and expandable channel for mutual market access between the Mainland and Hong Kong by a broad range of investors, paving the way for further opening up of the Mainland's capital account and RMB internationalisation. The Programme imposes different restrictions for Northbound trading and Southbound trading. For instance, unlike Northbound trading, which allows all Hong Kong and overseas investors to participate in the Programme, Southbound trading was, when the Programme started, only open to Mainland institutional investors and to eligible Mainland individual investors. The restrictions were relaxed when the CSRC announced on 27 March 2015 that with effect from the date of announcement fund managers are allowed to launch new publicly offered securities investment funds that invest in the Hong Kong stock market through the Shanghai-Hong Kong Stock Connect, without being Qualified Domestic Institutional Investors ("QDII"). The aggregate quotas have been abolished since 16 August, 2016.

Furthermore, the CSRC and SFC signed a memorandum of regulatory cooperation on 22 May 2015 in respect of a Mainland-Hong Kong Mutual Recognition of Funds ("MRF") initiative. Starting from 1 July 2015, through the MRF, eligible Mainland and Hong Kong funds are allowed to follow streamlined procedures to obtain authorisation or approval for offering to retail investors in each other's market.

3.3.8 Market Indexes

Market index is widely adopted in different stock exchange markets as reference of the price level of a particular stock market. By comparing the market index of the same market over a period, one can find out the performance of the stock market during that period. Therefore market index is commonly used by investors as a barometer of share price movement. It can also be used as a benchmark to evaluate whether an investment fund outperforms or underperforms the market.

(a) Hang Seng Index (HSI)

The HSI was launched on 24 November 1969 and has become the most widely quoted indicator of the performance of the Hong Kong stock market. It is calculated and managed by the Hang Seng Indexes Company Limited.

As of January 2024, the HSI includes 82 constituent stocks. In general, eligible securities will be evaluated according to the following considerations:

- Representativeness;
- Market capitalisation; and
- Turnover;

Since its launch, the HSI was calculated based on the full market capitalisation weighted methodology using the following formula:

$$\text{Current Index} = \frac{\text{Today's Current Aggregate Market Capitalisation of Constituent Stocks}}{\text{Yesterday's Closing Aggregate Market Capitalisation of Constituent Stocks}} \times \text{Yesterday's Closing Index}$$

Currently, the HSI is calculated using a free float-adjusted market capitalisation weighted methodology with an 8% cap on individual stock weightings. Free float-adjusted Factor ("FAF") is adopted to exclude for index calculation the long-term strategic holdings not ready for trading in the market. It ensures the liquidity needed for investment. The 8% capping is to avoid single stock domination in the HSI.

(b) Hang Seng Composite Index Series

The Hang Seng Composite Index Series ("HSCI Series") serves to function as a comprehensive benchmark of the general performance of the Hong Kong stock market. The HSCI Series comprises the Hang Seng Composite Index ("HSCI") and two sub-index series- Hang Seng Composite Size Indexes and Hang Seng Composite Industry Indexes.

The HSCI Series strives to cover the top 95% in terms of cumulative market capitalisation of the Hong Kong stock market. There are three size indexes under the Hang Seng Composite Size Indexes: Hang Seng Composite LargeCap Index ("HSLI"), Hang Seng Composite MidCap Index ("HSMI") and Hang Seng Composite SmallCap Index ("HSSI"), with respective target coverage of the top 80%, the next 15% and the remaining 5% in terms of cumulative market capitalisation of the HSCI.

The Hang Seng Composite LargeCap & MidCap Index ("HSLMI") and Hang Seng Composite MidCap & SmallCap Index ("HSMSI") aim at reflecting the overall performance of LargeCap & MidCap companies and MidCap & SmallCap companies respectively. There are 12 Industry Indexes under the Hang Seng Composite Industry Indexes based on the Hang Seng Industry Classification System ("HSICS"). The HSCI is free float-adjusted market-capitalisation weighted with individual and category capping. Stocks are free float-adjusted with weightings capped at 10%.

(c) International Indexes

The following international indexes are widely used to track the performance of the world markets:

Dow Jones Industrial Average

The Dow Jones Industrial Average ("DJIA") has been tracking the performance of the US stock market since it was founded in 1896. Including 30 constituent companies - large publicly owned companies based in the United States, DJIA is calculated by taking the average of the sum of the prices of all the 30 stocks.

Standard & Poor's 500 Index

Despite the long history and popularity of the DJIA, it is generally considered that the Standard & Poor's 500 Index (S&P 500) is more reflective of the stock performance of the US stock market. It is more broadly based consisting of 500 large-cap stocks. Similar to the HSI, S&P 500 is also a market capitalisation weighted index.

Nasdaq Composite & Nasdaq-100 Index

The most common index which tracks the performance of stock market on the Nasdaq Stock Market (commonly known as the Nasdaq) is the Nasdaq Composite. The composition of the Nasdaq Composite is heavily weighted towards companies in the information technology sector. The Nasdaq-100, which includes 100 of the largest domestic and international non-financial companies in the Nasdaq Composite, accounts for over 90% of the Nasdaq Composite's movement.

Financial Times Stock Exchange ("FTSE") 100 Index

FTSE Group operates the well-known FTSE 100 Index which tracks the performance of the London stock market. It is again a market capitalisation weighted index.

Nikkei 225 Stock Average

The most popular Japanese market index for the stocks traded on the Tokyo Stock Exchange is the Nikkei 225 Stock Average.

Morgan Stanley Capital International ("MSCI") Indexes

MSCI Indexes are more commonly used by mutual funds companies as benchmarks for the performance of the funds managed.

3.3.9 Fundamental Investment Analysis

Funds managers' investment decisions are based on their analysis of the value of the subject securities. There are two schools of thoughts in investment analyses: fundamental and technical analysis (see section **3.3.10** for details). Fundamental analysis is the study of the economic and political factors to determine the intrinsic value of the securities. For example, valuation of a stock involves the study of the company's financial statements, operations, future prospects, etc.

(a) Top-down and Bottom-up Analysis

In making a fundamental analysis on a stock, an analyst may take the top-down approach or the bottom-up approach.

The top-down approach starts with a study of the macroeconomic factors from a global and domestic perceptive such as GDP, interest rates, inflation rate, etc. The analysts then move down to identify which industries would perform favourably under the macroeconomic environment. The industry analysis includes consideration of the market competition, entry barrier, market turnover, technology development, etc. Only then the analysts would narrow down to the companies in the industry.

The bottom-up analysts would however take an opposite approach. They focus on the financial performance of specific companies first before moving on to the industries and finally the economy.

(b) Industry Analysis and Competitive Analysis

Industry analysis is important in fundamental analysis because it is common sense that a company in a prospering industry would more likely perform well. The ultimate question to be asked is which part in the life cycle the industry is which can be described by four stages:

(i) Start-up stage: the sales and earnings will grow at an extremely rapid rate as a new product has just emerged. There is no market leader and there is a risk that a company may be driven out of the market when the industry moves on to the next stage.

(ii) Consolidation stage: industry leaders begin to emerge when the product becomes more established. Those remaining in the industry are more stable. The industry will grow faster than the rest of the economy.

(iii) Maturity stage: further growth of the industry simply follows that of the economy. The product becomes standardised and the competition is based on price, thus narrowing the profit margin.

(iv) Decline: the industry grows slower than the overall economy due to obsolescence of the products and competition from new products.

Other relevant issues in industry analysis include the competition structure (monopoly, oligopoly or monopolistic competition), the impact of economics variables on the industry (interest rates and exchange rates), and government policy (whether favourable or unfavourable to the industry), etc.

(c) Ratio Analysis of a Specific Company

Ratio analysis is used to ascertain a company's financial performance as compared to previous years and to an industry standard. The raw data of ratio analysis is sourced from the previous financial statement of a company such as balance sheet and profit & loss statement. In other words, ratio analysis only reflects the historical performance instead of providing a forward-looking view.

The following are some commonly used ratios:

(i) Liquidity ratios:

It measures a company's ability to repay its short-term debt:

$$\text{Current Ratio} = \frac{\text{Current Asset}}{\text{Current Liability}}$$

$$\text{Quick Ratio} = \frac{\text{Current Asset} - \text{Current Inventory}}{\text{Current Liability}}$$

(ii) Profitability ratios:

It highlights a company's profitability and management's performance:

$$\text{Return on Equity} = \frac{\text{Profit after Tax}}{\text{Shareholder's Capital}}$$

$$\text{Earnings per Share} = \frac{\text{Profit after Tax}}{\text{Number of Issued Shares}}$$

$$\text{Price Earnings ratio} = \frac{\text{Market Price per Share}}{\text{Earnings per Share}}$$

(iii) Solvency ratios:

It determines a company's ability to fulfil its long-term debt obligation:

$$\text{Debt Ratio} = \frac{\text{Total Debt}}{\text{Total Assets}}$$

$$\text{Gearing Ratio} = \frac{\text{Total Debt}}{\text{Shareholder's Capital}}$$

(d) Valuation of Equity Securities

While the ratio analysis discussed above focuses on historical performance of a company, an investor is more concerned about the future price of the shares of the company. There are different valuation methods a fundamental analyst can use to find out the intrinsic value of a company. We will look into three of the most common valuation methods.

(i) Dividend Discount Model ("DDM")

The DDM works on the same principle as the pricing of bonds which is based on the present value of all future cash flow. In the case of stock, the future cash flow is the future dividends payment and there is no repayment of principal because there is no maturity date for equity investment. The DDM states that the share price is equal to the present value of all expected future dividends discounted at the required rate of return on the share:

$$P = \frac{D1}{(1+r)^1} + \frac{D2}{(1+r)^2} + \frac{D3}{(1+r)^3} \cdots \frac{Dn}{(1+r)^n}$$

Where: P = Share price
D = Expected annual dividend per share
r = Required rate of return on the share

There are different variations of DDM. The constant growth DDM assumes that the dividends increase at a stable growth rate. The DDM formula can be simplified to:

$$P = \frac{D}{r - g}$$

Where: P = Share price
D = Annual dividend per share expected for the following year
r = Required rate of return on the share
g = Dividend growth rate

Under the zero growth DDM, the same amount of dividends is expected to be paid forever. Then the DDM formula can be further simplified as:

$$P = \frac{D}{r}$$

(ii) Price Earnings Model ("P/E model")

The P/E model is to compare the PE Ratio of companies in the same industry to ascertain the relative value of an individual company.

A company with a high PE Ratio in comparison with other companies in the same industry reflects that the market expects it to have higher earnings growth. On the other hand, it may also be an indication that the company is overvalued.

Though P/E model is simple to use, it has its own pitfalls. It is a ratio based on historical accounting data. Current earnings can however differ significantly from future earnings. PE Ratio would also be distorted by inflation rate. As a result, it is not possible to say if a PE Ratio is high or low without referring to the general trend of the company and the industry in question.

(iii) Capital Asset Pricing Model ("CAPM")

CAPM is a highly complex model. In short, it relates the expected return of a security to its risk as measured by beta. Beta is the measure of the change of return on a security for a 1% change in the return on the whole market. The higher the beta, the more sensitive is the return of the security to the market; and therefore, the riskier the investment. The CAPM laid down the theoretical explanation of the well-known risk-return trade-off of investment.

3.3.10 Technical Analysis

(a) Historical Data

Technical analysis is a study of historical market data to predict future securities prices. It ignores the financial aspect of the underlying securities such as the company's financial statements or the economic environment in which the company is operating. It is widely used by day traders. They will plot the historical market prices onto a chart and rely on the past pattern to predict future trends and reversal points.

(b) Charts and Trend Lines

There are different types of charts used by market players. The most common one is the **bar chart** which draws a vertical line to connect the highest price and the lowest price recorded during a fixed period. Then a short horizontal line to the left is used to indicate the opening level and another one to the right for the closing price.

The **point and figure chart** is usually used for day trading. Circles and crosses are plotted on a graph paper to represent price moments: a cross indicates the price is up and a circle represents the price is down.

Another popular charting technique is the Japanese **candlestick chart** which was invented by Japanese rice trader in the 17th century. It is similar to a bar chart save that it has a fat body to represent the range between the opening and closing price. If the market opening price is higher than the closing, the body is blackened. When the opening is lower than the closing, the body will be white.

Based on these charts, technical analysts try to draw trend lines and pattern so as to find out support and resistance levels of the market price.

(c) Technical Indicators

Besides chart, technical analysts also rely on certain technical indicators to read market trends such as moving average and relative strength indicator.

Moving average is the calculation of the average closing prices for a specific period such as 10-day, 20-day or 250-day moving averages. A simple trading strategy is to buy the securities whenever the price goes above the moving average and to sell whenever it drops there below. Another popular strategy is called **cross-over trade** which relies on the cross over between a shorter and a longer moving average. For example, if the 10-day moving average crosses above the 20-day moving average, it is a buying signal and a downward crossover is a selling signal.

The **relative strength indicator** (RSI) plots the price relationship between the closing prices of up days and down days within a specific period, the most common is 14-day RSI. RSI has a value between 0 to 100%. Analysts normally use the 30 and 70 levels as the thresholds. If the RSI drops below 30, the market is said to be oversold while RSI above 70 indicates an overbought signal.

(d) Common Technical Analysis Methods

There are also some common theories of technical analysis which assist investors to make investment decision.

Wave theory assumes that a market cycle consists of two phases, the Bull or up phase and the Bear or down phase. Financial market prices unfold according to a basic pattern of five waves up and three waves down to form a complete cycle.

The Fibonacci sequence and the golden ratio are also common theories to predict market reversal points and target levels.

3.3.11 Advantages of Equities

- dividend income;
- capital appreciation;
- part ownership of the company;
- limited liability;
- liquidity;
- higher return than bonds; and
- a good hedge against inflation.

3.3.12 Disadvantages of Equities

- subject to fluctuations in company earnings;
- high short-term price volatility;
- market risk;
- company risk; and
- economic risk.

3.4 FINANCIAL DERIVATIVES

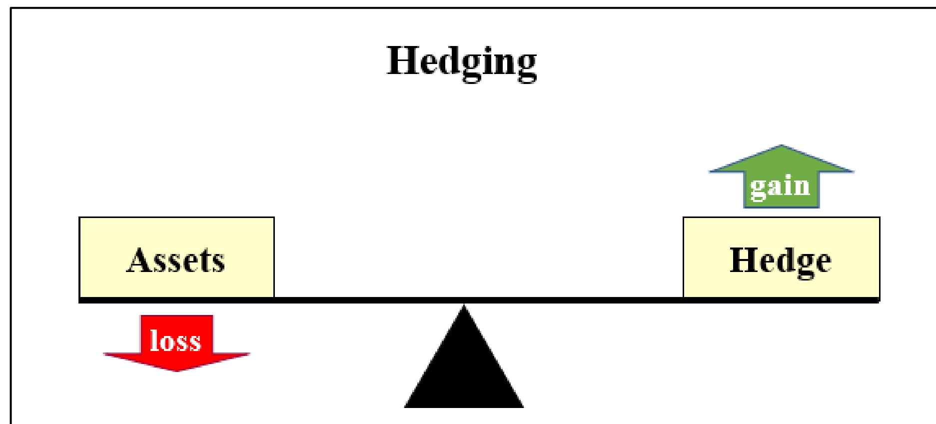
A financial derivative is a financial instrument whose value depends on or is ***derived*** from an underlying financial asset such as stock, bond, interest rate, foreign currency or stock market index. There are many types of financial derivatives such as option and forward contract. Being more speculative in nature and complex in structure than other types of investment, financial derivatives are only suitable for sophisticated or professional investors.

3.4.1 Uses of Financial Derivatives

Financial derivatives can be used for different purposes: risk management, speculation or arbitrage:

(a) **Risk management**: Derivatives are being used for hedging extensively. The purpose of hedging is to eliminate the impact of change in market price on the value of an asset or investment portfolio. For instance, a fund manager holding a portfolio of stocks is expecting a short-term downward correction in the market. In order to protect the portfolio value, the manager may sell short stock index futures contracts so that when the stock market

drops, the gain from the short stock index futures contracts will "offset" the loss in value of the portfolio. If the stock market continues to go up, the futures hedge will incur a loss that would be offset by the appreciation of the portfolio. Thus, hedging with futures contracts will eliminate the downside risk but at the same time forfeit the upside potential.



(b) **Speculation:** Speculators buy and sell derivatives for the sole purpose of making a profit by closing out their positions at a price that is better than the initial price. For instance, a trader who believes the HSI will go down may sell short HSI futures contracts. Should the HSI go down as expected, he/she can buy back his/her futures contracts at a lower level and make a profit. On the other hand, if his/her view is proved wrong and the HSI goes up, a loss will result. Speculators are often blamed for creating excessive volatility in the market. This may be an unfair accusation in view of their contribution to the liquidity of the market.

(c) **Arbitrage**: An arbitrage is a simultaneous purchase and sale of same or similar assets in different markets in order to capture a risk-free profit caused by mis-pricing. As the value of a financial derivative is derived from an underlying asset, there exists a relationship between the price of the underlying asset and that of the derivative. However, as the two markets are driven by different demand and supply, such relationship breaks down occasionally. This provides an opportunity for arbitrageur to make a profit by buying the under-priced (e.g. the stocks) and selling the over-priced (e.g. the index) simultaneously. For instance, if the HSI futures contract trades at a premium of, say 300 points above the current HSI, investment managers may enter the market to sell short HSI futures contracts and buy back the underlying stocks in the cash market. On the settlement date of the HSI futures contracts, the two markets will converge and a risk-free profit is generated.

There are a wide variety of financial derivative products and their structure can be highly complex. Here we will focus only on the more basic types of derivatives. There are two major types of financial derivatives:

1. Forward and Futures Contracts; and
2. Options and Warrants.

3.4.2 Forward and Futures Contracts

A **forward contract** is an agreement between two parties (buyer and seller) to set a price today for assets/goods that will be delivered on a specified future date. The assets or goods being traded include stocks, bonds, interest rates, foreign currencies, commodities, stock indexes etc.

A **futures contract** is typically a standardised forward contract that is traded in an organised market called futures exchange. Futures contracts are traded on a large number of underlying assets such as agricultural and metallurgical products, interest earning assets, foreign currencies and stock indexes. Futures contracts are settled either through offsetting deals, physical delivery or cash settlement.

A **stock index futures contract** is based on a particular stock market index, e.g. DJIA, S&P 500, HSI, which is constructed to measure the overall price movement of a stock market.

The trading of stock index futures involves standardised contracts to buy or sell a hypothetical portfolio of all stocks included in the index at some specified future date at a price agreed at the time of the deal.

For futures contract of deliverable underlying goods, the buyer agrees to take delivery and to make payment at expiry date, and the seller agrees to make delivery at the same time. But for stock index futures contract, the settlement is made in cash without the actual delivery of the securities covered by the index. The profit or loss derived from trading stock index futures is determined by the difference between the price of the original contract and the final settlement price. For example, an investor bought one HSI futures contract at 25,500 and the final settlement price of the contract is 26,000, then the investor will make (26,000 – 25,500) x HKD50 (each index point of the HSI futures contract is worth HKD50) = HKD25,000.

In Hong Kong, HSI futures contracts are traded at the Hong Kong Futures Exchange Limited. There are two types of HSI futures, the standard HSI futures and the Mini-HSI futures contracts. The value of a standard HSI futures contract equals HKD50 times the index points whereas the multiplier for the Mini-HSI futures contract is HKD10. That is to say, if the contracts are traded at 26,000 index points, their values will be HKD1,300,000 (HKD50 x 26,000) and HKD260,000 (HKD10 x 26,000) respectively.

Buyers and sellers of contracts are exposed to the overall movement of the stock market, as measured by the market index. Whereas an investor in the underlying stocks needs to pay in full for the purchases within two business days of trading, the buyer or seller of a futures contract pays only a margin which is a certain percentage of the contract value. The margin requirements are different in different markets and for different types of investment products and may be subject to the prevalent market condition. Thus, the investor gains exposure to the index by using only a fraction of the capital that would otherwise be needed to gain the same exposure to the underlying stocks. It must be pointed out that the leverage effect of futures contract may backfire. Should the stock market move 10% against the investor, all the capital invested in the futures contract will be wiped out.

3.4.3 Options and Warrants

An **option** contract gives the holder the **right**, but not the obligation, to buy or sell a specified amount of an underlying asset at an agreed price within or at a specified time.

In order to get this right, the **buyer** (also referred to as **holder**) pays the ***seller*** (also referred to as **writer**) an agreed fee, which is known as the **premium.**

Underlying assets: Stock, index, bond, FX, commodity ?

To exercise an option means the holder puts this right into effect and the two parties enter into the specified transaction in the option contract. If the holder chooses to exercise the option, the writer has the obligation to complete the specified deal.

Options on different **underlying assets** are being traded. Such underlying assets include stocks (stock options or warrants), stock indexes, bonds (callable and putable bonds), foreign exchanges (currency options), interest rates, commodities etc.

A **call option** gives the holder the right, but not the obligation, to buy the underlying asset while a **put option** gives the holder the right, but not the obligation, to sell the underlying asset.

The pre-agreed price for a holder of a call option to buy the underlying asset or a holder of a put option to sell the underlying asset is called the **strike or exercise price**. The strike price is fixed when the option contract is being negotiated.

There is a time limit for an option contract. The date (last day) the right has to be exercised is called the **expiration date**, **expiry date or maturity date**. There are two types of option styles, namely, European and American options. A **European option** can only be exercised on the expiration date while an **American option** may be exercised on or before the expiration date.

Deal date: 23 May 0x
Buyer: ABC
Seller: XYZ
American style
HSBC Call
Quantity: 400 shares
Strike: $140
Expiration Date:
23 Aug 0x
Premium: $2,800

By paying $2,800 premium to XYZ, ABC has the right to buy from XYZ 400 shares of HSBC stock at a price of $140 per share on or before 23 Aug 0x

Options can be traded over-the-counter or through organised exchanges. Option trading is facilitated by standardised contracts traded on organised exchanges. These exchanges employ the services of a clearing corporation, which maintains records of all trades and acts as a buyer from all option writers and a writer to all option buyers.

Option writers are required to deposit margin to ensure performance of their obligations. The amount and form of the margin will depend on the particular option contract involved.

A **warrant** works in the same way as a stock option. In Hong Kong, most warrants are call warrants although there are a few put warrants. There are two types of warrants, namely equity warrants and derivative warrants. Equity warrants are issued by the company issuing the underlying stock, whereas derivative warrants are issued by a third party, typically an investment house or a financial institution.

A special feature of options and warrants is that the payoff of such contracts is asymmetrical. Suppose an investor is bullish on Cheung Kong Holdings (CKH) and chooses to buy a call option on 1,000 shares of CKH at a strike price of HKD85 for a premium of HKD6,000 and hold the option contract to maturity. At the expiry date of the option, if CKH's share price stays below HKD85, the option will not be worth exercising and the investor loses what he/she has paid, the premium of HKD6,000. No matter how low CKH share price goes, the maximum loss is HKD6,000. However, if CKH share price goes up to say, HKD100, the investor will make (HKD100 – HKD85) x 1,000 = HKD15,000 from exercising the option. After deducting the HKD6,000 premium paid, the net profit is HKD9,000. In this case, the higher the CKH share price at the expiration of the option, the larger will be the profit.

Therefore, the maximum loss of an option buyer is limited to the premium paid but the gain, in theory, is unlimited. However, the payoff for the option writer is exactly the reverse where the gain is limited (to the premium received) but the loss could be unlimited.

3.4.4 Advantages of Derivatives

- provide effective hedge for unwanted risks;
- efficient means for speculative purpose;
- loss limited to premium paid only (for buyer of options);
- highly leveraged;
- potential high return;
- liquidity (for exchange traded derivatives); and
- low transaction cost.

3.4.5 Disadvantages of Derivatives

- extremely high risk;
- unlimited loss (for writer of options and trader of futures);
- substantial front end premium outlay (for buyer of options);
- total loss in value (premium paid) after maturity date; and
- no right of ownership or dividend income to underlying securities.

These financial instruments are not for everyone as they can be complex and have unique risk features. Prior to trading in derivatives, the investors should make certain that they fully understand the nature of, and the risks associated with, these products.

3.5 REAL ESTATE

Real estate investment is one of the best types of investment in Hong Kong. According to the CBRE Global Living 2020 report, Hong Kong topped the global rankings of the world's most expensive property markets and remained resilient, despite the unstable factors such as the continuous market-cooling measures imposed by the government, the US-China trade war, the predicaments of the COVID-19 pandemic and socio-political unrest with the enactment of the China's National Security Law, which came into effect on June 30 2020. Over the past decade, Hong Kong's residential property prices increased multi-fold and have skyrocketed by 262% (162% inflation-adjusted), including spectacular growth of 28.5% in 2009, 21% in 2010, 25.7% in 2012, 13.6% in 2014, and 14.7% in 2017. In contrast, real incomes have virtually stagnated in Hong Kong for years.

Real estate investment can be carried out in different forms. The most common type is ***rental property*** where investors acquire apartments, houses, shops or office premises with down payments and use rental incomes to pay off the mortgage and other expenses. Simultaneously, rental property provides both a cash flow and an opportunity to capital appreciation of property market value.

Another form of real estate investment involves the purchase of apartments, houses, shops, office premises or even raw land with an intention to sell them later for a profit. Such investment could be financed by mortgage as well.

3.5.1 Advantages of Real Estate Investment

- capital appreciation;
- inflation hedge;
- leverage through bank mortgages available; and
- pride of ownership.

3.5.2 Disadvantages of Real Estate Investment

However, as a means of investment, it has the following disadvantages:

- high volatility/risk;
- high transactions costs;
- illiquid market;
- management problems;
- high denomination; and
- low rental yield.

3.6 LOW LIQUIDITY INVESTMENTS

We will finish this part by a brief discussion on another class of investment assets that is viewed more as hobbies than investment even though some of these assets did experience substantial returns in the past. They include **antiques, art, coins and stamps, diamonds** and other **collectible items**.

Apart from possible financial return from such investments, investor may also gain satisfaction and enjoyment from the ownership of such items. However, the market for such investments is always illiquid and transaction costs could be very high. Many of these assets are sold at auctions and prices may thus vary substantially. Also, special knowledge and expertise are required.

3.7 INVESTMENT FUNDS

In the following sections, terms such as investment funds, mutual funds, or unit trusts are regarded as collective investment schemes under the ***Securities and Futures Ordinance*** (Cap. 571).

Since investment-linked long-term insurance policies are mostly offered with their value directly linked to the performance of investment fund(s), the insurance intermediary selling these products should possess thorough knowledge on the features, benefits, and operations of investment funds.

Investment funds are a form of collective investment schemes through which a number of investors having similar investment objectives combine their money into a large central pool. The investment company then channels the funds from this pool into a diversified portfolio of financial instruments such as stocks and bonds. In return, the investors are entitled to any earnings that the company may generate.

There are a wide variety of funds created to suit different needs of investors. Investment funds can be classified according to the asset class they invest in such as stock funds, bond funds, money market funds, venture capital funds etc. They can also be termed as aggressive growth funds, growth funds, income funds, balanced funds etc. according to their investment objectives. Some funds are set up for investment in specific industry (e.g. technology funds), or geographic areas such as global funds, American funds, European funds, Far East funds, China funds, Hong Kong funds etc.

The market for investment funds is huge. According to the Investment Company Institute, worldwide mutual funds' total net assets amounted to over USD23.41 trillion in March 2023. In Hong Kong, the number of SFC authorized mutual funds and unit trusts as at 31 March 2023 was 2,330 (source of data: the SFC).

Investment funds are highly regulated in Hong Kong. Under section 103 of the **"Securities and Futures Ordinance"** (Cap 571), it would be an offence to issue advertisements, invitations or documents relating to certain investments, including collective investment schemes, to the public unless the issue is authorized by the SFC under section 105(1), or exempted. Section 104 of the Ordinance provides power to the SFC to grant authorisation for such collective investment schemes which include investment funds. In addition, pursuant to the Ordinance, the SFC also published the "**Code on Unit Trusts and Mutual Funds**" in April 2003, which established guidelines for the authorisation of collective investment schemes in the nature of mutual fund corporations or unit trusts, and whose latest edition became effective on 1 January 2019. Some of the relevant issues will be discussed in the following sections.

3.7.1 Mutual Fund and Unit Trust

Investment funds differ in many ways and thus classification is difficult. Different names are often used depending on the jurisdiction. Investment funds are commonly known as mutual fund or unit trust.

(a) Mutual Fund

This is the simplest and most common situation. An investment company is set up with the objective of investing in shares of other companies and has only one type of investors, i.e. the stockholders for whom it makes the investment. These stockholders own the investment company directly and thus own indirectly the financial assets that the company itself owns.

A mutual fund company has a board of directors that is elected by its stockholders. In turn, the board will commonly hire professional money manager, the management company, to manage the company's assets. These management companies may be authorized financial institutions, registered companies, or authorized insurers. Often the management company is the business entity that started and promoted the mutual fund. A management company may have contracts to manage a number of mutual funds, each of which is a separate organisation with its own board of directors.

(b) Unit Trust

Trust is an old concept under English Common Law. This concept is recognised in common law jurisdictions such as the UK, Australia, Canada and Singapore. It is also adopted in Hong Kong. However, in other jurisdictions such as the US, Japan, France or Luxembourg, it is not recognised; instead mutual funds are adopted.

A unit trust is an investment vehicle set up under a trust. To form a unit trust, the investment company purchases a specific set of securities and deposits them with a trustee. The investors who share similar investment objectives then pool their money together for the investment into such types of assets.

A number of units known as redeemable trust certificates are sold to the public. These certificates provide their owners with proportional interests in the securities that were previously deposited with the trustee. All income received by the trustee on these securities is subsequently paid out to the certificate holders, as are any repayments of principal.

An investor who purchases units of a unit trust is not required to hold them for the entire life of the trust. Instead the units usually can be sold back to the trust, at a price calculated on the basis of bid prices for the underlying assets in the portfolio, i.e. the market value of the securities in the portfolio. This is otherwise known as the Net Asset Value ("NAV") per unit.

The NAV is derived using the following formula:

$$\text{NAV} = \frac{\text{Total Assets} - \text{Total Liabilities}}{\text{Number of Units Outstanding}}$$

Having determined the per unit price, the trustee may sell one or some of the securities to raise the required cash for the repurchase.

3.7.2 Open-end and Closed-end Funds

Investment funds sell shares to investors and use the proceeds to purchase assets and securities according to the investment objective of the funds. However, funds differ in the way they operate after the funds have been launched and can be classified as open-end or closed-end.

(a) Open-end Funds

An open-end fund has a variable capitalisation. It stands ready to purchase existing shares at a price based on or near the NAV of the underlying investments. On the other hand, it may continuously offer new shares to

investors, again at a price based on the NAV. The open-ended nature means that the fund gets bigger and more shares are created as more people invest in it. The fund shrinks and shares are cancelled as people withdraw their investment. The price of the shares is based on the value of the investments the fund has invested in.

(b) Closed-end Funds

A closed-end fund is an investment company whose line of business is investing in other financial assets or companies. It issues a set number of shares initially to capitalise the fund, i.e. the fund size is fixed. After the initial launch, new shares are rarely issued or repurchased and the number of shares does not change regardless of the number of investors.

An investor who wants to buy or sell shares in the closed-end fund has to do it through the secondary market. These funds are commonly traded on organised exchanges such as the New York Stock Exchange, the American Stock Exchange or the Hong Kong Stock Exchange.

Although the price of the shares of a closed-end fund reflects the value of the investments in the fund, it does not equal to the NAV of the fund as in the case of open-end funds. If there are more people willing to sell their shares than people willing to buy, the share price tends to fall and may be lower than the NAV, in which case a discount exists. If there are more buyers than sellers, the share price tends to rise and may be higher than the NAV, in which case a premium exists. The premium or discount may vary dramatically depending upon market sentiments and market conditions.

Closed-end funds are generally established to invest in markets where the assets are less liquid, e.g. the stock markets of emerging economies or property. This is due to the closed-ended nature of the fund which protects the underlying assets from having to be sold (at unreasonable price) to meet the redemption requirement of the investors during extreme market condition.

3.7.3 Charges and Fees of Investment Funds

There are, at a minimum, usually two types of fees incurred in investment in funds. The first type is a sales fee or load of a fund for the operation and distribution costs of the fund and the second type is the annual management fee paid to the fund management company for their services.

(a) No Load

With direct marketing, the fund house sells the units/shares directly to the investors without the use of a sales organisation. This type of investment fund is known as a no-load fund and imposes no initial sales fee. The units/shares are sold to the investors at a price equal to their NAV. However, some fund houses may charge a redemption fee or exit penalty if the units/shares are sold back to them within a certain time limit. Other fund houses may charge an on-going distribution fee on an annual basis.

(b) Sales Fee/Load

When investment funds are sold through the use of a sales force, the fund house has to pay a commission based on the units/shares sold. This is known as a load charge and the common load types are described as follows:

- Front-end load;
- Back-end load; and
- Level load.

(i) Front-end Load/Subscription Fee

A front-end fee is charged to the investors when the shares/ units are purchased from the fund house. The fee is paid up-front and just once, as a percentage of the initial purchase price. This type of funds is commonly known as class A unit/share and is an attractive choice for long-term investors.

(ii) Back-end Load/Redemption Fee

Back-end load will only be paid by the investors when the units/shares are sold back to, rather than when they are purchased from, the fund house. That is, when the investors sell their units/shares back to the fund house, a deferred contingent sales charge or redemption charge may be applicable. The deferred contingent sales charge is typically calculated as a percentage of the NAV and applies for the first few years that the investors own the units/shares. The fee decreases over time in steps until it disappears. The redemption charge may be a fixed percentage of the NAV, or based on the time period for which the investors have held their units/shares. In addition, a ***distribution fee*** of up to 1% is usually applicable annually. This type of funds is commonly known as class B unit/share and is more attractive for investors who intend to hold the units/shares for a medium term of at least 5 years. Some class B units/shares may be set up so that they convert to class A units/shares after a number of years and the annual distribution fee will be avoided thereafter.

(iii) Level Load

A level load fund requires the investors to pay a small front-end charge when the units/shares are purchased from the fund house, and possibly a small back-end charge if they are sold back to the fund house in less than a year. However, a distribution fee is again applicable to cover the selling expenses. This type of funds is commonly known as class C unit/share and is more attractive for the short-term investors. However, it should be noted that level load is not too common in Hong Kong.

(c) Management Fees

In addition to sales charges, the management company will charge annual management fees for the investment and advisory services provided by the professional fund manager. The management fee is set at a certain percentage, usually ranges from 0.5% to 1% per annum, of the average market value of the fund.

Under the **"Code on Unit Trusts and Mutual Funds"**, the level/basis of calculation of all costs and charges payable from the scheme's property must be clearly stated, with percentages expressed on a per annum basis. The aggregate level of fees for investment management advisory functions should also be disclosed.

If a performance fee (i.e. a fee based on the actual investment gains achieved) is levied, the fee can only be payable:

(1) no more than annually; and

(2) if the NAV per unit/share exceeds the NAV per unit/share on which the performance fee was last calculated and paid (i.e. on a high-on-high basis).

(d) Other Fees

Other fees which may be charged by the investment company include (but not limited to):

(1) administration fee which covers record keeping and services to investors;
(2) guarantee fee (mainly for guaranteed funds);
(3) trustee fee; and
(4) custodian fee.

3.7.4 Benefits of Investment Funds

The benefits of investment funds have been well summed up by one of the many quotations: "they offer people with limited time, or limited investment skills or modest means, access to investment returns available only to more sophisticated investors who are able to buy their own professional advice. They generally entail less risk than direct holdings of securities, and offer economies of scale."

Some of the major benefits are summarized as follows.

(a) Diversification

Investment funds provide an assortment of investment options. They offer growth, income, or a mixture of both, and the opportunity to invest in international markets, as well as in the local market. Investment managers typically establish a portfolio of as many as 50 to 200 or more different securities.

In effect, they are putting the investors' money in many baskets instead of just one. Traditionally, only large institutions and "high net worth" individual investors can attain the diversification on their own. This is now made available to mass investors through investment funds.

(b) Professional management

With investment funds, investors have access to professional, expert and full-time investment managers who base their buying and selling decisions on extensive and on-going economic research. After analysing macro-economic conditions, stock market conditions, interest rates, inflation and the financial performances of individual companies, they select investments that best match the fund's objectives. Again, only large institutions and high net worth individual investors used to enjoy the service of such professional investment managers but investment funds have made this type of financial expertise accessible by the mass market.

(c) Growth potential

Investment funds create possibility of higher long-term returns than conventional savings. As a matter of fact, one reason for the phenomenal growth of investment funds is their performance record in relation to what individual investors might expect by investing on their own. Of course, performance varies from fund to fund, but on average and over the long run, the growth of equity funds has paralleled the growth in the US economy. In addition, bond and money market funds have also reflected the long-term movements in their respective markets.

(d) Convenience

Investors can purchase most types of investment funds through a professional licensed representative of an investment company. The intermediary can help analyse the investor's financial needs and objectives and recommends the appropriate funds. Nowadays, most of the commercial banks in Hong Kong sell their own investment funds while some also sell the funds of investment companies.

Investors, depending on the availability of secondary market and subject to the terms of the funds, also have access to their money. They can redeem all or part of their investment on any business day and receive the current value of the investment, which of course may be more or less than the original cost. Payment for redeemed investment will generally be made within a few business days.

(e) Access to global markets

Some markets may not allow access by foreign investors. However, international investment companies may be able to establish a local company and thus invest into the market. This provides additional opportunity to investors who may otherwise not be able to take advantage of the investment opportunity.

(f) Flexibility

Investment funds offer various features that allow investors to stay in control of their investment. Investors can choose the type of investment that most fits their own investment objectives and risk tolerance.

(g) Liquidity

Most of the investment funds are readily marketable at a price equal to the net asset value (NAV). Investors can therefore realise their investment easily without having to make a substantial price concession.

(h) Affordability

For those investors with moderate financial resources who wish to invest in the stock market, they could only purchase stocks in odd lots, which result in high brokerage commission. Moreover, they would have to sacrifice the benefits of diversification. Economies of scale in investment funds make such investment possible to the mass market.

Furthermore, investment funds are available in small units that make them affordable even to the mass market. Investors can get an investment programme started for HKD10,000 (or lower). Subsequent and regular monthly investments can be made for as little as HKD1,000.

(i) Cost efficiency

Investors sometimes have the feeling that investing in investment funds are expensive given that they are charged an upfront (front-end load) commission of up to 5%. However, with this amount of money they are hiring the professional service of some world class experts in their particular field to make the investment decision for them. Furthermore, the investment companies often employ “state-of-the-art” computer equipment that is usually unaffordable for individual investors.

Moreover, dealing and administrative costs would be greatly reduced by pooling the investors’ funds together to take advantage of buying in bulk.

(j) Administration

Investors do not have to perform any administrative work associated with managing their own portfolios, such as handling payments connected with share trading, registering shares, arranging for custodian, collecting dividends and applying for rights issues.

(k) Protection

The assets of the investment funds are typically protected by the trustees, or custodians, who have the responsibility to act in the interests of investors, owning the investments on their behalf. It is also the trustee’s role to ensure the investment is made according to its investment objectives while the custodian will be responsible for the safekeeping of the assets.

Investment fund business is highly regulated. In Hong Kong, investment funds must be authorized by the SFC before being marketed to the public. Although SFC authorisation is not a guarantee of an investment product, it has made specific requirements necessary before authorisation will be granted.

(l) Up-to-date investment position

Most investment funds publish the bid and offer price, and their NAV if applicable, daily on newspapers. With the advance in technology, some of them even make their information available through the internet.

(m) Automatic reinvestment of gains

Most investment funds allow investors to automatically reinvest their dividends and capital gains to purchase additional fund units/shares at no extra cost. Over time, the power of compounding may significantly increase the value of investors’ assets.

(n) Switch privilege (into other funds)

Within a fund family, investors can generally switch all, or any portions, of their investments into other funds with different objectives as their financial situations, and thus investment strategies, change.

3.7.5 Disadvantages of Investment Funds

(a) Management fees

The professional investment managers running the investment fund on behalf of the investors will inevitably take a fee directly from the investment fund. This is a cost, which investors could avoid if they manage their own investment.

(b) Lack of choice

Although investors can choose the type of fund they intend to invest in, they have no control over the choice of individual share, or bond which goes into the fund.

(c) Lack of owner's rights

If investors hold a company's shares direct, they will have the right to attend the company's annual general meeting and vote on important matters. Investors in an investment fund have none of the rights connected with the individual investment in the fund.

3.7.6 Roles of the Various Parties of an Investment Fund

Pursuant to the **"Securities and Futures Ordinance"**, the SFC published the "**Code on Unit Trusts and Mutual Funds**" in April 2003, which outlines the authorisation criteria and on-going obligations in respect of authorized investment funds that are offered to the public in Hong Kong, and whose latest edition became effective on 1 January 2019. Some of the major sections have been extracted as follows (**Note**: these have only been reproduced in a simplified version, for full details please refer to the Code):

(a) Role of Management Company

"Authorized" investment funds must appoint a management company acceptable to the SFC. A management company must be properly licensed or registered under Part V of the **"Securities and Futures Ordinance"** to carry on its regulated activities if it is incorporated in and/or operates from Hong Kong. It is responsible for investment management within the scope of the constituent documents. For this, a management company must:

(1) be engaged primarily in the business of fund management;

(2) have sufficient financial resources to enable it to conduct its business effectively and meet its liabilities; in particular, it must have a minimum issued and paid-up capital and capital reserves of HKD1 million or its equivalent in foreign currency;

(3) not lend to a material extent;

(4) maintain at all times a positive net asset position; and

(5) have its investment management operations based in a jurisdiction with an inspection regime acceptable to the SFC.

The general obligations of the management company are that it must:

(1) manage the fund in accordance with the constitutive documents in the exclusive interest of the holders and to fulfil the duties imposed on it by the general law;

(2) maintain the books and records of the fund and prepare the fund's accounts and reports. At least two reports must be published each financial year; and

(3) ensure that the constitutive documents are made available for inspection by the public.

(b) Role of Trustee/Custodian

Every "authorized" investment fund established as a unit trust or mutual fund must respectively appoint a trustee or custodian acceptable to the SFC. Trustees are expected to fulfil the duties imposed on them by the general law of trusts. In the case of a mutual fund corporation, the responsibilities of a custodian should be reflected in a constitutive document such as a Custodian Agreement.

As outlined under the Code, an acceptable trustee/custodian should either:

(1) on an on-going basis, be subject to regulatory supervision; or

(2) appoint an independent auditor to periodically review its internal controls and systems on terms of reference agreed with the SFC and should file such report with the SFC.

A trustee/custodian must be:

(1) a bank licensed under Section 16 of the **"Banking Ordinance"**; or

(2) a trust company which is a subsidiary of such a bank; or

(3) a trust company registered under Part VIII of the **"Trustee Ordinance"**; or

(4) a banking institution or trust company incorporated outside Hong Kong which is acceptable to the Commission. Additionally, a trustee/custodian must be independently audited and have minimum issued and paid-up capital and non-distributable capital reserves of HKD10 million or its equivalent in foreign currency and liquid capital of HK$3 million.

A. General obligations of Trustee/Custodian

The trustee/custodian must:

(1) take under its control all the property of the fund in trust for the holders in accordance with the provisions of the constitutive documents;

(2) register all assets in the name of the trustee/custodian; where borrowing is undertaken for the account of the fund, such assets may be registered in the lender's name;

(3) be liable for the acts of its agents in relation to assets forming part of the property of the fund;

(4) take reasonable care to ensure that the sale and repurchase of units/shares are carried out in accordance with the constitutive documents;

(5) take reasonable care to ensure that the sale and repurchase prices are calculated in accordance with the constitutive documents;

(6) carry out the instructions of the management company unless they are in conflict with the provisions of the constitutive documents or the Code;

(7) take reasonable care to ensure that the investment and borrowing limitations set out in the constitutive documents are complied with;

(8) issue a report to the holders on whether the management company has managed the fund in accordance with the provisions of the constitutive documents; if not, the steps which the trustee/custodian has taken; and

(9) take reasonable care to ensure that unit/share certificates are not issued until subscription moneys have been paid.

