

FSA: Hong Kong Regulation and Taxation – Model Solution for Differences between Canadian and U.S. Regulatory Provisions Exercise

How Did You Do?

On the following pages, you will find a model solution to the exercise you just completed. Spend about thirty minutes comparing your solution to the model. As you compare the two solutions, consider the criteria listed below.

Your memorandum meets minimum requirements if it:

- Answers the fundamental question as to whether the Canadian product can be sold in the United States in its present form or needs to be modified.
- Given a conclusion that modifications are necessary, includes a clear conclusion as to whether the modifications required can reasonably be made to the current policy or if designing a new product from scratch would be more practical because the modifications would be so substantial.
- Focuses on the main concerns but also identifies and analyzes issues where U.S. and Canadian rules are consistent or unlikely to conflict and lists any additional review or analysis that should be performed to assure compliance with U.S. regulatory rules.
- Does not exceed three pages.
- Is a formal document, with appropriate grammar and formatting, and written for a CEO that is broadly aware of the actuarial aspects of an insurance product.

Model Solution

Memorandum

To: Mary Maydhyt, CEO

From: Ernest Student, ASA,
MAAA Associate
Actuary

Date: October 31, 2007

Subject: Evaluation of Canadian Policy Form #123456 for Possible Sale in the United States

Per your request, I have reviewed the above referenced policy to determine whether or not this policy could be sold in the United States in its present form or whether it would require substantial changes.

POLICY DESIGN

The policy is in essence a variable universal life contract. As our company and sales staff are currently authorized to sell variable products in the United States, we will not need to seek additional regulatory authority to sell this kind of policy.

POSSIBLE MODIFICATIONS TO POLICY PROVISIONS

My assessment of the significant policy provisions that may require modification are as follows:

- **Sale to 85** – In some U.S. states, the issue age for these types of products cannot exceed age 70. Some restrictions on sales may therefore be necessary.
- **Minimum Face Amount and Minimum Premium Requirement** – These requirements will not require modification.
- **Maximum Annual Premium** – The Canadian policy states that the maximum premium is the largest amount that will permit the contract to remain tax-exempt under Canadian law. The contract must be changed to limit the maximum premium to that permitted under U.S. law, as the U.S. limitation may differ significantly from the Canadian limitation. The requirement in the Canadian policy that excess premiums will be refunded within 30 days may remain unchanged, however, as this provision is also acceptable in the United States.
- **Grace Period** – The 31-day grace period in the current policy is acceptable in the United States and will not have to be changed.
- **Reductions in Face Amount** – The Canadian policy includes a provision that reduces the face amount automatically, at the policy owner's option, to the minimum amount that will maintain tax-exempt status under Canadian law. Clearly, the references – and tests of tax-exempt status – will have to be changed to reflect U.S. law and calculations. In addition, however, reductions in benefits are dangerous under U.S. tax law. The policy should be modified to assure that the relationship between the face amount, the cash value and the premiums paid must comply with the U.S. definition of life insurance under IRC section 7702. Otherwise, the contract may be taxed as a bank account.

In addition, the Canadian policy permits face amount reductions to be exercised at any policy anniversary, starting with the 5th anniversary. Unless policy owners are willing to own modified endowment contracts, reductions in benefits probably should not be permitted (or should be tightly restricted) before the 7th policy anniversary. Reductions before then would trigger retesting under the rules of IRC section 7702A and may result in the contract being classified as a Modified Endowment Contract (MEC). MECs are subject to less favorable tax treatment than other life insurance contracts.

- **Disability Income** – The Canadian policy incorporates a provision that a monthly income benefit will be paid to the policyholder under very broad conditions, including terminal illness and continuous disability. This is a very unusual inclusion in a U.S. policy and may cause difficulties in two areas.
 - First, this provision may be considered as a disability benefit, and U.S. reporting requirements generally require the separate reporting of the premiums and losses of life and health coverages.
 - Second, a number of states limit or restrict the definition of disability. Inclusion of this provision may be in conflict with state requirements.

I recommend that this provision be eliminated from the base policy language and offered as a separate rider, with a separate premium and benefit triggers that conform to the limitations of the state in which the rider will be sold. Our company currently sells disability policies and riders that would be appropriate for this purpose.

- **Payment of Death Benefit** – The Canadian policy states that if the named beneficiary predeceased the insured the death benefit would be paid to the policy owner. The policy should be changed to reflect the fact that under U.S. law the death benefit should be paid to the beneficiary's estate, not to the policy owner.
- **Maturity** – The Canadian policy pays the amount in the side fund to the policy owner and then terminates. This provision is acceptable under U.S. law.

