Institute of Financial Planners of Hong Kong
IFPHK 香港財務策劃師學會

IFPHK's Response to the Insurance Authority's Consultation Paper on Draft Insurance (Financial and Other Requirements for Licensed Insurance Broker Companies) Rules

January 2019

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IFPHK's Profile

Background

The Institute of Financial Planners of Hong Kong ("IFPHK") was established in June 2000 as a non-profit organization for the fast-growing financial industry. It aims to be recognized in the region as the premier professional body representing those financial planners that uphold the highest standards for the benefit of the public.

The IFPHK is the sole licensing body in Hong Kong authorized by Financial Planning Standards Board Limited ("FPSB") to grant the much-coveted and internationally-recognized CFP$^{\text{CM}}$ certification and AFP$^{\text{TM}}$ certification to qualified financial planning professionals in Hong Kong and Macau.

It represents more than 6,800 financial planning practitioners in Hong Kong from such diverse professional backgrounds as banking, insurance, independent financial advisory, stockbroking, accounting, and legal services.

Currently there are more than 147,000 CFP certificants in 24 countries/regions; the majority of these professionals are in the U.S., Canada, China, Australia and Japan, with more than 4,700 CFP certificants in Hong Kong.

CFP$^{\text{CM}}$, CERTIFIED FINANCIAL PLANNER$^{\text{CM}}$, CFP$^{\text{CM}}$, CERTIFIED FINANCIAL PLANNER ™, AFP$^{\text{TM}}$, ASSOCIATE FINANCIAL PLANNER$^{\text{TM}}$, AFP® and ASSOCIATE FINANCIAL PLANNER® are certification marks and/or trademarks owned outside the U.S. by Financial Planning Standards Board Limited. The IFPHK is the marks licensing authority for the CFP marks and AFP marks in Hong Kong and Macau, through agreement with FPSB.

IFPHK's interest in this consultation

The Institute of Financial Planners of Hong Kong ("IFPHK") was established in June 2000 as a non-profit organization for the fast-growing financial industry. It aims to be recognized in the region as a professional body representing those financial planners that uphold the highest standards for the benefit of the public. The IFPHK is the sole licensing body in Hong Kong authorized by Financial Planning Standards Board Limited to grant the much-coveted and internationally-recognized CFP^{CM} Certification and AFP^{TM} Certification to qualified financial planning professionals in Hong Kong and Macau. In view of the growing demand for knowledge in retirement planning products, the IFPHK, in 2016, pioneered in offering a retirement-centric qualification – the Qualified Retirement Advisor ("QRA") – focusing on products and practical skills.

It is the IFPHK's mission to promote the importance of financial planning. Financial planning refers to the process of setting, planning, achieving and reviewing life goals through the proper management of finances. Insurance is considered the cornerstone of financial planning. The effective and proper use of insurance products helps spread risk, which can minimize the impact of risk on families should events take a downturn. Insurance is therefore an important part of the IFPHK's financial planning education and certification programme. Having knowledgeable insurance practitioners, proper consumer understanding of what insurance policies do, effective products, and financially sound underwriters is essential for those who seek financial planning.

In Hong Kong, financial planners work in different segments within the financial services industry. Financial planners can be insurance agents working in insurance companies, insurance brokers working in insurance brokerages, or Independent Financial Advisors ("IFAs"). At present, about 41% of the IFPHK's members work in the insurance industry and 9% work as IFAs.

As the leading professional institute representing the interests of the financial planning industry, the IFPHK has a duty to respond to any consultation paper that may impact its members and their clients. The IFPHK has previously provided feedback on the Consultation Papers "Proposed Establishment of an Independent Insurance Authority" and "Financial Services and the Treasury Bureau Consultation Paper on Key Legislative Proposals on Establishment of an Independent Insurance Authority ("IIA")". The IFPHK always strongly supports the establishment of an Independent Insurance Authority, which we would consider to be the most important breakthrough of Hong Kong's financial industry. We have provided our comments on the following consultation papers by the IA in the past few months:

- draft guidelines on both the fit and proper criteria for licensed insurance intermediaries, and their continuing professional development;
- the draft rules on maximum number of insurers;

We have also provided our comments to the draft requirements for insurance brokers at the soft consultation stage, and have interest in this public consultation paper.

<u>IFPHK's representation</u>

The IFPHK was founded by 30 members (the "Founding Members") to raise the standards of financial planners and highlight the importance of sound financial planning.

The IFPHK currently has 38 Corporate Members, including banks, financial advisors, insurance companies and securities brokerages. With our Corporate Members providing a full spectrum of client services and products, the IFPHK is well positioned to understand the needs, concerns and aspirations of the financial planning community.

Executive Summary

On 23 November 2018, the Insurance Authority (IA) launched a two-month public consultation on the draft Insurance (Financial and Other Requirements for Licensed Insurance Broker Companies) Rules (the "Rules") under the new regulatory regime for insurance intermediaries (the Consultation Paper). The submission deadline of the Consultation Paper is 23 January 2019.