B. Independence of Trustee/Custodian and Management Company

The trustee/custodian and the management company must be persons who are independent of each other. Where the trustee/custodian and the management company have the same ultimate holding company, they are deemed to be independent of each other if:

(a) (1) they are both subsidiaries of a substantial financial institution;

(2) neither the trustee/custodian nor the management company is a subsidiary of the other;

(3) no person is a director of both the trustee/custodian and the management company; and

(4) both the trustee/custodian and the management company sign an undertaking that they will act independently of each other; or

(b) the fund is established in a jurisdiction where the trustee/custodian and the management company are required by law to act independently of one another.

(c) Role of Auditor

The management company or the directors of a mutual fund corporation must, at the outset and upon any vacancy, appoint an auditor for the scheme.

The auditor must be independent of the management company, the trustee/ custodian and, in the case of a mutual fund corporation, the directors.

The management company must cause the fund’s annual report to be audited by the auditor.

(d) Role of Registrar

The fund, or in the case of a unit trust the trustee, or the person so appointed by the trustee must maintain a register of holder. The Commission must be advised on request of the address where the register is kept.

3.8 LIFE INSURANCE AND ANNUITY

The US Life Office Management Association Inc. ("LOMA") defines a life insurance policy as follows:

"A policy under which the authorized insurer promises to pay a benefit upon the death of the person who is insured."

3.8.1 Life Insurance

(a) Major Types of Life Insurance

Some of the major types of life insurance are summarized as follows:

(i) **Term insurance**: this provides cover for a specified period or term only, and may also be described as temporary insurance. The policy benefit is only payable if the insured person dies during the specified period, and the policy is valid at the time of death.

(ii) **Endowment insurance**: this provides for the payment of the face amount at the end of a specified term or upon earlier death. Should the insured survive the term, the policy is said to mature.

(iii) **Whole life insurance**: this involves a policy that is designed to last the whole of one's life. The fundamental feature is that the face amount is paid on death, whenever that occurs, and not before.

(iv) **Universal life insurance:** this is basically a life insurance contract with the following special features:

(1) It is subject to a flexible premium;

(2) It has an adjustable benefit;

(3) The expenses and other charges are disclosed to a purchaser;

(4) It accumulates a cash value; and

(5) It separates and discloses to the policyholder (unbundles) the pure cost of protection, the investment earnings, and the company expenses.

(b) Advantages of Life Insurance (as an investment vehicle)

- protection against uncertainty;
- suitable for long-term investment (except term insurance);
- protection against loss of income arising out of premature death;
- low risk; and
- accumulation of funds for specific purposes (except term insurance).

(c) Disadvantages of Life Insurance (as an investment vehicle)

- current cash flow reduced;
- low yield;
- need to have insurable interest at the inception of life insurance policy;
- illiquid (at least in the short term);
- lack of flexibility;
- no ownership of any underlying assets; and
- acceptance of purchase dependent upon underwriting decision of the insurer.

3.8.2 Annuity

An annuity is a series of periodic payments to an annuitant for life or other agreed term or conditions, in return for a single payment (premium) or series of payments. For example, an annuitant pays HKD1,500,000 now to buy an annuity that will pay the annuitant a monthly fixed payment of HKD10,000 for twenty years.

(a) Features of Annuities

Some features to be noted with annuities are:

(i) **Immediate annuity**: this is usually purchased with a single payment. The benefits or instalments begin one annuity period (one month or six months) immediately thereafter.

(ii) **Deferred annuity**: the instalment payments begin at some specified time or specified age of the annuitant.

(iii) **Variations**: a number of possible variations exist. One provides for instalments to be paid for a fixed number of years only (whether death occurs in the meantime or not – an annuity certain). Another provides for instalments to be paid for at least a specified number of years, whether death occurs or not, and for life if longer than that number of years – known as a guaranteed annuity (or life income with period certain).

(b) Advantages of Annuities (as an investment vehicle)

- stable cash flow;
- suitable for retiree;
- suitable for long-term investment;
- protection against lack of income arising out of excessive longevity;
- accumulation of fund for specific future purposes;
- regular and guaranteed income;
- low risk; and
- hedge against adverse financial developments.

(c) Disadvantages of Annuities (as an investment vehicle)

- decreasing purchasing power with fixed payments if inflation exists;
- retiree may outlive the annuity;
- low return;
- illiquid in the short term;
- no ownership of any underlying assets; and
- lack of flexibility.

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Representative Examination Questions

Type "A" Questions

1. Which of the following is not a benefit for investing in investment funds?

   (a) affordability;
   (b) bank guarantee;
   (c) convenience;
   (d) diversification.

   [Answer may be found in **3.7.4**]

2. Which one of the following investment options has all the advantages of capital appreciation, dividend income, liquidity and inflation hedge?

   (a) cash;
   (b) bonds;
   (c) options;
   (d) shares.

   [Answer may be found in **3.3.11**]

3. Looking at the charges only, which type of investment funds is more suitable for an investment-linked insurance policy?

   (a) Class A stock because the investors are typically looking for a long-term investment;
   (b) Class B stock because there is no load charge;
   (c) Class C stock because there is both load charge and an annual distribution fee;
   (d) None of the above.

   [Answer may be found in **3.7.3**]

4. One of the advantages of investing in derivatives is:

   (a) the low level of volatility;
   (b) the guaranteed return;
   (c) the potential high return;
   (d) the dividend income.

   [Answer may be found in **3.4.4**]

Type "B" Questions

5. A time deposit placed in a major bank is a good form of investment because of:

   (i) its high degree of liquidity
   (ii) its low level of risk
   (iii) its traditional high return
   (iv) its low cost of investment

   (a) (i) and (ii) only;
   (b) (i) and (iv) only;
   (c) (ii) and (iii) only;
   (d) (ii) and (iv) only.

[Answer may be found in **3.1.3**]

6. Some of the advantages of investing in bonds are:

   (i) liquidity
   (ii) higher return than money market instruments
   (iii) risk free
   (iv) regular and determinable income

   (a) (i) and (ii) only;
   (b) (i), (ii) and (iv) only;
   (c) (ii) (iii) and (iv) only;
   (d) all of the above.

[Answer may be found in **3.2.13**]

7. Some of the disadvantages of investing in investment funds are:

   (i) management fees charged
   (ii) lack of choice
   (iii) lack of owner's rights
   (iv) liquidity problems

   (a) (i) and (ii) only;
   (b) (iii) and (iv) only;
   (c) (i), (ii) and (iii) only;
   (d) (ii), (iii) and (iv) only.

[Answer may be found in **3.7.5**]

[*If still required, the answers may be found at the end of the Study Notes.*]

Chapter 4
INVESTMENT-LINKED LONG TERM INSURANCE POLICIES

4.1 HISTORICAL DEVELOPMENT

Life insurance started some 400 years ago. It was created to satisfy the need for financial security. Over the years, existing insurance products were enhanced and new insurance products were developed to satisfy the market's evolving requirements.

Term life and ordinary whole life are the two traditional types of life insurance and have occupied the majority of the world individual life insurance market. Different features have been added to these two traditional types of life insurance to cater to customers' requirements over the years, with universal life, variable life and variable universal life (US-name) / unit-linked (UK-name) / investment-linked (Asia-name) being the most significant derivatives over the past decades.

Universal life is a type of permanent life insurance that is characterised by flexible premiums (both size and frequency), adjustable death benefits, and transparency of the administrative expenses and cost of insurance; but it gives the policyowner no freedom to invest in his preferred investment portfolio. Variable life is a type of permanent life that shifts investment risk to the policyowner, who is given the choice to select from a wide range of investment options; the interests that his account or accounts earn increase the cash value(s) of the account(s). Variable universal life combines the premium and death benefit flexibility of universal life with the investment flexibility and risk of variable life.

We will briefly discuss the historical development of investment-linked policies through the review of the two bigger insurance markets: the US and the UK.

In the UK, unit-linked policies were first introduced in l957. In 1958, the government required that unit trusts could only be sold by intermediaries or by advertisements in the newspapers and for very modest commissions. This led to a problem for unit trust managers that it was almost impossible for them to produce a regular stream of sales of units. Therefore, they developed an idea to set up a regular savings plan under the form of a life insurance policy whereby the premiums would effectively be invested in a unit trust.

This type of unit-linked policies was a life insurance and not a direct holding in the unit trust. It was regulated in the same way as other forms of life insurance products; thus it was possible to sell it directly to the public by salesmen and for higher commissions. Therefore, many unit trust companies began to write unit-linked policies or make arrangements with existing life companies to offer policies linked to their own units. A number of authorized life insurers also started to develop their own unit-linked products along similar lines. At the same time, single premium unit-linked life business also began in the UK. That was considered as a better way of lump sum investment than unit trusts. Another point to note was that originally in the UK, unit trusts were not allowed to invest in property because of its illiquidity. However, there was no such limitation on single premium life insurance. If the UK people wanted to invest a lump sum in property "units", single premium unit-linked life insurance was the only option.

The unit-linked insurance market in the UK is fast growing since then and now occupies a large portion of the individual life insurance market. The main factors which have led to the popularity of this product are:

- favourable economic trends leading to good performance of unit-linked products;
- consumers finding the product attractive;
- the sales environment of aggressive marketing;
- limited regulation on sales methods;
- tax relief on premiums; and
- advance in information technology (without which it would be impossible to administer the unit-linked business).

Another major reason for the growth in the UK for unit-linked life insurance versus unit trusts was that the latter could not offer managed funds (or more recently described as balanced funds). Unit trusts were usually single entity or specialist sector investments e.g. growth, technology, geographic funds, etc. On the other hand, the internal funds of unit-linked life assurance companies could offer a managed fund investing in varying proportions of fixed interest securities, equities, properties and cash deposits without the need at the outset to fix the exact proportions.

Of the 5.2m investment and savings policies in force in the UK in 2019 (source of data: Association of British Insurers), the UK major banks have all set up their own life insurance subsidiaries and they have also concentrated on selling unit-linked products.

In the US, both universal life and variable life were first introduced in the mid-1970s. Both products gained modest success when they were first introduced. When variable life was introduced in the US, after being marketed successfully in the UK, Canada, and the Netherlands, it was considered as a product that could help offset the adverse effects of inflation on life insurance policy death benefits. Variable universal life was introduced to the US market in 1986.

The US life insurance market enjoyed a period of steady growth in premiums during the period 1995 to 2005. Then the Global Financial Crisis of 2007–2008 caused significant drops in life insurance sales in 2008 and 2009, probably owing to a decline in consumers' purchasing power and to withdrawal of supply of premium finance to institutional buyers. Individual life insurance sales have begun to recover gradually since 2010. In 4Q of 2022, the US market shares by product in terms of new premiums were as follows: fixed universal life and indexed universal life combined (32%), whole life (38%), term life (19%) and variable universal life (11%). (Source of data: LIMRA)

Hong Kong has been slower than the overseas markets in the development of investment-linked long term insurance products. They were first introduced in the late 1980’s. They gained popularity over the years because of the increasing demand of Hong Kong customers for higher returns on the insurance policies and the increasing familiarity of Hong Kong customers to investment funds especially with the introduction of the Mandatory Provident Fund Scheme in 2000.

Investment-linked long-term insurance policies are one of the major life insurance products in Hong Kong. According to the statistics published by the Insurance Authority (“IA”) on investment-linked individual life in-force business, its office premiums amounted to HKD55,035 million as at the end of 2021, constituting 11.8% of total office premiums of individual life in-force business, with the number of policies increasing by 1.9% over the previous year. In respect of investment-linked individual life new business, the amount of office premiums for 2021 was HKD30,663 million, accounting for 20.1% of individual life new business.

4.2 CHARACTERISTICS OF INVESTMENT-LINKED LONG TERM INSURANCE POLICIES

The premium rate for a life insurance policy/annuity is based on three main factors:

- cost of insurance;
- expenses to cover distribution and operation costs and to provide for contingency and profits of the authorized insurer; and
- interest/investment earnings.

The main characteristics of investment-linked policies are follows:

1. all fees and charges are made known to the policyholder;

2. premium payments net of relevant charges such as cost of insurance and expenses are invested in the policyholder's chosen investment funds accounts that are separated from the company's general assets or investments (please refer to sections **4.6.2** and **4.6.8** for the different methods of premium application);

3. the value of the policy will fluctuate with the value of the underlying investment funds. The policy benefit such as the death benefit amount or annuity payment amount or cash value thus varies with investment performance while the downside is protected by a minimum guaranteed death benefit;

4. generally offers a variety of investment funds each with a different investment strategy – such as money market, stock, bond funds etc.;

5. the policyholder takes on all the investment benefits as well as losses relating to the performance of his/her chosen investment fund; and

6. generally does not work well for too small premium amounts because deduction of expenses (some of which are in terms of fixed amounts) and cost of insurance will leave behind a very small amount available for investment.

4.3 TYPES OF CHARGES OF INVESTMENT-LINKED LONG TERM INSURANCE POLICIES

As mentioned above, one of the fundamental differences of investment-linked policies and traditional term or whole life policies is that all charges are separated and made known to the policyholder. To better understand this product, we will start with an overview and description of the charges as follows:

4.3.1 Charges

Authorized insurers charge certain fees for the provision of insurance policies to cover the marketing, distribution, administration, and insurance expenses. These will also contribute to the profit margins of the authorized insurers. These charges apply to all insurance policies. The only difference is that for investment-linked policies, they are separately specified.

(a) Cost of Insurance/Mortality Charges

The cost of insurance is to cover the mortality, annuity payment and other benefits and is mainly based on the gender, age, smoking habit, sum assured, class of risk of life assured and death benefit option. Cost of insurance for life insurance policies is also known as mortality charges. The sharing of risk of death among a large group of people is the basis of life insurance. Mortality tables that reflect the average life expectancy of each age group are often used to give companies an estimate of how much will be required to pay for death claims per year.

Authorized insurers in Hong Kong usually use various mortality tables, e.g. "Hong Kong Assured Lives Mortality Table 2018" published by the Actuarial Society of Hong Kong on 3 September 2020 and some creditable overseas mortality tables as a reference. Cost of insurance for annuities is based on Annuity Mortality Tables instead of Life Insurance Mortality tables.

(b) Policy Fee/Initial Charges

This is also described as "premium charges" and "contribution charges" by some authorized insurers. This covers the distribution, marketing and policy issue expenses of setting up a policy. The charges may be small when you look at the life of the policy. However, on the short term, it can be a sizable amount that equates the premium payments for the first twelve months of the policy.

There are three common methods to impose initial charges, depending on the terms of the investment-linked policy.

The most common method used is to charge them as a percentage of the premium payments. For example, it can be 100% of the first year regular premium payment and a specified percentage of the contributions in subsequent years, generally on a sliding scale.

The second one is the concept of "initial contribution period". While most authorized insurers have set the "initial contribution period" as the first 18 months, this can actually be extended to the first few years, or even throughout the whole term, of the policy. Alternatively, particular schemes offer the policyholder choices of initial contribution period. Units purchased during the initial contribution period will be allocated into an "initial units account" notionally created for the policy. One or more types of initial charge, usually expressed as percentages of the account value of the "initial units account", are deducted from the initial units account during specified periods, which may be longer than the initial contribution period.

The third one is the concept of "initial investment allocation ratio". For example, if the "initial investment allocation ratio" is set at 95%, then only 95% of the contributions will be invested (subject to other charges) and an initial charge of 5% is imposed.

The name of "initial charges" seems to suggest that they are only imposed at the beginning of the policy. However, they are in essence the type of charges to recover the initial cost of setting up the policy. Furthermore， whenever a policyholder increases the amount of regular premium or tops-up a single premium after policy inception, the same set of "initial charges" will be levied on the increased amount of contributions.

(c) Administration/Maintenance Fee

This is normally a fixed charge per year and/or a percentage of the premium applied to cover the authorized insurer's administrative expenses.

4.3.2 Charges related to Investment-linked Policy

(a) Bid-offer Spread

Premium payments net of insurance charges are allocated for purchase of investment fund, in accordance with the policyholder's investment strategy. The purchase of investment fund involves a charge reflected in the price difference between the purchase and sale of the investment units to the authorized insurer called the bid-offer spread.

The spread is the difference between the price at which the policyholder can buy units (the offer price) from the authorized insurer and that at which the policyholder can sell units (the bid price) to the authorized insurer.

The bid price is typically set at the Net Asset Value ("NAV"), which represents the value at which the underlying assets can be realised. Hence, when the NAV is HKD12, the bid price will normally be HKD12 and if the offer price is HKD12.60, then we would say the spread is 5% (expressed as a percentage of the bid price).

This is a charge imposed by the authorized insurer and is normally used to fund the marketing cost of the policy and the trading cost of the funds. It is normally directly proportional to the size of the policy.

(b) Fund Management Fee

This is charged by the investment fund manager for their services rendered to manage the fund. It is usually expressed as a specified percentage of the fund's market value and is used to support the authorized insurer's investment management team and may range from 0.5% to 1% per annum. The level of this charge depends on competition, the type of assets under management, the level of management activity involved and the profit requirements of the authorized insurers. For example, an index fund would normally attract a lower management charge compared to an equity fund. Pricing of the units would have taken this into account.

(c) Fund Switching Charge

This relates to the fee charged for the policyholder to amend his/her investment option and allocation from time to time, i.e. to switch his/her investments between different funds offered by the authorized insurer. Normally, authorized insurers may allow several switches per year free of charge. However, it should be noted that some authorized insurers do not impose any charges for switching.

(d) Surrender Charge

This is charged when the policyholder surrenders his/her policy through the sale of the investment fund units. The fee is normally deducted from the value of the units sold at surrender. It represents the upfront expenses that have already been incurred by the authorized insurer such as policy fee, initial charges etc., but not yet recovered. As such, the surrender fee of an investment-linked policy is normally charged on a sliding scale. The first-year surrender charge may be as high as 100% of a policyholder's contributions to cover the authorized insurer's upfront expenses.

(e) Top-up Fee

This is charged when the policyholder chooses to top-up his/her investment, i.e. to pay in further single premiums to purchase additional units. Some authorized insurers apply a flat fee or percentage charge on the top-up amount. Please refer to section **4.6.3** for an example of top-up application.

(f) Fees and Charges of Underlying Funds

Some investment fund choices available under investment-linked policies are "feeder' or "mirror" funds in the sense that contributions made into these fund choices are invested entirely into an underlying fund which in turn invests in direct investments such as shares, bonds etc. (please refer to section **3.7** for details on investment funds). This design is aimed at taking advantage of the investment management expertise of the manager of the underlying fund and economies of scale where monies from a wide range of investors are pooled together at the underlying fund level and invested.

Although the feeder/mirror fund structure has its advantages, policyholders who invest via the investment-linked policy will have to indirectly bear all fees and charges of the underlying fund, including investment management fee, custodian or trustee fee, administration fee and perhaps also subscription and redemption charge when units/shares in the underlying fund are subscribed to or redeemed by the authorized insurer on behalf of policyholders (please refer to section **3.7.3** for details of fees and charges of investment funds). These fees are in addition to whatever charges imposed at the policy level. However, depending on the relationship and bargaining power of the authorized insurer vis-à-vis the investment manager of the underlying fund, some of the fees and charges at the underlying fund level may be reduced or waived.

4.4 TYPES OF INVESTMENT-LINKED LONG TERM INSURANCE POLICIES

Investment-linked long term insurance policies include the following:

(a) Investment-linked annuities – this is a type of annuities whose annuity payment is variable according to the performance of the investment funds. Annuities are not common in Hong Kong due to the lack of demand.

(b) Investment-linked life insurance – the more common linkages are with whole life and endowment. It should be noted that the most popular type of investment-linked long term insurance policy sold in Hong Kong is known as "flexible premium variable life insurance" or "variable universal life" or "universal variable life" in the US. The policy, in addition to the investment linkage, also offers premium and sum assured flexibility. Therefore, besides the characteristics of investment-linked long term insurance policies we mentioned in section **4.2**, these policies may also include (but not mandatory) some of the following features:

(i) It usually offers flexibility in premium payments, although single premium payment options are also offered. It allows the policyholder to increase or decrease the amount of regular premiums, add top-ups to the policy at any time, or even skip premium payments for a period of time (take premium holiday), provided that the policy value is sufficient to cover the mortality charges and fees.

(ii) It offers flexibility in the sum assured. The policyholder can adjust the sum assured of the policy. Increase in sum assured is usually subject to evidence of insurability.

(iii) It offers three options of death benefit. The policyholder can choose between a level death benefit option, an increasing death benefit option, or a 105 Plan (please refer to section **4.6.6** for details).

(iv) It allows withdrawal from the policy provided that the remaining balance is sufficient to cover mortality charges and fees and no debit interest is incurred.

(c) Protection Linked Plan ("PLP") is an Investment Linked Assurance Schemes ("ILAS") product with embedded high insurance protection. PLP should at least meet the following criteria:

1. Death benefit: Before the insured reaches the age of 65, the minimum death benefit should be not less than the higher of:

   (i) 105% of account value; or

   (ii) prescribed percentage of total premiums payable less withdrawals at different issue ages before the insured reaches the age of 65.

   For issue age of 0-45, the prescribed percentage of total premiums payable before 65 is 150% or 200% or 250%. For issue age of 46-55, the prescribed percentage of total premiums payable before 65 is 150% or 200%. For issue age of 56-64, the prescribed percentage of total premiums payable before 65 is 150%.

   On or after the age of 65, the minimum death benefit should be not less than the higher of (i) 105% of the account value or (ii) total premiums paid less withdrawals.

2. Fees and Charges: The policy holder may be charged either upfront charge or surrender charge, but not both. Single ongoing fee should be charged in fixed amount or based on account value at ILAS policy level.

3. Optional protection features: Any additional protection features should be set as optional riders which require additional premium payment (i.e. unit deducting riders not allowed).

4. Investment choices: At least one investment choice linked to an SFC-authorized Environmental, Social and Governance ("ESG") fund should be provided for customers to choose. Each investment choice under the PLP should be solely linked to an SFC-authorized fund. Furthermore, at least one of the investment choices should facilitate de-risking of policy holders towards retirement[1] (e.g., life-style funds, target date funds, or arrangement that reduces investment risk as policy holders approach target retirement age, etc.)

   Investors are increasingly applying ESG factors as part of their analysis process to identify material risks and growth opportunities. Environmental criteria consider how a company safeguards the environment and how corporate policies addressing climate change. Social criteria examine how it manages relationships with

[1] The criteria of providing at least one of the investment choices facilitating de-risking of policy holders towards retirement became optional from 12 October 2022.

employees, suppliers, customers, and the communities where it operates. Governance deals with a company's leadership, executive pay, audits, internal controls, and shareholder rights.

SFC-authorized ESG funds should incorporate ESG factors as their key investment focus and reflect such in the investment objective and/or strategy. Besides, the ESG focus, ESG investment strategy, asset allocation, reference benchmark and risk should be disclosed in its offering document.

It is however important to note that the above-mentioned special features, and in particular the flexibility, are offered at a cost. The policyholder is to pay continually a higher level of charges throughout the term of the policy, even when he/she ceases paying into it, especially when he/she tops up the payment.

In July 2022, the Hong Kong Monetary Authority ("HKMA") issued the **Guidance to Authorized Institutions ("AIs") on Selling of PLP** for the purpose of providing guidance to AIs on the selling of PLP with a view to according protection to customers. It covers aspects of product due diligence, suitability assessment and product recommendation, product disclosure, audio recording and record maintenance, management oversight and protection of vulnerable customers.

4.5 PREMIUM STRUCTURES OF INVESTMENT-LINKED POLICIES

We can generally classify investment-linked policies into two categories which are differentiated by its premium structure: single premium plan and regular premium plan. It should be noted that in 2008, 74.4% (in value) of the office premiums of new investment-linked business were in the form of single premium payments, the remaining 25.6% being regular premium payments. In 2021, the percentages were 71.4% and 28.6% respectively.

4.5.1 Single Premium Plan

Investment-linked policies that are financed by single premiums are for individuals who have a large capital sum at their disposal. In addition to the value of protection, they will be looking for a long-term and profitable investment alternative that will also provide them with the freedom to implement their own investment strategy.

4.5.2 Regular Premium Plan

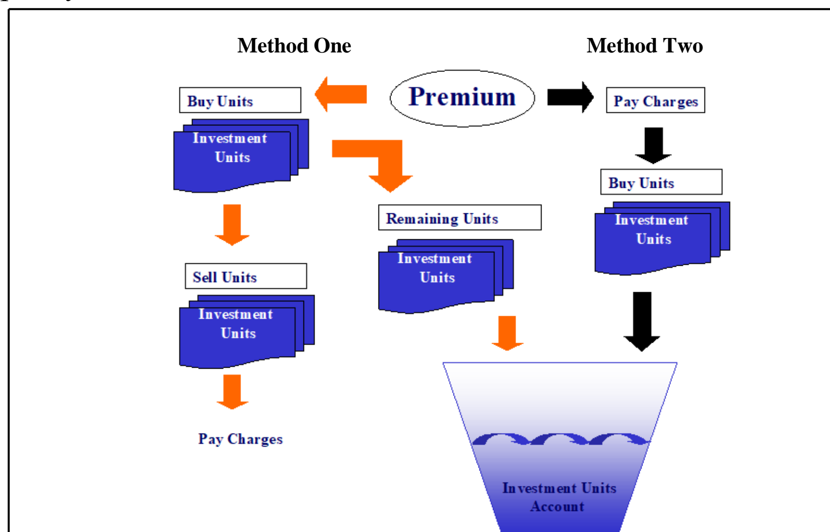
Investment-linked policies financed by regular premiums are for individuals who want to build up savings on a regular basis. Also, in addition to the value of protection, they will enjoy a flexible investment strategy as well as the ability to spread the risk of investment with small amounts of capital investment through unit participation in various investment funds.

4.6 BASIC CALCULATIONS OF SINGLE PREMIUM AND REGULAR PREMIUM INVESTMENT-LINKED POLICIES AND THEIR DEATH BENEFITS

4.6.1 Basic Calculations of Single Premium Policies

Initially, a single premium is paid to the authorized insurer. Insurance charges are deducted from the premium either initially when the premium is paid or at regular intervals (monthly, annually etc.) throughout the life of the policy. The remainder is used to purchase units of the selected investment funds.

There are generally two ways used by an authorized insurer to deduct insurance charges from the premium. One method is to convert the entire premium into investment units and then convert the appropriate number of units back into cash to cover the relevant charges. The other method is to deduct the relevant insurance charges upfront with the remaining to be converted into investment units for the policyholder's investment account.



The following example is used to demonstrate the calculation of premium application, top-up, withdrawal or partial surrender benefit, the two types of death benefit options, applicable in the case of a single premium policy. An example on the calculation of return on gross premium is also illustrated. For simplicity of illustration, we will assume that only life cover is purchased, no other rider benefits are attached to the policy and the investment has been put into one single fund.

Assuming:

Single premium = HKD50,000
Current NAV per unit of investment fund = HKD12
Bid-offer spread = 5%

4.6.2 Premium Application Method One

One of the practices is to apply all of the HK50,000 premium into the purchase of investment fund units. Bid price as mentioned earlier is usually set at the net asset value ("NAV"). Given the bid-offer spread of 5%, with the bid price at HKD12, the offer price can be calculated as HKD12 x (1 + 0.05), or HKD12.60. That is, the authorized insurer will sell the units for this investment fund at HKD12.60 each.

The number of units that can be purchased will be 50,000/12.60, i.e., 3,968.25 units or, in other words, the fund will allocate 3,968.25 units to this policy.

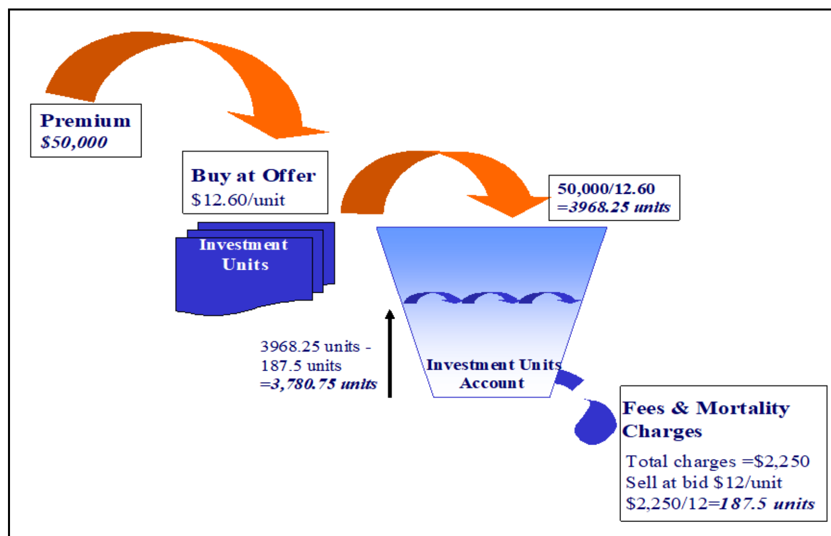
Assuming:
Policy fee = HKD1,000
Administration and mortality charges for the entire duration of the policy
= **2.5% of premium

** It is an assumed rate because we will not get into the mortality rate of the specific policyholder. Charges and fees will be collected through the cancellation of units. We will assume that all charges and fees are deducted at inception and that other selling expenses are charged into the bid-offer spread. Then, the number of units which is required to be cancelled (cashed) would be:

Policy fee = HKD1,000
Administrative and mortality charge = HKD50,000 x 2.5% = HKD1,250
Total charges = HKD1,000 + HKD 1,250 = HKD2,250

Since the units will be cancelled at the bid price, i.e. HKD12

Number of units to be cancelled = 2,250/12 = 187.5
Hence, the number of units left = 3,968.25 - 187.5 = 3,780.75



4.6.3 Top-up Application

If the policyholder wants to top-up HKD20,000 two years after the inception of the policy.

Assuming:
Top-up fee = HKD200
Administrative charge = 1.5% of top-up premiums applied

Assuming that the unit price does not fluctuate but grows at a flat rate of 8% per annum for two years from the initial bid price of HKD12.

Bid price in year one = HKD12 x 1.08 = HKD12.96
Bid price in year two = HKD12.96 x 1.08 = HKD14.00

Or = HKD12 x 1.08^2
= HKD12 x 1.1664 = HKD14.00

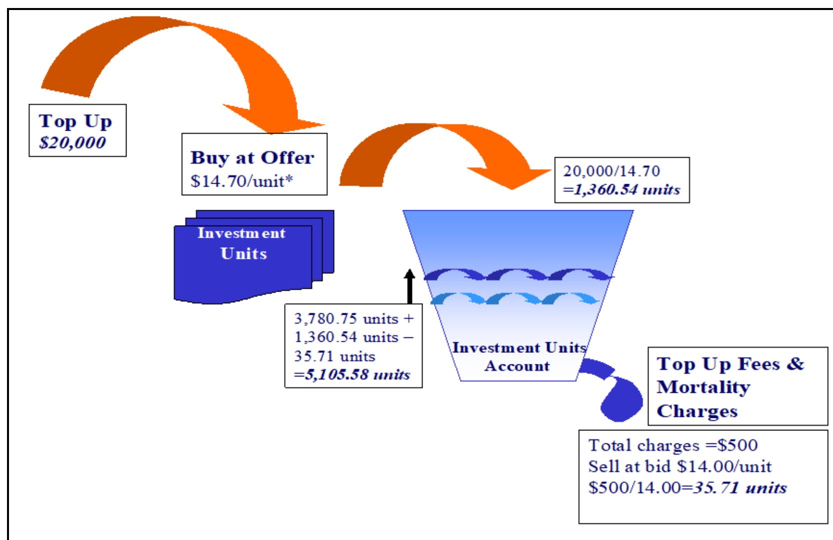
Offer price in year one = HKD12.60 x 1.08 = HKD13.61
Offer price in year two = HKD13.61 x 1.08 = HKD14.70

Number of additional units that can be purchased
= 20,000/14.70 = 1,360.54

Administrative charge = HKD20,000 x 1.5% = HKD300
Total charges for top-up = HKD200 + HKD300 = HKD500
Number of units to be cancelled = 500/14.00 = 35.71

Additional number of units purchased = (1,360.54 - 35.71) units = 1,324.83 units

Total holding (in number of units) = (3,780.75 + 1,324.83) units = 5,105.58 units

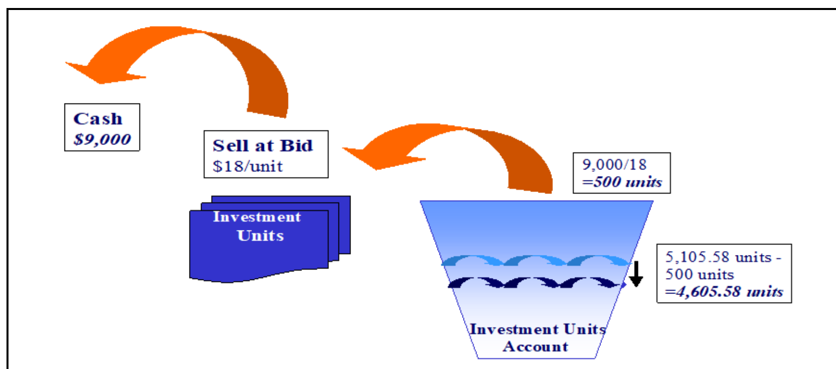


4.6.4 Partial Withdrawal (Partial Surrender) Benefit

One of the features of investment-linked policies is that the policyholder can withdraw, or surrender (subject to withdrawal/surrender charge) all or part of the units at the bid price at any time (some policies may specify minimum amount of withdraw/surrender).

If the policyholder now wishes to withdraw, say HKD9,000, at a bid price of HKD18, the number of units that has to be cancelled is 9,000/18 = 500 units

The number of remaining units = 5,105.58 - 500 = 4,605.58 units



4.6.5 Surrender Value

If, instead of a partial withdrawal, the policyholder chooses to surrender the whole policy (again at a bid price of HKD18), the surrender value will be:

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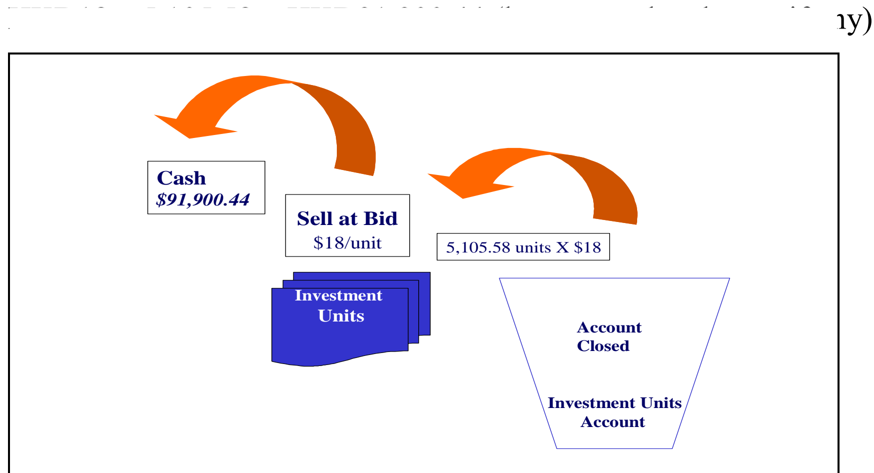


4.6.6

Three types of death benefits options are commonly available with investment-linked policies: increasing death benefit, level death benefit, or 105 plan.

(a) Increasing Death Benefit ("IDB")

The death benefit will be the value of the units accumulated in the policyholder's account, at the date of death, plus the chosen death cover. Under an increasing death benefit, and assuming the coverage is, say 150% of the single premium, the sum assured payable at death is:

Sum assured at death = **value of units (at the date of death) at bid price + 150% of HKD50,000

Based on the above example where the number of units left in the policy, after the HKD20,000 top-up and the HKD9,000 withdrawal, is 4,605.58 units, and assuming the bid price at the date of the death claim is HKD20, the sum assured is:

HKD20 x 4,605.58 + HKD50,000 x 150%
= HKD92,111.60 + HKD75,000 = HKD167,111.60

(b) Level Death Benefit ("LDB")

The death benefit will be the higher of the value of units accumulated in the policyholder's account at the date of death or the chosen death cover.

Under a level death benefit, assuming that the coverage is, say 150%, the sum assured payable at death is:

Sum assured at death = **value of units (at the date of death) at bid price or 150% of HKD50,000, whichever is the higher

Again, based on the above example where the number of units left in the policy, after the HKD20,000 top-up and the HKD9,000 withdrawal, is 4,605.58 units, and assuming the bid price at the date of the death claim is HKD20, the sum assured is:

The higher of HKD20 x 4,605.58 or HKD50,000 x 150%, i.e. the higher of HKD92,111.60 or HKD75,000.

The sum assured payable at death will be HKD92,111.60 since this is the higher value.

(c) 105 Plan

105 Plan generally has a smaller insurance protection element as opposed to policies with either increasing death benefit or level death benefit.

The death benefit of 105 Plan will be 105% of the value of the policy account.

Sum assured at death = **value of units (at the date of death) at bid price x 105%

** It should be noted that, for simplicity of illustration, we have used the same mortality charges for the IDB, LDB, and 105 Plan calculations, thus the three options have the same value of units at the date of death. In actual case, the mortality charges or cost of insurance will depend upon the type of death benefit option chosen and the mortality charge for IDB will always be more expensive than that of the LDB while most 105 Plans only attract minimal insurance charge. When the mortality charges are higher, the amount of premium invested in the investment funds will be smaller and thus the total number of units accumulated in the policyholder's account should also be smaller.

Based on the above example where the number of units left in the policy, after the HKD20,000 top-up and the HKD9,000 withdrawal, is 4,605.58 units, and assuming the bid price at the date of the death claim is HKD20, the sum assured is:

HKD20 x 4,605.58 x 105%
= HKD96,717.18

4.6.7 Return on Gross Premium

This is a calculation most authorized insurers will use on their illustration documents to provide an estimated return for various investment related products.

The calculation takes into account the compound rate of return and is calculated as follows. Using the above example where the policyholder starts with HKD50,000 and has been allocated 3,780.75 units (after all the charges). The initial unit bid price is HKD12. In 10 years' time, HKD12 will be HKD25.91 assuming a growth rate of 8%. Thus, in 10 years' time, the value of the units will be 3,780.75 x HKD25.91 = HKD97,959.23. The return on gross premium using the same HKD50,000 as per the previous example will be calculated as follows:

(Please refer to **Appendix A** for the concept of compound rate of return.)

Let r be the rate of return on gross premium per annum.

$$HKD50,000 \times (1 + r)^{10} = HKD97,959.23$$

$$(1+r)^{10} = HKD97,959.23/HKD50,000$$

$$= 1.9592$$

$$(1+r) = 1.9592^{1/10}$$

$$= 1.0696$$

$$r = 1.0696 - 1$$

$$= 0.0696$$

$$= 6.96\%$$

4.6.8 Premium Application Method Two

Another method that is sometimes used for the calculation of the number of units allocated to the policy is to deduct the policy fee, and the administrative and mortality charges from the single premium before applying the net balance to purchase the units.

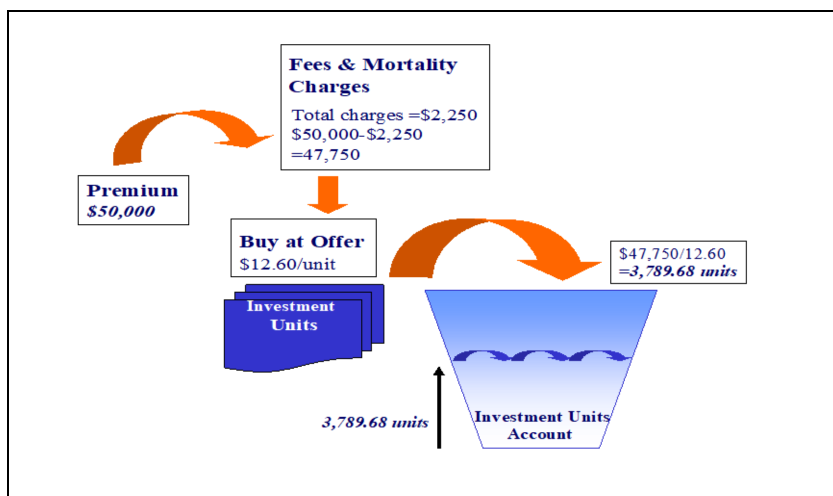
Assuming:
Single premium = HKD50,000
Policy fee = HKD1,000
Administrative and mortality charges = HKD50,000 x 2.5% = HKD1,250

Net premium for investment = HKD50,000 - HKD 1,000 - HKD 1,250
= HKD47,750

As the current NAV (bid price) is HKD12, the offer price is HKD12.60 (please refer to section **4.6.2**), the number of units purchased is therefore 47,750/12.60 = 3,789.68 units. It should be noted that the number of units that is attributable to the policyholder is slightly higher due to the fact that the policy fee and the administrative and mortality charges do not suffer the bid-offer spread.

Another method commonly used in Australia and the UK is for the policy fee, administrative and mortality charges to be deducted at regular interval, e.g. monthly, throughout the life of the policy even for the single premium policy.

The application of top-up, withdrawal, surrender, IDB, LDB, and 105 Plan will follow the same calculations as previously illustrated.



4.6.9 Basic Calculations of Regular Premium Policies

Regular premium policies operate under similar principles as single premium policies. The major difference is that the policyholder pays premiums regularly. The policyholder has the flexibility of being able to vary the level of regular premium payments and make single premium top-ups or skip premium payments for a period of time.

It should be noted that depending on each authorized insurer's level of commission and expense charges, during the first year, although the policyholder is assigned some units, quite a substantial part of these units might have been redeemed to pay for the "long-term" charges due to the initial distribution and policy issuance cost incurred by the insurer at the initial stage. As such, the policyholder of regular premium policies might not own any investment units for the first year of premium payments. A typical structure of premium allocation may be as follows:

Year 1	Net of initial charges, monthly administration and mortality charges 0% will be invested
Year 2	Net of initial charges, monthly administration and mortality charges 50% will be invested
Year 3 & After	Net of monthly administration and mortality charges 100% will be invested

In this example, we assume that all initial charges are amortised over two years with a heavier allocation for year one. Through this example, we can see why it is costly for the policyholder to surrender the policy within the first few years of purchase.

It should be noted that some authorized insurers do not use the above initial charge amortisation but choose to amortise it over a longer period of time. This will result in the allocation of some units in the policyholder's investment account, even during the first year. However, in doing so, the authorized insurer is taking the risk of not being able to recover all of its upfront expenses in the event the policy is cancelled within the first couple of years after issuance. In this situation, the authorized insurer may impose a surrender charge to recover the upfront expense.

4.6.10 Monthly Application of Regular Premium

Method one of deduction is the normal practice of authorized insurers used in Hong Kong, that is, they will convert all monthly premiums into investment units and then cancel sufficient units to cover monthly charges.

Calculations are similar to single premium except that mortality charges for the life of the policy under single premiums are usually fully deducted at the commencement of the policy, and mortality charges for regular premium policies are calculated monthly and are deducted from the investment account.

There are different types of death benefit options, and the calculations in respect of IDB and LDB will be slightly different for regular premium versus single premium. These are separately illustrated in the following paragraphs. Since most 105 Plans only impose minimal insurance charge, no calculation will be shown here.