ADDITIONAL CONSIDERATIONS

- **Language** – There are some slight differences in spelling and wording between Canadian and U.S. English. These should be identified and changed. In addition, it would be wise to have this policy reviewed by our legal staff to see if any standard disclaimers, caveats or required wording should be added.
- **Non-Forfeiture Values** – Since non-forfeiture values are not required in Canada, this policy should be tested to see if it generates minimum non-forfeiture amounts under U.S. law.
- **Illustrations** – Any illustrations used for the marketing of this policy will have to be reviewed by, and certified to, by our illustrations actuary.

SUMMARY AND CONCLUSION

A new policy will not have to be developed, as the Canadian policy can reasonably be modified for sale in the United States. Assuming we would like to proceed to sell this policy in the United States, below is a summary of tests we would perform and modifications we would make:

Tests

- Review language by legal staff for appropriateness.
- Test for generation of non-forfeiture amounts.
- Illustration review and certification by illustrations actuary.

Modifications

- Make minor spelling and wording changes to reflect the difference between Canadian and American English.
- Incorporate non-forfeiture values, if necessary.
- Eliminate embedded disability benefit and offer this benefit – modified to meet our standard U.S. disability language – as a separate rider.
- Change maximum annual premium to that permitted by U.S. tax law.
- Reduce face amount to that permitted by U.S. tax law and not permitted prior to the 7th policy anniversary.
- Change wording regarding payment of death proceeds in the case of the beneficiary pre-deceasing the insured to require payment to the beneficiary's estate.

Your memorandum under task 2 meets minimum requirements if it:

- Provides a summary on what an actuarial investigation entails, and mentions dynamic solvency testing.
- Identifies the potential strategy changes that do not comply with Hong Kong regulations and, where possible, provides recommendations for modifications that can be made in order to comply with regulations.
- For potential changes that are already compliant, discusses relevant regulations that may put constraints on or otherwise affect the change itself.
- Clearly cites the relevant regulation or guidance where suitable.
- Does not exceed four pages.
- Is a formal document, with appropriate grammar and formatting, and written for an Appointed Actuary who is fully aware of the actuarial aspects of an insurance company.

Model Solution – Task 2

Memorandum

To: Michael Carpenter, Appointed Actuary
From: Ernest Student, Associate Actuary
Date: October 29, 2015
Subject: Hong Kong regulatory environment

Introduction

Per your requests, I have provided a summary of actuarial investigations in Hong Kong pursuant to section 18 of the Insurance Companies Ordinance (“the ICO” or “Cap 41”). Furthermore, I have reviewed your potential strategy changes to the Hong Kong branch (the “branch”) and provided commentary on whether or not they are compliant with regulations and how regulations could affect them.

Actuarial Investigations

Actuarial investigations are required under Section 18 of the ICO. These investigations must occur once in every 12 months and require that investigation be made into the insurers “financial condition in respect of [the long term] business including a valuation of its liabilities in respect thereof”. This investigation must be conducted by the insurer’s actuary, which in this case is you. Following the investigation, an abstract of your report must be submitted to the Insurance Authority (“IA”) along with a signed opinion of the insurer’s financial condition.

The Actuarial Society of Hong Kong (“ASHK”) has released Professional Standard 1 (“PS1”), which covers the responsibilities of an Appointed Actuary, including details about actuarial investigations and written reports. Furthermore, ASHK has also released Actuarial Guidance Note 7 (“AGN7”) which gives instructions on how to perform dynamic solvency testing (“DST”). You are required to comply with both PS1 and AGN7 when performing your actuarial investigation.

The key goal of the actuarial investigation is that you, as the Appointed Actuary, have to satisfy yourself to the existing business. To do so, you must consider the liabilities, the assets, their interrelationship, and the financial position of the company. You should use appropriate liability methods, and decide on what rates of interest to use for the valuation of the liabilities. These methods have to take into account any ancillary guaranteed benefits, such as surrender values, on top of the principal benefits. You must also satisfy yourself that the margins, including any margins required by statute, are adequate. Appropriate provision needs to be made for expected future expenses, including expenses for expected new business in the next 12 months. The Insurance Companies (Determination of Long Term Liabilities) Regulation (“Cap 41E”) as well as Actuarial Guidance Note 3 (AGN3) and its two supplements cover the valuation of liabilities in more detail.

On the asset side, you must consider what rate of return, capital, and income would likely be realised over the periods relevant to the liabilities, taking into account the nature of the portfolio. You should also pay attention to the relationship between the nature and term of those assets and the corresponding liabilities, and satisfy yourself that the approach is prudent. You are also

responsible for deciding if the company's investment policy is inappropriate when considering the nature and term of those liabilities, and advising the company if it is.