Example Calculations:

Assuming:
Rate of annual cost of life cover = HKD6 per thousand
Chosen death cover = HKD500,000
Number of units in the investment account = 400
Bid price = HKD12
Offer price = HKD12.60
Monthly policy fee = HKD30
Monthly premium = HKD500

1. Increasing Death Benefit (IDB)

IDB = value of account + sum assured (chosen death cover)
Value of account = 400 x HKD12 = HKD4,800
Sum assured at death = HKD4,800 + HKD500,000 = HKD504,800

Deduction Calculations:

Units purchased per month = 500/12.60 = 39.68 units
Amount at risk = chosen death cover = HKD500,000

Mortality charge for one month
= rate of annual cost of life cover x (1/12) x amount at risk
= HKD(6/1,000) x (1/12) x HKD500,000
= HKD250

Total charges plus policy fee = HKD250 + HKD30
= HKD280
Number of units to be cancelled = 280/12
= 23.33 units
Total number of units remaining = (400 + 39.68 – 23.33) units
= 416.35 units

2. Level Death Benefit (LDB)

LDB = the higher of value of account OR sum assured (chosen death cover)
Value of account = 400 x HKD12 = HKD4,800
Sum assured at death = HKD500,000
LDB = HKD500,000 (higher of HKD4,800 or HKD500,000)

Deduction Calculations:

Units purchased per month = HKD500/12.60 = 39.68 units
Amount at risk = chosen death cover less account value
= HKD500,000 - HKD4,800
= HKD495,200

Mortality charge for one month
= rate of annual cost of life cover x (1/12) x amount at risk
= HKD(6/1,000) x (1/12) x HKD495,200
= HKD247.60

Total charges plus policy fee = HKD247.60 + HKD30
= HKD277.60

Number of units to be cancelled = 277.60/12
= 23.13 units
Total number of units remaining = (400 + 39.68 – 23.13) units
= 416.55 units

As the mortality charges are calculated monthly and are deducted from the account, it is very simple for the authorized insurer to allow the policyholder to vary the chosen life cover over time. The increase in life cover is subject to evidence of insurability. Because of this feature, investment-linked policies enjoy a substantial advantage over traditional policies in flexibility. Monthly charges for other benefits like dread disease, total and permanent disability and accidental benefits are calculated in a similar way.

4.7 STRUCTURES OF INVESTMENT-LINKED FUNDS

Similar to the majority of investment funds, investment-linked funds are generally structured as follows:

(a) **Accumulation Units**: all profits generated from the investments are "accumulated" and reinvested back into the original fund; thus enhancing the price of the units. The number of units held will remain the same.

(b) **Distribution Units**: all profits generated from the investments are "distributed" as bonus units to the investors; thus increasing the number of units held. The price of the units will remain the same.

As the policyholder will be entitled to all the profits generated, or all the losses incurred, from the investments, he/she will therefore benefit, or suffer, either from the higher, or lower, unit price (accumulation units) or the increased, or decreased, number of units (distribution units).

4.8 TYPES OF INVESTMENT-LINKED FUNDS

In theory, an investment-linked insurance policy can be linked to any type of investment funds. There are many types of investment funds, ranging from conservative funds (money market funds) to risky funds (warrant funds). Their classification is usually based on the stated investment objectives and underlying investments of the funds.

Authorized insurers usually offer a wide range of funds to the policyholder. According to the individual policyholder's investment strategy, he/she may first select the appropriate investment funds, and then form his/her own investment portfolio by allocating weights to the funds selected. For example, he/she may select Funds A, B, C and D and allocate 40% of the investment in Fund A, 30% in Fund B, 20% in Fund C and 10% in Fund D. The contributions will be invested according to this allocation. Authorized insurers usually allow the policyholder to switch funds or alter the portfolio at any time.

Fund allocation is very important to balance the risk and return of the portfolio. It is therefore desirable that insurance intermediaries understand and are able to present the benefits and disadvantages of different type of funds for the policyholders to make their final decision.

In Hong Kong, most authorized insurers categorise their funds as deposit fund and unitised funds. They will be briefly summarized in the following sections.

4.8.1 Deposit Fund

This is a notional interest-bearing fund. Unit offer price of the funds is typically set at HKD1,000. Interest, in the form of units being purchased at the unit offer price, will be credited to the account.

This allows the small investors to invest in money market instruments. This is also called money market fund or money fund.

Principal objective:	to invest in short-term money markets instruments in order to provide stable income with minimal capital risk
Special features:	open-ended; unit offer price remains constant (e.g. HKD1,000); interest credited to the account as units purchased; and participation in short-term investment instruments.
Advantages:	the safest, the most stable; higher return than bank deposits; and asset liquidity.
Disadvantages:	interest rate may fluctuate; and relatively low return.

4.8.2 Unitised Funds

These are specific, separately managed funds, either managed by the authorized insurer itself or independent fund managers. Some of the commonly used types of investment funds are outlined as follow:

(a) Bond Fund

Principal objective:	to provide stable income with minimal capital risk
Special features:	investing in bond market; being equivalent to a diversified bond portfolio; debt securities issued by governments or large corporations; and some may invest in higher yield junk bonds.
Advantages:	higher return than money market fund; fund managers can trade and take advantage of interest rate movements; and usually can cover inflation.
Disadvantages:	risk of rising interest rate; and credit risk of issuer.

(b) Equity Fund

Principal objective: to achieve higher long-term capital appreciation

Special features:	investing in equity market; more suitable for long-term investment; and being equivalent to a diversified shares portfolio.
Advantages:	higher historical return; good hedge against inflation; and full utilisation of fund manager's expertise.
Disadvantages:	higher management fee may be charged; higher risk than bond funds; and risk of company failure.

(c) Index Fund

Principal objective:	to mirror specific index performance
Special features:	passive management; automatic investment decisions; limited number of transactions; and may also be tied to non-equity indices.
Advantages:	easy to understand; lower management fee; less risky than index futures; and hedging available.
Disadvantages:	cannot capitalise on market movements; only track market performance; cannot outperform market; and unwelcome during a bear market.

(d) Warrant Fund

Principal objective:	to achieve exceptional high return
Special features:	investing mainly in warrants; and leverage through the use of warrants.
Advantage:	possible high return
Disadvantage:	extremely high risk

(e) Global Fund

Principal objective:	to invest in stocks or bonds throughout the world
Special feature:	international investment
Advantages:	diversification; and capture overseas investment opportunities.
Disadvantages:	currency, political risks; complicated custodian arrangement; differences in accounting procedures; and lesser degree of public information.

(f) Regional/Country Fund

Principal objective: to invest in a specific region or country

Special feature: typically closed-end funds, could as well be open-ended funds

Advantages: potentially high growth; and
capture the opportunity of a region.

Disadvantages: high risk;
low liquidity; and
lack of diversification.

(g) Specialty Fund

Principal objective: to invest in a specific industry/sector and capitalise on the return potential

Special features: concentration in one particular industry; and
high risk, high return.

Advantages: potentially high growth;
full utilisation of fund manager's knowledge on the particular industry; and
capture the opportunity of an industry.

Disadvantages: higher risk potential;
lack of diversification; and
low liquidity.

(h) Income Fund

Principal objective: to generate current income rather than to achieve growth

Special features: dividends from preferred stocks; and
coupon payments from bonds.

Advantages: regular income;
medium risk; and
good liquidity.

Disadvantage: relatively low capital appreciation

Some income funds maintain more aggressive objectives than others.

(i) Balanced Fund

Principal objective: to achieve both income and capital appreciation and to avoid excessive risk

Special features:	investing in a combination of stocks and bonds; emphasising the growth potential of stocks; relative stability of income from bonds; and mid-way between bond and growth fund.
Advantages:	balanced risk and return; and diversification.
Disadvantages:	medium return; and may not fully capitalise on a bull market.

(j) Growth Fund

Principal objective:	to achieve maximum capital appreciation rather than a flow of dividends
Special features:	investing in growth stocks; and may invest in smaller, lesser-known companies out of mainstream market which fund managers believe possess dynamic potential.
Advantages:	higher growth rate; and full utilisation of fund manager's expertise.
Disadvantages:	some fund managers may adopt highly aggressive/ speculative strategy; extremely high risk; and no consistent income/dividend flow.

(k) Guaranteed Fund

Principal objective:	to be neutral to negative market performance with a guarantee on the principal/return
Special feature:	guaranteed amount will be paid upon maturity
Advantage:	no risk of principal
Disadvantages:	application of high guarantee fee; minimum investment period applicable; special conditions may apply; and relatively lower return.

(l) Fund of Funds (Unit Portfolio Management Funds)

Principal objective:	to carry out diversified professional management
Special feature:	investing in other mutual funds
Advantage:	diversification
Disadvantage:	higher management fee may be incurred

4.8.3 Switching

Most authorized insurers in Hong Kong selling investment-linked policies will offer more than one fund to its policyholders. The policyholders will be allowed to switch funds or alter their investment portfolios from time to time.

The switching facility benefits the policyholders in the implementation of an optimal investment portfolio to fit their personal investment objective or to react to changes in the financial markets. For example, as retirement age approaches, the policyholders may wish to switch their investment from a more aggressive equity fund to a more stable and liquid income fund. Alternatively, at some stage of the investment, the policyholders may wish to switch their investment from a balanced fund to a specialty fund (e.g. a technology fund) to take advantage of the growth potential in that particular industry.

4.9 BENEFITS OF INVESTING IN INVESTMENT-LINKED POLICIES

As the investment performance of an investment-linked policy is directly linked to that of the underlying investment fund, it inherits all of the benefits as well as the risks (please refer to section **3.7.4**) of an investment fund.

When compared with other types of life insurance products, the major advantage of an investment-linked policy lies in the potential return on investment and flexibility. This flexibility allows an appropriate insurance programme to be tailored to each individual policyholder. Some of the benefits are outlined as follows:

(a) **Wide Spectrum of Investment Choices**: The policyholder, in addition to the death benefit cover, will have the opportunity to devise his/her own investment portfolio based on the number of funds available to suit his/her investment objective. The policyholder can design his/her own investment strategy and invest into different investment funds offered by the authorized insurer to balance his/her risk/return preference. He/she can also choose to switch between different funds to fit his/her own investment needs during different stages of his/her life cycle, or take advantage of the prevailing market condition.

(b) **Flexible Premium**: One of the most attractive features of investment-linked policies is that the policyholder has the option to vary the premium, that is, to increase or decrease the amount of regular premiums to be paid as well as to add top-ups to the policy from time to time.

Flexible premium enables the policyholder to pay higher amounts when his/her cash flow is strong. Provided that the balance in the investment account is sufficient to cover fees and related investment charges, the policyholder can also reduce, or stop altogether, payment of premium in situations where his/her cash flow is insufficient, e.g. when he/she loses his/her current job.

(c) **Variable Sum Assured**: In addition to the flexibility of varying premiums, a policyholder can vary the sum assured. In the regular premium investment-linked policies, a policyholder can choose his/her own sum assured, within certain limits, for any given premium. Subsequent to the completion of the contract, he/she can still adjust the sum assured up or down (again within certain limits) according to his/her new circumstances. Normally, such variations are subject to one change per year and underwriting requirement.

Compared to traditional whole life insurance, this is a convenient and lower cost version to increase the sum assured. The reason is that most whole life policies do not allow the increase of sum assured and thus a new policy will have to be issued for the additional amount.

(d) **Variable Death Benefit**: There are three common options of death benefit. The policyholder can choose a level death benefit option, an increasing death benefit option or only 5% of the policy account value (under the 105 Plan). Please refer to **4.6.6** for the concept of Death Benefit. It should be noted that a healthy and successful investment portfolio will increase the death benefit of the policy in the long run.

(e) **Partial Surrender/Withdrawals Allowed**: The policyholder is usually allowed to make withdrawals for a specific minimum amount provided that the remaining balance is sufficient to cover fees and related insurance charges. Such a withdrawal is achieved by cashing in the number of units necessary to give the withdrawal amount.

Compared to traditional life policies, the benefit of investment-linked policies is that the policyholder has the option of withdrawing units/cash from the policy without having to take out a policy loan where interest costs will be incurred, or to surrender the policy in return for a surrender value and thus losing the protection.

(f) **Capture the Benefits of Investing in Investment Funds**: A couple of obvious benefits derived from investing in investment funds include the access to professional fund management expertise and to a diversified portfolio through limited capital requirement.

4.10 RISKS OF INVESTING IN INVESTMENT-LINKED POLICIES

There are a number of risks associated with investing in investment-linked policies:

Market Risk: Performance of investment funds is not guaranteed and may go up and down. Since the values of investment-linked policies are directly related to the performance of their underlying investments, the poor performance of the chosen investments can potentially reduce the values of the policies. As such, while the potential yield of investment-linked policies may be higher than that of traditional policies, they can also be lower depending on the performance of their underlying investments.

Liquidity Risk: Unlike investment into direct investment funds, investment-linked policies have an additional time factor to be considered. The policies are usually established for a pre-determined period with a lifespan of at least 5 years with the initial costs to insurers heavily stacked at the beginning of the term. Thus, as discussed previously, early redemption of these policies will be subject to very high encashment charges because of the deduction of fees and charges to cover the upfront expenses of the insurers.

Other Risks, including the following:

- Insurers and fund managers are subject to credit and insolvency risks.
- Those with whom the client has entered into a financial contract may fail to fulfil their obligations under the contract.
- The values of the policy and the underlying funds are subject to foreign exchange risk.
- The funds put into the policy are subject to reinvestment risk should any investment be suspended or subject to a prolonged turnaround time to trade.

- If monies paid into the policy are funded by premium financing, leverage or gearing, and if the rate of return of the policy is lower than the interest rate payable for the premium financing, leverage or gearing, there is a risk of financial loss caused by such interest rate risk.
- If the policyholder ceases premium payments temporarily by virtue of a policy provision of "premium holiday", he will face the risks of reduced policy value, reduced bonuses, and even a policy lapse.

4.11 COMPARISON OF INVESTMENT-LINKED LONG TERM INSURANCE POLICIES WITH GUARANTEED AND WITH-PROFITS POLICIES

4.11.1 Guaranteed Policies/Without-Profits/Non-Participating Policies

These products guarantee a fixed rate of return to policyholders in terms of death benefit and cash value, if any. Examples are term insurance and non- participating whole life and endowment insurance. These policies are sold on a guaranteed cost basis, meaning that all policy elements (i.e., the premium, the face amount, and the cash values, if any) are guaranteed and will not vary with the experience of the company.

4.11.2 With-Profits/Participating Policies

Examples of such policies are with-profits (participating) whole life and endowment insurances. These policies are entitled to receive a share of (participate in) the divisible surplus (profits) of the authorized insurer. These are normally paid in the form of dividends which will be credited into the account. For authorized insurers using UK style practice, they will use bonus systems which include reversionary bonus, performance or terminal bonuses.

4.11.3 Comparison Criteria

Basically, we should compare investment-linked long term insurance policies with other conventional life insurance policies based on the following criteria:

- Investment returns and risks;
- Investment option;
- Premium;
- Death benefit;
- Death benefit option;
- Cash value;
- Partial withdrawal; and
- Authorisation by Securities and Futures Commission ("SFC").

The comparison is summarized in the following table:

Criteria	Guaranteed Policies / Without-Profits Policies / Non-Participating Policies	With-Profits Policies / Participating Policies	Investment-linked Policies
Investment Returns and Risks	Fixed amount of payment will be made on death or at maturity, therefore no investment risks for these products except the risk of insolvency of the authorized life insurer. However, the returns are low.	The returns are linked to the authorized insurer's overall investment performance. Hence it offers returns which are "smoothed" because authorized insurer contributes into reserves in good investment years and draws from reserves in bad years. Smoothing can also be achieved by way of offering bonuses and imposing market value reduction, where appropriate. Future bonus/dividends are never guaranteed.	The investment risk is higher and borne by the policyholders. The policy values vary according to the values of the investment funds. As such, the benefits and risks of these products accrue directly to the policyholders and no smoothing is made, unlike a with-profits policy. The risk or volatility of returns depends on the investment strategy of the fund.
Investment Option	No	No	Yes
Premium	Fixed Increasing or level during the term for term policies and usually level for non-participating whole life and endowment policies.	Fixed and usually level	Flexible. Allow to change premium payments, to take premium holidays and to add premium top-ups. Also, the authorized insurer may vary some of the charges made under the policy. If future experience diverges from what had been assumed when the product was priced, it may vary charges. Hence, there is an initial pricing exercise and on-going review, comparing actual experience with what has been assumed.

Criteria	Guaranteed Policies / Without-Profits Policies / Non-Participating Policies	With-Profits Policies / Participating Policies	Investment-linked Policies
Death Benefit	Level/increasing/decreasing for term policies, level for non-participating whole life and endowment policies.	Generally, fixed and level	Variable, based on investment performance but there is a minimum death benefit payable upon the death of the life insured.
Death Benefit Options Available	No	No	Yes, usually three options are available. They are "Increasing death benefit", "Level death benefit", and "105 Plan".
Cash Value	No cash value for term policies. Fixed and guaranteed, if any, for non-participating whole life and endowment policies.	Generally, fixed and guaranteed	Variable, based on investment performance. Not guaranteed
Partial Withdrawal Permitted	No	Generally, dividend withdrawal permitted, or in the form of Partial Surrender	Yes, usually permitted in the form of Partial Surrender which may be subject to withdrawal charges.
Authorisation by SFC	Not required	Not required (Please refer to **Note** below)	Required

Note: Depending on the features and characteristics of the policy, some with-profits policies/ participating policies may be classified as Class C business and as such constitute as collective investment schemes under the **"Securities and Futures Ordinance"** and require authorisation by the SFC. Please refer to section **1.1** for the detailed classification of Class C business.

4.12 TAXATION

Under the laws of Hong Kong, returns on investment are not subject to capital gains tax. It follows that the investment returns generated by the underlying investment funds of the investment-linked policies will normally not be taxable.

It should however be noted that overseas residents may be subject to the tax laws of their respective countries and this can be very restrictive. Prospective policyholders should be advised to obtain their own independent tax advice.

4.13 SALES PRACTICE

The industry and the regulatory authorities are equally concerned about the manner in which investment linked assurance schemes (or ILAS products) would be sold by insurance intermediaries and how they would be understood by clients.

4.13.1 Customer Protection Requirements Relating to Sale of Investment Linked Assurance Schemes ("ILAS")

To better protect customers of ILAS products, the IA published a set of enhanced guidelines entitled "**Guideline on Sale of Investment-Linked Assurance Scheme ("ILAS") Products**" (GL26) which took effect from 23 September 2019 for compliance by authorized insurers and insurance intermediaries that sell ILAS products, and is supplementary to the **Guideline on Underwriting Class C Business** (GL15) which stipulates proper standards of conduct and business practices for authorized insurers underwriting linked long term business, i.e. ILAS products, covering requirements in relation to both the design of ILAS products and the sale process for ILAS products (please refer to section **5.2.6**). The "**Guideline on Financial Needs Analysis**" (GL30) issued by the IA also took effect from 23 September 2019 to supersede the "Initiative on Financial Needs Analysis" issued by the Hong Kong Federation of Insurers ("HKFI"), which applies to Class C business as well as Class A business (subject to specified exceptions). Please refer to **Appendix B2** for the full version of the GL30.

The HKMA and the SFC, in close working relationship with the IA, issued corresponding circulars in April 2013, May 2013, December 2014, July 2015, April 2018, September 2019 and July 2022 respectively to introduce or update enhanced requirements or measures applicable to the sale of ILAS products. The HKMA has since 2009 imposed on all its authorized institutions a mandatory requirement for audio-recording of the sales process of ILAS products. It has also requested them to produce a product key facts statement (as prescribed by the SFC; please refer to section **4.13.2 (c)** for details) for their prospective ILAS clients since 2011. The HKMA's circular issued in December 2014 also requires its authorized institutions to provide prospective clients with Important Facts Statements (as introduced by the HKFI; please refer to section **4.13.1 (e)** for details). For detailed requirements set out by the SFC, please refer to sections **4.13.2 (b)** and **(c)**, **4.13.3**, **4.15** and **5.3**.

Below is a summary of the IA's GL26. For the full version of the Requirements, please refer to **Appendix B1** to the Study Notes.

(a) Purposes

The purposes of the GL26 is to guide the authorized insurers and licensed insurance intermediaries to ensure customers, before they purchase ILAS products, are fully apprised of the nature, key features and risks of such products, as well as the rights and obligations associated with such products.

GL26 supplements GL15 by including more detailed requirements on the sale process for ILAS products and setting out the minimum standards and practices that should be implemented and adopted by authorized insurers and licensed insurance intermediaries in that sale process. The aim is to achieve the objectives stated above and ensure fair treatment of customers.

(b) Fair Treatment of Customers in the Sale Process for ILAS Products

Authorized insurers and licensed insurance intermediaries should ensure that the sale process for ILAS products is fair to customers. In this regard, the suitability of an ILAS product (including its underlying investment choices) for a customer should be properly assessed with due regards to the customer's circumstances. An ILAS product should only be recommended if it is considered suitable to meet the customer's insurance, financial and investment needs. During the sale process of an ILAS product, the risks associated with the product, its key features and the fees and charges structure (including those of the underlying investment choices) and the fact that the customer has a cooling-off period (i.e. information included in Important Facts Statements ("IFS") need to be fully disclosed and explained to the customer, and the customer should be given adequate opportunity to consider these before deciding to purchase the product. The sale process for an ILAS product should cover certain steps as stipulated in 4.2 of GL26 (see Appendix B1). The insurance intermediary must also strictly follow the proper selling process for ILAS products as set out in clause 12.2 of and in the Appendix to GL15 (please also refer to section 5.2.6).

(c) Financial Needs Analysis (FNA)

The objective of the FNA process is for an assessment of a customer's circumstances including needs, financial situation, ability and willingness to pay premiums, etc., to be made before a recommendation in respect of a suitable life insurance product (including an ILAS product) is made to the customer. Authorized insurers and licensed insurance intermediaries should use the FNA process as part of the sale process for an ILAS product to achieve this objective.

In the FNA process, if the prospective customer indicates that one of the customer's objectives for seeking an insurance product is "investment", information must be collected during the FNA process about whether the customer is able and willing to make his/her own decision to choose and manage different investment choices available under an ILAS product before an ILAS product should be introduced or recommended to the customer.

According to the detailed requirements for the FNA set out in GL30, an FNA must be performed for every application for a new life insurance policy, unless the type of policy is exempted, such as term insurance, refundable insurance, group policies, etc. As such, neither authorized insurers nor customers can opt out of the FNA. Authorized insurers must require the intermediaries to carry out an FNA (including comparison of different insurance options) with the customers before recommending to them any life insurance products and signing the application, while the licensed insurance intermediary cannot recommend any insurance product to the customer if he/she refuses to disclose information during the FNA process.

Intermediaries should take into account the relevant information provided by customers in an FNA before making any recommendation. Where an ILAS product may be recommended to a customer, information must be collected during the FNA process about whether the customer is able and willing to make his/her own decision to choose and manage different investment choices available under the ILAS product. The factors considered, evaluation, and reason(s) for the recommendation made by the selling intermediary should also be included in the FNA.

The FNA form must include all the questions and multiple-choice options in the FNA template as set out in the Appendix of the GL30, including but not limited to objectives for seeking to purchase an insurance product, ability and willingness to pay insurance premiums, monthly disposable income, etc. Authorized insurers or licensed insurance intermediaries shall, in accordance with the particular circumstances of the customers, add questions or modify the exact wording of the questions

(d) Risk Profile Questionnaire ("PRQ")

The objective of the RPQ process is for an assessment of a customer's investment risk appetite, and to determine if a particular ILAS product and its underlying investment choices are suitable for the customer, before making a recommendation. Authorized insurers and licensed insurance intermediaries should use the RPQ process as part of the sale process for an ILAS product. The form of the RPQ should include, as a minimum, questions covering the following areas aiming to ascertain the customer's:

1. investment objectives;
2. preferred investment horizon;
3. risk tolerance;
4. financial circumstances; and
5. knowledge (including investment knowledge in derivatives) and experience (including experience in investment and the period of such experience).

Customers are not allowed to opt out of or deviate in any respect from the RPQ process. Authorized insurers are required not to accept the application if a customer chooses to opt out or deviate from the RPQ process. Authorized insurers have the duty to verify all information collected and assess whether a particular ILAS product is suitable for the client.

After the ILAS policy has been issued, if the customer subsequently applies to make a top-up investment to the policy, the FNA and RPQ processes should be completed. However, if the customer purchases a top-up investment from the same authorized insurer or via the same licensed insurance intermediary within 12 months from the completion of the previous FNA and RPQ processes, the FNA and RPQ processes are not required (in relation to applications for base plan or top-up), unless there are material changes in the circumstances of the customer or the top-up investment would result in a mismatch.

(e) Important Facts Statement, Applicant's Declarations and Remuneration Disclosure

Important Facts Statement ("IFS") provides important facts in relation to an ILAS product being recommended, including but not limited to key products features, risks, etc., to the customer, while Applicant's Declaration ("AD") provides a check-point to assist the authorized insurer and licensed insurance intermediary to focus the customer's attention on whether the ILAS product recommended is suitable for the customer. It also helps to confirm the customer's understanding of the risks associated with it. The IFS and AD also serve as effective tools to provide disclosure of the licensed insurance intermediaries' remuneration to the customer. As such, the IFS and AD process must be used as part of sale process for an ILAS product (either for new application or top up).

It is required under the GL 26 that the template of IFS and AD (including the disclosure of licensed insurance intermediaries' remuneration) issued by the IA from time to time should be followed and adopted in terms of structure, groupings and signatures.

A completed IFS and AD form must be signed and dated by the customer and the licensed insurance intermediary.

(f) Controls and Procedures in Suitability Checks and Product Disclosure

Authorized insurers, licensed insurance agencies and licensed insurance broker companies are required to establish effective controls and procedures to (i) verify that the ILAS product sold and the key features such as the premium amount and term are considered suitable and affordable for the customer(s) based on the information disclosed by the customer(s), (ii) verify that the insurance intermediaries have taken due account of the reasons/considerations set out by the customer in the "Statement of Purpose" paragraph of the IFS, together with other relevant information, in assessing whether a particular ILAS product is suitable for the customer (s), (iii) verify whether the licensed insurance intermediary has properly disclosed and explained the key features and risks of the ILAS product together with rights and obligations of the customer during the sale process, and (iv) handle appropriately with any exceptions as per the section headed "Post-sale Controls".

(g) Post-sale Controls

To reconfirm customers' understanding of the ILAS product they purchased, including their rights and obligations under the ILAS product, it is required that authorized insurers should implement post-sale controls in accordance with GL26, including delivery of copies of the signed IFS and AD together with the issued policy to the customer. Authorized insurers should also send a notice to inform the customer that the original signed FNA and RPQ are available for inspection and advise where and how the customer may access the said documents.

It is also required that either post-sale calls or point-of-sale audio recordings should be conducted by authorized insurers for base plans of ILAS products sold via all distribution channels. (For bancassurance channel, authorized insurers and licensed insurance intermediaries should observe HKMA's relevant requirements, such as audio recordings requirements of the sale of ILAS products.)

It should be noted that licensed insurance intermediaries are required to remind customers of the importance of post-sale calls and should not abet customers to evade the aforesaid post-sale control measures.

(h) Certification of Copies of FNA and RPQ

Under GL26, authorized insurers are required to retain the original signed FNA, RPQ and IFS/AD. For business introduced by authorized institutions and licensed insurance brokers, authorized insurers are allowed to accept copies of the original signed FNA and RPQ which must be properly certified by the representatives of authorized institutions and licensed insurance brokers. It is important to note that the said representatives should have no conflict of interest with the sale of the relevant ILAS policy.

(i) Documentation and Record Keeping

Authorized insurers, licensed insurance agencies and licensed insurance broker companies should put in place proper documentation systems for all the processes/ requirements in GL26. The policy documents, FNA, RPQ and the IFS/Applicant's Declarations, and records relevant to the post-sale controls should also be maintained.

Authorized insurers, licensed insurance agencies and licensed insurance broker companies should provide the records for the inspection, review and investigation by the IA and other relevant regulatory bodies as soon as practicable upon request.

4.13.2 Information to be Communicated in Sales Process

Several pieces of important information which should be clearly communicated to clients in the sales of investment-linked life insurance policies are:

- Investment time frame;
- Principal brochure and illustration document;
- Product Key Facts Statement;

- Product risk;
- Product features and benefits;
- Fees and charges;
- Early termination, surrender and/or withdrawal risk; and
- Premium holiday risk.

(a) Investment Time Frame

Investment-linked insurance policies should not be used as speculative investment products. Like most insurance products, it is suitable as an investment vehicle only if the policyholder has a long-term investment horizon.

The insurance intermediary should also point out to prospective clients that since the fees and charges of an investment-linked insurance policy are heavily stacked at the beginning of the term, early redemption will be subject to very high encashment charges due to the deduction of fees and charges to cover the expenses of the authorized insurer as well as the load charges of the underlying investments.

(b) Principal Brochure and Illustration Document

As the policyholder of an investment-linked insurance policy bears the immediate consequences of the investment performance of the fund, the SFC is very concerned about the provision of adequate and accurate information to the policyholders. In this regard, the **"Code on Investment-linked Assurance Schemes"** (the ILAS Code), under Section III of "SFC Handbook for Unit Trusts and Mutual Funds, Investment-Linked Assurance Schemes and Unlisted Structured Investment Products" published by the SFC pursuant to section 399(1) of the **"Securities and Futures Ordinance" (Cap. 571),** imposes detailed requirements on information to be disclosed during the sales process. It specifically requires the insurance intermediary to produce three documents to the prospective clients: the principal brochure (please refer to section **4.13.3**), the illustration document (please refer to section **4.15**) and the product key facts statement (please refer to (c) below).

(c) Product Key Facts Statement

A product key facts statement ("KFS") for ILAS is one that gives a prospective investor a concise and user-friendly summary, in plain language, of the key features and risks of the product. The KFS is a part of the offering documents which require the SFC's prior approval pursuant to the ILAS Code, although revisions to the KFS of existing ILAS schemes solely to reflect the enhanced disclosure requirements do not require the SFC's prior approval. Please refer to **Appendix C** for the KFS illustrative template.

(d) Product Risk

In investment terms, risk is defined as the uncertainty associated with the end of period value of investment. As a general rule, assets that produce higher prospective rates of return are generally more volatile in nature or in other words, carry higher risks. Some of the key investment considerations were described in section **2.2**.

It is appropriate for the insurance intermediary to point out to the prospective clients that the historic performance of an investment fund is not indicative of future performance.

(e) Product Features and Benefits

Investment-linked policies possess some powerful features, such as wide spectrum of investment choices and flexible premium payments. Since their product features and their comparison to traditional life products have already been covered in the previous sections, they will not be repeated here.

(f) Fees and Charges

In addition to the standard insurance charges (such as fees and charges relating to early termination, surrender and/or withdrawal), investment-linked policies may attract some additional fees and charges as a result of the investment into the underlying funds (please refer to section **4.3.2**). It is always a good practice for the insurance intermediaries to explicitly explain the relevant fees and charges to the customers in order to protect both parties.

(g) Early Termination, Surrender and/or Withdrawal Risk

While the policyholder is normally given the options of early termination, surrender and/or withdrawal, he/she should be alerted that he/she will incur a surrender or withdrawal charge and/or may even lose his/her entitlement to bonuses.

(h) Premium Holiday Risk

While the policy provision of "premium holiday" allows the customer to cease premium payments temporarily, the customer should be alerted that all relevant fees and charges will continue to be deducted from the policy value during the premium holiday, so that the policy value may be significantly reduced and the customer's entitlement to bonuses affected.

4.13.3 Principal Brochure

As laid down in the ILAS Code, all authorized schemes must issue to each prospective ILAS customer an up-to-date ***Principal Brochure*** which contains prescribed information (see below).

This should be given to all ILAS customers before they submit the formal application for the policy. Since the principal brochure may consist of various parts and documents, the prospective participants should be advised to check against the list of its components in the application form to make sure that they have received all relevant documents.

The principal brochure, preferably in one single document, should contain such information as is necessary to enable prospective scheme participants to make an informed judgment of the scheme; in particular:

(a) Name and Type of Scheme

The name and description of the scheme must not be misleading to potential ILAS customers and should be an accurate reflection of the type of scheme and its objectives.

(b) Parties Involved

The names and registered addresses of all parties involved in the operation of the scheme with a brief description of the authorized insurer.

(c) Investment Returns

Details of how the investment return of the scheme is determined should be given. Except where the scheme's investment returns are subject to a non-variable guarantee, a warning should be stated to the effect that investment involves risks. Furthermore, a statement to the effect that the unit(s) allocated to the policy is notional and is solely for the purpose of determining the value of the policy should be included. The ILAS Code imposes additional disclosure requirements for guarantee and with-profits or similar features.

If the nature of the investment policy so dictates, a warning should be given that investment in the scheme or investment option linked to a scheme is subject to abnormal risks, together with a description of the risks involved.

(d) Fees and Charges

Explanations of fees and charges may be abbreviated, but should be clearly identified to include:

(i) the level of all fees and charges payable by an ILAS customer, including all charges levied on subscription, redemption and switching;

(ii) the level of all fees and charges payable by the scheme or an investment option linked to the scheme; and

(iii) details of whether charges are subject to change and the relevant notice period.

A summary of all fees and charges in tabular form should be provided to give scheme participants an overview of the fees structure at a glance. Where complex calculations are required to disclose fees and charges, illustrative examples should be given for clarity.

(e) Investment Objectives and Restrictions

A summary of the investment objective of the scheme or investment option(s) linked to a scheme including, where applicable:

(i) the types of intended investments, and their relative proportions in the portfolio;

(ii) the geographical distribution of the intended investments;

(iii) the investment and borrowing restrictions; and

(iv) if the nature of the investment policy so dictates, a warning that investment in the scheme is subject to abnormal risks, and a description of the risks involved.

(f) Borrowing Powers

The circumstances under which the scheme or investment option(s) linked to a scheme may have outstanding borrowings and the purpose for which and the extent to which such outstanding borrowings were or may be incurred.

(g) Summary of Provisions in Constitutive Documents

A summary of the provisions with respect to:

- Valuation of property and pricing;
- Characteristics of premiums/contributions;
- Benefits;
- Maturity and early surrender values; and
- Conditions of termination.

(h) Application and Surrender Procedures

A summary of the procedures for application and surrender.

(i) Warning Statements

The following warning statements should be disclosed in the principal brochure, where applicable, in a prominent manner:

(i) Investment-linked assurance schemes are insurance policies issued by the authorized insurer.

(ii) An ILAS customer's investments are therefore subject to the credit risks of such authorized insurer.

(iii) Premiums paid by a scheme participant towards the insurance policy will become part of the assets of the authorized insurer. An ILAS customer does not have any rights or ownership over any of those assets. The recourse of a scheme participant is against the authorized insurer only.

(iv) The ILAS customer's return on investments is calculated or determined by the authorized insurer with reference to the performance of the underlying funds/assets.

(v) Where the return of the scheme is based on investment options linked to the scheme which is calculated or determined by the authorized insurer with reference to the performance of a corresponding SFC-authorized fund, a warning statement that the return of investments under the scheme shall be subject to the charges of the scheme and may be lower than the return of the corresponding SFC-authorized fund.

(vi) Early surrender or withdrawal of the policy/suspension of or reduction in premium may result in a significant loss of principal and/or bonuses awarded. Poor performance of underlying funds/assets may magnify the scheme participant's investment losses, while all charges are still deductible.

The investment options available under the scheme can have very different features and risk profiles. Some may be of high risk.

(j) Cooling-off Period

A summary of the provisions of the ILAS Code with respect to the cooling-off period (please refer to section **4.13.4**).

(k) General Information

(i) A list of constitutive documents and an address in Hong Kong where they can be inspected free of charge or purchased at a reasonable price.

(ii) A statement that the authorized insurer accepts full responsibility for the accuracy of the information contained in the offering document and confirm, having made all reasonable enquiries, that to the best of their knowledge and belief there are no other facts the omission of which would make any statement misleading.

(iii) A statement that the SFC does not take any responsibility for the contents of the offering document, makes no representation as to its accuracy or completeness, expressly disclaims any liability whatsoever for any loss howsoever arising from or in reliance upon the whole or any part of the contents of the offering document.

(iv) Where a scheme is described as having been authorized by the SFC, a prominent note should be disclosed that:

"SFC authorisation is not a recommendation or endorsement of the scheme nor does it guarantee the commercial merits of a scheme or its performance. It does not mean the scheme is suitable for all investors nor is it an endorsement of its suitability for any particular investor or class of investors."

(v) If available, website address of the scheme which contains publication of its offering document, principal brochures, circulars, notices, announcements, financial reports and the latest available offer and redemption prices or net asset value.

(l) Governing Law

The governing law of the scheme should be disclosed and an acknowledgment that the parties involved have the right to bring legal action in a Hong Kong court as well as in any court elsewhere which has a relevant connection with the scheme.

(m) Taxation

Where the likely tax benefits to be enjoyed by ILAS customers are described, the principal brochure should also briefly explain the authorized insurer's understanding of the tax implications for Hong Kong scheme participants, based on expert advice received by the authorized insurer. ILAS customers should also be advised to seek professional advice regarding their own particular tax circumstances.

(n) Date of Publication of the Principal Brochure

All facts and figures in the principal brochure should be as reasonably up to date as possible.

(o) Authorisation Statement

Where a scheme is described as having been authorized by the SFC, it must be stated that authorisation does not imply official recommendation.

4.13.4 Cooling-off Period

One of the popular perceptions, and certainly a popular fear in the general public, is that life insurance intermediaries may be too assertive, even aggressive, in their selling. The perceived result from this could be that a person might be pressurized into purchasing a life insurance policy that they do not really want, or cannot really afford.

To counteract this perceived possibility, effective from July 1996 the Life Insurance Council ("LIC") under the HKFI launched what was termed the *"***Cooling-off Period Initiative***"*. The cooling-off period provides policyholders a chance to re-think within a reasonable period of time their decision to purchase a life insurance product which is a long-term commitment. During that period, if the policyholders wish to change their mind, they will have the rights to serve a written notice to cancel the policy and obtain a refund of the paid premium less a market value adjustment, if any.

Upon taking over the regulatory functions of the former authority, the IA has replaced the "**Cooling-off Period Initiative"** by the **"Guideline on Cooling-off Period" (GL29)**, providing an opportunity to policy holders to reflect on their decision, which is a key aspect of the "fair customer treatment" principle and helps to protect policy holders' interests. For full document of GL29, please refer to the IA's circular dated 13 September 2019.

Some of the topics in GL29 which are directly related to Investment-linked Long Term Insurance Policies are summarized in the following paragraphs.

(a) Cooling-off Period

i. The Cooling-off Period is the period of **21 calendar days immediately following the day of the delivery of the life insurance policy or the Cooling-off Notice to the policy holder or the policy holder's nominated representative, whichever is the earlier**. For the avoidance of doubt, the day of delivery of the life insurance policy or the Cooling-off Notice is not included for the calculation of the 21 calendar day period. However, if the last day of the 21 calendar day period is not a working day, the period shall include the next working day.

ii. The Cooling-off Notice should include the following information: (1) the availability of the life insurance policy and the expiry date of the Cooling-off Period; (2) the right to re-consider the decision to purchase the life insurance product within the Cooling-off Period; (3) the right to obtain a refund of premium paid if the policy is cancelled within the Cooling-off Period; (4) the contact information of the customer service department of the authorized insurer (including the address, service hotline number and email address); and a reminder that if the policy holder or the nominated representative of the policy holder does not receive the policy within 9 calendar days after

delivery of the Cooling-off Notice, the policy holder should contact the authorized insurer.

iii. Where the life insurance policy is to be delivered by the authorized insurer directly to the policy holder (or the nominated representative of the policy holder), the authorized insurer should deliver the policy within 9 calendar days of the date of issue of the policy.

iv. If the life insurance policy is to be delivered to the policy holder (or the nominated representative of the policy holder) via a licensed insurance intermediary, the authorized insurer should provide the policy to the licensed insurance intermediary sufficiently in advance of the end of the 9 calendar day period, to enable the licensed insurance intermediary to deliver the policy to the policy holder (or the nominated representative of the policy holder) within the 9 calendar day period; and on receipt of the policy, the licensed insurance intermediary should use all reasonable endeavours to deliver the policy to the policy holder (or the nominated representative of the policy holder) within the 9 calendar day period.

v. The authorized insurer should deliver the Cooling-off Notice directly to the policy holder (or the nominated representative of the policy holder) within the 9 calendar day period; and if the last day of the 9 calendar day period is not a working day, the period shall include the next working day.

vi. Authorized insurers should devise internal control measures to ensure and provide proof that policies are delivered to policy holders (or the nominated representatives of policy holders) within the 9 calendar day period; and Cooling-off Notices are delivered to the policy holders (or the nominated representatives of the policy holders) within the 9 calendar day period. Authorized insurers should keep records of proof such as copies of the acknowledgements of receipt of policy delivery to demonstrate that the policy or the Cooling-off Notice was delivered and when the delivery took place.

(b) Cooling-off Rights

i. Subject to the clauses below, a policy holder has the right to cancel the life insurance policy within the Cooling-off Period and obtain a refund of premium paid by providing a written notice to the authorized insurer directly and return the insurance policy, if applicable.

ii. For all investment-linked life insurance policies and all single premium policies, the authorized insurers have the right to apply a "**market value adjustment**" ("MVA") to the premium to determine the amount that is to be refunded.

iii. Any such MVA must be calculated solely with reference to the loss that the authorized insurer might make in realising the value of any assets acquired through investment of the premiums made under the life policy. It shall therefore not include any allowance for expenses or commissions in connection with the issuance of the policy.

iv. The authorized insurer's right to apply an MVA and its basis of calculation must be disclosed in the relevant product brochure, and the prospective policy holder must have been informed of the authorized insurer's right to apply an MVA and its basis of calculation before the prospective policy holder signs his/her policy application form.

(c) Statement in relation to Cooling-off Period in Policy Application Form

i. A statement in line with the "**Guideline on Statement in relation to Cooling-off Period in Policy Application Form**" (**Appendix 1 in GL29 or Appendix D in this study guide**) must be included in the application form immediately above the space for the signature of the prospective policy holder.

ii. The size of the printing for the statement must not be smaller than the font size used for any other declarations on the form. This requirement applies irrespective of whether the policy application form is paper, electronic or in some other format.

iii. It shall be communicated in the same language(s) as are used for all other sections of the application form.

(d) Reminder of Cooling-off Period at Policy Issuance

i. When the policy is delivered, the authorized insurer should include a reminder to the policy holder of the Cooling-off Period with the life insurance policy.

ii. This may be done by way of a letter from the authorized insurer delivered direct to the policy holder, or a statement on the policy jacket or policy cover, taking into account the specificities of the medium used.

iii. The reminder must be communicated in the same language(s) as the policy and other communications/documents which are (or have been) provided or sent to the policy holder in relation to the policy.

iv. The reminder must be prominently displayed using a legible font size.

v. In case if an authorized insurer conducts insurance business through a digital distribution channel (e.g. webpage/mobile app) on an life insurance policies to which the GL29 applies, the authorized insurer should use appropriate tools to ensure compliance with the requirements.

vi. For further details regarding the required reminder, please refer to **Appendix 2** of **GL29**.

Furthermore, authorized insurers should specify in their intermediaries' training materials and internal guidelines that their insurance intermediaries must comply with the requirements of GL29. Authorized insurers should also maintain records in respect of complaints or disputes where policy holders have sought to cancel their policies and obtain refund of premiums after the Cooling-off Period has expired, but such requests have been refused.

4.13.5 Policy Replacement

A policy holder, having purchased a life insurance policy, may later consider purchasing another life insurance policy to replace (whether in whole or in part) the life insurance policy initially purchased. If a policy holder applies to purchase a new life insurance policy and combines this with replacing or making changes to a life insurance policy previously purchased, authorized insurers and licensed insurance intermediaries should ensure the policy holder is fully informed of the consequences of such replacement of changes, so that he/she can make a fully informed decision. To address this issue, the Guideline on Long Term Insurance Policy Replacement (GL27) was issued in September 2019 by the IA pursuant to section 133 of the Insurance Ordinance (Cap 41) and its principal function to regulate and supervise the insurance industry for the protection of existing and potential policy holders.

Required by the GL27, authorized insurers and licensed insurance intermediaries should take all reasonable steps to ascertain whether the customers are purchasing the life insurance policy as a policy replacement.

The purchase of a life insurance policy is a policy replacement if at the time of the application date for the new life insurance policy,

(a) the customer has or had another life insurance policy (or other life insurance policies) (collectively "existing life insurance policy);

(b) the policy holder(s) of the existing life insurance policy and the life insurance policy being purchased is (are) the same; and

(c) in order to fund the purchase of the new life insurance policy, the customer is using, or intends to use, some or all of the total cash value of the existing life insurance policy or any savings made or to be made as a result of reducing the premium payable under the existing life insurance policy, by means of the following:

    (i) reducing the total cash value or sum insured of the existing life insurance policy, by the customer exercising (or having exercised) a right under the policy (e.g. withdrawal, surrender) or by automatic operation of the terms and conditions under the policy (e.g. lapse, reduced paid-up insurance, extended term insurance); or

    (ii) by the customer taking out (or having taken out) a policy loan from the existing life insurance policy (whether at the customer's request or by automatic operation of the policy terms and conditions); or

    (iii) by the customer suspending premium payment or ceasing to pay premium under the existing life insurance policy.

However, it is important to note that some transactions are not considered as policy replacement. For example, if the new life insurance policy is being effected solely by reason of the existing life insurance policy being converted into the new life insurance policy under the provisions of the existing life insurance policy, it is not a policy replacement. (For details, please refer to the GL27.)

When a policy replacement (or a potential policy replacement) is identified, the authorized insurer or licensed insurance intermediary should require an "Important Facts Statement - Policy Replacement" (IFS-PR) to be signed by the customer. The purpose of this is to make the customer aware of the disadvantages which may arise from the policy replacement, so that the customer can consider these disadvantages together with the information and advice given by the licensed insurance intermediary and make an informed decision as to whether or not to proceed with purchasing the new life insurance policy. The relevant licensed insurance intermediary should explain to the customer the implications of and risks associated with the policy replacement as identified in the IFS-PR and ask the customer to read the IFS-PR and consider the information contained in it.

The originals of the signed IFS-PR should be kept by the authorized insurer of the new life insurance policy which is the subject of the application. The authorized insurer must provide a copy of the IFS-PR to the customer on or before the date of issue of the new life insurance policy. Authorized insurers should maintain complete records of the signed IFS-PRs dispatched to customers applying for new life insurance policies which have been identified as policy replacements. Such records should include the signed IFS-PRs, the dispatch date and mode of dispatch of the copies of the signed IFS-PRs to customers. Such records should be made available to the IA for inspection as soon as practicable upon request. For full details of the IFS-PR, please refer to Appendix B of the GL27 or **Appendix F** in this study guide.

4.13.6 Guideline on Offering of Gifts (GL25)

The offering of Gifts or other similar gratuities in the marketing, promotion or distribution of insurance products may unduly influence or otherwise distract customers when it comes to making informed decisions in relation to insurance products and the suitability of such products to meet their insurance needs and other circumstances. In view of this, Guideline on Offering of Gifts (GL25) provides guidance on certain restrictions on the use of gifts and rebates which authorized insurers and licensed insurance intermediaries should follow when marketing, promoting or distributing insurance products classed as long term business.

In general, according to GL25, authorized insurers and licensed insurance intermediaries are restricted to directly or indirectly offer Gifts to customers when marketing, promoting or distributing long term Products (Class C (Investment-linked) Products; Class A (Life and annuity) Products and Class D (Permanent health) Products).

One exception to the above is that authorized insurers and licensed insurance intermediaries which offer Class A Products, Class C Products or Class D Products may offer Permitted Gifts as specified in GL25, such as allocation of bonus fund units, gifts offered for relationship building purposes or can be redeemed at a later date under a customer loyalty programme, provision of sponsorship and support for customers, brand building campaigns and ancillary services, provided that the criteria referenced in the Annex to GL25 is strictly adhered to.

4.14 ETHICS

This is important for licensed insurance intermediaries regardless of insurance products being sold. Licensed Insurance agents are required to comply with the Code of Conduct for Licensed Insurance Agents while licensed insurance brokers should comply with the Code of Conduct for Licensed Insurance Brokers issued by the IA. These will be covered in Chapter **5**.

Besides, a licensed insurance broker company is required to comply with the requirements as set out in Insurance (Financial and Other Requirements for Licensed Insurance Broker Companies) Rules (Cap 41L) issued by the IA pursuant to the Insurance Ordinance (Cap 41)'s subsidiary legislation which will be discussed in more details in Chapter **5**.

Authorized insurers and clients place their trust in their insurance intermediaries. Unethical practices will tarnish the reputation of the company one represents as well as collectively tarnish the professionalism and reputation of the Hong Kong insurance industry. With effect from 23 September 2019, the IA took on the direct regulation of all insurance intermediaries in Hong Kong and has been handling complaints in relation to intermediaries directly since that date. Prior to this, insurance intermediaries were regulated by the former Self-Regulatory Organizations (i.e. Insurance Agents Registration Board ("IARB"), The Hong Kong Confederation of Insurance Brokers ("CIB") and Professional Insurance Brokers Association ("PIBA")). The IA received 1,196 complaints during the period from 1st April 2021 to 31st March 2022. In terms of category, the most significant number of complaints were received in the category of "conduct".

Listed below are several common unprofessional practices that should be avoided:

Misrepresentation is the practice where an insurance intermediary deliberately makes misleading statements to induce a prospect to purchase insurance products. For example, it is a misrepresentation by claiming that the investment return is guaranteed when it is not, etc.

Twisting (also refers to "policy replacement" in 4.13.5 above) is the practice where an insurance intermediary makes misleading statements, non-disclosure, misrepresentations and incomplete comparisons to induce an insured to replace existing life insurance with other life insurance resulting in a disadvantage to the insured.

Fraud is the practice where an insurance intermediary deliberately makes false statements and claims, or concealing important information with the intention to deceive or cheat. For example, the intermediary deliberately conceals information concerning the current health condition of the client.

Rebating is the practice where an insurance agent offers a rebate of his/her commission to entice a prospect to purchase a policy. Since a client should evaluate the risks and benefits of each insurance product on its own merit, rebating may prevent him/her from making the appropriate decision. Licensed insurance intermediaries should also comply with relevant requirements stipulated under GL25: Guideline on Offering of Gifts. (Please refer to section **4.13.6**)

4.15 ILLUSTRATION DOCUMENTS

Since January 1997, authorized insurers have been required to produce an **"Illustration Document"** in addition to the principal brochure (please refer to section **4.13.3**). The SFC provides guidelines for use of illustration documents for investment-linked policies in the ILAS Code while the IA also provides same requirements for Benefit Illustration Documents for ILAS policies under Appendix I to **Guideline on Benefit Illustration For Long Term Insurance Policies (GL28)**. A sample of the document for standard illustration for ILAS policies as provided by the SFC's ILAS Code and the IA's GL28 is reproduced in **Appendix G**. Some of the more important features are summarized below:

4.15.1 Linked Policy Illustration Documents

(a) **Illustration Document**: An illustration document must be prepared by the Authorized Insurer in conjunction with each proposed investment by each prospective ILAS customers. This document must be provided to the ILAS customers for his review and signature prior to signing of the application form.

(b) **Minimum Requirements**: Minimum requirements for the information to be included in the illustration document are:

(i) **Surrender values**: The Authorized Insurer is required to illustrate, what the ILAS customers would be expected to receive if he redeems at the end of each of the first 5 years of the contract, and for every fifth year thereafter until maturity, after deduction of all relevant charges. The computation of these surrender values shall not take into account any non-guaranteed returns, including, without limitation, any discretionary bonus, dividend payments, reimbursements of charges. These expected surrender values should be based on at least 2 different assumptions on the rate of return.

With effect from 1 January 2015, the projected surrender values and death benefits should be based on either 4 different assumed rates of return of 0%, 3%, 6% and 9% per annum respectively (Version 1 Template) or 3 different assumed rates of return of 0%, 3% and 6% per annum respectively (Version 2 Template). For both of the above options, aside the illustration of 0% assumed net annual rate of return, all other rates of return (i.e. 3%, 6% and 9%) are maximum rates that authorized insurers can adopt.

(ii) **Prescribed statements**: The following statements should appear in the Illustration Document as shown in **Appendix G**:

THE ASSUMED RATES USED BELOW ARE FOR ILLUSTRATIVE PURPOSES.

THEY ARE NEITHER GUARANTEED NOR BASED ON PAST PERFORMANCE. THE ACTUAL RETURN MAY BE DIFFERENT!

IMPORTANT:

THIS IS A SUMMARY ILLUSTRATION OF THE SURRENDER VALUES OF [Name of Product]. IT IS INTENDED TO SHOW THE IMPACT OF FEES AND CHARGES ON SURRENDER VALUES BASED ON THE ASSUMPTIONS STATED BELOW AND IN NO WAY AFFECTS THE TERMS OF CONDITIONS STATED IN THE POLICY DOCUMENT.

The following statements should be clearly disclosed before the ILAS customer's signature:

"Warning: You should only invest in this product if you intend to pay the premium for the whole of your chosen premium payment term. Should you terminate this product early, you may suffer a significant loss.

I confirm having read and understood the information provided in this illustration and received the principal brochure.

(c) **Company Customisation**: Subject to the approval of the SFC, the authorized insurer may customise the document to include additional information, provided that such additional information is not misleading and does not otherwise detract from the information disclosed in the minimum requirements. Any additional information provided in addition to the minimum requirements of the Standard Illustration must be relevant and of value to customers.

4.16 POLICY ADMINISTRATION AND STATEMENT TO POLICYHOLDERS

Similar to the conventional life insurance policies, policy administrative activities in relation to investment-linked policies such as policy issuance, correspondence, documentation, premium collection, benefit administration and policy changes have to be performed by the authorized insurer.

Given that different policyholders may have varying insurance and investment needs, the authorized insurer will, in response to each application, issue a unique policy document for each policyholder which contains all the binding terms and conditions of his/her participation on the basis of the information submitted in his/her application form.

4.16.1 Policy Issuance

Once the underwriting process is completed and cover is approved, the policy can be prepared and then delivered to the policyholder. The important fact worth mentioning is that a policy cannot be cancelled or amended after its issuance without the agreement of the policyholder. Issuing and delivering the policy in some respects may be looked upon as the point of no return for the authorized insurer. Careful policy checking and confirmation are therefore needed before this happens.

4.16.2 Policy Delivery

This may be considered with policy issuance as the two are very closely connected. Using modern technology, policy documents can be produced with great speed and accuracy. The in-house system should create the policyholder's records and verify

whether the first premium has been received. Therefore, only variations affecting the particular policyholder will alter the routine format. All of these can be dealt with by an automated system.

However, it is important that licensed insurance intermediaries should observe cooling-off period and deliver policies to the policyholders in accordance with GL29.

4.16.3 Policy Changes

Similar to other conventional life insurance policies, the policyholder of investment-linked policy can request for changes to the policy. These changes include non-financial changes such as:

- change of beneficiary;
- assignment of the policy; and
- change of address/personal particulars;

or financial changes such as:

- reinstatement;
- change of frequency of premium payment;
- change of sum assured;
- policy loan; and
- surrender.

For policyholders of investment-linked policies, they can enjoy the additional policy features which are unique and typically not available to traditional life insurance policies such as:

- change of premium amount;
- fund switching; and
- premium holidays.

4.16.4 Information to Policyholders

An authorized insurer typically provides two reports to each investment-linked policyholder. One is on the performance and value of his/her policy (policy statement). The other is on the performance of the investment-linked fund (fund performance report).

In order to be able to carry out the administration of any investment-linked business, the use of computer is effectively mandatory. The administration of this flexible insurance product involves a large degree of calculation and record keeping which calls for the need of a powerful and flexible computer system. Besides the standard functions of any insurance administration system, the system has to handle other issues such as dealing with unit fund, allocations of units as a result of premiums received, the payment of the various types of charges (insurance charges and investment charges) by cancellation of units (please refer to section **4.6**), varying allocation rates and so on.

4.16.5 Policy Statement

The policy statement is prepared at least annually, within 30 days after the policy anniversary. Instead of basing on the policy anniversary, the authorized insurer may choose to prepare the statements as of a specified date in the policy year, such as December 31 of each calendar year. The statement date should be consistent from year to year.

The purpose of the policy statement is to provide the policyholder with a summary of the transactions that occurred during the statement period, and the values of his/her policy as of the statement date. As a minimum, the statement normally includes the following information:

1. Number and value of units held at the beginning of the period; bought during the period; sold during the period; and held at the end of the period;
2. Charges levied during the period;
3. Premiums received during the period;
4. The level of death benefit as of the statement date;
5. The net cash surrender value as of the statement date; and
6. The amount of outstanding loans, if any, as of the statement date.

4.16.6 Fund Performance Report

The authorized insurer will also prepare their fund performance reports annually. The purpose of the fund performance report is to summarize the performance of the fund during the period and to highlight any changes in the investment policy. As a common practice, most of them include the following information:

1. A summary of the audited financial statement of the fund;
2. A comparison of the net investment return of the fund for the year with the investment returns during the preceding five or more years if available;
3. A list of investments held by the fund as of the reporting date;
4. Any charges levied against the fund during the year; and
5. A statement of any change in the investment objective and orientation of the fund, any change in investment restrictions or any change in the fund management since the last report.

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Representative Examination Questions

Type "A" Questions

1. Investment-linked business was first introduced in:

   (a) the UK;
   (b) the US;
   (c) Canada;
   (d) Australia.

[Answer may be found in **4.1**]

2. Which of the following is one of the main characteristics of an investment-linked policy?

   (a) it is used solely for investment purposes;
   (b) its cash value is usually the value of units allocated to the policy calculated at the prevailing bid price;
   (c) it has a guaranteed maturity value;
   (d) it is intended for short-term speculation purpose.

[Answer may be found in **4.2**]

3. Which one of the following funds comprises a higher proportion of equity and a lower proportion of fixed income instruments?

   (a) money market fund;
   (b) bond fund;
   (c) balanced fund;
   (d) growth fund.

[Answer may be found in **4.8**]

4. Which of the following is one of the disadvantages of an index fund?

   (a) higher risk;
   (b) higher management fee;
   (c) cannot outperform the market;
   (d) risk of company failure.

[Answer may be found in **4.8.2**]

Type "B" Questions

5. Which of the following are some of the flexibility features of investment-linked policies?

   (i) variation of premium
   (ii) variable death benefit
   (iii) flexible investment options
   (iv) flexible payment of premiums

   (a) (i) and (ii) only;
   (b) (iii) and (iv) only;
   (c) (i), (ii) and (iii) only;
   (d) all of the above.

[Answer may be found in **4.9**]

6. Which two of the following statements concerning the "cooling-off period" are true?

   (i) The period is for 14 days only.
   (ii) All authorized insurers subscribe to this initiative.
   (iii) If properly exercised, the policy is cancelled and premiums are returned.
   (iv) The period relates to the time during which the authorized insurer may cancel the policy.

   (a) (i) and (ii) only;
   (b) (i) and (iii) only;
   (c) (ii) and (iii) only;
   (d) (iii) and (iv) only.

[Answer may be found in **4.13.4**]

7. An authorized insurer typically provides which of the following two reports to each investment-linked policyholder annually:

   (i) policy statement
   (ii) death benefit report
   (iii) fund performance report
   (iv) top-up report

   (a) (i) and (ii) only;
   (b) (i) and (iii) only;
   (c) (ii) and (iii) only;
   (d) (iii) and (iv) only.

[Answer may be found in **4.16**]

8. The common unprofessional practices which are generally considered to be harmful to the life insurance business and must therefore be avoided include:

(i) twisting
(ii) misrepresentation
(iii) rebating
(iv) receiving commission

(a) (i), (ii) and (iii) only;
(b) (ii), (iii) and (iv) only;
(c) (i), (ii) and (iv) only;
(d) (i), (iii) and (iv) only.

[Answer may be found in **4.14**]

[*If still required, the answers may be found at the end of the Study Notes.*]

Chapter 5
REGULATORY FRAMEWORK IN HONG KONG

The **Insurance Ordinance (Cap 41) (IO)**, formerly entitled the Insurance Companies Ordinance ("ICO"), is a very important piece of legislation which provides the framework for the prudential supervision of the insurance industry of Hong Kong. In fact, it covers not only the supervision and regulation of *insurers*, but also that of *insurance intermediaries*.

An authorized insurer intending to underwrite investment-linked long term insurance policies is required to be authorized by the Insurance Authority ("IA") under the Insurance Ordinance to carry on Class C of long-term business. An insurance intermediary intending to sell investment-linked insurance policies should be duly licensed by the IA.

On the other hand, investment-linked long term insurance policies that are collective investment schemes are required by law to be authorized by the Securities and Futures Commission ("SFC") before they can be offered to the public, unless exempted. However, it must be stressed that an SFC authorization of an investment product does not imply an official recommendation of that product.

5.1 REGULATORY AUTHORITIES

5.1.1 Insurance Authority ("IA")

On 7 December 2015, the IA was established under the Insurance Companies (Amendment) Ordinance 2015 ("IC(A)O"). The IA is a new insurance regulator independent of the Government. The objectives of its establishment are to modernize the regulatory infrastructure to facilitate the stable development of the Hong Kong insurance industry, provide better protection for policy holders, and comply with the requirement of the International Association of Insurance Supervisors ("IAIS") that insurance regulators should be financially and operationally independent of the government and industry.

On 26 June 2017, the IA took over the regulatory functions of the Office of the Commissioner of Insurance ("OCI"), which was a government department, and started regulating authorized insurers. On 23 September 2019, the IA took over the regulation of insurance intermediaries from the three Self-Regulatory Organizations ("SROs"). The three SROs were the Insurance Agents Registration Board ("IARB") established under The Hong Kong Federation of Insurers ("HKFI"), The Hong Kong Confederation of Insurance Brokers ("HKCIB") and Professional Insurance Brokers Association ("PIBA").

The principal functions of the IA remain unchanged, i.e., to regulate and supervise the insurance industry for the promotion of the general stability of the insurance industry and for the protection of existing and potential policy holders. The IO stipulates that the IA shall:

(a) be responsible for supervising an authorized insurer's and a licensed insurance intermediary's compliance with the provisions of the Ordinance;

(b) consider and propose reforms of the law relating to insurance business;

(c) promote and encourage the adoption of proper standards of conduct and sound and prudent business practices by authorized insurers;

(d) promote and encourage the adoption of proper standards of conduct by licensed insurance intermediaries;

(e) review and, if necessary, propose reforms of the systems for regulating authorized insurers and licensed insurance intermediaries;

(f) regulate the conduct of insurance intermediaries through a licensing regime;

(g) promote the understanding by policy holders and potential policy holders of insurance products and the insurance industry;

(h) formulate effective regulatory strategies and facilitate the sustainable market development of the insurance industry, and promote the competitiveness of the insurance industry in the global insurance market;

(i) conduct studies into matters affecting the insurance industry;

(j) assist the Financial Secretary of the Government in maintaining the financial stability of Hong Kong by taking appropriate measures in relation to the insurance industry

(k) co-operate with and assist financial services supervisory authorities of Hong Kong or of any place outside Hong Kong, whenever appropriate, to the extent permitted by the Ordinance;

(l) liaise and co-operate with any involved supervisor in any place outside Hong Kong in the determination of the group supervisors of insurance groups;

(m) regulate and supervise insurance groups of which the IA is appointed as the group supervisor; and

(n) perform functions imposed or conferred on the IA by the Ordinance or any other Ordinance.

5.1.2 Securities and Futures Commission ("SFC")

The SFC is an independent statutory body established in 1989 to regulate Hong Kong's securities and futures markets. It derives its investigative, remedial and disciplinary powers from the Securities and Futures Ordinance ("SFO") ***(Cap 571)*** and subsidiary legislation. The **SFO** came into operation on 1 April 2003 consolidating and modernising the statutes previously regulating Hong Kong's securities and futures markets. The SFC is responsible for regulating participants in the securities and futures markets, including brokers, investment advisers, fund managers and intermediaries carrying out regulated activities, and investors. The regulated activities defined in Schedule 5 to the SFO are:

Type 1: dealing in securities;

Type 2: dealing in futures contracts;

Type 3: leveraged foreign exchange trading;

Type 4: advising on securities;

Type 5: advising on futures contracts;

Type 6: advising on corporate finance;

Type 7: providing automated trading services;

Type 8:	**securities margin financing;**
Type 9:	**asset management;**
Type 10:	**providing credit rating services;**
Type 11:	**dealing in OTC derivative products or advising on OTC derivative products;**
Type 12:	**providing client clearing services for OTC derivatives transactions.**

Licensed insurance intermediaries engaging in promoting, offering or selling investment-linked insurance policies to the public are generally not, by virtue of such activities, required to be licensed under the SFO for the purpose of advising on securities or dealing in securities.

For the same reason, neither does an intermediary require a licence from the SFC for advising or making recommendations to policyholders concerning selection by them of the underlying funds of their investment-linked insurance policies.

Section **5.3.1** explains why an investment-linked insurance policy does not constitute a security for the purposes of the SFO.

Notwithstanding the above, if a licensed insurance intermediary, in addition to the conduct of insurance business, engages in functions that are an integral part of a business of advising on, or dealing in, securities, he may be required to be licensed by the SFC as a consequence of the performance by him of those functions. In that event, he will fall within the regulatory regime created by the SFO and will be obliged to comply with all the relevant provisions of the SFO and such additional regulatory requirements as may be imposed on him by the SFC.

Furthermore, investment-linked long term insurance policies fall under the definition of collective investment scheme of the SFO and in certain aspects are subject to the regulation of the SFC (see section **5.3** for details). Therefore, it is imperative for a licensed insurance intermediary intending to sell investment-linked insurance policies to have a basic understanding of the regulatory framework of the SFC empowered by the SFO.

The major statutory regulatory objectives of the SFC are set out in the SFO. In carrying out its mission, the SFC would take into account of Hong Kong's continued success and development as an international financial centre. Its regulatory objectives include:-

- to maintain and promote the fairness, efficiency, competitiveness, transparency and orderliness of the securities and futures industry;
- to help the public understand the operation and functioning of the securities and futures industry;
- to provide protection for the investing public;
- to minimise crime and misconduct in the securities and futures industry;
- to license and supervise intermediaries that conduct activities under the SFC's regulatory responsibility;
- to authorize investment products and offer documents prior to their distribution to retail investors;
- to reduce systemic risks in the securities and futures industry; and

- to assist the Government in maintaining the financial stability of Hong Kong by taking appropriate steps in relation to the securities and futures industry.

The SFC sets out licensing standards to ensure that all practitioners are fit and proper. It is empowered to approve licences and maintain a public register of licensees. It develops codes and guidelines to inform the industry of its expected standard of conduct and then to monitor the licensees' financial soundness and compliance with Ordinance, codes, guidelines, rules and regulations. More importantly, the SFC may, upon receipt of complaints from investors against licensees, handle the misconduct complaints, investigate and then take action as it thinks fit.

5.2 INSURANCE LEGISLATION, CODES AND GUIDELINES

5.2.1 Insurance Ordinance ("IO")

This area has been dealt with some depth in the Study Notes for **"Principles and Practice of Insurance"** and we will not repeat the details here. However, by way of reminder, the following important regulatory aspects should be noted:

The purposes of the **IO (Cap. 41)** are to:

1. regulate the carrying on of insurance business;

2. establish the IA (as a body corporate) to regulate the insurance industry for protecting policy holders and potential policyholders and for promoting the stable development of the insurance industry; and

3. provide for related matters.

It has certain strict requirements regarding authorized insurers, which include reference to:

1. authorization of insurers;
2. capital requirements;
3. solvency margin requirements;
4. 'fit and proper' requirement for controllers, directors, key persons in control functions and appointed actuaries; and
5. 'adequate' reinsurance arrangements.

These requirements are to ensure the economic and social viability of authorized insurers, which in the broader sense must be related to customer service.

Under section 8 of the IO, any company intending to carry on any class of insurance business in or from Hong Kong may apply to the IA for authorization. Section 8(2) provides that the IA shall not authorize a company if it appears that any person who is a director or controller of the company is not a fit and proper person to hold the position.

5.2.2 Code of Conduct for Licensed Insurance Agents & Code of Conduct for Licensed Insurance Brokers

There are two types of licensed insurance intermediary in Hong Kong: licensed insurance agents and licensed insurance brokers. Both play an important role in the Hong Kong insurance industry, serving as a vital conduit between the public and the insurance sector. Both Codes are issued by the IA and released in September 2019. The Code of Conduct for Licensed Insurance Agents (Agents' Code) aims, in certain instances, to inform and explain the statutory conduct requirements in sections 90 and 91 (and in any rules made by the IA under section 94) of the IO with which licensed insurance agents are required to comply, whereas the Code of Conduct for Licensed Insurance Brokers (Brokers' Code) aims, in certain instances, to inform and explain the statutory conduct requirements in sections 90 and 92 (and in any rules made by the IA under section 94) of the IO as they apply to licensed insurance brokers.

There are 8 general principles to be noted for the Agents' Code. For "GP 1 Honesty and Integrity", a licensed insurance agent should act honestly, ethically and with integrity. "GP 2 Acting Fairly and in the Client's Best Interests" states that a licensed insurance agent should always treat clients fairly and act in their best interests. "GP 3 Exercising Care, Skill and Diligence" requires a licensed insurance agent to act with due care, skill and diligence while "GP 4 Competence to Advise" requests a licensed insurance agent to possess appropriate levels of professional knowledge and experience and only carry on regulated activities in respect of which the agent has the required competence.

According to "GP 5 Disclosure of Information", a licensed insurance agent should provide clients with accurate and adequate information to enable them to make informed decisions. "GP 6 Suitability of Advice" states that a licensed insurance agent's regulated advice should be suitable for the client taking into account the client's circumstances while "GP 7 Conflicts of Interest" asks a licensed insurance agent to use best endeavours to avoid conflicts of interests and when such conflicts cannot be avoided, the agent should manage them with appropriate disclosure to ensure clients are treated fairly at all times. Lastly, "GP 8 Client Assets" mentions that a licensed insurance agent should have sufficient safeguards in place to protect client assets received by the agent or which are in the agent's possession.

In terms of "Corporate Governance and Controls and Procedures", a licensed insurance agency should have proper controls and procedures in place to ensure that the agency and its licensed technical representatives (agent) meet the General Principles, Standards and Practices set out in the Agents' Code.

Similarly, there are also 8 general principles to be noted for the Brokers' Code. For "GP 1 Honesty and Integrity", a licensed insurance broker should act honestly, ethically with integrity and in good faith. "GP 2 Acting in the Best Interest of Clients and Treating Clients Fairly" states that a licensed insurance broker should always act in the best interests of its clients and treat its clients fairly. "GP 3 Exercising Care, Skill and Diligence" requires a licensed insurance broker to act with due care, skill and diligence while "GP 4 Competence to Advise" requests a licensed insurance broker to possess appropriate levels of professional knowledge and experience and only carry on regulated activities in respect of which the broker has the required competence.

According to “GP 5 Disclosure of Information”, a licensed insurance broker should provide clients with accurate and adequate information to enable them to make informed decisions. “GP 6 Suitability of Advice” states that a licensed insurance broker’s regulated advice should be suitable for the client taking into account the client’s circumstances while “GP 7 Conflicts of Interest” asks a licensed insurance broker to use best endeavours to avoid conflicts of interests and when such conflicts cannot be avoided, the broker should manage them with appropriate disclosure to ensure clients are treated fairly at all times. Lastly, “GP 8 Client Assets” mentions that a licensed insurance broker should have sufficient safeguards in place to protect client assets received by the broker or which are in the broker’s possession.

In terms of “Corporate Governance and Controls and Procedures”, a licensed insurance broker company should have proper controls and procedures in place to ensure that the broker company and its licensed technical representatives (broker) meet the General Principles, Standards and Practices set out in the Brokers’ Code.

Two separate Practice Notes supplementing certain Standards and Practices of the Code of Conduct for Licensed Insurance Brokers have been issued by IA. The first Practice Note, which supplements Standard and Practice 5.4 in the Brokers Code, sets out the minimum information which the IA expects a licensed insurance broker company to include in the terms and conditions of its client agreements for linked long term business (i.e. ILAS policies). The second Practice Notice, which supplements Standard and Practice 7.1 of the Brokers’ Code, sets out the minimum information which the IA expects a licensed insurance broker company to disclose to a client with respect to remuneration received from an insurer for arranging an insurance policy with the insurer on behalf of the client.

5.2.3 Guideline on “Fit and Proper” criteria for licensed insurance intermediaries under the Insurance Ordinance (GL23)

GL23 was issued pursuant to section 133 of the IO (Cap. 41) to outline the criteria and matters that the IA will normally consider in determining the fitness and properness of licensed insurance intermediaries and related persons.

Under the IO, a person who is applying to be a licensed insurance intermediary is required to satisfy the IA that he/she/it is a fit and proper person. In addition, for a licensed insurance agency or a licensed insurance broker company, its responsible officer(s), controller(s), partner(s) and director(s) (where applicable) are also required to be fit and proper persons. These “fit and proper” requirements aim at ensuring that licensed insurance intermediaries are competent, reliable and financially sound, and have integrity.

Besides, the Insurance (Financial and Other Requirements for Licensed Insurance Broker Companies) Rules (Cap. 41L) set out the requirements applicable to licensed insurance broker companies for minimum share capital, net assets, professional indemnity insurance, the keeping of proper books and records, and contents for audited financial statements and auditor’s report.

5.2.4 Three Former Self-Regulatory Bodies

The IA took over the regulatory functions from the three SROs, namely the IARB set up by the HKFI, the HKCIB and the PIBA on 23 September 2019.

(a) Hong Kong Federation of Insurers ("HKFI")

An important objective of the HKFI is to promote and advance the common interest of insurers and reinsurers transacting business in Hong Kong. According to its Mission Statement, the HKFI exists to promote insurance to the people of Hong Kong and build consumer confidence in the industry by encouraging the highest standards of ethics and professionalism amongst its members.

In the past, the HKFI also ran a self-regulatory organisation ("SRO") named the 'Insurance Agents Registration Board' ("IARB"), which was established in January 1993. The IARB used to perform the dual role of registering insurance agents and their Responsible Officers and Technical Representatives, and of handling complaints against insurance agents or their Responsible Officers or Technical Representatives, pursuant to the Code of Practice for the Administration of Insurance Agents. However, the IARB ceased to perform any self-regulatory functions on 23 September 2019 when the IA took over the regulation of insurance intermediaries from all three SROs.

(b) Hong Kong Confederation of Insurance Brokers ("CIB")

Like the HKFI, CIB, which was formed in February 1993, used to perform a self-regulatory function in relation to their members who are insurance brokers. That role, however, ended when the new regulatory regime for licensed insurance intermediaries came into effect on 23 September 2019.

Currently, CIB which engages with the IA on a regular basis serves as a professional body representing the interest of their insurance broker members, in particular providing compliance support via its Help Desk service to promote professionalism amongst brokers in the industry, and assist in making policy recommendations that will affect the local insurance broking industry and make relevant training available to their members.

(c) Professional Insurance Brokers Association ("PIBA")

Similar to CIB, PIBA, formally established on 29 January 1988, was the other self-regulatory body for their own insurance broker members. After the taking over of regulation by the IA on 23 September 2019, PIBA continues to work with the IA to play a vital role in representing their broker members, by assisting the insurance broker to comply with the insurance regulations and resolving issues encountered by insurance brokers.

PIBA also communicates regularly to members as regards the industrial trends and market changes so as to let its members keep abreast of industry development in the fast-changing market, and assist in making policy recommendations that will affect the local insurance broking industry and make relevant training available to their members.

5.2.5 Guideline on the Use of Internet for Insurance Activities (GL8)

In appreciation of the role of the Internet as the prime driver of contemporary electronic commerce, the insurance industry is increasingly engaging the Internet as an alternative medium for conducting business, particularly in marketing of insurance products and servicing of clients. To provide the insurance industry with guidelines on the use of the Internet to conduct insurance activities, the IA has published a ***Guideline on the Use of Internet for Insurance Activities (GL8)***. It aims at better protecting the insuring public and ensuring the healthy development of the insurance industry in the new information technology era.

The Internet is one of the channels for authorized insurers and insurance intermediaries, etc. to solicit business and to provide services to existing and potential policy holders. Hence, in conducting insurance business over the Internet, the parties concerned have to comply with the IO (Cap. 41) and other regulatory guidelines or industry rules in the same manner as conducting business in the conventional way.

The aim of GL8 is to better protect the insuring public and to ensure the healthy development of the insurance industry in the new information technology era. The scope of GL8 covers the internet insurance activities of all service providers to the extent that such activities fall within the jurisdiction of Hong Kong. The contents of GL8 cover the following areas: identity of service providers, authorisation status, security, privacy of client information, form of communication, sale of insurance products, use of third party websites and information from other websites.

5.2.6 Guideline on Underwriting Class C Business (GL15)

GL15 (see **Appendix H**) was issued by the IA pursuant to the IO and the Insurance Core Principles, Standards, Guidance and Assessment Methodology promulgated by the International Association of Insurance Supervisors. GL15 aims to set out proper standards of conduct and business practices for authorized insurers underwriting Class C business (investment-linked long term insurance). It should be read in conjunction with other relevant codes/circulars/guidelines/guidance notes issued by the IA or other regulatory bodies.

In assessing whether the requirements have been duly followed by authorized insurers, the IA will consider the substance and nature of the matters involved. The major areas covered by GL15 are: **Duties of the board of directors, the controller and the appointed actuary** It is the duty of the Controller to ensure that requirements set out in GL15 and other relevant codes and guidelines which should be read in conjunction are complied and observed throughout the life cycle of all ILAS policies, while it is the duty of the Board to maintain general oversight over the implementation of measures in compliance with GL15.

Product Design

The market products should be developed with due regard to the interest of customer by authorized insurers. An authorized insurer should ensure the product meets the "fair treatment of customers" principle. For instance, when designing the ILAS products, the insurers should ensure that the relevant product brings insurance value to clients, e.g. all ILAS products provide a minimum death benefit of 105% of the account value; the fee and charges paid by the customers should be fair, commensurate with the insurance protection offered; and the ILAS product should be sustainable.

Provision of Adequate and Clear Information

Insurers should provide customers with clear information before, during and after the point of sale. Information to be provided to customers should include key products features and risks associated in all product documents (the product brochure, Key Facts Statement ("KFS") and Important Facts Statement/Applicant's Declaration).

Suitability Assessment

ILAS products could only be sold to clients with both insurance and investment needs. Insurers should seek information from customers that is appropriate for assessing their insurance need through the use of Financial Needs Analysis ("FNA") form, before giving advice or concluding a contract, e.g. their financial knowledge and experience; needs, priorities and circumstances; ability to afford the product and risk profile.

Advice to Clients

A client should be fully apprised of the product features, fees and charges, surrender penalties as well as investment risks when he/she is considering and when he/she has decided to precure an ILAS policy, the client should be fully aware of his/her rights and obligations, such as the 21-day cooling-off period.

Appropriate Remuneration Structure

Authorized insurers have the duty to ensure that the remuneration structure for their intermediaries do not create misaligned incentives for the intermediaries to engage in mis-selling, aggressive selling, money laundering activities, etc. For example, an overly high commission in the initial year of an ILAS policy term, coupled with a short clawback period, may create misaligned incentives.

Avoidance of Conflict of Interests

Insurers and intermediaries should ensure all potential conflicts of interest are properly managed when customers receive advice before concluding an insurance contract.

Clients' Investments and Assets

Authorized insurers must strictly follow the investment instructions of policy holders in the allocation of premiums received, unless the deviation is based on sound actuarial principles and subject to the agreement of the IA.

Post-sale Control

To reaffirm clients' understanding of the ILAS policy that they have procured, and that they are fully aware of their rights and obligations under the ILAS policy, authorized insurers are required to make audio-recorded post-sale confirmation calls to all ILAS clients within 5 working days of the date of policy issue.

Authorized insurers should follow the formulation stipulated by the IA pursuant to clause 10.2 of GL 15, which sets out (a) a clear and uniform methodology to calculate the remuneration provided to intermediaries for the sale of individual ILAS products; and (b) a clear and uniform format in the disclosure of such remuneration

to clients procuring ILAS products. The objective of such remuneration disclosure is to enhance the transparency of ILAS products and allow clients to consider whether there exists any potential conflicts of interests and whether the remuneration would affect the intermediaries' recommending the ILAS product concerned. The remuneration figure disclosed must be realistic and meaningful to the client and the disclosure format must be simple and understandable by an average client.

5.3 SECURITIES LEGISLATION AND CODE OF CONDUCT

5.3.1 Securities and Futures Ordinance ("SFO")

The SFO *(Cap 571)* consolidates and modernizes the 10 previous Ordinances that regulate the securities and futures markets in Hong Kong. The purposes of the SFO are to:

1. consolidate and amend the law relating to financial products, the securities and futures market and the securities and futures industry;

2. regulate activities and other matters connected with financial products, the securities and futures market and the securities and futures industry;

3. provide for the protection of investors and other matters incidental thereto or connected therewith, and for connected purposes.

Section 4 of the Ordinance elaborates the regulatory objectives of the SFC which have been set out in section **5.1.2** above.

The SFO regulates not only various activities concerning securities but also that of collective investment schemes. It is therefore important to learn whether investment-linked insurance policies fall into the definition of securities or collective investment schemes.

(a) Collective Investment Scheme ("CIS")

The scope of CIS includes unit trusts and mutual fund corporations as previously defined in the repealed Securities Ordinance **(Cap 333)**. The detailed definition of CIS can now be found in Part 1 of Schedule 1 of the SFO. Generally, all CISs share the following common features:

- The participating persons of the CIS do not have day-to-day control over the management of the property;
- The property of the CIS is managed as a whole by or on behalf of the person operating the arrangements;
- The contributions of the participating persons and the profits or income from which payments are made to them are pooled.

Investment-linked insurance policies (see section **1.1**) fall within the definition of the term "collective investment scheme", made in Part 1 of Schedule 1 of the SFO.

(b) Securities

Securities are defined in Part 1 of Schedule 1 of the SFO. Interests in collective investment schemes fall within paragraph (d) of the definition of securities. However, subparagraph (ii)(C) of the definition explicitly excludes a contract of insurance in relation to any class of insurance business specified in Schedule 1 to the IO.

5.3.2 Licensing and Registration Requirements

General Requirements

Section 114(1) makes it an offence to carry on a business in regulated activities without being properly licensed or registered, a breach of which carries a maximum fine of HKD5,000,000 (plus a further fine of HKD100,000 for every day in the case of a continuing offence) and a maximum term of imprisonment of 7 years.

Sections 116, 119, and 120 stipulate the licensing and registration requirement as a licensed corporation, registered institution, and licensed representative for carrying on regulated activities.

5.3.3 Other Relevant Codes Issued by the SFC

Investment-linked policies are usually sold through insurance brokers/agents. As such, insurance intermediaries are encouraged to study and acquire knowledge of the ***Code on Unit Trusts and Mutual Funds***, which provides guidelines for authorisation of collective investment schemes in the likes of mutual fund corporations and unit trusts, and the ***Code on Investment-linked Assurance Scheme (the ILAS Code)***, which provides guidelines for authorisation of investment-linked assurance schemes. Some of the relevant issues have been discussed in section **3.7**. The ILAS Code specifically requires that an up-to-date offering document (including the principal brochure, illustration document, and **product KFS**) be issued to prospective ILAS customers to enable them to make an informed judgement of the proposed investment (see section **4.13.2 (b) and (c)** for details).

5.3.4 Offers of Investments

Part IV of the SFO regulates the offers of investment which includes, among others, authorization of collective investment schemes ("CIS") (section 104); authorization of advertisement, invitations or document containing an invitation to invest (section 105); and criminal and civil liability for making misrepresentation in inducing others to invest (sections 107 and 108).

(a) Authorization of Collective Investment Scheme & Advertisement

Section 103(1) makes it an offence to issue any advertisement, invitation, or documents, which to his knowledge is or contains an invitation to the public to acquire an interest in a collective investment scheme, unless authorized by the SFC, or exempted. A breach of this provision carries a maximum fine of HKD500,000 (plus a further fine of HKD20,000 for every day in the case of a continuing offence) and a maximum term of imprisonment of 3 years. Therefore, insurance intermediaries must not make use of documentation which has not been authorized by the SFC in the selling of investment-linked policies.

Section 104 empowers the SFC to authorize collective investment schemes. By virtue of section 104(1), the authorization may be granted subject to such conditions as the SFC considers appropriate.

Section 105(1) empowers the SFC to authorize any advertisement, invitation or document and to impose any other conditions as it considers appropriate.

(b) Misrepresentation

A fraudulent misrepresentation is defined in Section 107 of the SFO as any statement when it is made, is to the knowledge of its maker false, misleading or deceptive. Reckless misrepresentation is defined in the same section as any statement which, at the time when it is made, is false, misleading or deceptive and is made recklessly. It is important to note that a misrepresentation may include promise, forecast or even omission as the case may be.

Section 107(1) of the SFO stipulates that a person commits an offence if he makes any fraudulent misrepresentation or reckless misrepresentation for the purpose of inducing another person:

(a) to enter into or offer to enter into:

  (i) an agreement to acquire, dispose of, subscribe for or underwrite securities; or

  (ii) a regulated investment agreement; or an agreement to acquire, dispose of, subscribe for or underwrite any other structured products; or

(b) to acquire an interest in or participate in, or offer to acquire an interest in or participate in, a collective investment scheme.

It is worth noting that it is not an element of this offence that the accused has gained through such conduct or the other person has actually made an investment. A breach of this provision carries a maximum fine of HKD1,000,000 and a maximum term of imprisonment of 7 years.

Finally, section 108 of the SFO imposes civil liability for making fraudulent misrepresentation, reckless misrepresentation or negligent misrepresentation by which another person is induced:

(a) to enter into or offer to enter into:

  (i) an agreement to acquire, dispose of, subscribe for or underwrite securities; or

  (ii) a regulated investment agreement; or an agreement to acquire, dispose of, subscribe for or underwrite any other structured products; or

(b) to acquire an interest in or participate in, or offer to acquire an interest in or participate in, a collective investment scheme.

Negligent misrepresentation is defined in Section 108 of the SFO as any statement which is false, misleading or deceptive at the time when it is made and is made without reasonable care to ensure its accuracy. The wrongdoer may have to pay compensation by way of damages for any pecuniary loss sustained by the other party.

5.3.5 Market Misconduct

Various activities in relation to securities are prescribed as market misconducts which may lead to civil liability under Part XIII of the SFO. They include insider dealing, false trading, price rigging, stock market manipulation, disclosure of information about prohibited transactions and disclosure of false or misleading information that is likely to induce investment decisions or have a material price effect.

5.3.6 CIS Internet Guidance Note

In April 2013, the SFC issued an updated **"Guidance Note for Persons Advertising or Offering Collective Investment Schemes on the Internet"** (or CIS Internet Guidance Note). This clarifies the regulatory requirements concerning CIS activities on the Internet and should be read in conjunction with the "**Guidance Note on Internet Regulation**" issued in March 1999, and the IA's **"Guideline on the Use of Internet for Insurance Activities (GL8)"** (please refer to section **5.2.6**).