AGN7 requires that the capital adequacy of an insurer is projected throughout a forecast period (typically three years for life insurers) for at least ten different scenarios when performing DST. The base scenario uses realistic assumptions, which typically follow the insurer's business plan. The capital adequacy projections are required to meet the minimum regulatory capital requirements under the base scenario. There are also six prescribed scenarios and at least three plausible adverse scenarios that have to be tested, and the insurer's assets have to exceed its liabilities through the forecast period under these scenarios. The six prescribed scenarios have to follow the six given in AGN7 and typically change one or two assumptions. The three plausible adverse scenarios given in AGN7 are compound scenarios where multiple assumptions are changed, but the actuary can choose alternate or additional plausible adverse scenarios to best suit the insurer. Assets, liabilities, and the minimum regulatory capital requirement should be revalued throughout the forecast period.

One of the items that is highlighted in PS1 is the potential use of the results from your actuarial investigation by the directors to determine an allocation of profits to policyholders and/or the shareholders. If you believe that the company plans to announce an allocation of profits based on the anticipated results of your investigation, it is your duty to ensure that the directors will have time to consider a suitable written report from you before the announcement. If you are proposing any allocation of profits in your report, it is imperative that you examine and discuss each significant factor and appraise all relevant experience. Even if no allocation of profits is involved, it is your duty to first report in writing your findings of the investigation to the directors, prior to submitting the required documents to the IA.

Potential strategy changes – changes to existing traditional participating (“par”) products

For par products, the key regulation is Guidance Note 16 (“GN16”) which has been issued by the Office of the Commissioner of Insurance (“OCI”). GN16 covers the underwriting of all long term insurance business, except for class c business. To clarify, class c business is investment linked products, so our par products would fall under the purview of GN16.

1. Overhaul of product brochures:
 - a. All brochures in English only – This violates section 6 of GN16, which requires that all product information be provided in both English and Chinese.
 - b. Increasing range of benefit illustration – This change is fine, but it is mandatory that both high and low return scenarios be shown. Section 3 of GN16 contains further guidelines on benefit illustrations.
 - c. Increased disclosure of risks – This does not violate any of Hong Kong's regulations.
2. Removal of post-sale call - A post-sale call is mandatory for what GN16 terms “vulnerable customers”, which are customers who are over 65 years of age, have no regular source of income, or whose education level is “primary level” or below. The post-sale call can be removed, but only for the policyholders who are not considered vulnerable.
3. Increased frequency of communication – This does not violate any regulations in Hong Kong, as annual communication is the minimum frequency required by GN16.

Potential strategy changes – overall strategy changes

These strategy changes will fall under a variety of regulations. The specific regulation relevant to each point will be cited in that point.

4. Change in method of assessing profits for tax purposes – The proposed change is not allowed under the Inland Revenue Ordinance (“Cap 112”). The branch has already elected to use the adjusted surplus method instead of the 5% of premiums method, and any such election is irrevocable under Cap 112.
5. Changing the primary reinsurer – Insurers in Hong Kong are required to arrange ‘adequate’ reinsurance protection under section 8 of the ICO, although what constitutes ‘adequate’ protection is not specified. Guidance Note 12 covers reinsurance with a related company. In particular to our situation, the security offered by reinsurance arranged through Awesome Re would be considered adequate if it has a Standard & Poor’s rating of AA- or above. As Awesome Re has been rated AA+ by Standard and Poor’s, the change in primary reinsurer is acceptable if the type and retention limit of the reinsurance treaties are unchanged. However, should the rating be dropped below AA-, the branch would either need to change reinsurers again, or obtain special permission from the OCI.
6. Change in reinvestment yield assumption – There are a number of limits placed on reinvestment yield, the hard upper limit of which is 7.5% per annum, and the planned assumption of 8.0% exceeds this limit. I am not able to calculate what the limit would be for the branch with the information given. Section 8 of Cap 41E and the Notice for Appointed Actuaries: Chapter 41E – Reinvestment Yield for Reserving issued by the ASHK contain more information on reinvestment yield.
7. Increased investment in CAD denominated assets – This change is acceptable within the regulations, but as all of the branch’s liabilities are in HKD, a prudent provision for exchange rate risk will need to be included in the liabilities, pursuant to section 6 of Cap 41E.
8. Begin selling investment-linked products – The branch is authorized to sell all classes of long-term business in Hong Kong, including class C (investment-linked) business. Guidance Note 15 regulates the underwriting of Class C business.
9. Establish an underwriting committee – The underwriting committee should be composed of directors with the necessary knowledge and expertise. The committee will be responsible for formulating the underwriting policy which lays out the criteria for assessing insurance risks and set premium policy.