The **CIS Internet Guidance Note** consists of eight parts headed as follows:

1. Introduction;
2. Scope of CIS Internet Guidance Note;
3. General Regulatory Approach;
4. Advertisements on the Internet;
5. Offering of CIS on the Internet;
6. Provision of Analytical Tools;
7. Communication with CIS Investors via Electronic Means; and
8. Regulatory Development.

5.4 OTHER RELEVANT LEGISLATION

5.4.1 Anti-Money Laundering and Counter-Terrorist Financing Ordinance ("AMLO") and Guideline on Anti-Money Laundering and Counter-Terrorist Financing (GL3)

As per the Financial Action Task Force ("FATF"), an inter-governmental organization which sets global standards for combating money laundering ("ML"), terrorist financing ("TF") and proliferation financing ("PF"), the purchase of insurance products is a known international typology employed during the layering and integration stages of the money laundering process.

As a member of the FATF, Hong Kong is obliged to implement the latest FATF Recommendations, and it is important that Hong Kong complies with the international AML/CFT standards in order to maintain its status as an international financial centre. The main pieces of legislation in Hong Kong that are concerned with ML, TF, PF and financial sanctions are the AMLO, the Drug Trafficking (Recovery of Proceeds) Ordinance ("DTROP"), the Organized and Serious Crimes Ordinance ("OSCO") , the United Nations (Anti-Terrorism Measures) Ordinance ("UNATMO") , the United Nations Sanctions Ordinance ("UNSO") and the Weapons of Mass Destruction (Control of Provision of Services) Ordinance ("WMD(CPS)O").

The AMLO, coming into operation in April 2012, stipulates the CDD and record-keeping requirements for Financial Institutions ("FIs")[2] and Designated Non-Financial Business Professionals ("DNFBP"), and provides for a range of supervisory and enforcement powers to relevant authorities, which includes the IA. It also empowers the relevant authorities to impose supervisory sanctions for breaches of the statutory CDD and record-keeping requirements, together with the relevant review and appeal mechanism. Criminal sanctions may also be applied in some circumstances, e.g. a FI contravenes the statutory obligations knowingly or with an intent to defraud.

The IA issues a Guideline on Anti-Money Laundering and Counter-Terrorist Financing (commonly referred to as the "GL3"), which is published under section 7 of the AMLO and section 133 of IO, for authorized insurers, and reinsurers carrying on long term business, and licensed individual insurance agents, licensed insurance agencies and licensed insurance broker companies carrying on regulated activities in respect of long-term business. Its primary objectives are twofold: firstly, to provide a general background on the subjects of ML and TF, including a summary of the main provisions of the applicable AML/CFT legislation in Hong Kong; and secondly, to offer practical guidance to assist IIs and their senior management in developing and implementing their own policies, procedures and controls in the relevant operational areas to meet the relevant AML/CFT statutory and regulatory requirements, in particular those stipulated in Schedule 2 to the AMLO. However, the content of this GL3 is not intended to be an exhaustive list of the means of meeting the statutory and regulatory requirements. IIs should use this GL3 as a basis to develop measures appropriate to their structure and business activities.

While a failure to comply with any provision of the GL3 does not by itself render the person liable to any judicial or other proceedings but, in any proceedings under the AMLO before any court, the GL3 is admissible in evidence. In addition, a failure to comply with any provision of the GL3 by a licensed individual insurance agent, a licensed insurance agency or a licensed insurance broker company carrying on regulated activities in respect of long term business may, for example, reflect adversely on the fitness and properness of the licensed individual insurance agent, and (in the case of a licensed insurance agency and a licensed insurance broker company) its controller(s), director(s) and responsible officer(s), and may result in disciplinary action taken against the regulated person.

(a) Vulnerabilities of Money Laundering with Investment-Linked Long-Term Insurance

Linked long term business, commonly known as ILAS products, carries an increased inherent risk of money laundering, as highlighted in the Hong Kong Money Laundering and Terrorist Financing Risk Assessment Report. ILAS is a hybrid product with both insurance and investment elements. Policyholders assume the associated investment risks while also benefiting from insurance protection to some extent. The policy value depends on the performance of the

[2] As defined in section 1, Part 2 of Schedule 1 to the AMLO, FIs include authorized insurers, licensed individual insurance agents, licensed insurance agencies, and licensed insurance broker companies. As defined in sections 5(2) and 5(3) of the AMLO, the requirements on CDD and record-keeping as defined in Schedule 2 to the AMLO only has effect with respect to: -

(1) an authorized insurer only in relation to long term business carried on by the insurer.
(2) a licensed individual insurance agent, licensed insurance agency or licensed insurance broker company only in relation to any transaction carried out by that agent, agency or company involving a contract of insurance described in column 3 of Part 2 of Schedule 1 to the Insurance Ordinance (Cap. 41).

"underlying or reference funds". To prevent money laundering or fraudulent activities, certain market practices that could create misaligned incentives for insurance intermediaries have been strictly prohibited by the IA under GL15. These practices include indemnity commission, or any forms of excessively high upfront commission combined with a short clawback period. Insurers are also required by the IA's GL15 to have in place appropriate remuneration structures for insurance intermediaries and implement suitable clawback mechanisms to address the risks associated with ILAS products.

(b) AML/CFT Requirements under the GL3

In combating ML/TF risks, insurance intermediaries play a pivotal role as they are often the direct link to the policy holder for distribution, underwriting and claims settlement of long-term insurance products. The same principles that apply to insurers should generally extend to insurance intermediaries. Criminals seeking to launder money or finance terrorism may seek an insurance intermediary who is not aware of or does not conform to necessary procedures, or who fails to recognise or report information regarding possible cases of ML or TF. The intermediaries themselves could have been set up to channel illegitimate funds to insurers. Therefore, it is important for insurance intermediaries to be conversant with the statutory and regulatory requirements of AML/CFT, including those covered under the GL3, and the ML/TF risks arising from its businesses.

As mentioned above, GL3 provides practical guidance to assist IIs and their senior management in designing and implementing their AML/CFT Systems in the relevant operational areas. In designing the AML/CFT System, an II should also takes into consideration their specific circumstances, allowing them to meet the applicable AML/CFT statutory and regulatory requirements. The requirements under GL3 are summarised below:

(i) Risk-based Approach ("RBA")

RBA is central to the effective implementation of an AML/CFT regime. IIs are expected to identify, assess and understand the ML/TF risks to which they are exposed and take AML/CFT measures commensurate with those risks in order to manage and mitigate them effectively. RBA allows an II to allocate its resources more effectively and apply preventive measures that are commensurate with the nature and level of risks, in order to focus its AML/CFT effort in the most effective way. Therefore, an II should adopt an RBA in the design and implementation of its AML/CFT policies, procedures and controls (hereafter collectively referred to as "AML/CFT systems") with a view to managing and mitigating ML/TF risks.

(a) Institutional ML/TF Risk Assessment ("IRA")

The IRA forms the basis of the RBA, enabling an II to understand how and to what extent it is vulnerable to ML/TF. The II should conduct an IRA to identify, assess and understand its ML/TF risks in relation to:

(i) its customers;

(ii) its countries or jurisdictions its customers are from or in;

(iii) the countries or jurisdictions the II has operations in;

(iv) the products/services/transactions of the II; and

(v) delivery/distribution channels of the II.

In carrying out the IRA, an II should also give due consideration to the ML/TF threats and vulnerabilities in insurance industry, identified in the relevant risk assessment which may be issued from time to time (such as the aforementioned risk associated with ILAS products as identified in the Hong Kong's jurisdiction-wide ML/TF risk assessment) and any higher risks notified to the IIs by the IA.

To keep the IRA ML/TF risk assessment up-to-date, an II should conduct its assessment every two years and upon trigger events which are material to the II's business and risk exposure.

(b) Customer Risk Assessment ("CRA")

An II should assess the ML/TF risks associated with a proposed business relationship, which is usually referred to as a CRA. The CRA conducted at the initial stage of the CDD process would determine the extent of CDD measures to be applied. This means that the amount and type of information obtained, and the extent to which this information is verified, should be increased where the ML/TF risks associated with the business relationship are higher. It may also be simplified where the ML/TF risks associated with the business relationship is lower.

Similar to other parts of the AML/CFT Systems, an II should adopt an RBA in the design and implementation of its CRA framework, and the complexity of the framework should be commensurate with the nature and size of the II's business and should be designed based on the results of II's IRA. In general, the CRA framework will include customer risk factors; country risk factors; product/service/transaction risk factors and delivery/distribution channel risk factors.

(ii) AML/CFT Systems

An II should implement AML/CFT Systems, which includes appropriate policies, procedures and controls, having regard to the nature, size and complexity of its businesses and the ML/TF risks arising from those businesses, and which should include:

(a) compliance management arrangements;

(b) an independent audit function;

(c) employee screening procedures; and

(d) an ongoing employee training programme.

The senior management of an II is responsible for implementing effective AML/CFT Systems that can adequately manage the ML/TF risks identified. In particular, the senior management should appoint a Compliance Officer ("CO") at the management level to have the overall responsibility for the establishment and maintenance of the II's AML/CFT Systems; and a senior staff as the Money Laundering Reporting Officer ("MLRO") to act as the central reference point for suspicious transaction reporting.

(iii) Group-wide AML/CFT Systems

A Hong Kong-incorporated II with overseas branches or subsidiary undertakings that carry on the same business as a financial institution ("FI") as defined in the AMLO should implement group-wide AML/CFT Systems to apply the requirements set out in the GL3 to all of its overseas branches and subsidiary undertakings in its financial group, wherever the requirements in the GL3 are relevant and applicable to the overseas branches and subsidiary undertakings concerned.

In particular, a Hong Kong-incorporated II should, through its group-wide AML/CFT Systems, ensure that all of its overseas branches and subsidiary undertakings that carry on the same business as an FI as defined in the AMLO, have procedures in place to ensure compliance with the CDD and record-keeping requirements similar to those imposed under Parts 2 and 3 of Schedule 2 to the AMLO, to the extent permitted by the laws and regulations of that place.

(iv) Customer Due Diligence ("CDD")

An II should apply an RBA (usually through its CRA framework) when conducting CDD measures and the extent of CDD measures should be commensurate with the ML/TF risks associated with a business relationship. Where the ML/TF risks are high, the II should conduct enhanced due diligence ("EDD") measures. In low-risk situations, the II may apply simplified due diligence ("SDD") measures.

The following are CDD measures applicable to an II:

(a) identify the customer and verify the customer's identity using documents, data or information provided by a reliable and independent source;

(b) where there is a beneficial owner in relation to the customer, identify and take reasonable measures to verify the beneficial owner's identity so that the II is satisfied that it knows who the beneficial owner is, including, in the case of a legal person or trust, measures to enable the II to understand the ownership and control structure of the legal person or trust;

(c) obtain information on the purpose and intended nature of the business relationship (if any) established with the II unless the purpose and intended nature are obvious; and

(d) if a person purports to act on behalf of the customer:

(i) identify the person and take reasonable measures to verify the person's identity using documents, data or information provided by a reliable and independent source; and

(ii) verify the person's authority to act on behalf of the customer.

When an II knows that a customer or a beneficial owner of a customer is a non-Hong Kong Politically Exposed Person ("PEP")[3], it should, before (i) establishing a business relationship or (ii) continuing an existing business relationship where the customer or the beneficial owner is subsequently found to be a non-Hong Kong PEP, apply all the following EDD measures:

(a) obtaining approval from its senior management for establishing or continuing such business relationship; and

(b) taking reasonable measures to establish the customer's or the beneficial owner's source of wealth and the source of the funds.

(v) Ongoing Monitoring

Ongoing monitoring is an essential component of effective AML/CFT Systems. An II should continuously monitor its business relationship with a customer in two aspects:

(a) **ongoing CDD**: reviewing from time to time documents, data and information relating to the customer that have been obtained by the II for the purpose of complying with the requirements imposed under Part 2 of Schedule 2 to ensure that they are up-to-date and relevant; and

(b) **transaction monitoring**:

(i) conducting appropriate scrutiny of transactions carried out for the customer to ensure that they are consistent with the II's knowledge of the customer, the customer's business, risk profile and source of funds; and

(ii) identifying transactions that (i) are complex, unusually large in amount or of an unusual pattern; and (ii) have no apparent economic or lawful purpose, and examining the background and purposes of those transactions and setting out the findings in writing.

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[3] A non-Hong Kong PEP is defined in section 1 of Schedule 2 to the AMLO as:
(a) an individual who is or has been entrusted with a prominent public function in a place outside Hong Kong and
(i) includes a head of state, head of government, senior politician, senior government, judicial or military official, senior executive of a state-owned corporation and an important political party official;
(ii) but does not include a middle-ranking or more junior official of any of the categories mentioned in subparagraph (i);
(b) a spouse, a partner, a child or a parent of an individual falling within paragraph (a) above, or a spouse or a partner of a child of such an individual; or
(c) a close associate of an individual falling within paragraph (a).

(vi) Targeted Financial Sanctions, Database Maintenance, Screening and Enhanced Checking

The UNSC from time to time imposes sanctions on countries, entities and individuals deemed to be engaged in activities including terrorism, proliferation of weapons of mass destruction and corruption. The UNSC sanctions are generally implemented in Hong Kong under the UNSO and the UNATMO. Sanctions lists are published and updated via notices in the Government Gazette or on the website of the Commerce and Economic Development Bureau ("CEDB") pursuant to the relevant legislation. The IA provides links to these notices in its circulars and email alerts issued to the IIs and require the IIs to screen all new designation against their customer lists as soon as practicable whenever there are such updates.

Inclusion of a country, individual, entity or activity in a UNSC sanctions resolution or sanctions list may constitute grounds for knowledge or suspicion for the purposes of relevant money laundering and terrorist financing laws, thereby triggering statutory (including reporting) obligations as well as offence provisions. IIs should therefore establish and maintain effective policies, procedures and controls that they should be able to identify terrorist suspects and possible designated parties, and detect prohibited transactions. To this end, an II should ensure that it maintains (or subscribe to) a database of names and particulars of terrorist and designated parties which consolidates the various lists that have been made known to the II.

An II should implement an effective screening mechanism, which should include:

(a) screening its customers and any beneficial owners of the customers against current database at the establishment of the relationship; and

(b) screening its customers and any beneficial owners of the customers against all new and any updated designations to the database as soon as practicable.

The screening requirements should extend to the connected parties (such as director of a corporate customer) and the person purporting to act of behalf of the customer (PPTA) using an RBA. An II should also screen its payees, including policy beneficiaries, to ensure that proposed payments to terrorist suspects and possible sanctioned parties are not made at the time of the payout.

When possible name matches are identified during screening, an II should conduct enhanced checks to determine whether the possible matches are genuine hits. In case of any suspicions of TF, PF or sanctions violations, the II should make a report to the JFIU. Records of enhanced checking results, together with all screening records, should be documented, or recorded electronically.

(vii) Suspicious Transaction Reports ("STR")

It is a statutory obligation under sections 25A(1) of the DTROP and the OSCO, as well as section 12(1) of the UNATMO, that where a person knows or suspects that any property: (a) in whole or in part directly or indirectly represents any person's proceeds of, (b) was used in connection with, or (c) is intended to be used in connection with drug trafficking or an indictable offence; or that any property is terrorist property, the person shall as soon as it is reasonable for him to do so, file a suspicious transaction report ("STR") with the Joint Financial Intelligence Unit ("JFIU") of the Hong Kong Police Force. The STR should be made together with any matter on which the knowledge or suspicion is based. Under the DTROP, the OSCO and the UNATMO, failure to report knowledge or suspicion carries a maximum penalty of imprisonment for three months and a fine of $50,000.

"Tipping off" is another offence under the DTROP, OSCO and UNATMO. It is an offence to reveal to any person any information which might prejudice an investigation; if a customer is told that a report has been made, this would prejudice the investigation and an offence would be committed. The tipping off provision includes circumstances where a suspicion has been raised internally within an II, but has not yet been reported to the JFIU.

An II should implement appropriate AML/CFT Systems in order to fulfill its statutory reporting obligations as set out above, and properly manage and mitigate the risks associated with any customer or transactions involved in an STR. The AML/CFT Systems should include:

(a) appointment of an MLRO;

(b) implementing clear policies and procedures over internal reporting, reporting to the JFIU, post-reporting risk mitigation and prevention of tipping off; and

(c) keeping proper records of internal reports and STRs.

As far as an II is concerned, when a transaction or a series of transactions of a customer is not consistent with the II's knowledge of a customer, or is unusual (e.g. in a pattern that has no apparent economic or lawful purpose), the II should take appropriate steps to further examine the transactions and identify if there is any suspicion. Examples of what might constitute suspicious transactions are provided in paragraph 7.4, Annex I and Annex II of the GL3, which are not intended to be exhaustive. However, identification of any of the types of these transactions should prompt further investigations and be a catalyst towards making at least initial enquiries about the source of funds.

An II should provide sufficient guidance to its staff to enable them to form suspicion or to recognize the signs when ML/TF is taking place. Also, an II should establish and maintain clear policies and procedures to ensure that: (a) all staff are made aware of the identity of the MLRO and of the procedures to follow when making an internal report; and (b) all internal reports should reach the MLRO without undue delay. Once a staff of an II has reported suspicion to the MLRO in accordance with the policies and procedures established by the II for the making of such reports, the statutory obligation of the staff has been fully satisfied.

When evaluating an internal report, an MLRO should take reasonable steps to consider all relevant information, including CDD and ongoing monitoring information available within or to the II concerning the customer to which the report relates. The review process should be documented, together with any conclusions drawn. If after completing the review of the internal report, an MLRO decides that there are grounds for knowledge or suspicion, he should disclose the information to the JFIU as soon as it is reasonable to do so after his evaluation is complete together with the information on which that knowledge or suspicion is based.

(viii) Record-keeping

Record-keeping is an essential obligation as required under the AMLO as well as the GL3 as it forms the audit trail for the detection, investigation, and confiscation of criminal or terrorist property and funds. An II should maintain CDD information, transaction records and other records that are necessary and sufficient to meet the statutory and regulatory requirements that are appropriate to the nature, size, and complexity of its businesses. All documents and records as required under the AMLO and GL3 should be kept throughout the continuance of the business relationship with the customer and for a period of at least five years after the end of the business relationship.

Where customer identification and verification documents are held by an intermediary on which an II is relying to carry out CDD measures, the II concerned remains responsible for compliance with all record-keeping requirements. The II should ensure that the intermediary being relied on has systems in place to comply with all the record-keeping requirements under the AMLO and the GL3, and that documents and records will be provided by the intermediary as soon as reasonably practicable after the intermediary receives the request from the II.

For individual insurance agents who are appointed agents of an authorized insurer, the GL3 points out that they are usually required to provide all customer and transaction related documentation to the insurer directly, and they do not have the capacity to maintain such documents. Under this arrangement, and from the perspective of meeting the record-keeping requirements set out in Part 3 of Schedule 2 to the AMLO, these individual agents are considered to have deposited the required records and documents at the premises of the insurer. However, the individual insurance agents should still ensure that:

(a) the insurer to which they provide the records and documents has systems in place to comply with all the record-keeping requirements under the AMLO; and

(b) such records and documents are accessible from the insurer without delay upon request by the IA.

(ix) Staff Training

According to GL3, it is an II's responsibility to provide adequate training for its staff so that they are adequately trained to implement its AML/CFT Systems. An II should implement a clear and well-articulated policy for

ensuring that relevant staff receive adequate AML/CFT training. The scope and frequency of training should be tailored to the specific risks faced by the II and pitched according to the job functions, responsibilities and experience of the staff. New staff should be required to attend initial training as soon as possible after being hired or appointed. Apart from the initial training, an II should also provide refresher training regularly to ensure that its staff are reminded of their responsibilities and are kept informed of new developments related to ML/TF.

It is important for the II's staff to be made aware of their II's and their own personal statutory obligations and the possible consequences for failure to comply with CDD and record-keeping under the AMLO; and failure to report suspicious transactions under the DRTOP, the OSCO, and the UNATMO. The staff should also observe the other statutory and regulatory obligations under the DTROP, the OSCO, the UNATMO, the UNSO, the WMD(CPS)O and the AMLO and the possible consequences of breaches. The II should also adequately train their staff on their policies and procedures relating to AML/CFT, including suspicious transaction identification and reporting, and any new or emerging techniques, methods and trends in ML/TF to the extent that is needed by the staff to carry out their role in the II with respect to AML/CFT.

No matter what training approach is adopted, an II should maintain records of who have been trained, when the staff received the training and the type of training provided for a minimum of 3 years.

(x) Wire Transfers

GL3 provides guidance on wire transfers, which primarily applies to authorized institutions and money service operators. Other FIs should also comply with section 12 of Schedule 2 and the guidance on wire transfers if they act as an ordering institution, an intermediary institution or beneficiary institution as defined under the AMLO.

5.4.2 Personal Data (Privacy) Ordinance ("PDPO")

The PDPO was enacted to protect the privacy of individuals in relation to personal data. For the purposes of the PDPO, an office has been established by the name of the Privacy Commissioner for Personal Data. A very important function of the Commissioner is to monitor and supervise compliance with the PDPO.

Personal data includes any data relating directly or indirectly to a living individual; from which it is practicable for the identity of the individual to be directly or indirectly ascertained; and in a form in which access to or processing of the data is practicable.

The PDPO provisions that data users should comply with are numerous, including the following six data protection principles, which are set out in Section 4 and Schedule 1 of the PDPO:

<u>Principle 1: purpose and manner of collection of personal data</u>

Personal data should not be collected unless: (i) the data are collected for a lawful purpose directly related to a function or activity of the data user who is to use the

data; (ii) the collection of the data is necessary for or directly related to that purpose, and (iii) the data are adequate but not excessive in relation to that purpose. The data should be collected by lawful and fair means.

The data subject should be informed of: (i) the purpose for which the data are to be used; (ii) the classes of persons to whom the data may be transferred; and (iii) his/her rights to access and to request the correction of the data.

Principle 2: accuracy and duration of retention of personal data

The personal data should be accurate, up-to-date and kept no longer than is necessary. In particular, if a data user engages a data processor, whether within or outside Hong Kong, to process personal data on the data user's behalf, the data user should adopt contractual or other means to prevent any personal data that has been transferred to the data processor from being kept longer than is necessary for processing of the data. The term 'data processor' means "a person who (a) processes personal data on behalf of another person, and (b) does not process the data for any of the person's own purposes".

Principle 3: use of personal data

Personal data shall not, without the prescribed consent of the data subject, be used for a new purpose (i.e. any purpose other than (i) the purpose for which the data was to be used at the time of the collection of the data; or (ii) a purpose directly related to that purpose.

Principle 4: security of personal data

All practicable steps should be taken to ensure that personal data (including data in a form in which access to or processing of the data is not practicable) held by a data user and the data processor engaged by the data user are protected against unauthorized or accidental access, processing, erasure or other use.

Principle 5: openness and transparency of personal data

A data user must take practicable steps to make personal data policies and practices known to the public regarding the types of personal data it holds and how the data is used.

Principle 6: access and correction to personal data

A data subject must be given access to his personal data and to make corrections where the data is inaccurate.

Apart from the PDPO, insurance practitioners are advised to read the guidelines, guidance notes and information leaflets issued by the relevant regulatory bodies for practical guidance on collection and use of personal data, including the "Guidance on the Proper Handling of Customers' Personal Data for the Insurance Industry" issued by the Office of the Privacy Commissioner for Personal Data.

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Representative Examination Questions

Type "A" Questions

1. Which of the following is not one of the purposes of the ***Insurance Ordinance***?

    (a) to regulate the carrying on of insurance business;
    (b) to establish the Insurance Authority to regulate the insurance industry for protecting policy holders and potential policyholders;
    (c) to establish a regulatory control framework for the wording of investment-linked insurance policies;
    (d) to establish the Insurance Authority to regulate the insurance industry for promoting its stable development.

[Answer may be found in **5.2.1**]

2. To promote an unauthorized fund is a breach of the SFO and will be subject to:

    (a) a fine of up to HKD500,000 and imprisonment for up to 3 years;
    (b) a fine of up to HKD1,000,000 and imprisonment for up to 7 years;
    (c) imprisonment for up to 10 years;
    (d) reprimand by the SFC.

[Answer may be found in **5.3.4**]

Type "B" Questions

3. Some of the purposes of the ***Securities and Futures Ordinance*** are to:

    (i) consolidate and amend the law relating to financial products, the securities and futures market and the securities and futures industry
    (ii) regulate activities and other matters connected with financial products, the securities and futures market and the securities and futures industry
    (iii) provide for the protection of investors
    (iv) provide for other matters incidental thereto or connected therewith, and for connected purposes

    (a) (i), and (ii) only;
    (b) (ii) and (iii) only;
    (c) (ii), (iii) and (iv) only;
    (d) all of the above.

[Answer may be found in **5.3.1**]

4. Which of the following are some of the matters that the Insurance Authority will take into account in considering whether a person is fit and proper to be licensed as a technical representative?

   (i) financial status
   (ii) relevant educational or other qualifications
   (iii) relevant criminal conviction or professional misconduct
   (iv) having integrity

   (a) (i), and (ii) only;
   (b) (ii) and (iii) only;
   (c) (ii), (iii) and (iv) only;
   (d) all of the above.

[Answer may be found in **5.2.3**]

[*If still required, the answers may be found at the end of the Study Notes.*]

Appendix A

Compound Interest Rate and Yield (1/2)

Time value of money is the concept that the purchasing power of money in the future (future value) is worth more than that same amount today (present value) due to an assumed interest earning growth or implied inflation expectation.

Present value (PV) = the value of money today
Future value (FV) = the value of the same amount of money compounded at a given rate in the future

Example:

If a group of assets is valued at HKD100 today. It is assumed that this value will grow at a rate of 8% per year for two years. The future value or the value of the same HKD100 in two years would be as follows:

Year 1 HKD100 x 1.08 = HKD108
Year 2 HKD108 x 1.08 = HKD116.64

<u>Or</u> you can calculate it as HKD100 x 1.08^2

The concept of time value of money incorporates the concept of the compound rate of interest. Compounding is the ability of an asset (in above case the HKD100) to generate interest that is then added to previous principal plus interest (HKD108).

The formal formula is: $PV (1 + r)^n = FV$

PV = Present Value
r = the interest rate per period
n = the number of compounding periods
FV = Future Value

In the example at section **4.6.7**, we assumed a policyholder has 3,780.75 units. The unit bid price is HKD12.

In 10 years' time, HKD12 will be HKD25.91 assuming a growth rate of 8%.

It is calculated as HKD12 x $(1.08)^{10}$ = HKD25.91

Thus, in 10 years' time, the value of the units will be 3,780.75 x HKD25.91 = HKD97,959.23. The return on gross premium using the same HKD50,000 single premium as per the previous example will be calculated as follows:

HKD50,000$(1 + r)^{10}$ = HKD97,959.23

Appendix A

Compound Interest Rate and Yield (2/2)

Let r be the rate of return on gross premium per annum.

HKD50,000 x $(1 + r)^{10}$	= HKD97,959.23
$(1+r)^{10}$	= HKD97,959.23/HKD50,000
	= 1.9592
(1+r)	= $1.9592^{1/10}$
	= 1.0696
r	= 1.0696-1
	= 0.0696
	= 6.96%

GL26

GUIDELINE ON SALE OF INVESTMENT-LINKED ASSURANCE SCHEME ("ILAS") PRODUCTS

Insurance Authority

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Guideline on Sale of Investment-Linked Assurance Scheme ("ILAS") Products (GL26) and Important Facts Statement and Applicant's Declarations (Appendix 1) (3/24)
(Source: IA GL26)

1. Introduction

1.1 The Insurance Authority ("IA") issues this Guideline pursuant to section 133 of the Insurance Ordinance (Cap. 41) ("Ordinance"), its principal function to regulate and supervise the insurance industry for the protection of existing and potential policy holders and its function to promote and encourage the adoption of proper standards of conduct and sound prudent business practices by authorized insurers and proper standards of conduct by licensed insurance intermediaries. This Guideline also takes account of the Insurance Core Principles, Standards and Guidance and Assessment Methodology ("ICP") promulgated by the International Association of Insurance Supervisors, in particular ICP 19 which stipulates that the conduct of the business of insurance should ensure that customers are treated fairly.

1.2 Linked long term business (as defined in paragraph 2.2(h) below), more commonly known as Investment-linked Assurance Schemes ("ILAS") products are long term contracts of insurance which provide both life insurance protection and investment options. Customers who purchase ILAS products bear investment risk associated with the product. As ILAS products are long-term in nature, they also often have more restricted liquidity levels as compared with other forms of investments. The charging structure for ILAS products can also be complex, with fees being incurred in relation to both the insurance and investment elements of the contract. Given these features, it is important for authorized insurers and licensed insurance intermediaries to ensure that customers, before they purchase ILAS products, are fully apprised of the nature, key features and risks of such products, as well as the rights and obligations associated with such products. This is the main objective of this Guideline.

1.3 The Guideline on Underwriting Class C Business (GL15), which applies to authorized insurers, already stipulates proper standards of conduct and business practices for authorized insurers underwriting linked long term business, i.e. ILAS products, covering requirements in relation to both the design of ILAS products and the sale process for ILAS products. This Guideline supplements GL15 by including more detailed requirements on the sale process for ILAS products and setting out the minimum standards and practices that should be implemented and adopted by authorized insurers and licensed insurance intermediaries in that sale process in order to achieve the objectives stated in this Guideline and ensure fair treatment of customers.

2. Scope and Interpretation

2.1 This Guideline applies to all authorized insurers carrying on or advising on linked long term business, and all licensed insurance intermediaries carrying on regulated activities in respect of linked long term business.

2.2 In this Guideline, unless the context otherwise specifies:

(a) "Applicant's Declarations" means the written declarations which an authorized insurer and licensed insurance intermediary are required to obtain from a customer, as a check-point to assist the authorized insurer and licensed insurance intermediary to focus the customer's attention on the suitability of the ILAS product for the customer and to confirm the customer's understanding of the risks associated with the ILAS product (see further paragraph 7 below);

(b) "Authorized institution" has the meaning assigned to it by section 2(1) of the Banking Ordinance (Cap. 155);

(c) "Base plan" means the ILAS policy issued by the authorized insurer based on a customer's original application. The base plan does not include any subsequent additional insurance cover purchased (such as top-up investment under the same policy) which are the subject of subsequent application(s) made by the customer on the same ILAS policy;

(d) "Customer" bears the same meaning as policy holder or potential policy holder, and those terms are used under the Ordinance;

(e) "Date of policy issue" means the date on which the authorized insurer, having accepted an application for an ILAS policy by the policy holder, creates the document that is the policy holder's ILAS policy;

(f) "Financial Needs Analysis" or "FNA" means the assessment of a customer's circumstances including needs, financial situation, ability and willingness to pay premiums, etc. which an authorized insurer and licensed insurance intermediary are required to undertake before making any recommendation in respect of a suitable life insurance policy to the customer, with the recommendation being based on that assessment. The requirements in relation to an FNA are set out in Guideline on Financial Needs Analysis issued (GL30) by the IA (see further paragraph 5 below);

(g) "Important Facts Statement" or "IFS" means the statement in relation to an ILAS product being recommended which should be provided to a customer and the content of which should include information such as the investment risk, liquidity risk and other risks associated with the product, the fees and charges structure for the product and the fact that the customer has a cooling-off period (see further paragraph 7 below);

(h) "Linked long term business" refers to contracts of insurance in Class C (Linked long term) of Part 2 of Schedule 1 to the Ordinance. In this Guideline, a reference to an "ILAS product" or "ILAS policy" is to a contract of insurance within the definition of "linked long term business";

(i) "Point-of-sale audio recording" means an audio recording that an authorized insurer is required to arrange for a customer to listen to (in lieu of conducting a post-sale call), after the sale process for a base plan of an ILAS product has been completed with the customer (including after the customer having chosen the underlying investment choices in relation to the ILAS product he/she has purchased). The authorized insurer should arrange for the customer to listen to the audio recording at the place where the sale process for the ILAS product was completed, and the content of the audio recording should re-affirm the customer's understanding of the ILAS product he/she has just purchased (and the underlying investment choices selected) and remind the customer of his/her rights and obligations under the ILAS product (see further paragraphs 4.2(k), 9.3 and 9.4 below); and

(j) "Risk Profile Questionnaire" or "RPQ" means the questionnaire which a customer is asked to complete in order for an assessment to be made by an authorized insurer or a licensed insurance intermediary of the customer's investment risk appetite, and to determine if a particular ILAS product and its underlying investment choices are suitable for the customer, before the licensed insurance intermediary makes a recommendation on an ILAS product (see further paragraph 6 below).

2.3 Unless otherwise specified, words and expressions used in this Guideline shall have the same meanings as given to them in the Ordinance.

3. Relevant Regulatory Documents and Status of this Guideline

3.1 This Guideline should be read, where appropriate, in conjunction with the relevant provisions of the Ordinance and all other relevant rules, codes, circulars and guidelines issued by the IA or other regulatory/professional bodies, including but not limited to the following:

(a) Guideline on Classification of Class C – Linked Long Term Business (GL11) issued by the IA;

(b) Guideline on Underwriting Class C Business (GL15) issued by the IA;

(c) Guideline on Offering of Gifts (GL25) issued by the IA;

(d) Guideline on Long Term Insurance Policy Replacement (GL27) issued by the IA;

(e) Guideline on Benefit Illustrations for Long Term Insurance Policies (GL28) issued by the IA;

(f) Guideline on Cooling-off Period (GL29) issued by the IA;

(g) Guideline on Financial Needs Analysis (GL30) issued by the IA;

(h) Code of Conduct for Licensed Insurance Agents issued by the IA;

(i) Code of Conduct for Licensed Insurance Brokers issued by the IA;

(j) All relevant rules, codes, circulars and guidelines relating to ILAS products administered or issued by the Hong Kong Monetary Authority ("HKMA"); and

(k) All relevant rules, codes, circulars and guidelines relating to ILAS products administered or issued by the Securities and Futures Commission ("SFC").

3.2 This Guideline does not have the force of law, in the sense that it is not subsidiary legislation, and should not be interpreted in a way that would override the provision of any law. A non-compliance with the provisions in this Guideline would not by itself render an authorized insurer or a licensed insurance intermediary liable to judicial or other proceedings. A non-compliance may, however, for example reflect on the IA's view of the

continued fitness and properness of (i) the directors, controllers and key persons in relevant control functions of the authorized insurers to which this Guideline applies; and (ii) the licensed insurance intermediaries to which this Guideline applies and (in the case of licensed insurance agencies and licensed insurance broker companies) their directors, controllers and responsible officers. The IA may also take guidance from this Guideline in considering whether there has been an act or omission likely to be prejudicial to the interests of policy holders or potential policy holders (albeit the IA will always take account of the full context, facts and impact of any matter before it in this respect).

3.3 In assessing whether the minimum standards and practices in this Guideline have been duly followed, the IA will adopt a principle-based approach by considering whether the objectives of this Guideline are achieved. The IA may also take into account whether further guidance provided by the IA by way of circulars or other documents on the minimum standards and practices in this Guideline have been followed.

4. Fair Treatment of Customers in the Sale Process for ILAS Products

4.1 Authorized insurers and licensed insurance intermediaries should ensure that the sale process for ILAS products is fair to customers. In this regard, the suitability of an ILAS product (including its underlying investment choices) for a customer should be properly assessed with due regards to the customer's circumstances. An ILAS product should only be recommended if it is considered suitable to meet the customer's insurance, financial and investment needs. During the sale process of an ILAS product, the risks associated with the product, its key features and the fees and charges structure (including those of the underlying investment choices) need to be fully disclosed and explained to the customer, and the customer should be given adequate opportunity to consider these before deciding to purchase the product.

4.2 To achieve the objectives in paragraph 4.1 above, the sale process for an ILAS product should cover the following steps:

(a) An adequate suitability assessment in relation to a prospective customer, covering the requirements in paragraphs 4.2(b) to (k) below should be carried out in order to assess whether, based on the customer's circumstances, objectives, needs and priorities, an ILAS product (including its underlying investment choices) is a suitable option.

(b) The completion of a Financial Needs Analysis ("FNA") in relation to the prospective customer is an imperative step which needs to be completed as part of the suitability assessment. Based on the information gathered in the FNA and any other relevant information provided, the licensed insurance intermediary should explore suitable insurance options for the customer.

(c) If an ILAS product is considered as a potentially suitable option for the customer, the licensed insurance intermediary should assess the customer's investment risk appetite. This should be done by means of completing a Risk Profile Questionnaire ("RPQ") in relation to the customer.

(d) If, based on the information obtained in the FNA and RPQ processes, and any other relevant information obtained, a particular ILAS product (including its underlying investment choices) is considered to be suitable for the customer, then it may be recommended.

(e) If, after the ILAS policy has been issued, the customer subsequently applies to make a top-up investment to the policy, the FNA and RPQ processes should be completed. However, the FNA and RPQ processes are not required if the customer purchases a top-up investment from the same authorized insurer or via the same licensed insurance intermediary within 12 months from the completion of the previous FNA and RPQ processes (in relation to applications for base plan or top-up), unless there are material changes in the circumstances of the customer or the top-up investment would result in a mismatch.

(f) During the sale process of an ILAS product, the customer should be properly apprised of the product features, particularly the fees and charges, including but not limited to surrender or withdrawal charges (if any), as well as the product and investment risks (as set out in paragraph 4.2(j) below) (including those of the underlying investment choices). Accordingly, the licensed insurance intermediary should disclose and explain to the customer, and provide the customer with information on the product (including information on the underlying investment choices), for example, product brochures, product key facts statement and illustration documents, and the customer should be given adequate opportunity to review them and ask questions. Authorized insurers should ensure that all such materials are approved by the SFC (if so required) and are up to date.

(g) The customer should also be provided with an Important Facts Statement ("IFS") in relation to the ILAS product being recommended, the content of which should include information such as the investment risk, liquidity risk and other risks associated with the product, the fees and charges structure for the product and the fact that the customer has a cooling-off period. These matters should be explained by the licensed insurance intermediary during the sale process before the customer signs the IFS / Applicant's Declarations and the application for the product is submitted. The IFS / Applicant's Declarations must be completed for base plan and top-up applications.

(h) If a customer refuses to disclose requisite information during the above process(es), the licensed insurance intermediary should clearly explain to the customer that without such information the authorized insurer and licensed insurance intermediary would be unable to comply with the requirements contained in this Guideline, and consequently this would likely result in the authorized insurer rejecting the application. No ILAS products should be recommended to the customer if requisite information is not disclosed by the customer.

(i) Where an ILAS product (including its underlying investment choices) has any unusual features (e.g. market value adjustment, leverage, investment choices based on hedge funds, or extensive use of derivatives other than for risk management purposes), licensed insurance intermediaries are required to take additional care when explaining these unusual features at the point-of-sale.

(j) Licensed insurance intermediaries also have the duty to disclose and explain the risks associated with ILAS products (including those of the underlying investment choices), such as counterparty risk, credit risk, liquidity risk, foreign exchange risk, market risk, etc., to customers. They should also take all reasonable measures to satisfy themselves that customers fully understand and accept the features and risks associated with the ILAS products (including those of the underlying investment choices), and such understanding should be documented in writing, signed and dated by customers.

(k) To re-affirm the customer's understanding of the ILAS product (including those of the underlying investment choices) purchased, and also to re-affirm that the customer is fully aware of his/her rights and obligations under the ILAS product, the authorized insurer issuing the

product is required to make an audio-recorded post-sale confirmation call within 5 working days of the date of policy issue or conduct a point-of-sale audio recording for the customer to listen to at the end of the sale process for the base plans of ILAS products.

4.3 The indicative sale flow referencing the process described above is set out in the flowchart in the Appendix[1]. Further details on the key stages in the process and their objectives are also set out in the following paragraphs and Appendix to this Guideline. Authorized insurers, licensed insurance agencies and licensed insurance broker companies are required to put in place an effective operational control mechanism and provide appropriate and regular training to licensed insurance intermediaries and staff, where appropriate, to ensure that the process as set out in this Guideline is duly completed.

5. The FNA Process

5.1 The objective of the FNA process is for an assessment of a customer's circumstances including needs, financial situation, ability and willingness to pay premiums, etc., to be made before a recommendation in respect of a suitable life insurance product (including an ILAS product) is made to the customer. Authorized insurers and licensed insurance intermediaries should use the FNA process as part of the sale process for an ILAS product to achieve this objective.

5.2 Where, in the FNA process the prospective customer indicates that one of the customer's objectives for seeking an insurance product is "investment", information must be collected during the FNA process about whether the customer is able and willing to make his/her own decision to choose and manage different investment choices available under an ILAS product before an ILAS product should be introduced or recommended to the customer.

5.3 The detailed requirements for the FNA process are set out in the Guideline on Financial Needs Analysis (GL30).

[1] The flowchart in this Guideline is an updated version of the flowchart in the Annex to GL15.

6. The RPQ Process

6.1 The objective of the RPQ process is for an assessment of a customer's investment risk appetite, and to determine if a particular ILAS product and its underlying investment choices are suitable for the customer, before making a recommendation. Authorized insurers and licensed insurance intermediaries should use the RPQ process as part of the sale process for an ILAS product to achieve this objective.

6.2 As a minimum, the RPQ should aim to ascertain, the customer's:

(a) investment objectives;

(b) preferred investment horizon;

(c) risk tolerance;

(d) financial circumstances; and

(e) knowledge (including investment knowledge in derivatives) and experience (including experience in investment and the period of such experience).

6.3 Authorized insurers, licensed insurance agencies and licensed insurance broker companies may develop their own form of RPQ, subject to such RPQ conforming with the objectives, standards and practices in this Guideline.

6.4 A completed RPQ form must be signed and dated by the customer and the licensed insurance intermediary.

7. IFS, Applicant's Declarations and Remuneration Disclosure

7.1 The objective of an IFS is to set out important facts including the key product features and risks in relation to an ILAS product being recommended, for the customer's attention. The objective of the Applicant's Declarations is to provide a check-point to assist the authorized insurer and licensed insurance intermediary to focus the customer's attention on the suitability of the ILAS product for the customer and to confirm his/her understanding of the risks associated with it. A further objective of the IFS and Applicant's Declarations process is to provide disclosure of the licensed insurance intermediaries' remuneration to the customer. Authorized insurers and licensed insurance

intermediaries should use the IFS and Applicant's Declarations process as part of the sale process for an ILAS product to achieve these objectives.

7.2 It is for the authorized insurer of an ILAS product to create and produce the IFS form including the Applicant's Declarations for the product. The Applicant's Declarations should require the customer to declare that he/she has received, read and understood the following documents in relation to the product:

(a) product brochure;

(b) product key facts statement;

(c) illustration document;

(d) investment choice brochure; and

(e) any other document as may be specified by the IA and other regulators from time to time.

7.3 The template issued by the IA from time to time by way of circular, for an IFS and Applicant's Declarations including the disclosure of licensed insurance intermediaries' remuneration, should be followed and should be adopted in terms of structure, groupings and signatures.

7.4 A completed IFS and Applicant's Declarations form must be signed and dated by the customer and the licensed insurance intermediary.

7.5 Authorized insurers, licensed insurance agencies and licensed insurance broker companies are required to put in place mechanisms to ensure the customer's understanding of the information provided during the sale process, including key product features and risks as well as his/her rights and obligations, as evidenced in the IFS/ Applicant's Declarations.

7.6 In addition to the disclosure of remuneration made in the IFS, authorized insurers and licensed insurance intermediaries should observe the following principles in handling requests/enquiries from customers on remuneration and formulate an approach to handle such requests/enquiries in accordance with such principles:

(a) disclosure must be made and should not be refused;

(b) the remuneration amount and methodology should be accurate, and not misleading to customers;

(c) disclosure must be clear and given in such a way that it can easily be understood by average customers; and

(d) a common approach should be taken for all products and customer groups.

8. Effective Controls and Procedures in relation to Suitability Checks and Product Disclosure

8.1 In assessing whether a particular ILAS product (including its underlying investment choices) sold is suitable for the customer and proper product disclosure has been made, authorized insurers, licensed insurance agencies and licensed insurance broker companies are required to establish effective controls and procedures to:

(a) verify whether the key features of that ILAS product and the underlying investment choices chosen are considered suitable for the customer, including whether the premium amount and payment term are considered suitable for the customer based on the information disclosed;

(b) verify whether the licensed insurance intermediary has taken due account of the reasons/considerations as set out by the customer in the "Statement of Purpose" paragraph of the IFS, together with all other relevant information;

(c) verify whether the licensed insurance intermediary has properly disclosed and explained the key features and risks of the ILAS product (including its underlying investment choices) as well as the customer's rights and obligations during the sale process; and

(d) handle appropriately any exceptions in accordance with the post-sale controls as set out in paragraph 9.

8.2 Licensed insurance intermediaries are required to verify and ensure that all available information obtained from customers are not contradictory. Authorized insurers are also required to verify all available information during their underwriting process and reject applications for ILAS products if any of

the requirements in this Guideline are not met. Where appropriate, authorized insurers should follow up via the licensed insurance intermediaries concerned, e.g. in case of mismatch.

8.3 ILAS products may have a common feature to allow customers to switch their investment choices and to place top-up investment after policy inception. Authorized insurers, licensed insurance agencies and licensed insurance broker companies should have effective controls in place to ensure customers are aware of the possible risks associated with switching investment choices or placing top-up investment after policy inception that may become inconsistent with their risk profile.

9. Post-Sale Controls

9.1 The objectives of post-sale controls is to reaffirm customers' understanding of the ILAS policy that they have purchased, and that they are fully aware of their rights and obligations under the ILAS policy. The requirements in this paragraph 9 supplement and provide further details on the post-sale control requirements in paragraph 12 of GL15.

9.2 Authorized insurers should send the following documents along with the issued policy to the customer upon the completion of the sale process:

(a) copies of the signed IFS and Applicant's Declarations; and

(b) a notice (i) informing the customer that his/her original signed FNA and RPQ are available for inspection; and (ii) advising where and how the customer may access these documents.

9.3 Authorized insurers should conduct either post-sale calls or point-of-sale audio recordings for base plans of ILAS products sold via all distribution channels. For bancassurance channel, authorized insurers and licensed insurance intermediaries have the duty to observe the relevant requirements imposed by the HKMA, including the requirement for audio recordings of the sale of ILAS products.

9.4 During the post-sale calls or point-of-sale audio recordings which authorized insurers are required to conduct, authorized insurers should confirm the following with the customer:

(a) the details in the suitability assessment as set out in both the FNA and

RPQ;

(b) the details in the IFS and Applicant's Declarations; and

(c) whether proper product disclosure and explanation has been made by the licensed insurance intermediary to the customer.

Authorized insurers should keep the relevant post-sale call recordings or point-of-sale audio recordings in accordance with the relevant provisions under the Personal Data (Privacy) Ordinance (Cap. 486) or any other requirements imposed by the Office of the Privacy Commissioner for Personal Data from time to time.

9.5 Authorized insurers should remind the customers of their rights to contact them if the customer disagrees with any of the matters communicated during the post-sale process and/or wishes to make any enquiries before the expiry of the cooling-off period. In the event of disagreement or an uncertain reply by a customer, the authorized insurer should follow-up either directly or through the relevant licensed insurance intermediary with the concerned customer. If such follow-up is made through the licensed insurance intermediary, then the licensed insurance intermediary should report back on the latest situation to the authorized insurer as soon as practicable after following-up.

9.6 Licensed insurance intermediaries should remind customers of the importance of post-sale calls and the cooling-off period and should not abet customers to evade post-sale control measures implemented by authorized insurers.

10. Certification of Copies of FNA and RPQ

10.1 Authorized insurers should retain the original signed FNA, RPQ and IFS/Applicant's Declarations for record purpose and provide such documents for the IA's inspection as soon as practicable upon request.

10.2 For business introduced by authorized institutions and licensed insurance brokers, authorized insurers may accept copies of the original signed FNA and RPQ provided that those documents are properly certified by the representatives of authorized institutions and licensed insurance brokers, who have no conflict of interest with the sale of the relevant ILAS policy.

11. Documentation and Record Keeping

11.1 Authorized insurers, licensed insurance agencies and licensed insurance broker companies should put in place proper documentation systems for each of the processes/ requirements in this Guideline, where applicable. Apart from the policy documents, FNA, RPQ and the IFS/Applicant's Declarations, records relevant to the post-sale controls should also be maintained.

11.2 Authorized insurers, licensed insurance agencies and licensed insurance broker companies should provide the records for the inspection, review and investigation by the IA and other relevant regulatory bodies as soon as practicable upon request.

12. Commencement

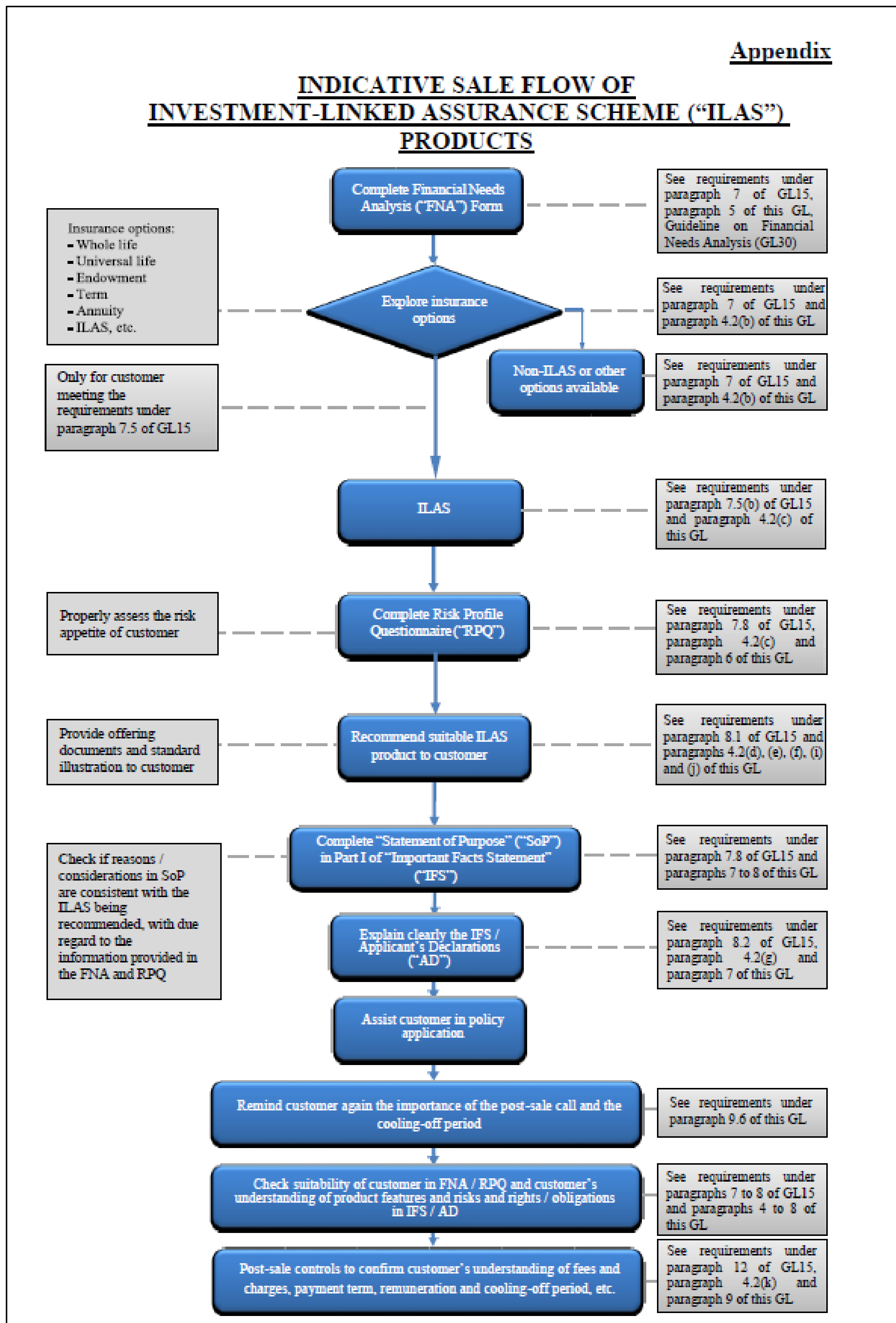
12.1 This Guideline shall take effect from 23 September 2019 ("Effective Date").

September 2019

Appendix B1

Guideline on Sale of Investment-Linked Assurance Scheme ("ILAS") Products (GL26) and Important Facts Statement and Applicant's Declarations (Appendix 1) (17/24)

(Source: IA GL26)



<u>**Appendix 1**</u>

<u>IMPORTANT FACTS STATEMENT AND APPLICANT'S DECLARATIONS</u>
<u>INVESTMENT-LINKED ASSURANCE SCHEME ("ILAS") POLICY</u>

[Name of authorized insurer]
Name of the ILAS Policy:

PART I – IMPORTANT FACTS STATEMENT

You should carefully consider the information in this statement and the product documents (including the Product Brochure, Product Key Facts Statement, and the Illustration Document). **If you do not understand any of the following paragraphs or do not agree to any particular paragraph or what your licensed insurance intermediary has told you is different from what you have read or understood from this statement, please do not sign the confirmation and do not purchase the ILAS policy.**

You may request the Chinese version of this statement from your licensed insurance intermediary. 閣下可向銷售的持牌保險中介人索取本文件的中文版本。

SOME IMPORTANT FACTS YOU SHOULD KNOW

(1) **<u>Statement of Purpose:</u>** Please set out your reasons/considerations for procuring this ILAS policy. The licensed insurance intermediary is required to take due account of the reasons/considerations as set out by you, together with other relevant information, in assessing whether a particular ILAS policy is suitable for you. (*Customer must set out your own reasons/considerations*.)

____

____

(2) **<u>Cooling-off Period:</u> You have the right to cancel this ILAS policy** and get back your original investments (subject to market value adjustment) within the cooling-off period, which is the period of **<u>21 calendar days</u>** immediately following either the day of delivery of (i) the policy; or (ii) the Cooling-off Notice to you or your nominated representative containing the information regarding your right within the cooling-off period, whichever is the earlier. For details of how you can exercise this right, please refer to the application form.

(3) **<u>No Ownership of Assets and No Guarantee for Investment Returns:</u> You do not have any rights to or ownership over any of the underlying/reference investment assets** of this ILAS policy. Your recourse is against [pre-printed name of the authorized insurer] only. You are subject to the credit risk of [pre-printed name of the authorized insurer]. Investment returns are not guaranteed.

(4) **Long-term Features (delete wherever inapplicable):**

(a) **For complex charge structure:**

Upfront charges: An upfront charge will be deducted upfront from the premiums you pay as charges and will not be available for investment. **This means that the remaining amount of premiums available for investment will be lower than your premiums paid.** The upfront charge is calculated as follows:

Upfront Charge = Premiums received X Upfront Charge %

Policy year	Upfront charge %	% of premium received available for investment after upfront charge
1	A%	(100 – A)%
2	B%	(100 – B)%
3	C%	(100 – C)%
4	D%	(100 – D)%
5...	…..	…..

For simple charge structure:

Upfront charges: [% Range] of the premiums you pay for the first [ ] policy years will be deducted upfront as charges and will not be available for investment. **This means that the remaining amount of premiums available for investment may be as low as [ ]% of your premiums paid in this period.**

(b) **For complex charge structure:**

Early surrender/withdrawal charges: You will be subject to an **early surrender or withdrawal charge ("Early Termination Charge")** and **possible loss of entitlement to bonuses**, if policy termination or surrender, partial withdrawal, or suspension of or reduction in premium payment occurs within a prescribed period before the end of the policy term. The Early Termination Charge is calculated as follows:

Early Termination Charge = Account Value withdrawn/surrendered/lapsed X Early Termination Charge %

Policy year	Early Termination Charge %
1	A%
2	B%
3	C%
4	D%
5…	…..

For simple charge structure:

Early surrender/withdrawal charges: You will be subject to an **early surrender or withdrawal charge ("Early Termination Charge")** and **possible loss of entitlement to bonuses**, if policy termination or surrender, partial withdrawal, or suspension of or reduction in premium payment occurs within the initial [ ] years of the policy term.

(c) **Loyalty bonuses:** You will be entitled to a loyalty or special bonus if you meet certain conditions. For details, please refer to the product documents of this ILAS policy.

(5) **Fees and Charges: Some fees/charges will be deducted** from the premiums you pay and/or your ILAS policy value, and will reduce the amount available for investment. Accordingly, **the return on your ILAS policy as a whole may considerably be lower than the return of the underlying/reference funds you selected.** For details, please refer to the product documents of this ILAS policy.

(6) **Switching of Investment:** If you switch your investment choices, you may be subject to a charge and your risk may be increased or decreased.

(7) **Risks Associated with Investment Choices with an Objective to Distribute Cash Dividends on a Regular Basis:** If you choose any investment choice which aims to distribute cash dividends on a regular basis, please note that the distribution of cash dividends is **NOT GUARANTEED**. Also, the distribution of cash dividends may be/effectively be paid out of the capital of the corresponding underlying fund of the investment choice, which may therefore result in a drop in the unit price of that investment choice.

(8) **Premium Holiday:** Please check with your licensed insurance intermediary and the product documents whether and under what specific conditions a premium holiday (during which premium payment is suspended) may be taken. If your ILAS policy allows a premium holiday, you should note that:

(a) Premium holiday means that you may temporarily suspend your regular premium payments. It **does not mean that you are only required to make premium contribution during the initial contribution period**.

(b) As all relevant fees and charges will continue to be deducted from your ILAS policy value during the premium holiday, **the value of your ILAS policy may be significantly reduced**.

(9) **Risk of Early Termination: Your ILAS policy may be automatically early terminated and you could lose all your premiums paid and benefits accrued** if any condition of automatic early termination is triggered. This may happen if you fail to make premium contribution (for regular premium payment), or if your policy has very low or negative value (e.g. poor investment performance, exercise of premium holiday), etc. For details, please refer to the product documents of this ILAS policy.

(10) **Licensed Insurance Intermediaries' Remuneration: If you take up this ILAS policy, the (licensed insurance agent/licensed insurance broker) will on average receive remuneration of HK$x.x per HK$100 of the premium that you pay.**

The remuneration is an average figure calculated on the assumption that you will pay all the premiums throughout the entire premium payment period. It covers all payments to the (licensed insurance agent/licensed insurance broker) directly attributable to the sale of this policy (including upfront and future commissions, bonuses and other incentives).

[Note: Only print the relevant sections below]

3

[For remuneration structure where payments are made over a number of years and not at a flat rate] The amount of remuneration actually receivable by the (licensed insurance agent/licensed insurance broker) may vary from year to year and is higher in the first policy year/early policy years.

[For remuneration structure which involves non-monetary benefits] Certain benefits that are immaterial, not directly attributable to the sale of this policy and not readily convertible to cash are not included from the calculation.

[For whole-life premium payment policies] As this policy involves whole-life premium payment, a 30-year period has been adopted for calculating both the total premiums and the total remuneration.

You are entitled to make enquiry with your (licensed insurance agent/licensed insurance broker) if you wish to know more about the remuneration that he/she/they may receive in respect of this policy.

[The following paragraphs should be included for ILAS products with embedded high level of insurance protection. An ILAS product with high level of insurance protection generally refers to an ILAS product with a death benefit of at least 150% of total premiums payable before the insured reaches age 65. This is consistent with the requirements under the "Additional Guidance on Internal Product Approval Process" issued by the Securities and Futures Commission.]

(11) **Long Term Nature of the Policy**

An ILAS policy with high level of insurance protection provides the insured with life insurance protection in the form of a death benefit payment which is substantially more than the total premiums payable under the policy before you (being the insured)/he/she retire(s) (assuming a retirement age of 65)[1]. This is combined with an investment element whereby (through the investment choices you selected under the policy) you/he/she have/has the potential for (but not the guarantee of) long term capital growth over the course of the policy term. As such, such an ILAS policy is designed to be held for a long period and is not suitable for customers with short- or medium-term liquidity needs.

(12) **Cost of Insurance Protection**

Throughout the policy term, you will be required to pay for the cost of insurance protection provided by the policy (being the death benefit payable if the insured dies during the policy term). The cost of insurance protection will be deducted from the account value under your ILAS policy, which means that the amount available for investment under the policy will be reduced.

You should also note that, in general, the rates of the cost of insurance protection will increase with the insured's age, and as such the deduction from your account value under the ILAS policy to cover the cost of insurance protection will generally increase throughout the policy term. In addition, when the performance of the underlying investment choice(s) is poor, the cost of insurance protection may also increase.

[1] An ILAS product with high level of insurance protection generally refers to an ILAS product with a death benefit of at least 150% of total premiums payable before the insured reaches age 65.

In cases where the account value is insufficient to cover the cost of insurance protection and the applicable platform fees, the ILAS policy will lapse and you may lose all your investments and benefits (including the life insurance coverage). Please also refer to the **Supplementary Sheet of Benefit Illustration Statement**, which provides you with an at-a-glance table of how the cost of insurance protection and platform fees would affect the amount of premiums available for investment under your ILAS policy. Your licensed insurance intermediary is required to explain to you in detail the information as contained in that document.

(13) **Sum Assured under your ILAS Policy**

The amount of sum assured under your ILAS policy dictates the amount of the death benefit that will be paid out under the insurance protection provided by your policy in event of the insured's death during the policy term. The sum assured is calculated by reference to the account value, total premiums payable or total premiums paid under your ILAS policy depending on the insured's age and the account value at any given time. Where the sum assured is calculated by reference to the account value, the sum assured may vary depending on the performance of the underlying investment choice(s). If the performance of the underlying investment choice(s) is poor, the account value of your ILAS policy would decrease and there may be significant adverse impact on the sum assured and the death benefit.

I ("customer") confirm that I have read and understood and agree to be bound by paragraphs above.

Name of Customer	Signature of Customer	Date
Name of Licensed Insurance Intermediary	Signature of Licensed Insurance Intermediary	Date

PART II – APPLICANT'S DECLARATIONS

Section I: Disclosure Declaration

- I *("customer")* confirm that the licensed insurance intermediary, (insert name and registration number of the relevant licensed insurance intermediary), has conducted a Financial Needs Analysis and a Risk Profile Questionnaire for me.
- I have received, read and understood the following documents:
  - Product Brochure

- Product Key Facts Statement
- Illustration Document
- Supplementary Sheet of Benefit Illustration Statement (applicable to ILAS policy with embedded high level of insurance protection)
- Investment Choice Brochure
- # [Other documents provided]

- # I fully understand and accept the potential loss associated with any market value adjustment, where the authorized insurer has the right and absolute discretion under certain situations (e.g. early policy surrender) to apply a downward/negative market value adjustment to the ILAS policy.

Name of Customer	Signature of Customer	Date
Name of Licensed Insurance Intermediary	Signature of Licensed Insurance Intermediary	Date

 # Section II: Affordability Declaration (For regular premium payment)

- I *("customer")* anticipate that my disposable income and/or savings is/are sufficient to pay the regular premium payments for the entire payment term of the ILAS policy; and
- I confirm that I am willing to pay the premiums for the entire payment term of the ILAS policy.

Name of Customer	Signature of Customer	Date
Name of Licensed Insurance Intermediary	Signature of Licensed Insurance Intermediary	Date

 # delete as appropriate

Section III: Suitability Declaration

I *("customer")* understand and agree that (tick one only):

A ☐ the features and risk level of the ILAS policy and my selected mix of underlying investment choices are suitable for me based on my disclosed current needs and risk profile, etc. as indicated in the Financial Needs Analysis and Risk Profile Questionnaire.

OR

B ☐ despite the fact that the features and/or risk level of the ILAS policy and/or my selected mix of underlying investment choices may not be suitable for me based on my disclosed current needs and risk profile, etc. as indicated in the Financial Needs Analysis and Risk Profile Questionnaire, I confirm that it is my intention and desire to proceed with my application(s) as explained below:

(If Box B is ticked, customer must complete explanation in this box.)

I acknowledge I should not purchase this ILAS policy and/or the selected mix of underlying investment choices unless I understand these and their suitability has been explained to me and that the final decision is mine.

[For business introduced by licensed insurance brokers:

I understand that the authorized insurer will retain copy(ies) of the completed Financial Needs Analysis and Risk Profile Questionnaire for verification purpose.]

Name of Customer	Signature of Customer	Date
Name of Licensed Insurance Intermediary	Signature of Licensed Insurance Intermediary	Date

Notes:
1. In this Statement & Declaration, "I" refers to customer. The singular shall include the plural; the word "I" shall include "we"; & the word "my" shall include "our". For joint customers, all customers must sign all sections.

2. The customer(s) are required to inform the licensed insurance intermediary or us (the authorized insurer) if there is any material change of information provided in these Declarations before the policy is issued.

Guideline on Financial Needs Analysis and its Appendix (GL30) (1/16)
(Source: IA GL30)

GL30

GUIDELINE
ON
FINANCIAL NEEDS ANALYSIS

Insurance Authority

Guideline on Financial Needs Analysis and its Appendix (GL30) (2/16)
(Source: IA GL30)

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Financial Needs Analysis Template Appendix

Guideline on Financial Needs Analysis and its Appendix (GL30) (3/16)
(Source: IA GL30)

1. Introduction

1.1 The Insurance Authority ("IA") issues this Guideline pursuant to section 133 of the Insurance Ordinance (Cap. 41) ("Ordinance") and its principal function to regulate and supervise the insurance industry for the protection of policy holders and potential policy holders. This Guideline also takes account of the Insurance Core Principles, Standards, Guidance and Assessment Methodology ("ICP") promulgated by the International Association of Insurance Supervisors, in particular ICP 19 which stipulates that the conduct of the business of insurance should ensure that customers are treated fairly.

1.2 Life insurance policies are generally long term in nature and may lock up the liquidity of customers. It is therefore important for authorized insurers and licensed insurance intermediaries to ensure that a proper assessment of each customer's circumstances including needs, financial situation, ability and willingness to pay premiums, etc., is undertaken before any recommendation is made in respect of a suitable life insurance policy for the customer, and that the recommendation is based on that assessment. For the purposes of this Guideline, this assessment is referred to as a Financial Needs Analysis ("FNA").

1.3 This Guideline sets out the minimum standards and practices that need to be implemented and adopted for carrying out appropriate FNAs in respect of customers looking to enter into life insurance policies.

2. Interpretation

2.1 In this Guideline, unless the context otherwise specifies:

(a) "Customer" bears the same meaning as policy holder or potential policy holder, and those terms are used under the Ordinance;

(b) "Group policy" means a life insurance policy under which a group of employees of a company, partnership or sole proprietor, or members of an organization or other similar group of people, are insured; and

(c) "Life insurance policy" means a contract of insurance which is classed as long term business as defined under the Ordinance.

Guideline on Financial Needs Analysis and its Appendix (GL30) (4/16)
(Source: IA GL30)

2.2 Unless otherwise specified, words and expressions used in this Guideline shall have the same meanings as given to them in the Ordinance.

3. Relevant Regulatory Requirements and Status of this Guideline

3.1 This Guideline should be read in conjunction with the relevant provisions of the Ordinance, all other relevant rules, codes, circulars, and guidelines issued by the IA or other regulatory bodies, including but not limited to the following:

(a) Section 90(d) of the Ordinance, which requires a licensed insurance intermediary when carrying on a regulated activity "*to have regard to the particular circumstances of the policy holder or the potential policy holder that are necessary for ensuring that the regulated activity is appropriate to the policy holder or potential policy holder.*"

(b) Guideline on Underwriting Class C Business (GL15) issued by the IA;

(c) Guideline on Underwriting Long Term Insurance Business (other than Class C Business) (GL16) issued by the IA;

(d) Guideline on Sale of Investment Linked Assurance Scheme ("ILAS") Products (GL26) issued by the IA;

(e) Guideline on Benefit Illustrations for Long Term Insurance Policies (GL28) issued by the IA;

(f) Code of Conduct for Licensed Insurance Agents issued by the IA;

(g) Code of Conduct for Licensed Insurance Brokers issued by the IA; and

(h) All relevant rules, codes, circulars and guidelines administered or issued by the Hong Kong Monetary Authority.

3.2 This Guideline does not have the force of law, in that it is not subsidiary legislation, and should not be interpreted in a way that would override the provision of any law. A non-compliance with the provisions in this Guideline would not by itself render an authorized insurer or a licensed insurance intermediary liable to judicial or other proceedings. A non-

compliance may, however, for example, reflect on the IA's view of the continued fitness and properness of (i) the directors, controllers and key persons in relevant control functions of the authorized insurers to which this Guideline applies and (ii) the licensed insurance intermediaries to which this Guideline applies and (in the case of licensed insurance agencies and licensed insurance broker companies) their directors, controllers and responsible officers. The IA may also take guidance from this Guideline in considering whether there has been an act or omission likely to be prejudicial to the interests of policy holders or potential policy holders (albeit the IA will always take account of the full context, facts and impact of any matter before it in this respect).

4. Scope of Application

4.1 This Guideline applies to all authorized insurers carrying on or advising on long term business, and all licensed insurance intermediaries carrying on regulated activities in respect of long term business.

5. Purpose

5.1 The FNA is a process during which an authorized insurer or a licensed insurance intermediary collects relevant and sufficient information from a customer so that the authorized insurer or licensed insurance intermediary can properly assess the circumstances[1] of the customer (including needs, financial situation, etc.) before making any recommendation in respect of certain types of life insurance policies (detailed in paragraph 6 below) to the customer.

5.2 The FNA process is vital to the principle of "fair customer treatment" and must be strictly adhered to so that:

(a) customers are provided with adequate and accurate information before, during and after the point-of-sale of a life insurance policy; and

[1] When investment-linked assurance scheme ("ILAS") products (i.e. contracts of insurance in Class C (Linked long term) of Part 2 of Schedule 1 to the Ordinance) may be the subject of a recommendation to a customer, the assessment should also include the customer's investment objectives, preferred investment horizon, risk tolerance, investment knowledge and experience, and other relevant attributes. The assessment should be carried out based on all relevant information collected in an FNA, Risk Profile Questionnaire ("RPQ") and the "Statement of Purpose" in the Important Facts Statement ("IFS"). For the RPQ and IFS requirements, please refer to the Guideline on Sale of Investment Linked Assurance Scheme ("ILAS") Products (GL26) issued by the IA.

(b) any recommendation given to a customer in respect of a life insurance policy is suitable for the customer.

5.3 In assessing whether the requirements in this Guideline have been satisfied, the IA will adopt a principle-based approach. This approach requires that the underlying objective and substance of each requirement in this Guideline be achieved, regardless of the exact form of arrangement adopted by authorized insurers or licensed insurance intermediaries to achieve it.

6. Detailed Requirements for the FNA

Types of life insurance policies for which an FNA must be carried out

6.1 Save in the case of exempted products (see paragraph 6.2 below), and regardless of the channel of distribution, an FNA must be performed for every application for a new life insurance policy[2], where the policy which is the subject of the application is one of the following types:

(a) policies of the nature specified in Class A in Part 2 of the Schedule 1 to the Ordinance except:

(i) term insurance policies;

(ii) refundable insurance policies without substantial savings component, or renewable insurance policies without cash value, that provide insurance protection (e.g. hospital cash, medical, critical illness, personal accident, disability or long-term care cover); or

(iii) group policies;

(b) policies of the nature specified in Class C in Part 2 of the Schedule 1 to the Ordinance.

6.2 A policy is an exempted product for the purposes of paragraph 6.1 above (and hence an FNA would not be required in respect of an application for such policy), if the product meets all the requirements in (a) to (d) below:

[2] Treatment of a new rider or additional top-up to an existing policy should follow the FNA requirements as if the rider or top-up is a new life insurance policy.

Guideline on Financial Needs Analysis and its Appendix (GL30) (7/16)
(Source: IA GL30)

(a) the policy is:

(i) a non-participating endowment product with guaranteed payment of not less than the total premium paid upon maturity; or

(ii) a universal life product providing a surrender value which is not less than the total premium paid at all times;

(b) the policy is sold to customers directly by an authorized insurer or by a licensed insurance agency of an authorized insurer through a digital distribution channel (e.g. webpage or mobile app);

(c) the authorized insurer or licensed insurance agency does not provide a recommendation to the customer before or during the point-of-sale; and

(d) in addition to complying with the existing product disclosure requirements, the authorized insurer or licensed insurance agency makes the following disclosures in relation to the policy before a customer is able to purchase it:

(i) state the objective(s) of the policy;

(ii) state the type and nature of the policy (e.g. "The product is a long term insurance plan underwritten by [name of authorized insurer] and is neither a bank deposit nor a bank savings plan");

(iii) highlight the target premium amount, payment period and benefit periods;

(iv) include a prominent warning to the customer concerning affordability of the policy during the entire premium payment period; and

(v) include relevant information highlighting the liquidity risk associated with the product.

Guideline on Financial Needs Analysis and its Appendix (GL30) (8/16)
(Source: IA GL30)

Information to be collected

6.3 Save for the life insurance policies within the scope of paragraphs 6.1(a)(i) to (iii) and 6.2 above, an authorized insurer or a licensed insurance intermediary cannot opt out (and cannot accept an application from a customer who wishes to opt out) of the FNA process unless it obtains the IA's prior consent (e.g. through the InsurTech Sandbox).

6.4 The extent and granularity of the information to be collected can be varied depending on the particular circumstances of the target customers and the mode of operation of the distribution channel. Authorized insurers and licensed insurance intermediaries have an obligation to collect adequate information to place themselves in a position whereby they can perform reasonable assessments before making any insurance recommendation.

6.5 A template is set out at **Appendix** to illustrate the information that should normally be collected during the FNA process. Authorized insurers and licensed insurance intermediaries can add questions or modify the exact wording of the questions for the purposes of a proper assessment of the customer's particular circumstances, having due regard to the products available under the relevant distribution channel and technology adopted. However, any such changes must be justifiable on the basis that, (i) the substantive meaning of the questions (in the Appendix) are retained in spite of the changes made; (ii) in spite of the changes made, the principle of "fair customer treatment" continues to be satisfied; and (iii) the reason(s) for such changes must be documented.

6.6 If a customer refuses to disclose information during the FNA process, the licensed insurance intermediary should clearly explain to the customer that without such information the authorized insurer and licensed insurance intermediary would be unable to comply with the requirements contained in this Guideline, and consequently this would likely result in the authorized insurer rejecting the application. In these circumstances, the licensed insurance intermediary cannot recommend any insurance product to the customer.

Documentation and signatures

6.7 A licensed insurance intermediary must properly document the information provided by the customer during the FNA process. The factors considered, evaluation, the recommendation(s) made by the licensed insurance intermediary, and reason(s) for such

recommendation(s) should also be documented as appropriate. When conducting the FNA, care should be taken to determine from whom, and in relation to whom, the relevant information should be collected (e.g. where the policy is to be held on trust, the assessment should be made based on the circumstances of the potential policy owner and/or the insured (e.g. settlor, beneficiary, protector or enforcer of the trust) rather than the trustee) and proper documentation should be maintained.

6.8 Before the issuance of a life insurance policy which requires an FNA to be conducted, an authorized insurer has the obligation to ensure that a proper and complete FNA has been conducted. In the case of business referred from a licensed insurance broker company, the authorized insurer is required to ensure that an FNA has been properly conducted by the licensed insurance broker company before accepting the application.

6.9 A completed FNA form must be signed and dated by the customer and the licensed insurance intermediary. Digital signatures or other similar signature verification technology are permitted. A completed and signed FNA form shall be valid for 12 months from the date the customer signs it. Customers should be reminded to inform the relevant authorized insurer or the licensed insurance intermediary of any material changes to the information provided during the FNA process. In the event that a customer purchases an additional insurance policy(ies) or coverage from the same authorized insurer or via the same licensed insurance intermediary within 12 months after an FNA form is completed, it is not necessary to conduct another FNA unless there are material changes in the circumstances of the customer or the purchase of the additional insurance policy or the additional coverage would result in a mismatch (see paragraphs 6.15 to 6.18 for further details on mismatch situations).

Matters to consider before making the recommendation

6.10 Licensed insurance intermediaries must have due regard to the relevant information provided by customers in an FNA before making any recommendation. Where a customer has other policy(ies) in force, whether with the same authorized insurer or with other authorized insurers as disclosed by the customer, the assessment should be carried out based on an aggregate of all the in force policies of the customer, rather than just the policy which is the subject of the application. An authorized insurer should have internal controls for identifying the accumulation of multiple policies it has in force for the same individual customer.

Guideline on Financial Needs Analysis and its Appendix (GL30) (10/16)
(Source: IA GL30)

6.11 When assessing a customer's ability and willingness to pay insurance premium, the source of funds of the customer must be duly considered to ensure that the customer can afford the recommended product(s) throughout the entire duration of the premium payment term. For instance, where the premium payment term of the recommended policy will last beyond the target retirement age of the customer, the licensed insurance intermediary should assess whether the customer can afford the premium payment after his/her retirement. Where the customer has indicated that premium financing is intended to be used, the licensed insurance intermediary must take that into account when assessing a customer's ability and willingness to pay insurance premium.

6.12 Where an ILAS product may be the subject of a recommendation to a customer, information must be collected during the FNA process about whether the customer is able and willing to make his/her own decision to choose and manage different investment choices available under the ILAS product. If the customer has indicated that he/she does not want or is unwilling to choose or manage different investment choices, no ILAS product should be introduced or recommended to the customer. If the customer has indicated that he/she wants or is willing to choose or manage different investment choices with professional advice to be provided by the authorized insurer or licensed insurance intermediary, no ILAS product should be introduced or recommended to the customer unless such a service will be provided to the customer by the authorized insurer or the licensed insurance intermediary.

Provision of insurance options

6.13 For the purposes of GL15, whenever an ILAS policy is recommended to a customer, a participating policy that meets the customer's investment objective should also be provided to the customer as an option in accordance with the relevant requirement under GL15.

6.14 For the purposes of GL16, where, following an FNA process as required by this Guideline, a licensed insurance broker recommends an insurance product to a customer, the licensed insurance broker should also provide the customer with at least another insurance option from a different authorized insurer that meets the customer's needs and circumstances. The only exception to this would be where the licensed insurance broker concludes that there is no other insurance option available to the customer. In this exceptional situation, the licensed insurance broker should document its justification for reaching the conclusion that no such other insurance option is available.

Guideline on Financial Needs Analysis and its Appendix (GL30) (11/16)
(Source: IA GL30)

Handling of mismatch cases

6.15 When a licensed insurance intermediary recommends an insurance product which does not meet the needs and circumstances of the customer based on the information collected during the FNA process, this is regarded as a "mismatch". Authorized insurers, licensed insurance agencies and licensed insurance broker companies must put in place appropriate control measures to handle mismatch cases based on the principle of "fair customer treatment". Where a mismatch exists and the licensed insurance intermediary makes a recommendation despite the mismatch, the licensed insurance intermediary is required to clearly explain the mismatch to the customer and why (despite the mismatch) the product is recommended to the customer. The licensed insurance intermediary must also document the details of the explanation.

6.16 In the case a recommendation has been made as described in paragraph 6.15, the authorized insurer should, during the underwriting process, review and assess the reasonableness of such recommendation and satisfy itself that the mismatch case has been handled in accordance with the control measures it has put in place, before accepting the application.

6.17 For the avoidance of doubt, a deviation between the recommended level of insurance protection and the level of insurance protection identified during the FNA process (i.e. where the recommended level is higher or lower than the level of protection identified in the FNA) is not considered a mismatch if the deviation has a justified, sound and reasonable basis (e.g. the deviation is because of the underwriting limit set by the authorized insurer, or is based on the health status of the customer, etc.). In such a case, the licensed insurance intermediary is required to clearly explain to the customer, and properly document, how the recommended level of insurance protection is determined. This requirement also applies where the recommended benefit/protection period deviates from the customer's choice. Special care should be taken when the customer indicates a wealth accumulation-related objective, e.g. "saving up for the future". In such a case, if the recommended product(s) is not able to achieve the target savings amount within the timeframe indicated by the customer, this should be considered as a mismatch unless the deviation from the target savings amount has a justified, sound and reasonable basis.

6.18 Authorized insurers should normally not accept an application with a mismatch in affordability (e.g. the customer has indicated a target premium term of 10 years but is recommended a product with a whole-of-life payment term). In rare cases where there are valid reasons for

such a recommendation, the licensed insurance intermediary is required to clearly explain the mismatch to the customer and why the product is recommended to the customer despite the mismatch (and properly document such explanation). For the avoidance of doubt, it is not considered a mismatch when the recommended insurance policy has a shorter premium payment term than the target premium term indicated by the customer.

Controls, Procedures and Record Keeping

6.19 Authorized insurers should develop and implement effective policies, controls and procedures to ensure compliance with the requirements in this Guideline, including compliance by authorized insurers' appointed licensed individual insurance agents and licensed insurance agencies. Proper training must also be provided by authorized insurers to ensure that these policies, controls and procedures are effectively communicated to their appointed licensed individual insurance agents and licensed insurance agencies. An authorized insurer should also set up a robust monitoring programme to ensure ongoing compliance with this Guideline.

6.20 Licensed insurance broker companies and licensed insurance agencies are also required to develop and implement effective policies, controls and procedures, and provide proper training, to ensure that they and their licensed technical representatives (broker) and licensed technical representatives (agent), as the case may be, comply with the requirements of this Guideline. They should also establish robust monitoring programmes to ensure ongoing compliance with this Guideline.

6.21 Proper records should be maintained by authorized insurers, licensed insurance broker companies and licensed insurance agencies in respect of the FNA including but not limited to the required documentation set out in this Guideline for inspection and review by the IA and other regulatory bodies.

7. Commencement

7.1 This Guideline shall take effect from 23 September 2019 ("Effective Date").

Guideline on Financial Needs Analysis and its Appendix (GL30) (13/16)
(Source: IA GL30)

8. Transitional Provision

8.1 The IA recognizes that the authorized insurers and licensed insurance intermediaries to which this Guideline applies may require time to update their documentation, controls and processes to align with the requirements in this Guideline. A transitional period of 12 months from the Effective Date (i.e. from 23 September 2019 to 22 September 2020) will therefore apply in respect of the requirements in Section 6 of this Guideline ("Transitional Period"). The Transitional Period applies in respect of life insurance policies issued prior to the end of the Transitional Period.

8.2 During the Transitional Period, as an alternative to the provisions in Section 6 of this Guideline, authorized insurers which were carrying on long term business immediately prior to the Effective Date and their licensed insurance agents (including, in the case of licensed insurance agencies, the licensed technical representatives (agent) of the agencies) may continue to use the FNA forms and follow the FNA related policies and procedures which such insurers had in place immediately prior to the Effective Date, provided that such FNA forms, policies and procedures (prior to the Effective Date) complied with and (following the Effective Date) continue to comply with the following documents issued by the Hong Kong Federation of Insurers ("HKFI"):

- HKFI's Initiative on Financial Needs Analysis (effective 1 June 2018);
- HKFI's Questions and Answers on 'Initiative on Financial Needs Analysis' ("FNA") (effective 1 January 2016); and
- HKFI's Updated Requirements Relating to the Sale of Investment Linked Assurance Scheme ("ILAS") to Enhance Customer Protection (effective 1 January 2016).

8.3 During the Transitional Period, licensed insurance broker companies registered immediately prior to the Effective Date with the Hong Kong Confederation of Insurance Brokers ("CIB") and their licensed technical representatives (broker) may continue to use the FNA forms and follow the FNA related policies and procedures which such broker companies had in place immediately prior to the Effective Date, provided such FNA forms, policies and procedures (prior to the Effective Date) complied

with and (following the Effective Date) continue to comply with the following documents issued by the CIB:

- CIB's Guidance Note on Product Recommendation for Long Term Insurance Business (effective 1 January 2016); and
- CIB's Guidance Note on Conducting "Know Your Client" Procedures for Long Term Insurance Business (effective 1 January 2016).

8.4 During the Transitional Period, licensed insurance broker companies registered immediately prior to the Effective Date with the Professional Insurance Brokers Association ("PIBA") and their licensed technical representatives (broker) may continue to use the FNA forms and follow the FNA related policies and procedures which such broker companies had in place immediately prior to the Effective Date, provided that such FNA forms, policies and procedures (prior to the Effective Date) complied with and (following the Effective Date) continue to comply with the following documents issued by the PIBA:

- PIBA's Code of Conduct for Insurance Brokers Conducting Investment Linked Business (effective 1 March 2014);
- PIBA's Guidance Note on Conducting Investment Linked Business (effective 1 January 2015);
- PIBA's Circular dated 15 July 2015;
- PIBA's Circular dated 22 December 2015;
- PIBA's Circular dated 5 January 2016;
- PIBA's Circular dated 28 June 2016; and
- PIBA's Circular dated 28 September 2016.

8.5 The documents listed in paragraphs 8.2, 8.3 and 8.4 of this Guideline are hereby adopted solely for the Transitional Period.

September 2019

Guideline on Financial Needs Analysis and its Appendix (GL30) (15/16)

(Source: IA GL30)

Appendix

Financial Needs Analysis ("FNA") Template

The following questions form the basic content of the FNA form, authorized insurers or licensed insurance intermediaries shall, in accordance with the particular circumstances of the customers, add questions or modify the exact wording of the questions in compliance with requirements under paragraph 6.5 of this Guideline.

Notes to customer: This FNA form is to facilitate the identification of suitable insurance product(s) to meet your needs and circumstances. Please answer all questions in this form. Do NOT sign on this form if any questions are unanswered or have been crossed out. Do NOT sign on blank form. You need to inform us (the insurance company) if there is any substantial change of information provided in this form.

1. What are your objectives for seeking to purchase an insurance product? (tick one or more)
   - ☐ Financial protection against adversities (e.g. death, accident, disability etc.)
   - ☐ Preparation for health care needs (e.g. critical illness, hospitalization etc.)
   - ☐ Providing regular income in the future (e.g. retirement income etc.)
   - ☐ Saving up for the future (e.g. child education, retirement etc.)
   - ☐ Investment
   - ☐ Others (Please specify____________________________________)

(The supplementary question to Q1 below is applicable only if "Investment" is chosen as one of the objectives in Q1 above)

To meet your "Investment" objective indicated above, how would you prefer to manage different investment options/investment choices, if available, under the insurance product? (tick one)

- ☐ I want to make my own decisions (without any professional advice to be provided by the authorized insurer and/or licensed insurance intermediaries) to choose and manage different investment options/investment choices, if available, under an insurance product, and I am willing to do it throughout the entire duration of the target benefit/protection period of an insurance product
- ☐ I want to make my own decisions (with professional advice to be provided by the authorized insurer and/or licensed insurance intermediaries) to choose and manage different investment options/investment choices, if available, under an insurance product, and I am willing to do it throughout the entire duration of the target benefit/protection period of an insurance product
- ☐ I do not want to choose or manage different investment options/investment choices, if available, under an insurance product

(For Q2 and Q3, a specific period/amount can be stated instead of ticking one of the boxes)

2. What is your target benefit/protection period/expected timeframe for meeting the target amount for insurance policy? (tick one)

☐ Less than 1 year	☐ 1-5 years	☐ 6-10 years
☐ 11-15 years	☐ 16-20 years	☐ More than 20 Years
☐ Whole of life		

3. Your ability and willingness to pay insurance premiums:
   a. What is your average monthly disposable income (i.e. after deducting the expenditure) from all sources (including income from liquid assets) in the past 2 years?
      ☐ Not less than HK$ _______ ; or
      ☐ In the following range:
         ☐ less than HK$10,000
         ☐ HK$10,000 - HK$19,999
         ☐ HK$20,000 - HK$49,999
         ☐ HK$50,000 - HK$100,000
         ☐ over HK$100,000

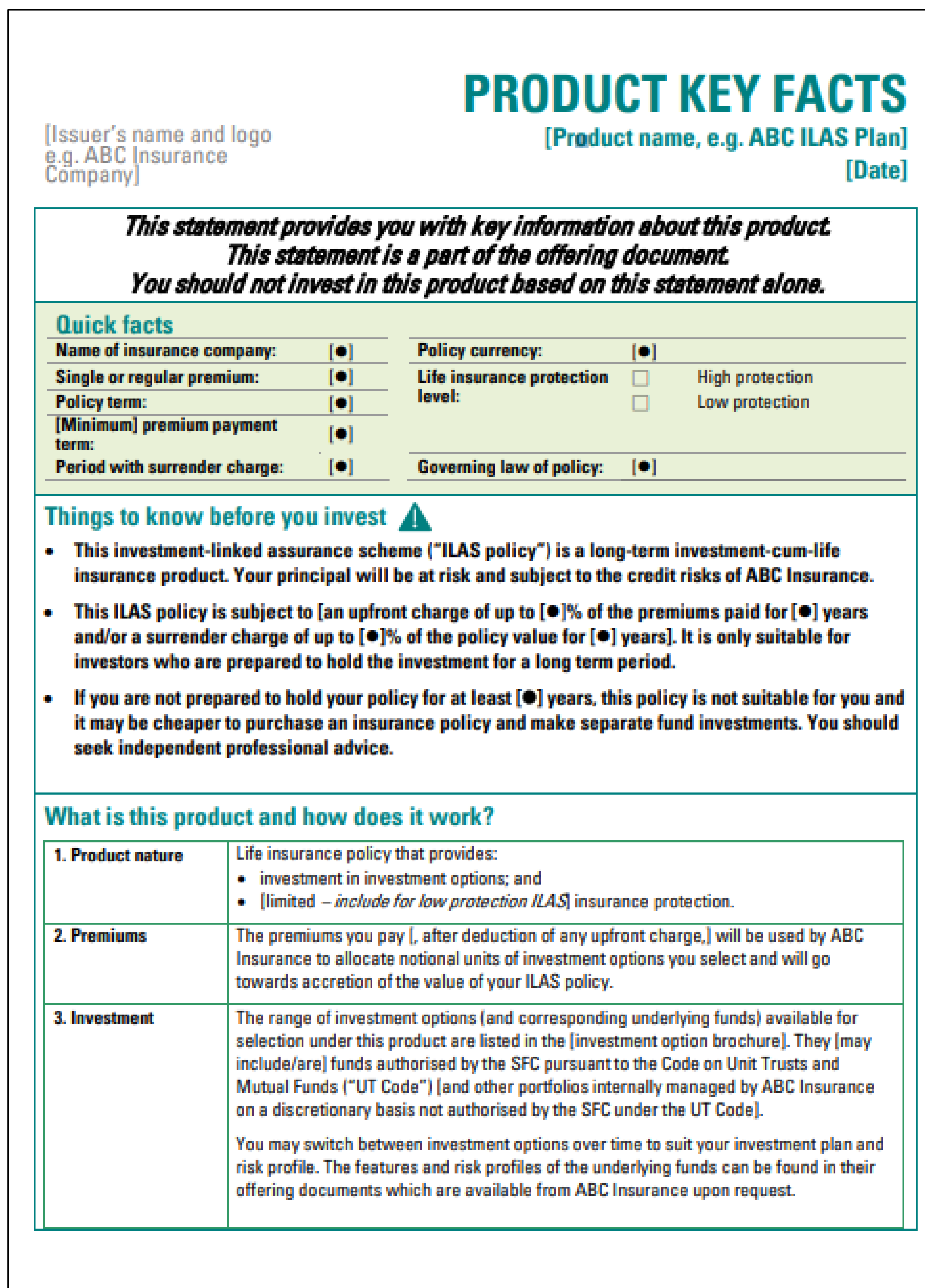
   b. What percentage of your monthly disposable income (i.e. after deducting the expenditure) from all sources (including income from liquid assets) would you be able and willing to use to pay for the insurance premium (including your existing insurance policy(ies)) throughout the entire term of the insurance policy? (tick one)
      ☐ Less than 10%
      ☐ 10% - 20%
      ☐ 21% - 30%
      ☐ 31% - 40%
      ☐ 41% - 50%
      ☐ More than 50%

   c. For how long are you able and willing to pay for an insurance policy? (tick one)
      ☐ 2-5 years ☐ 6-10 years ☐ 11-15 years ☐ 16-20 years
      ☐ More than 20 Years (until target retirement age of ____)
      ☐ Whole of life (including period after target retirement age of ____)
      ☐ A single payment of not more than HK$ _______

2

Appendix C

Product Key Facts Statement – Illustrative Template (1/7)
(Source: SFC)



PRODUCT KEY FACTS

[Issuer's name and logo e.g. ABC Insurance Company]

[Product name, e.g. ABC ILAS Plan]
[Date]

This statement provides you with key information about this product.
This statement is a part of the offering document.
You should not invest in this product based on this statement alone.

Quick facts

Name of insurance company:	[●]	**Policy currency:**	[●]	
Single or regular premium:	[●]	**Life insurance protection level:**	☐	High protection
Policy term:	[●]		☐	Low protection
[Minimum] premium payment term:	[●]			
Period with surrender charge:	[●]	**Governing law of policy:**	[●]	

Things to know before you invest

- **This investment-linked assurance scheme ("ILAS policy") is a long-term investment-cum-life insurance product. Your principal will be at risk and subject to the credit risks of ABC Insurance.**
- **This ILAS policy is subject to [an upfront charge of up to [●]% of the premiums paid for [●] years and/or a surrender charge of up to [●]% of the policy value for [●] years]. It is only suitable for investors who are prepared to hold the investment for a long term period.**
- **If you are not prepared to hold your policy for at least [●] years, this policy is not suitable for you and it may be cheaper to purchase an insurance policy and make separate fund investments. You should seek independent professional advice.**

What is this product and how does it work?

1. Product nature	Life insurance policy that provides: • investment in investment options; and • [limited – *include for low protection ILAS*] insurance protection.
2. Premiums	The premiums you pay [, after deduction of any upfront charge,] will be used by ABC Insurance to allocate notional units of investment options you select and will go towards accretion of the value of your ILAS policy.
3. Investment	The range of investment options (and corresponding underlying funds) available for selection under this product are listed in the [investment option brochure]. They [may include/are] funds authorised by the SFC pursuant to the Code on Unit Trusts and Mutual Funds ("UT Code") [and other portfolios internally managed by ABC Insurance on a discretionary basis not authorised by the SFC under the UT Code]. You may switch between investment options over time to suit your investment plan and risk profile. The features and risk profiles of the underlying funds can be found in their offering documents which are available from ABC Insurance upon request.

Appendix C

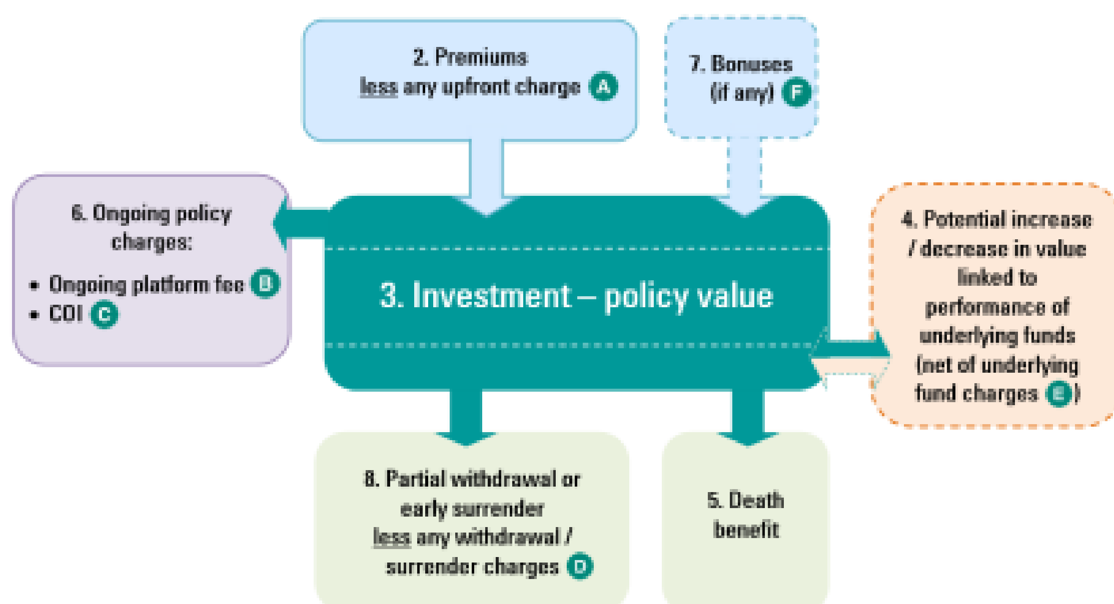
Product Key Facts Statement – Illustrative Template (2/7)

(Source: SFC)

ABC ILAS Plan

4. Investment returns	The value of your ILAS policy is calculated by ABC Insurance based on the performance of your selected investment options (linked to the corresponding underlying funds). Your return under this ILAS policy is subject to various fees and charges levied by ABC Insurance (see item 6 below) and will be lower than the return of the corresponding underlying funds.
5. Insurance protection	*[Include description on the determination of death benefit and, where applicable, describe the drop in level of death benefit after age 65]* [The cost of insurance ("COI") used to cover the insurance protection will be deducted from your ILAS policy. This charge may increase significantly when the insured gets older or your investments make a loss, etc.]
6. Fees and charges	There are various fees and charges under this ILAS policy. Please see below for details. Policy charges: Upfront charge (A), Ongoing platform fee (B) } Platform fee; COI (C); Early surrender/withdrawal charge (D) Underlying fund charges (E): E.g. management fee and performance fee
7. Bonuses (F)	You may be entitled to [name of bonuses/rebates/*other similar features*] subject to conditions [and clawback in certain events].
8. Partial withdrawal and early surrender	You may request to make partial withdrawal or early surrender your policy subject to conditions [and any withdrawal/surrender charges]. [You may also lose your entitlement to bonuses.] If you choose to fully surrender your policy early, you may not get back the full amount of premium you pay. Your personalised illustration will provide an indication of the policy surrender values over time.

[INSERT ANY OTHER KEY PRODUCT FEATURES AND MODIFY AS APPROPRIATE]



The numbers in this graph follow the items numbered in the table right above.

Product Key Facts Statement – Illustrative Template (3/7)
(Source: SFC)

ABC ILAS Plan

What are the key risks?

Investment involves risks. Please refer to the principal brochure of ABC ILAS Plan for details including the risk factors.

- **Credit and insolvency risks** – This product is an insurance policy issued by ABC Insurance. Your investments and insurance protection are subject to the credit risks of ABC Insurance.
- **No ownership over assets** – All premiums you pay towards your ILAS policy, and any investments made by ABC Insurance in the underlying funds, will become and remain the assets of ABC Insurance. You do not have any rights or ownership over any of those assets. Your recourse is against ABC Insurance only.
- **[Limited life protection after age 65** – This ILAS policy will no longer provide high life protection when the insured reaches age 65 and the amount of death benefit payable may be significantly reduced. *[Include for high protection ILAS with similar features]*]
- **Insurance benefits are at risk** – As [part of] your death benefit is linked to the performance of the investment options you selected from time to time, your death benefit is subject to investment risks and market fluctuations. The death benefit payable [may be significantly less than your premiums paid] and may not be sufficient for your individual needs.
- **Market risks** – Return of this ILAS policy is contingent upon the performance of the underlying funds corresponding to the investment options you selected and therefore there is a risk of capital loss.
- **Some investment options have higher risk** – The investment options available under this product can have very different features and risk profiles. Some may be of high risk. [*Include risks associated with specific investment options. For example,*
  - Investment options linked to derivative funds have high exposure to financial derivative instruments which may lead to a high risk of significant loss.
  - Some investment options linked to funds that pay dividends out of capital which may result in an immediate reduction of the funds' net asset value per unit and hence reduce the value of your ILAS policy.]
- **Early termination risks** – Reduction or suspension of premium contribution (during premium holiday), or withdrawal from the policy, may significantly reduce the value of the ILAS policy while all fees and charges are still deductible. Poor performance of the underlying funds may further magnify your investment losses. If the value of your ILAS policy becomes insufficient to cover all the ongoing fees and charges, your ILAS policy may be terminated early and you could lose all your premiums paid and benefits.
- **Foreign exchange risks** – The investment returns of your ILAS policy may be subject to foreign exchange risks as some of the underlying investments may be denominated in a currency which is different from that of your ILAS policy.

[INSERT ANY OTHER KEY RISKS WHERE RELEVANT]

Is there any guarantee?

[This ILAS policy does not have any guarantees. You may not get back the full amount of premium you pay.]

3

Product Key Facts Statement – Illustrative Template (4/7)
(Source: SFC)

ABC ILAS Plan

What are the fees and charges?

Total policy charges illustration

	Estimated policy charges for a non-smoking 40 year-old male over the respective holding periods (% of premiums) (Note 1)		
	10 years	**15 years**	**20 years**
Platform fee (net of bonuses) A + B – F	[●] % → equivalent to [●]% of policy value per year	[●] % → equivalent to [●]% of policy value per year	[●] % → equivalent to [●]% of policy value per year
COI C	[●] %	[●] %	[●] %
Total	[●] %	[●] %	[●] %

The actual percentage(s) may change depending on individual circumstances of each case, and will be significantly higher if [the premium amount is lower, the sum insured is higher and/or your selected underlying investments are making losses].

Policy charges payable to ABC Insurance

Platform fee		
	Annualised rate	When and how the charges are deducted
Upfront charge A	[●]	[Deduct upfront from each premium you pay]
Ongoing platform fee B	[●]	[Deduct from policy value monthly while the policy is in effect by redeeming units of investment options]

Cost of insurance protection		
COI C	[Insert determination basis of COI] Please ask your intermediaries and/or refer to the customised illustration documents for the details.	[Deduct from policy value monthly while the policy is in effect by redeeming units of investment options]

Charge on early surrender [or partial withdrawal]		
Early surrender/withdrawal charge D	[●]	[Deduct from policy value upon early surrender/partial withdrawal during the first [●] policy years]

[ABC Insurance may vary the charges or imposes new charges with not less than [1] month prior written notice or such shorter period of notice in compliance with the relevant regulatory requirements.]

Underlying funds charges E

Underlying funds corresponding to the investment options have separate fees and charges on top of the policy charges set out above. Such charges will be deducted and reflected in the unit price of the underlying funds.

4

Product Key Facts Statement – Illustrative Template (5/7)
(Source: SFC)

ABC ILAS Plan

Intermediaries' remuneration

- Although you may pay nothing directly to the intermediary who sells/distributes this ILAS policy to you, your intermediary will receive remuneration which, in effect, will be borne out of the charges you pay and is therefore not independent. Your intermediary should disclose to you in writing at the point-of-sale information about intermediary remuneration.
- The amount of remuneration actually receivable by your intermediary may vary from year to year and may be higher in the early policy years. You should ask your intermediary before taking up your ILAS policy to know more about the remuneration that your intermediary will receive in respect of your ILAS policy. If you ask, your intermediary should disclose the requested information to you.

What if you change your mind?

– Cooling-off period

- Cooling-off period is a period during which you may cancel this policy and get back your original investments (subject to market value adjustment) within the earlier of 21 calendar days immediately following the day of delivery of the policy or a notice to you or your representative. Such notice should inform you of, among other things, the availability of the policy and expiry date of the cooling-off period.
- You have to tell ABC Insurance by giving a written notice. Such notice must be signed by you and received directly by ABC Insurance at [Address of the issuer's Hong Kong Main Office]
- You may get back the amount you paid, or less if the value of the investment options chosen has gone down.

Additional information

- You should read the principal brochure of ABC ILAS Plan and the offering documents of the underlying funds, which are available from ABC Insurance upon request, for details of the product features, risks and charges.

[INSERT ANY OTHER ADDITIONAL IMPORTANT INFORMATION]

Insurance company's information

[Name of insurance company]
Address: [●]

Phone: [●]
Email: [●]
Website: [●]

Important

ABC Insurance is subject to the prudential regulation of the Insurance Authority. However, the Insurance Authority does not give approval to individual insurance products, including the ABC ILAS plan referred to in this statement.

If you are in doubt, you should seek professional advice.

The SFC takes no responsibility for the contents of this statement and makes no representation as to its accuracy or completeness.

5

Product Key Facts Statement – Illustrative Template (6/7)

(Source: SFC)

Note

1. The estimated total policy charges figures are calculated based on the following assumptions:

   (a) [the insured is a non-smoking 40 year-old male [with a sum insured of [●]]];
   (b) the payment of [single premium of [HKD1,000,000 or the minimum required single premium, whichever is higher] / regular premium of [HKD100,000 or the minimum required regular annual premium, whichever is higher] per annum] [throughout the premium payment term];
   (c) you hold your ILAS policy for 10, 15 and 20 years respectively;
   (d) there is no early withdrawal / termination of your ILAS policy;
   (e) an assumed rate of return of 3% per annum; and
   (f) [any optional supplementary benefits are not included *(only if the fee table includes charges for optional supplementary benefits)*].

   The platform fee per year means the equivalent annual fee (as a percentage of policy value) in respect of the total platform fee (net of all non-discretionary bonuses) levied under this ILAS policy.

Product Key Facts Statement – Illustrative Template (7/7)
(Source: SFC)

ABC ILAS Plan

Guidance for preparing this statement

1. If you want to include a responsibility statement in this statement, please make sure that such statement is consistent with the responsibility statement in other parts of the principal brochure.
2. Where an ILAS product is described as having been authorised by the SFC, please include a SFC non-endorsement statement in this statement pursuant to the requirements of the Code on Investment-Linked Assurance Schemes.
3. Disclosures shall be visually reader-friendly and written in plain language so that prospective scheme participants can easily read and understand them. Use of technical jargon or complex sentences shall be avoided.
4. Use of visual aids, graphs or charts is generally encouraged to illustrate the product structure and features.
5. Depending on the actual circumstances of the case, the contents of each statement may differ. Nevertheless, the headings set out in the template above are generally expected to be observed unless there are good reasons to do otherwise. Words inside the square brackets in the template are drafting notes. They should be construed as examples rather than suggestions, and are not meant to be exclusive or prescriptive. Issuers are responsible for what is and what is not to be included in the statement.
6. High protection ILAS refers to an ILAS product with death benefit of at least 150% of total premium payable before the insured reaches age 65. An ILAS product with death benefit of less than 150% of total premium payable before the insured reaches age 65 is regarded as low protection ILAS.
7. Issuers should determine the expected holding period to be disclosed under the section "Things to know before you invest" taking into account, amongst others, the level of insurance protection and other benefits, premium payment term and the level and period of surrender charge. Issuers may also make reference to their fee assessment (e.g. the time period for investors to receive a comparable payout if they surrender this ILAS policy as compared to the corresponding alternative products).
8. In the case where an ILAS product contains any guaranteed features provided by a third party guarantor, disclosure as regards the credit risks of such guarantor, amongst others, shall be disclosed in this statement.
9. "Underlying funds" can be used in the event that it has disclosed in the offering document that it will be investing the net premium received from the scheme participants into the funds corresponding to the investment options as selected by the scheme participants for such issuer's asset liability management. Otherwise, the issuer should adopt the term "reference fund(s)".
10. Issuers should also refer to the Guidance Note on Total Policy Charges Illustration Disclosure when preparing this statement.

7

Appendix D

Guideline on Statement in relation to Cooling-off Period in Policy Application Form (GL29 – Appendix 1) (1/2)

(Source: IA GL29)

Appendix 1

Guideline on Statement in relation to Cooling-off Period in Policy Application Form

An explanation of a policy holder's right to cancel the life insurance policy within the Cooling-off Period must be prominently displayed in the application form for the policy and (depending on the distribution channel utilized) must be clearly explained to him/her by the insurer or licensed insurance intermediary (as the case may be) during application process. Guidance on the appropriate wording which may be used for this statement is given below:

1. For all life insurance policies to which this Guideline applies (except policies of the nature specified in Class C in Part 2 of Schedule 1 to the Ordinance and single premium policies)

"Cancellation Rights and Refund of Premium(s) within Cooling-off Period

I understand that I have the right to cancel the policy and obtain a refund of any premium(s) paid by giving a written notice to [the name of authorized insurer]. I understand that to exercise this right, the notice of cancellation must be [signed by me and] received directly by [name of authorized insurer] at [address of the authorized insurer's Hong Kong Main Office] [see Notes (a) and (b) below] within the Cooling-off Period. I understand that the Cooling-off Period is the period of **21 calendar days** immediately following either the day of delivery of the policy or the Cooling-off Notice to me or my nominated representative (whichever is the earlier). I understand that the Cooling-off Notice is a notice that will be sent to me or my nominated representative by [name of authorized insurer] to notify me of the Cooling-off Period around the time the policy is delivered."

Notes

(a) Authorized insurers may adjust the above wording and specify the manner in which the written notice to cancel the policy is to be given by a policy holder. For example, a written notice may be sent by the policy holder to the authorized insurer by email.

(b) The address must be a Hong Kong address.

I-1

Guideline on Statement in relation to Cooling-off Period in Policy Application Form (GL29 – Appendix 1) (2/2)
(Source: IA GL29)

Appendix 1

2. For all policies of the nature specified in Class C in Part 2 of Schedule 1 to the Ordinance and all single premium policies to which this Guideline applies

"Cancellation Rights and Refund of Premium(s) within Cooling-off Period

I understand that I have the right to cancel the policy and obtain a refund of any premium(s) paid less any market value adjustment, by giving a written notice to [the name of authorized insurer]. I understand that to exercise this right, the notice of cancellation must be [signed by me and] received directly by [name of authorized insurer] at [address of the authorized insurer's Hong Kong Main Office] [see Notes (a) and (d) below] within the Cooling-off Period. I understand that the Cooling-off Period is the period of **21 calendar days** immediately following either the day of delivery of the policy or the Cooling-off Notice to me or my nominated representative (whichever is the earlier). I understand that the Cooling-off Notice is a notice that will be sent to me or my nominated representative to notify me of the Cooling-off Period around the time the policy is delivered."

Notes

(a) Authorized insurers may adjust the above wording and specify the manner in which the written notice to cancel the policy is to be given by a policy holder. For example, a written notice may be sent by the policy holder to the authorized insurer by email.

(b) As part of the sales process, authorized insurers will be required to disclose, before the application is signed, their rights to apply an MVA and the details of the basis of calculation of the MVA.

(c) An authorized insurer's right to apply an MVA (together with its basis of calculation) must be included in the relevant product brochure.

(d) The address must be a Hong Kong address.

I-2

Appendix E

Guideline on Reminder of Cooling-off Period at Policy Issuance (GL29 – Appendix 2) (1/2)

(Source: IA GL29)

Appendix 2

Guideline on Reminder of Cooling-off Period at Policy Issuance

A clear reminder of the Cooling-off Period must be given to the policy holder together with the life insurance policy at the time the policy is delivered. The policy holder must also be advised of the right to call the authorized insurer direct if he/she wishes to further understand the Cooling-off Period. Guidance on the appropriate wording which may be used for this reminder is given below:

"Your Right to Change Your Mind

If you are not fully satisfied with this policy, you have the right to change your mind.

We trust that this policy will satisfy your financial needs. However, if you are not completely satisfied then you should:

(a) return the policy, if applicable, and

(b) provide us with written notice, [signed by you], requesting cancellation.

The policy will then be cancelled and the premium(s) paid * will be refunded.

*[*For all policies of the nature specified in Class C in Part 2 of Schedule 1 to the Insurance Ordinance (Cap. 41) and all single premium policies, add "less a deduction of the amount (if any) by which the value of your investment has fallen at the time when your cancellation notice is received by us"*.]

These cancellation rights are subject to the following conditions:

(a) Your request to cancel the policy must be [signed by you and] received directly by our office at [address of the authorized insurer's Hong Kong Main Office] [see Note (a) below] within **21 calendar days** immediately following the day of delivery of this policy or the Cooling-off Notice to you or your nominated representative (whichever is the earlier). (The Cooling-off Notice is the notice sent to you or your

Guideline on Reminder of Cooling-off Period at Policy Issuance (GL29 – Appendix 2) (2/2)
(Source: IA GL29)

Appendix 2

nominated representative (separate from the policy) notifying you of your right to cancel within the stated 21 calendar day period).

(b) No refund can be made if a claim payment under the policy has been made prior to your request for cancellation.

Should you have any further queries, you may contact [contact information of the authorized insurer (including the address, service hotline number and email address)] and we will be happy to explain your cancellation rights further."

Note

(a) Authorized insurers may adjust the above wording and specify the manner in which the written notice to cancel the policy is to be given by a policy holder. For example, a written notice may be sent by the policy holder to the authorized insurer by email.

II-2

Appendix F

Question Template – Policy Replacement & Important Facts Statement - Policy Replacement (GL27 – Appendix A & B) (1/3)
(Source: IA GL27)

Appendix A

Question Template – Policy Replacement

Name of Insurer of this application : ____________________

Application/Proposal Number : ____________________

Name of Applicant/Proposer : ____________________

In order to fund the purchase of your new life insurance policy, are you using, or do you intend to use some or all of the funds arising from your existing life insurance policy, or any savings made by reducing the premium payable under your existing life insurance policy? For example, such funds or savings may arise from:

a) surrendering / partially surrendering your existing life insurance policy to obtain its surrender value
b) taking out a policy loan (including automatic premium loan) from your existing life insurance policy
c) withdrawing policy values from your existing life insurance policy (e.g. cash out dividends or redeem fund units etc.)
d) lapsation of your existing life insurance policy (e.g. by non-payment of premium)
e) exercising the right to a premium holiday under your existing life insurance policy

□ Yes □ Not yet decided □ No

Please check one appropriate box only

Warning: Please answer the above question carefully. Making changes on your existing life insurance policy may not be in your best interest. Your licensed insurance intermediary <u>must explain to you the financial implications, insurability implications and claims eligibility implications of such changes</u>. For this purpose, your licensed insurance intermediary may require certain information on your existing life insurance policy. You may need to approach the insurer of your existing life insurance policy to obtain accurate and up to date information on your existing policy.

If your answer is "Yes" or "Not yet decided", your licensed insurance intermediary must explain the "Important Facts Statement – Policy Replacement" to you.

____________________	____________________
Signature of the Applicant/Proposer	Date (DD / MM / YYYY)
Signature of Licensed Insurance Intermediary	Date (DD / MM / YYYY)
Full name of Licensed Insurance Intermediary	Type of License and License No.

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Question Template – Policy Replacement & Important Facts Statement - Policy Replacement (GL27 – Appendix A & B) (2/3)
(Source: IA GL27)

Appendix B

Important Facts Statement - Policy Replacement

This "Important Facts Statement – Policy Replacement" ("IFS-PR") aims to help you understand the factors to be considered and the risks involved in replacing your existing life insurance policy with a new life insurance policy. Your licensed insurance intermediary should explain to you the implications and associated risks involved in replacing your existing life insurance policy.

If you do not understand any of the following paragraphs or the advice or information provided to you by your licensed insurance intermediary is different from the information in this IFS-PR, please **do not sign** this IFS-PR and **do not proceed** with replacing your existing Life Policy.

SOME IMPORTANT FACTS YOU SHOULD KNOW
Please read carefully before signing.
Your insurance intermediary shall explain the content to you.

Financial Implications

1. **Informed Decision:** Life insurance policies usually lasts for a long period of time. If you surrender / take out policy loan from / withdraw policy values from / suspend or stop paying premium / reduce the premium payable on your existing life insurance policy, particularly during the early years of the policy period, you will usually suffer loss, including by way of having to pay charges. You should carefully compare your existing life insurance policy against the new life insurance policy you intend to purchase, and assess whether replacing your existing life insurance policy is in your best interests before you make a final decision.

2. **Difference between cash value from Surrender/ Lapse and total premium paid under your existing Life Policy** - The cash value that you may receive from surrendering your existing life insurance policy or allowing your existing life insurance policy to lapse, may be less than your total premium paid. This means that you may suffer a loss. Further, you may incur surrender charges if you surrender your existing life insurance policy or allow it to lapse.

3. **Policy Loan Interest -** The issuing insurer of your existing life insurance policy may charge you interest starting from the loan drawdown date. You should carefully review your regular statements to understand the opening and ending loan balance as well as the interest amount charged in the relevant period. Your existing life insurance policy may be terminated if the accumulated loan amount (and interest) exceeds a specified level of the account value / cash value of your existing life insurance policy.

4. **Withdrawal/ Partial Surrender Charges -** You may be subject to withdrawal charges or partial surrender charges within a prescribed period before the end of the policy term of your existing life insurance policy. For the new life insurance policy you intended to purchase, you may be subject to other early surrender / withdrawal charges within a prescribed period before the end of the term of the new life insurance policy.

5. **Policy Set-up Cost and Remuneration for licensed insurance intermediaries –** If you purchase a new life insurance policy, a substantial part of the initial premium may be used to pay for policy administration costs incurred by insurers and remuneration for the licensed insurance intermediaries. As a result, you may incur additional cost for replacing your existing life insurance policy.

Question Template – Policy Replacement & Important Facts Statement - Policy Replacement (GL27 – Appendix A & B) (3/3)
(Source: IA GL27)

6. **Higher Premium -** You may have to pay higher premium under the new life insurance policy in view of the difference in age, changes of health conditions, occupation, lifestyle / habit, and recreational activities (as compared with when you purchased your existing life insurance policy).

7. **Loss of Financial Benefit under the existing life insurance policy -** You may lose the financial benefit accumulated over the years (e.g. loyalty bonus or dividends) or to which you may be entitled (e.g. terminal bonus or dividends) under the existing life insurance policy.

8. **Financial Benefits under the New Life Insurance Policy Not Guaranteed -** The illustrated benefits of a new life insurance policy may NOT be guaranteed and whether they can be achieved depend on the performance of the issuing insurer of the new life insurance policy. If the new life insurance policy is an investment-linked assurance scheme policy, the illustrated benefits are based on assumed rates of return only.

Insurability Implications

9. **Changes in Coverage -** If you purchase a new life insurance policy and use it to replace an existing life insurance policy, some benefits, which are the policy features of the existing life insurance policy, may not be covered under the new life insurance policy due to changes in age, health conditions, occupation, lifestyle / habit or recreational activities. Also, riders / supplementary benefits under your existing life insurance policy may not be available under the new life insurance policy.

Claims Eligibility Implications

10. Benefits under the existing life insurance policy will no longer be payable to you if you surrender the policy or allow it to lapse. Besides, you may need to start a new waiting period in respect of certain benefits (e.g. medical, critical illness, suicide or incontestability) under the terms and conditions of the new life insurance policy.

Declaration

By the Insurance Intermediary
I declare that I have discussed and explained the implications and associated risks (including the above listed items) to the Applicant/Proposer regarding his/her decision to replace his/her existing life insurance policy with a new life insurance policy. I further declare that I have not made any inaccurate or misleading statements or comparisons, or withheld any information which may affect the decision of the Applicant/Proposer.

Signature of the Licensed Insurance Intermediary	Full Name of the Licensed Insurance Intermediary
Type of Licensed and Licensed No.	Date (DD/MM/YY)

By the Applicant/Proposer:
I understand the content of the above listed items.

Warning: you must read all items carefully and check that the licensed insurance intermediary has explained all the information on this IFS-PR before you sign this IFS-PR.

Signature of the Applicant/Proposer	Full Name of the Applicant/Proposer	Date (DD/MM/YYYY)

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Illustration Document for Investment-linked Policies (1/3)

(Source: SFC)

Information to be disclosed in the Illustration Document

X Y Z LIFE ASSURANCE COMPANY LIMITED

IMPORTANT:
THIS IS A SUMMARY ILLUSTRATION OF THE SURRENDER VALUES AND DEATH BENEFITS OF [NAME OF PRODUCT]. IT IS INTENDED TO SHOW THE IMPACT OF FEES AND CHARGES ON SURRENDER VALUES AND DEATH BENEFITS BASED ON THE ASSUMPTIONS STATED BELOW AND IN NO WAY AFFECTS THE TERMS OF CONDITIONS STATED IN THE POLICY DOCUMENT.

THE ASSUMED RATES OF RETURN USED BELOW ARE FOR ILLUSTRATIVE PURPOSES. THEY ARE NEITHER GUARANTEED NOR BASED ON PAST PERFORMANCE. THE ACTUAL RATES OF RETURN MAY BE DIFFERENT!

Proposal Summary for ABC product

1.

Name of Life Insured:	Age :	Sex :	Smoker / Non Smoker

2. Benefit Summary

Policy Currency:

Benefit Description	[Initial] Sum Assured [1]	[Initial] [M/Q/SA/A] Premium [2]	Premium Payment Term [3]	Benefit Term
Basic Plan				

Total [Initial] [M/Q/SA/A] Premium:

========

[Notes for insurers:
[1] Where the sum assured varies, the initial sum assured at the policy commencement has to be stated. "N.A." could be stated if sum assured is not applicable.

[2] Where the premium varies over the premium payment term, the initial premium at the policy commencement has to be stated. The monthly, quarterly, semi-annually or annually premium actually paid by the policy holder is to be stated.

[3] In case of single premium, this column should state 'Single Premium' or '1' (to denote the premium payment term has only 1 premium payment).]

PRINT DATE: DD/MM/YYYY

Illustration Document for Investment-linked Policies (2/3)

(Source: SFC)

First Option: with assumed net rate of return of 0%, 3%, 6% and 9% p.a.[#]

3a. Basic Plan – Illustration Summary of Surrender Values

Projected Surrender Values					
End of Policy Year	Total Premiums Paid	Assuming Net Rate of Return of 0% p.a.*	Assuming Net Rate of Return of [3%] p.a.*	Assuming Net Rate of Return of [6%] p.a.*	Assuming Net Rate of Return of [9%] p.a.*
1 2 3 4 5	9,999,999	9,999,999	9,999,999	9,999,999	9,999,999
10 15 .... At age 90 At age 95 At age 100					

3b. Basic Plan – Illustration Summary of Death Benefits

Projected Death Benefits					
End of Policy Year	Total Premiums Paid	Assuming Net Rate of Return of 0% p.a.*	Assuming Net Rate of Return of [3%] p.a.*	Assuming Net Rate of Return of [6%] p.a.*	Assuming Net Rate of Return of [9%] p.a.*
1 2 3 4 5	9,999,999	9,999,999	9,999,999	9,999,999	9,999,999
10 15 .... At age 90 At age 95 At age 100					

[#] These assumed net rates of return shall comply with the Guideline on Benefit Illustrations for Long Term Insurance Policies issued by the Insurance Authority, as amended from time to time.

PRINT DATE: DD/MM/YYYY

Illustration Document for Investment-linked Policies (3/3)

(Source: SFC)

Second Option: with assumed net rate of return of 0%, 3% and 6% p.a.#

3. Basic Plan – Illustration Summary

Projected Surrender Values and Death Benefits							
End of Policy Year	Total Premiums Paid	Assuming Net Rate of Return of 0% p.a.*		Assuming Net Rate of Return of [3%] p.a.*		Assuming Net Rate of Return of [6%] p.a.*	
		Surrender Value	Death Benefit	Surrender Value	Death Benefit	Surrender Value	Death Benefit
1 2 3 4 5	9,999,999	9,999,999	9,999,999	9,999,999	9,999,999	9,999,999	9,999,999
10 15 ... At age 90 At age 95 At age 100							

4. Explanatory Notes

* The Surrender Values and Death Benefits shown in the above illustration are calculated based on the net rates of return. However, the net rates of return are net of any underlying/ reference fund charges levied by fund houses which vary with different underlying/ reference funds. Assuming the underlying/ reference fund charges are [1.50%] p.a., the gross rates of return on the underlying assets of the underlying/ reference funds used in this illustration are therefore *[First Option: [1.50%] p.a., [4.50%] p.a., [7.50%] p.a. and [10.50%] p.a. / Second Option: [1.50%] p.a., [4.50%] p.a. and [7.50%] p.a.]* respectively. For details of underlying/ reference fund charges, please refer to the offering documents of the underlying/ reference funds. Please note that this illustration might not be relevant to the actual rates of return, which depend on your choice of investment options. Please consult your advisor for further details. If you select any investment options linked to a money market fund or a fixed income fund, the above returns in the growth scenarios would be considered higher in many cases and unlikely to be achieved should low interest rate environment persists. You are strongly encouraged to consult your financial advisor who could provide further information on these underlying/ reference funds - both for your initial and subsequent investment option selections.

[Under the assumed net rate of return at 0% [and b%] p.a., your policy will remain in force up to an attained age of x [and y] of the individual insured respectively. The policy will be terminated afterwards. Your policy may also be terminated under other adverse investment scenarios. If the actual investment return is below the above assumed net rate of return, the policy may be terminated earlier than above attained age(s). You could lose all your premiums paid and benefits accrued if any condition of automatic early termination is triggered.]

Warning

- ***You should only invest in this product if you intend to pay the premium for the whole of your chosen premium payment term.***
- ***Should you terminate this policy early or cease paying premiums early, you may suffer a significant loss.***
- ***Your policy may be terminated if the account value is insufficient to pay the fees and charges.***

Declaration

I confirm having read and understood the information provided in this illustration and received the principal brochure.

Name of Applicant: __________________ ***Signature:*** ___________________ ***Date:*** ____________________

These assumed net rates of return shall comply with the Guideline on Benefit Illustrations for Long Term Insurance Policies issued by the Insurance Authority, as amended from time to time.

PRINT DATE: DD/MM/YYYY

Guideline on Underwriting Class C Business (GL15) (1/13)
(Source: IA GL15)

GL15

GUIDELINE ON UNDERWRITING CLASS C BUSINESS

Insurance Authority

Guideline on Underwriting Class C Business (GL15) (2/13)
(Source: IA GL15)

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Guideline on Underwriting Class C Business (GL15) (3/13)

(Source: IA GL15)

1. Introduction

1.1 This Guideline is issued pursuant to section 133 of the Insurance Ordinance (Cap. 41) ("the Ordinance") taking into account the Insurance Core Principles, Standards, Guidance and Assessment Methodology ("ICP") promulgated by the International Association of Insurance Supervisors ("IAIS"). Specific references are:

(a) Section 4A of the Ordinance stipulates that the Insurance Authority ("IA")'s function is to protect existing and potential policyholders. Section 4A(2)(c) states that the IA shall promote and encourage the adoption of proper standards of conduct, and sound and prudent business practices by authorized insurers.

(b) ICP 19 stipulates that the conduct of the business of insurance should ensure that customers are treated fairly, both before a contract is entered into and through to the point at which all obligations under a contract have been satisfied. ICP 19.0.1 further stipulates that the conduct of insurance business should help to strengthen public trust and consumer confidence in the insurance sector.

1.2 This Guideline applies to all authorized insurers underwriting Class C business, or more commonly known as Investment-linked Assurance Schemes ("ILAS") business.

2. Relevant Regulatory Documents

2.1 Where appropriate, this Guideline should be read in conjunction with other relevant codes/circulars/guidelines issued by the IA or other regulatory bodies, including the following[1]:

(a) Updated Requirements Relating to the Sale of Investment-linked Assurance Schemes to Enhance Customer Protection issued by the

[1] The list is not exhaustive and may be subject to changes from time to time. Authorized insurers have the responsibility to ensure compliance with all the relevant requirements with due regard to their own circumstances.

Hong Kong Federation of Insurers ("HKFI")

(b) Enhanced Regulatory Requirements on Selling of Investment-Linked Assurance Scheme Products issued by the Hong Kong Monetary Authority (HKMA)

(c) Guidance on Internal Product Approval Process issued by the Securities and Futures Commission ("SFC")

(d) Handbook for Unit Trusts and Mutual Funds, Investment-Linked Assurance Schemes and Unlisted Structured Investment Products issued by the SFC

3. Purpose

3.1 ILAS is a hybrid product with both insurance and investment elements. Clients have to bear the associated investment risks but at the same time benefit from some form of insurance protection.

3.2 As ILAS are long term insurance contracts, they normally entail a more complex charging structure and the investments involved do not have the same level of liquidity as other forms of investments. Clients should be fully apprised of the nature of such products, as well as the associated rights and obligations, before they enter into such contracts.

3.3 Both the IAIS and the global insurance industry have placed increasing emphasis on fair treatment of customers. ICP 19.2.4 stipulates that fair treatment of customers encompasses:

(a) developing and marketing products in a way that pays due regard to the interests of customers;

(b) providing customers with clear information before, during and after the point of sale;

(c) reducing the risk of sales which are not appropriate to customers' needs;

(d) ensuring that any advice given is of a high quality; and

(e) managing the reasonable expectations of customers.

3.4 This Guideline aims to set out the proper standards of conduct and business practices for authorized insurers underwriting Class C business. In assessing whether the requirements have been duly followed by authorized insurers, the IA will consider the substance and nature of the matters involved. The name or form of the arrangements adopted by individual authorized insurers would be irrelevant.

4. Duties of the Board, the Controller and the Appointed Actuary

4.1 It is the duty of the Controller, as specified under section 13A(12) of the Ordinance, to ensure that requirements set out in this Guideline and the relevant ICPs are observed throughout the life cycle of all ILAS policies. It is also the duty of the Board to maintain general oversight over the implementation of measures in compliance with this Guideline.

4.2 Any attempt to circumvent the requirements prescribed in this Guideline would be regarded as acting in bad faith. In the case of Controllers, this may affect the "fit and proper" assessment under sections 8(2) and 13A(4) of the Ordinance. In the case of Appointed Actuaries, this may constitute non-compliance with professional standards under section 15C of the Ordinance, and may render the incumbent not acceptable to the IA under section 15(1)(b) of the Ordinance.

5. Product Design

5.1 ICP 19.2.4 stipulates that insurers should develop and market products with due regard to the interests of customers. During the product design stage, an authorized insurer should carry out a diligent review to ensure that the product meets the "fair treatment of customers" principle, particularly in the areas set out below.

5.2 Insurance Value

(a) ILAS products should bring insurance value to clients.

(b) Authorized insurers have agreed that effective from 1 January 2015,

all ILAS products would provide a minimum death benefit of 105% of the account value. This notwithstanding, authorized insurers are encouraged to provide additional insurance benefits beyond this minimum level.

5.3 Fees and Charges

(a) Fees and charges to be paid by the customers should be fair, commensurate with the insurance protection offered by the ILAS product concerned, and reflect the services/added value of the authorized insurer.

(b) It would be questionable whether an ILAS product, which only carries minimal insurance content but has high upfront charges or multiple charges, could meet the "fair treatment of customers" principle.

5.4 Sustainability of the product

ILAS products should be sustainable. High level of fees that could deplete a client's investment notwithstanding a modest growth scenario can hardly be considered as sustainable.

5.5 In considering whether the design of an ILAS product meets the requirements of this Guideline and the "fair treatment of customers" principle, the IA will look at all relevant factors in their totality, including the product features, insurance elements, added value/services to clients, all fees/charges, surrender penalties, remuneration structure etc.

6. Provision of Adequate and Clear Information

6.1 ICP 19.2.4 stipulates that insurers should provide customers with clear information before, during and after the point of sale.

6.2 ICP 19.3.4 stipulates that the product development and marketing process should include the use of adequate information on customer needs.

6.3 Authorized insurers should include information on the key product features

and risks in all the product documents, including the product brochure, Key Facts Statement and Important Facts Statement / Applicant's Declaration ("IFS/AD").

6.4 Product information should be bilingual[2], clear and succinct, with the use of plain language and legible font size, and should be easily understandable by average clients.

6.5 ICP 19.2.4 further stipulates that insurers should manage the reasonable expectations of customers. Accordingly, projections in relation to the growth scenarios should not be overly optimistic. Clients should at least be apprised of the no-growth scenario (0%), alongside other growth scenarios, in the standard illustration statement.

7. Suitability Assessment

7.1 ILAS products should only be sold to clients with both investment and insurance needs.

7.2 Authorized insurers should endeavour to reduce the risk of sales that do not meet the needs of customers.

7.3 ICP 19.6.2 specifies that insurers should seek the information from their customers that is appropriate for assessing their insurance needs, before giving advice or concluding a contract. This information may vary, but should at least include information on the client's:

(a) financial knowledge and experience;

(b) needs, priorities and circumstances;

(c) ability to afford the product; and

(d) risk profile.

7.4 Clients' needs must first be properly assessed through the use of Financial Needs Analysis ("FNA") form. ILAS must not be marketed to clients

[2] For the avoidance of doubt, the English and Chinese versions of the product documents can be separated, but BOTH must be available to the clients.

before their needs are properly analyzed.

7.5 Clients that have indicated their insurance needs should then be presented with different insurance options that are available to meet their specific needs and financial circumstances. Examples include:

(a) clients wanting both insurance protection and "saving up for the future" should be presented with the option of procuring an endowment policy; and

(b) clients wanting both insurance protection and benefitting from growth in the investment market should be presented with the options of procuring a participation policy or an ILAS policy, and the advantages and risks of both products should be explained in detail. Only in cases where the clients wish to make the investment decision and are willing to bear the investment risk should ILAS be recommended.

7.6 Suitability assessment includes assessing the investment horizon of the potential policyholder, with due regard to the financial circumstances, planned retirement age etc.

(a) Premium payment term – The clients' age at the time of policy inception as well as his/her target retirement age are relevant to the suitability of the premium payment term. For instance, a policy maturing in 40 years with prolonged redemption penalties would unlikely be appropriate for a 60-year-old client.

(b) Regular premium – It is also necessary to ascertain the client's ability to pay continuously throughout the policy payment term. For instance, it would not be appropriate to sell a regular premium product to retirees or clients that do not have a stable income.

7.7 The suitability assessment should be carried out whenever there are changes to the circumstances of the client, including the scenario where an existing policyholder requests a top-up.

7.8 Authorized insurers have the duty to verify all available information,

particularly the "Statement of Purpose" section in the IFS/AD, the FNA and Risk Profile Questionnaire ("RPQ"), and assess whether a particular ILAS product is suitable for the client.

8. Advice to Clients

8.1 After a client has considered the insurance options, and is beginning to consider an ILAS policy, he/she should also be properly apprised of all the product features, particularly the fees and charges, surrender penalties (if any) as well as the product and investment risks.

8.2 After a client has decided to procure an ILAS policy, he/she should be fully apprised of the key products features again, as well as his/her rights and obligations, such as the right to ask for details of the intermediaries' remuneration, the need to complete the post-sale call, the 21-day cooling-off period etc. The IFS/AD must be duly signed by the client.

8.3 Authorized insurers have the duty to put in place a proper mechanism to ensure full understanding of the above by the client, as evidenced in the IFS/AD.

9. Appropriate Remuneration Structure

9.1 ILAS products are susceptible to mis-selling and aggressive selling. In addition, they can be used as vehicles for fraudulent acts and money laundering activities.

9.2 Authorized insurers have the duty to ensure that the remuneration structure for their intermediaries do not create misaligned incentives for the intermediaries to engage in the aforesaid activities. For instance, an overly high commission in the initial years of the policy term, coupled with a short clawback period, may create such misaligned incentives.

9.3 Accordingly, indemnity commission, or any standing arrangement that offers advance payment of commission, is strictly prohibited. Authorized insurers should only pay commission on an earned basis. Commission

payable should also spread over an appropriate duration to encourage good after-sale service and duly reward long term relationship between intermediaries and policyholders.

9.4 Cases of mis-selling, aggressive selling, fraud and money-laundering often surface after the expiry of the clawback period. Authorized insurers should therefore put in place an appropriate clawback period to address this particular risk. In addition, to deter such activities, a clawback mechanism must also be put in place to fully recover all commission paid in proven fraud / money laundering / mis-selling cases.

10. Avoidance of Conflict of Interests

10.1 ICP 19.7 requires insurers and intermediaries to ensure that, where customers receive advice before concluding an insurance contract, any potential conflicts of interest are properly managed. ICP 19.7.5 further stipulates that conflicts of interest may be managed in different ways as relevant to the circumstances, for example, through appropriate disclosure and informed consent from customers.

10.2 In regard to intermediaries' remuneration, authorized insurers should follow the formulation stipulated by the IA in calculating the remuneration for each product and distribution channel. The presentation format and wordings should follow IA's template.

11. Clients' Investments and Assets

11.1 Authorized insurers are required to strictly follow the investment instructions of policyholders in the allocation of premiums received. Any deviation must be based on sound actuarial principles and subject to the agreement of the IA.

11.2 Authorized insurers are also reminded to strictly follow the requirements under sections 22, 22A and 23 of the Ordinance regarding segregation and application of assets.

Guideline on Underwriting Class C Business (GL15) (11/13)
(Source: IA GL15)

12. Post-sale Control

12.1 ICP 19.2 stipulates that insurers and intermediaries should establish and implement policies and procedures on fair treatment of customers. Authorized insurers should have proper control systems in place to achieve fair treatment of customers and monitor that such policies and procedures are adhered to.

12.2 The proper sales process flow is set out in the flowchart at the **Annex**. It involves completion of the FNA, confirmation of needs, comparison of different insurance options, completion of the RPQ, explanation of the key product features and completion of the IFS/AD.

12.3 To reaffirm clients' understanding of the ILAS policy that they have procured, and that they are fully aware of their rights and obligations under the ILAS policy, authorized insurers are required to make audio-recorded post-sale confirmation calls to all ILAS clients within 5 working days of the date of policy issue. The content of the call should follow the HKFI's template.

(a) The insurers should appoint a separate quality assurance team to make the post-sale calls.

(b) The insurers should use their best endeavours to make the post-sale calls, attempting different times of the day and different days of the week.

(c) The insurers are encouraged to adopt additional measures such as on-site recording at the service centre or immediate "dial-in" to or from the call centre for clients who are visitors or who may be difficult to reach.

(d) In the event of unsuccessful calls, a confirmation letter should be sent to the clients, alongside an email/SMS alert that draws the attention of the clients to the importance of the confirmation letter.

12.4 Authorized insurers are required to put in place an effective mechanism to identify possible cases of intermediaries abetting clients to evade the control measures, such as high frequency of clients opting out or deviating from the RPQ process, or having high rate of unsuccessful post-sale calls.

12.5 Authorized insurers should have in place proper documentation systems for quality control and future monitoring. Apart from the policy documents and the IFS/AD, records of the post-sale calls, confirmation letters and the email/SMS alerts, as well as control reports in respect of measures in paragraph 12.4, should also be kept properly.

12.6 Authorized insurers should, during the underwriting process, reject applications for ILAS policies if any of the requirements above are not met.

13. Commencement

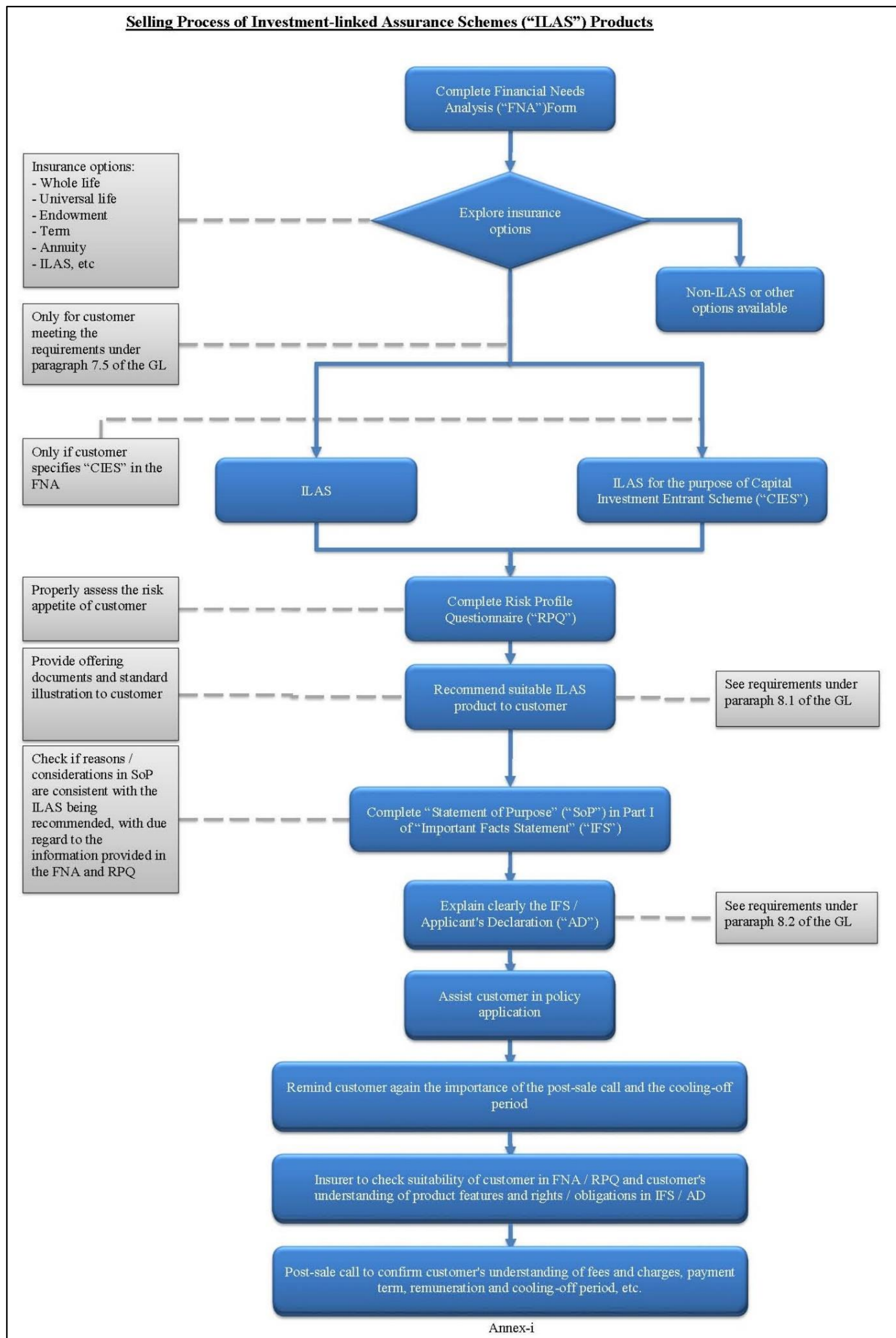
13.1 This Guideline shall take effect from 26 June 2017.

June 2017

Appendix H

Guideline on Underwriting Class C Business (GL15) (13/13)

(Source: IA GL15)



GLOSSARY

105 Plan The death benefit of it will be 105% of the value of the policy account. **4.6.6(c)**

Administration Fee A fixed charge per year and/or a percentage of the premium applied to cover the authorized insurer's administrative expenses, also known as Maintenance Fee. **4.3.1(c)**

Annuitant The person entitled to receive annuity payments. **3.8.2**

Annuity A series of periodic payments to an annuitant for life or other agreed term or conditions, in return for a single payment (premium) or series of payments. **3.8.2**

Applicant's Declarations It must be included in every application for an investment-linked insurance policy in the exact prescribed form. **4.13.1(e)**

Arbitrage A simultaneous purchase and sale of same or similar assets in different markets in order to capture a risk-free profit caused by mis-pricing. **3.4.1(c)**

Balanced Fund An investment fund which invests in a combination of stocks and bonds with an objective of achieving both income and capital appreciation while avoiding excessive risk. **4.8.2(i)**

Beneficiary The person nominated to receive the policy benefit in the event of a claim under the policy. **4.16.3**

Beta It is the measure of the change of return on a security for a 1% change in the return on the whole market. **3.3.9(d)(iii)**

Bid-offer Spread The difference between the price at which the policyholder can buy units (the offer price) from the authorized insurer and that at which the policyholder can sell units (the bid price) to the authorized insurer. **4.3.2(a)**

Bonds Debt instruments issued by corporations, municipal governments, countries, and supra-nationals. **3.2.1**

Bond Fund An investment fund which invests in the bond market with an objective of providing stable income with minimal capital risk **4.8.2(a)**

Bond Ratings Alphabetical designations assigned by rating agencies to reflect the investment quality of the bond issued. **3.2.10**

Bonus The approximate equivalents of dividends on participating policies, bonuses are reversionary amounts added to the ultimate benefit payable under UK style with-profits policies. **4.11.2**

Bonus Issue The issue of shares to the existing shareholders for free as a result of capitalisation of profits. **3.3.4**

Bottom-up Approach A fundamental analysis which focuses on the financial performance of specific companies first before moving on to the industries and finally the economy. **3.3.9(a)**

Call Option A contract which gives the holder the right, but not the obligation, to buy the underlying assets. **3.4.3**

Callable Bond A bond which is issued with an option for the issuer to "call" (repay prematurely) before the bond's maturity date. **3.4.3**

CAMEL Rating System It is an international recognised framework for assessing capital adequacy, asset quality, management, earnings and liquidity of a bank. **2.1.6(a)**

Capital Asset Pricing Model It relates the expected return of a security to its risk as measured by beta. **3.3.9(d)(iii)**

Cash Value It is a savings element of a permanent life insurance policy, which can be withdrawn in the form of surrender value (subject to surrender charges), or used as a pledge for policy loans. Not all policies have a cash value, e.g. term insurance. **1.2**

Certificates of Deposit Negotiable short-term time deposit certificates issued by commercial banks evidencing a deposit of a fixed maturity of less than 1 year. **3.1.2(b)**

CIS Internet Guidance Note Issued by the Securities & Futures Commission in May 2001, this note clarifies the regulatory requirements concerning Collective Investment Schemes activities on the Internet. **5.3.6**

Claims A crucial area for life insurers. The department concerned will be involved in all aspects of claims investigation, processing and settlement. **4.3.1(a)**

Closed-end Funds Type of fund which has a fixed number of shares, usually listed on a major stock exchange. Unlike open-end funds, closed-end funds do not stand ready to issue and redeem shares on a continuous basis. **3.7.2(b)**

Code of Conduct for Licensed Insurance Agents Issued in accordance with the relevant provisions of the Insurance Ordinance by the Insurance Authority covering the principles of professional conduct for insurance agents. **5.2.2**

Code on Investment-Linked Assurance Schemes This code establishes guidelines which will be applied by the Securities and Futures Commission for the authorization of investment-linked assurance schemes. **4.13.2(b)**

Commercial Papers Unsecured promissory notes issued by top-rated financial and non-financial institutions with maturities of under one year. **3.1.2(c)**

Company Customization Illustration Documents are allowed to be company customized provided the basic intentions of the document are respected. **4.15.1(c)**

Company Risk Negative developments such as the loss of market share, the failure of a new product launch will have an adverse effect on a company's financial status and thus its share price. **2.1.2**

Consumption One of the components of Gross Domestic Product by the expenditure method. **2.2.3(a)**

Cooling-off Period A time period which provides policyholders with the time to understand carefully all the information given in relation to a policy and a policyholder may serve a written notice to cancel the policy for a refund of the paid premium less any market value adjustment. **4.13.4**

Convertible Bonds A type of bond for which the investor may have a right to choose whether to receive the par value or the common stock of the issuer or of some other company. **3.2.3**

Corporate Bonds Medium or long-term debt obligations of private corporations. **3.2.1(e)**

Cost of Insurance The charge made by an authorized insurer to cover the mortality, annuity payment and other benefits and is mainly based on the gender, age, smoking habit, the sum assured, class of risk of the life assured and the death benefit option, also known as **mortality charges**. **4.3.1(a)**

Coupon Rate The interest rate the bond issuer promises to pay the investor. **3.2.4**

Custodian An authorized institution appointed by a mutual fund corporation, responsible for taking under its control all the property of the fund in trust for the holders in accordance with the provisions of the constitutive documents such as a Custodian Agreement. **3.7.6(b)**

Date of Death An important point to be established with life insurance death claims, especially with term or decreasing term insurances where the validity or amount of the claim may be affected. **4.6.6(a)**

Death Benefit The basic amount payable under the insurance in respect of the death of the life insured. This may be subject to additional factors, e.g. accidental death benefits etc. **4.6.6**

Debt Securities see fixed income securities **3.2.1**

Demand Curve It is a graph showing the quantity of a good that buyers are willing to buy on the x-axis at each price on the y-axis. **2.2.1(a)**

Deposit Fund A notional interest bearing fund which invests in short-term money market instruments which provide stable income with minimal capital risk. **4.8.1**

Default (Credit) Risk The potential inability of a debt issuer to pay interest and repay the principal. **2.1.2**

Deferred Annuity An annuity which has the instalment payments begin at some specified time or specified age of the annuitant. **3.8.2(a)(ii)**

Deflation It is negative inflation. **2.2.3(f)**

Derivative Warrant A warrant (option) that is issued by a third party, typically an investment house or financial institution. **3.4.3**

Direct Finance It refers to the borrowers obtaining funds directly from lenders. **2.2.2(a)**

Discount The bond is being sold at a price lower than the par value. **3.2.7**

Disinflation It refers to a decrease in the inflation rate. **2.2.3(f)**

Distribution Fee An annual fee charged by an investment fund to its investors to pay for selling the fund to new investors and providing services to existing investors. **3.7.3**

Diversification Owning different issues of the same asset class or different asset classes within a portfolio of investment, or investing in different markets, regions or countries in order to reduce the total risk of the portfolio. **2.1.4(a)**

Dividend Yield The current annualized dividend paid on a share, expressed as a percentage of the current market price of the corporation's common stock. **3.3.3**

Dividends (Equity) Payments made in cash to shareholders. **3.3.5**

Dividends (Insurance) A payment made in cash for participating policyholders on the divisible surplus of the authorized insurer. **1.2**

Dividend Discount Model A stock valuation model which states that the share price is equal to the present value of all expected future dividends discounted at the required rate of return on the share. **3.3.9(d)(i)**

Dollar Cost Averaging By buying a fixed dollar amount of an asset at intervals to avoid putting all money in the market at the inappropriate time. **2.1.4(b)**

Domestic Bonds Bonds issued in the domestic currency by corporations domiciled in the same country. **3.2.11**

Duration It is used to measure the percentage change in bond prices with respect to change in interest rate. **2.1.5(b)(iv)**

Economics It is the study of how individuals make choices under the constraint of limited resources and of the results of those choices for society. **2.2.1**

Economic Cycles It is the fluctuation of a country's economic performance as measured by the real GDP throughout history. **2.2.3(b)**

Economic Risk The possible impact of an overall economic slowdown. **2.1.2**

Economic Sectors They include the household sector, the business sector, the government sector, the foreign sector and the finance sector. **2.2.1(b)**

Endowment Insurance A life insurance contract which provides for the payment of the face amount at the end of a specified term or upon earlier death. **3.8.1(a)(ii)**

Equity An ownership interest in a corporation. It provides the investor with the opportunity to participate (share) in the long-term growth of a limited company. **3.3.1(a)**

Equity Fund An investment fund which invests in the equity market with an objective of achieving higher long-term capital appreciation. **3.8.2(b)**

Equity Warrant A warrant (option) that is issued by the company issuing the underlying stock. **3.3.2(c)**

Eurobonds Bonds denominated in US dollars or other currencies and sold to investors outside the country whose currency is used. **3.2.11**

Exchange Rate It is the amount of one currency that can be traded for the other. **2.2.3(e)**

Exchange (Currency) Risk A foreign financial investment denominated in a foreign currency may have to be converted into the home currency at a less favourable rate due to foreign exchange rate fluctuation. **2.1.2**

Financial Derivative A financial instrument whose value depends on or is derived from an underlying asset such as stock, bonds, interest rate, foreign currency, commodity, or stock market index. **3.4**

Financial Needs Analysis It must be included in every application for an investment-linked insurance policy to assess the financial needs of the customer. **4.13.1(c)**

Financial Risk The possible loss or reduction of the original sum invested. **2.1.1**

Fiscal Policy It is the decisions on the government's budget as to how much the government spends and how much tax it collects. **2.2.3(c)**

Fit and Proper A common phrase in regulatory instruments, indicating that the individual occupying or wishing to occupy a certain position is suitable and acceptable from a regulatory point of view. **5.2.3**

Fixed Income Securities A group of investment instruments that offer a fixed periodic return. **3.2.1**

Forward Contract An agreement between two parties (buyer and seller) to set a price today for an asset/good that will be delivered on a specified future date. **3.4.2**

Foreign Bonds Bonds issued in the currency of the country by foreign corporations. **3.2.11**

Fraud A non-ethical practice where the investment representative/insurance intermediary deliberately makes false statements and claims and intentionally conceals information with the intention to deceive or cheat. **4.14**

Fund Management Fee A fee charged by the investment fund manager for their services rendered to manage the fund. It is usually expressed as a specified percentage of the fund's market value and is used to support the authorized insurer's investment management team. **4.3.2(b)**

Fund of Funds An investment fund which invests in other mutual funds with an objective to carry out diversified professional management, also known as **Unit Portfolio Management Funds**. **4.8.2(l)**

Fund Performance Report A summary of the performance of the fund during the period which highlights any changes in the investment policy. **4.16.6**

Fund Switching Charge The fee charged to the policyholder to switch his/her investment option and allocation from time to time. **4.3.2(c)**

Fundamental Analysis It is the study of the economic and political factors to determine the intrinsic value of the securities. **3.3.9**

Futures Contract A standardized forward contract that is traded in an organized market called futures exchange. **3.4.2**

Global Fund An investment fund which invests in stocks or bonds throughout the world. **4.8.2(e)**

Government Bills Short-term debts issued by the government to finance their expenses. **3.1.2(a)**

Government Bonds These are financial instruments used by the government to borrow money from the public. **3.2.1(b)**

Gross Domestic Product ("GDP") The ultimate measurement of an economy's performance is its gross domestic product. It is the market value of the final goods and services produced in a country during a given period. **2.2.3(a)**

Gross Premium The premium in life insurance after taking into account the three rating factors of mortality, interest and expenses. **4.6.7**

Growth Fund An investment fund which invests in growth stocks with an objective of achieving maximum capital appreciation rather than a flow of dividends. **4.8.2(j)**

Guaranteed Fund An investment fund which provides a guarantee of the principal. Some funds may even guarantee a minimum return. **4.8.2(k)**

Guaranteed Policies These life insurance policies guarantee a fixed rate of return to policyholder in term of sum assured. They are sold on a guaranteed cost basis, meaning that all policy elements (i.e. the premium, the sum assured, and the cash values, if any) are guaranteed and will not vary with the experience of the company, also known as **non-participating/without-profit policies**. **4.11.1**

Hedging The process to eliminate the impact of change in market price on the value or an asset or investment portfolio. **3.4.1(a)**

Hong Kong Confederation of Insurance Brokers An approved body of insurance brokers under section 70 of the Insurance Ordinance to implement self-regulation in Hong Kong since the Insurance Authority took over its self-regulatory functions on 23 September 2019s. **5.2.4(b)**

Hong Kong Federation of Insurers As the Insurance Authority took over its self-regulatory functions on 23 September 2019, it focuses on developing an industry claims database to combat insurance fraud, building its capacity as a think-tank on insurance, as well as promoting and organizing quality insurance training, education, industry awards and conferences to nurture talent and enhancing the industry's professionalism. **5.2.4(a)**

Illustration Document A document based on two assumed rates of return that demonstrate clearly the projected surrender values over the term of the policy. **4.15**

Immediate Annuity An annuity purchased with a single payment, the benefits or instalments begin one annuity period (one month or six months) immediately thereafter. **3.8.2(a)(i)**

Income Fund An investment fund whose objective is to generate regular income rather than to achieve capital growth. **4.8.2(h)**

Increasing Death Benefit The death benefit will be the value of the units accumulated in the policyholder's account, at the date of death, plus the chosen death cover. **4.6.6(a)**

Index Fund An investment fund with an objective of mirroring specific index performance. **4.8.2(c)**

Industry Analysis A fundamental analysis which classifies an industry into four stages of life cycles. **3.3.9(b)**

Indirect Finance It occurs when the funds flow through the finance intermediaries from the lender to the borrower. **2.2.2(a)**

Inflation It is a measure of the annual percentage rate of change in the general price level. **2.2.3(f)**

Inflation Risk The loss of purchasing power as the return on investment does not match the inflation rate. **2.1.2**

Initial Public Offering It refers to the issue of stocks to the market for the first time when a privately owned company is to be listed on the stock market **3.3.2(a)**

Insurance Agent An agent in an insurance contract, usually representing the insurer and remunerated by commission on the premium paid. **5.2.2**

Insurance Authority The independent insurance regulator established under the Insurance Ordinance (Cap. 41) to regulate the carrying on of insurance business and to regulate the insurance industry in Hong Kong for protecting policy holders and potential policyholders and for promoting the stable development of the insurance industry. **5.1.1**

Insurance Broker A person who carries on the business of negotiating or arranging contracts of insurance in or from Hong Kong as the agent of the policyholder or potential policyholder or advising on matters related to insurance. **5.2.2**

Insurance Charges Fees charged by the authorized insurers for the provision of insurance policies to cover the marketing, distribution, administration, and insurance expenses. **4.3**

Insurance Intermediaries In Hong Kong, these consist of insurance agents (usually representing the insurer) and insurance brokers (usually representing the insured). Separate regulatory rules and provisions apply to each group. **5**

Interest Rate It is the price of holding money which is determined by the demand and supply of money. **2.2.3(d)**

Insurance Ordinance This is the legislation for regulating the carrying on of Hong Kong insurance business. It is also used to establish the Insurance Authority to regulate the insurance industry for protecting policy holders and potential policy holders and for promoting the stable development of the insurance industry. **5.2.1**

Interest Rate (Price) Risk The price fluctuation of certain fixed income investments prior to maturity due to current market interest rate changes. **2.1.2**

Investment To sacrifice present value for future value. **2.1.3**

Investment Advising It refers to the process of providing investment advices to the clients. **2.2.6(a)**

Investment Funds A form of collective investment through which a number of investors who have similar investment objectives combine their money into a large central pool. **3.7**

Investment Time Horizon This is the time period within which the investor intends to make the investment. **2.2.5(b)**

Investment-linked Annuity An annuity whose annuity payment is variable according to the performance of the investment funds. **4.4(a)**

Investment-linked Insurance Policy An insurance policy with its policy value generally linked to the performance of its underlying investments. **1.1**

Investment Risk The uncertainty associated with the end of period value of the investment, especially the possible loss or reduction of the original sum invested. **1.2**

Law of Fixed Income An inverse relationship between the yield and the price of a bond. **3.2.7**

Lead Manager It is an investment bank which has primary responsibility for organizing the marketing of the new issues of shares. **3.3.2(a)**

Level Death Benefit The death benefit will be the higher of the value of units accumulated in the policyholder's account at the date of death or the chosen death cover. **4.6.6(b)**

Limit Setting The trading limits set by a financial intermediary to limit market risk exposure. **2.16(b)(ii)**

Linked Long Term Business The business of effecting and carrying out of insurance on human life or contracts to pay annuities on human life where the benefits are wholly or partly to be determined by reference to the value of, or the income from, property of any description or by reference to fluctuations, in, or in an index of, the value or property of any description. **1.1**

Liquidity The ability of an investor to sell the asset quickly without having to make a substantial price concession. **2.2.5(a)**

Liquidity Risk The inability to liquidate (sell) an investment or the need to pay a substantial cost to liquidate. **2.1.2**

Load Charge A commission payable to the sales force which is based on the shares/units it sells. **3.7.3(b)**

Low Correlation Having little or no mutual relationship. In the process of diversification, investment is made in assets of little relationship to reduce the overall risk. **2.1.4(a)**

M1 The sum of legal tender notes and coins held by the public plus customers' demand deposits placed with banks. **2.2.1(c)**

M2 M1 plus customers' savings and time deposits with banks plus negotiable certificates of deposit (NCDs) issued by banks held outside the banking sector. **2.2.1(c)**

M3 M2 plus customers' deposits with restricted licence banks and deposit-taking companies plus NCDs issued by these institutions held outside the banking sector. **2.2.1(c)**

Management Company An institution, properly licensed or registered under Part V of the SFO to carry on the regulated activities, appointed by an investment fund responsible for investment management within the scope of the constituent documents. **3.7.6**

Management Fee A fee charged by the management company for the investment and advisory services provided by the professional fund manager. **3.7.3(c)**

Market Index It is the index adopted in different stock exchange markets as reference of the price level of a particular stock market. **3.3.8**

Market Risk The basic demand and supply in the market will affect the price of investment instruments. An investor will suffer a loss if he/she has to sell an asset when the price drops below his/her original purchase price. **2.1.2**

Market Value Adjustment The permitted right of an authorized insurer under the cooling-off initiative to adjust the refund of premiums, taking into account the loss the authorized insurer might suffer in realizing the value of any assets acquired through investment of the premiums made under the life policy. **4.13.4**

Marking to Market It is the process to revalue the collateral value of a client to reflect the current market value. **2.1.6(b)(i)**

Misrepresentation A non-ethical practice where an insurance intermediary/ licensed person deliberately makes misleading statements to induce a prospect to purchase insurance. **4.14**

Money Laundering A process through which illegally obtained funds, such as proceeds from criminal activities, are disguised to appear as if they came from legitimate sources. **5.4.1**

Money Market Instruments Short-term, highly liquid and low-risk debt instruments issued by governments, banks and large non-financial corporations. **3.1**

Monetary Policy It is the action by the government to influence the money supply in the economy so as to affect the market interest rate. **2.2.3(c)**

Mortality Charges See **Cost of Insurance.** **4.3.1(a)**

Mortality Tables Published statistics on mortality, indicating the expected rate of mortality at given ages. **4.3.1(a)**

Moving Average It is the calculation of the average closing prices for a specific period such as 10-day, 20-day or 250-day moving averages. **3.3.10(c)**

Municipal Bonds Bonds issued by states or local governments to finance their budgets. **3.2.1(d)**

Mutual Fund An investment fund which is set up with the objective of investing in shares of other companies. **3.7.1(a)**

Net Asset Value The market value of a fund calculated on the basis of the market value of the underlying assets in the portfolio after deducting liabilities and accrued expenses. **3.7.1(b)**

Office Premium For policies with single mode of payment, the premiums paid by the policyholders during the financial year or, for policies with regular mode of payment, the annualized premiums of the policies as at the valuation date or the flexible premium paid by the policyholders during the financial year. **4.1**

Open-end Fund An investment fund which stands ready to purchase existing shares/units at a price based on or near the NAV of the underlying investments. **3.7.2(a)**

Operational Risk The risk faced by a financial institution arising from the operations of the business deal processing, deficiency of information system, ineffective internal management and control system, human errors, etc. **2.1.2**

Option A contract which gives the holder the right, but not the obligation, to buy or sell a specified amount of an underlying asset at an agreed price within or at a specified time. **3.4.3**

Option sensitivity measures The measure of the option price changes as against changes in other parameters such as time, interest rate, volatility, etc. **2.1.5(b)(iv)**

Over-the-counter market It is an informal network of market participants such as brokers and dealers who negotiate sales of securities with each other. **3.2.1**

Par The bond is being sold at the same price as the par value. **3.2.7**

Par Value The amount the issuer agrees to repay the bondholder at maturity, also known as **face value**, **maturity value** or **redemption value**. **3.2.2**

Partial Withdrawal A facility which allows a policyholder to reduce the cash value in a policy by making withdrawals for a specific minimum amount provided that the remaining balance is sufficient to cover fees and related insurance charges. No penalty or debit interest will be incurred. It is also known as **partial surrender.** **4.6.4**

Participating/Non-Participating Also known as **With-Profits** or **Without-Profits**, the terms indicate whether or not the policies concerned share in the profits of the insurer. If they do, dividends or bonuses are payable. **4.11.1**

Payment Ratio The percentage of a corporation's earnings paid to shareholders in the form of cash dividends, also known as **Pay-out Ratio**. **3.3.3**

Performance Fee A fee charged by the investment company based on the actual investment gains achieved. **3.7.3(c)**

Policy Changes One of the duties of the Policyowner Service Department including such matters as minor amendments of address to significant issues such as change of beneficiary, assignment and change of insurance cover amount. **4.16.3**

Policy Delivery After policy document preparation, delivery of individual policy documents is normally done by the insurance intermediaries. **4.16.2**

Policy Fee The charge made by an authorized insurer to cover the distribution, marketing and policy issue expenses of setting up the policy, also known as **Initial Charges.** **4.3.1(b)**

Policy Issuance The process of preparation, checking and delivery of the policy document. **4.16.1**

Policy Statement A summary of the transactions that occurred during the statement period, and the values of the policy as of the statement date provided to the policyholder. **4.16.5**

Preference Share An ownership interest in a corporation which gives the investor a right to a fixed dividend provided enough profit has been made to cover it, also known as **Preferred Share**. **3.2.14**

Premium (Bond) The bond is being sold at a price higher than the par value. **3.2.7**

Premium (Option) The sum of money an option buyer pays to the seller for the option. **3.4.3**

Premium Holiday A facility which allows a policyholder of a regular premium plan to skip premium payments for a period of time provided that the policy value is sufficient to cover the mortality charges and fees. No penalty or debit interest will be incurred. **4.13.2(h)**

Premium Payment The amount payable by the policyowner for the insurance coverage. **4.3.1(b)**

Price Earnings Ratio A corporation's current stock price divided by its past 12-month earnings per share, also known as **PE Ratio**. **3.3.3**

Price Earnings Model It is to compare the PE Ratio of companies in the same industry to ascertain the relative value of an individual company. **3.3.9(d)(ii)**

Primary Market It is the market in which new securities are issued for the first time. **3.3.6(c)**

Principal Brochure A document which contains the information necessary for prospective ILAS customers to be able to make an informed decision on the proposed investment. **4.13.3**

Private Placement It takes place when the shares are issued to a specific class of investors. **3.3.2(b)**

Professional Insurance Brokers Association It is one of the self-regulatory bodies authorized by the Insurance Authority. Its function is to approve license to insurance brokers and to regulate the conduct of its members, their chief executives and technical representatives. Besides, it aims to promote good business practice in the business of insurance broking through its rules and code of conduct, and to assist in the settlement of any disputes and differences. **5.2.4(c)**

Proliferation Financing An act of providing funds or financial services which are used, in whole or in part, for the manufacture, acquisition, possession, development, export, trans-shipment, brokering, transport, transfer, stockpiling or use of nuclear, chemical or biological weapons and their means of delivery and related materials (including both technologies and dual use goods used for non-legitimate purposes), in contravention of national laws or, where applicable, international obligations. **5.4.1**

Put Option A contract which gives the holder the right, but not the obligation, to sell the underlying asset. **3.4.3**

Putable Bond A bond which is issued with an option for the holder to "put" (sell back to the issuer prematurely) before the bond's maturity date. **3.4.3**

Ratio Analysis It is used to ascertain a company's financial performance as compared to previous years and to an industry standard. **3.3.9(c)**

Regional/Country Fund An investment fund which invests in a specific region or country. **4.8.2(f)**

Rebating This is the practice where an insurance agent offers a rebate of his/her commission to entice a prospect to purchase a policy. **4.14**

Regular Premium Plan Investment-linked policies that are financed by regular premiums. This is more suitable for individuals who want to build up savings on a regular basis. **4.5.2**

Reinvestment-rate Risk The inability to reinvest interim cash flows or a mature investment at the same or higher rate of return. **2.1.2**

Relative Strength Indicator ("RSI") It plots the price relationship between the closing prices of up days and down days within a specific period, the most common is 14-day RSI. RSI has a value between 0 to 100%. **3.3.10(c)**

Responsible Officer A person who, alone or jointly with others, is responsible for the conduct of the insurance agency business of an insurance agent. **5.2.3**

Retention Ratio The proportion of a corporation's earnings that is not paid to shareholders but is instead retained for future expansion of the corporation. **3.3.3**

Return on Equity The earnings of a corporation divided by its book value. **3.3.3**

Reversionary Bonus A financial interest which exists now, but whose full enjoyment and privileges of ownership are deferred until some future time of event. **4.11.2**

Rights Issues It refers to a listed company raising funds by inviting existing shareholders to subscribe to new shares in proportion of their existing shareholding. **3.3.2(d)**

Risk Tolerance The largest amount of risk that an investor is willing to take for a given increase in the expected return. **2.2.4**

Risk-averse Investor An investor who prefers an investment with less risk to one with more risk if the two investments offer the same expected return, or higher expected return to lower expected return if the two investments have the same expected risk. **2.2.4**

Risk Profile Questionnaire It must be included in every application for an investment-linked insurance policy to assess the customer's risk appetite and determine if a particular product and its underlying investment choices are suitable for them. **4.13.1(d)**

Samurai Bonds Japanese Yen bonds issued in Japan by corporations domiciled outside Japan. **3.2.11**

Saving Income minus spending. **2.2.1(b)**

Secondary Market It is the transaction between buyers and sellers of the existing issued securities **3.3.6(c)**

Sell Short The sale of a security that is not owned by an investor with an obligation to repay in kind by purchasing the same security in a subsequent transaction. **3.4.1**

Sharpe Ratio The return of an asset over risk free rate per unit of risk undertaken. **2.1.5(b)(iii)**

Single Premium Plan Investment-linked policies that are financed by one single premium. This is more suitable for individuals who have a large capital sum at their disposal. **4.5.1**

Sovereign (Political) Risk Political instability may cause governments to take actions that are detrimental to the financial interest of financial investment instruments in that country. **2.1.2**

Specialty Fund An investment fund which invests in a specific industry or sector with an objective to capitalize on the return potential. **4.8.2(g)**

Sponsor It conducts due diligence to see if a company is qualified for listing and will then facilitate the company to list on the Stock Exchange of Hong Kong lodging the application and preparing all supporting documents. **3.3.2(a)**

Stress Test The assessment of how an investment performs when specific large moves in the market parameters occur. **2.1.5(b)(iv)**

Strike Price The pre-agreed price for a call holder to buy the underlying asset or a put holder to sell the underlying asset, also known as **Exercise Price**. **3.4.3**

Suitability Check The operational controls of authorized insurers to ensure that the Financial needs analysis, the Risk Profile Questionnaire, the Applicant Declarations are duly completed. **4.13.1(f)**

Sum Assured The amount payable upon the happening of a claim event as defined in an insurance contract, e.g. upon death. **4.3.1(a)**

Supply Curve It is a graph showing the quantity of a good that sellers are willing to sell on the x-axis at each price on the y-axis. **2.2.1(a)**

Supra-nationals These are multilateral organizations such as the World Bank, the Asian Development Bank and the International Monetary Fund (IMF). **3.2.1(a)**

Surrender Charge This is a charge made by the authorized insurer when a policyowner surrenders his/her policy through the sale of the investment fund units. **4.3.2(d)**

Switching A facility which allows a policyholder to make transfer of his/her investment between funds offered or to alter their investment portfolios at any time. **4.8.3**

Technical Analysis It is a study of historical market data to predict future securities prices. **3.3.10(a)**

Technical Representative A person who provides advice to a policyholder or potential policyholder on insurance matters for an insurance intermediary, or arranges contracts of insurance in or from Hong Kong on behalf of that insurance intermediary. **2.2.7**

Term Life Life insurance where the benefit is payable only if the life insured dies during the period (term) specified; also known as Temporary/Term Insurance. **4.1**

Term to Maturity The number of years to the maturity of the bond. The maturity date is the date the issuer will repay the bondholder. **3.2.5**

Terrorist Financing An act of collecting, soliciting, or providing property with the intention of supporting terrorist organizations or carrying out terrorist acts. **5.4.1**

Time Value of Money It is the relationship between the value of dollars today and that of dollars in the future. **3.2.6(a)**

Top-down Approach A fundamental analysis which starts with a study of the macroeconomic factors, then moves down to identify the industries and finally narrows down to the companies in the industry. **3.3.9(a)**

Top-up A facility which allows a policyowner to pay an additional fixed premium when the premium is due (called a regular top-up) or one-off premium at any time (called a lump sum top-up). **4.3.2(e)**

Top-up Fee This is the charge made by insurance companies when a policyholder chooses to top up his/her investment. **4.3.2(e)**

Trustee An authorized institution appointed by an investment fund to fulfil the duties imposed on them by the general law of trusts. **3.7.6(b)**

Twisting A non-ethical practice where an insurance intermediary makes misleading statements, non-disclosure, misrepresentations and incomplete comparisons to induce an insured to replace existing life insurance policies with other life insurance policies resulting in disadvantage to the insured. **4.14**

Underwriter It is an investment bank or a brokerage company which undertakes the risk of the new issue of share by taking up any unsold shares. **3.3.2(a)**

Underwriting The process of assessment and selection of risks for the purposes of insuring the insurance applicants or deciding what insurance terms should apply. It also means the process of guaranteed acceptance of an investment bank when arranging initial public offer for a stock or bond. **4.9(c)**

Unit Trust An investment vehicle set up under a trust. **3.7.1(b)**

Unit-linked The UK version of investment-linked insurance policy. **1.1(a)**

Unitised Funds These are specific, separately managed funds, either managed by the authorized insurer itself or independent fund managers. **4.8.2**

Universal Life A life insurance contract which is subject to a flexible premium, has an adjustable benefit and accumulated cash value. **4.1**

Unemployment Rate It is the percentage of the number of unemployed divided by the labour force. **2.2.3(g)**

Value at Risk It is a measure of the change in value of an investment as a result of changes in market conditions at a specified confidence level. **2.1.5(b)(iv)**

Variable Life The US version of investment-linked insurance policy. **1.1(b)**

Variable Universal Life A form of life insurance which combines the premium and death benefit flexibility of universal life insurance and its feature of unbundling of the pricing factors with the investment characteristics of variable life insurance. **1.1(b)**

Volatility The annualized standard deviation of the rates of return of an asset (stock, bond or mutual fund). The term is used to describe the size and frequency of the fluctuations in price and is an important factor for option pricing. **2.1.5(b)(ii)**

Warrant Fund An investment fund which invests mainly in warrants with an objective of achieving exceptional high return. **4.8.2(d)**

Whole Life A life insurance contract where the benefit is payable only on death, whenever that occurs, at a level premium rate that does not increase as the insured ages. **3.8.1(a)(iii)**

With-Profits The equivalent term in UK insurance terminology of a participating insurance. **4.11.2**

Without-Profits The equivalent term in UK insurance terminology of a non-participating insurance. **4.11.1**

Yankee Bonds USD bonds issued in the US market by foreign corporations **3.2.11**

Yield The net rate of return of the bond investors taking into account of the market price, par value, coupon interest rate and time to maturity. **3.2.7**

Yield Curve It is a graphic representation of the relationship between the level of interest rate and the corresponding maturity. **3.2.8**

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2	(a)	(b)	(d)	(b)	(a)
3		(a)	(a)	(d)	(d)
4		(c)	(c)	(c)	(d)
5		(d)	(a)	(d)	
6		(d)	(b)	(c)	
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