The draft Rules are mainly modelled on the relevant requirements for insurance brokers set out in the Guideline on Minimum Requirements for Insurance Brokers issued by the IA. The draft Rules set out the requirements in relation to (i) paid-up capital and net assets, (ii) professional indemnity insurance ("PII"), (iii) keeping of separate client accounts, (iv) keeping of proper books and accounts and (v) submission of audit and related information. The major proposals include raising the minimum amounts of paid-up capital and net assets of an insurance broker company (from HK$100,000 to HK$500,000) and the amount of minimum indemnity limit (from HK$3 million to HK$5 million) for its PII. Such proposals will help ensure that an insurance broker company has sufficient financial resources to meet its operational needs and potential claims for professional negligence against it.

IFPHK's responses are based upon the following advocacy principles:

- ***Enhancing consumer protection***

As financial products get more complex and sophisticated, it is of utmost importance that investors/consumers are provided with proper and adequate protection under a sound and effective regulatory system. The IFPHK supports a regulatory system that would facilitate delivering better insurance products and services to the benefit of members of the public, as well as protecting them.

- ***Aligning with International best practice***

The Insurance Core Principles, Standard, Guidance and Assessment Methodology ("ICP") provides a globally accepted framework for the supervision of the insurance sector. It contains 26 principles that IAIS members are advised to observe and adopt. Having financial requirements for brokers is common among regulators. Disciplinary actions will be taken against brokers that failed to fulfill the requirements. An insurance broker was suspended by ASIC in May 2012 for not meeting its ongoing financial requirements.

- ***Ensuring a level playing field across the financial services industry***

The IFPHK is frequently urged by industry professionals to highlight the need for implementing a consistent approach across the industry to establish a **'level playing field'** among all financial planners/advisors in the different distribution segments, i.e. banking, insurance and financial advisors. We have already expressed our views in our responses to various consultation documents. The IFPHK strongly believes that such a consistent approach would significantly reduce any regulatory arbitrage that could potentially undermine the good intention of protecting investors.

- ***Maintaining and enhancing the competitiveness and diversity of the insurance market***

The insurance market in Hong Kong is very competitive, and it is somewhat surprising that such a small place is able to accommodate over 70,000 practitioners. The IFPHK has always stressed that a regulatory framework should deliver measurable benefits to the insurance industry in the medium to long term. It should also enable a healthy and sustainable business environment for the industry to thrive and develop. To preserve the fair competition and diversity of the market, the IIA should not only be progressive and adhere to international standards when formulating its supervisory principles and details, but should have an explicit responsibility to strike a balance between regulation and market growth, keeping in mind the difference in business nature and operation model of the various market participants.

In view of the above, the IFPHK agrees with most of the proposals stipulated in the Consultation Paper, that:

- Agrees to increase the minimum paid-up share capital requirement. Statistics provided by HKCIB and PIBA shown that about 50-60% of insurance brokerages members are comprised of 5 or less staff. In this essence, an increase in required capital did have an impact on the small sized firms. We urge the IA to find a balance between enhance investor protections and increase burden to the industry. In view of the size and the risks associated with insurance brokerage, the increase may add some pressure to them, certain insurance brokerage members explore the possibility of slightly relax the proposed paid-up share capital requirement;

- Agrees to increase in the minimum limit of indemnity for professional indemnity insurance to 5 million;
- Agrees to introduce a cap on the amount of the deductible under PII;
- Considers the requirements to carry out monthly reconciliations between its ledger balances and bank account statements for client monies and the additional disclosures as acceptable.

The IA Consultation

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The draft Rules are mainly modelled on the relevant requirements for insurance brokers set out in the Guideline on Minimum Requirements for Insurance Brokers issued by the IA. The draft Rules set out the requirements in relation to (i) paid-up capital and net assets, (ii) professional indemnity insurance ("PII"), (iii) keeping of separate client accounts, (iv) keeping of proper books and accounts and (v) submission of audit and related information.

The major proposals include raising the minimum amounts of paid-up capital and net assets of an insurance broker company (from HK$100,000 to HK$500,000) and the amount of minimum indemnity limit (from HK$3 million to HK$5 million) for its PII. Such proposals will help ensure that an insurance broker company has sufficient financial resources to meet its operational needs and potential claims for professional negligence against it.

The draft Rules will be effective upon the commencement of the new regulatory regime for insurance intermediaries and applicable to newly licensed insurance broker companies. In relation to existing insurance brokers, the IA proposes to provide a transitional period of some three years to ensure they have sufficient time to raise their paid-up capital and net assets, and to arrange the PII. Detailed transitional arrangements are set out in the draft Rules.

The Consultation Paper contains 5 questions in 3 Chapters, which are set out as below:

Chapter 1 - Background

Chapter 2 – Discussion of the draft rules

1. Do you agree with the proposal to raise both required minimum amounts of paid-up capital and net assets from HK$100,000 to HK$500,000?

2. Do you agree with the proposal to raise the floor amount of the minimum limit of indemnity from HK$3 million to HK$5 million?

3. Do you agree with the proposal to introduce a cap on the amount of the deductible which may be included under the terms of a licensed insurance broker company's PII cover, and setting that cap at 50% of a licensed insurance broker company's net assets or, in the case of a licensed insurance broker company in its first 12 months of operation, at 50% of its paid-up share capital?

4. Do you agree with the proposed introduction of a requirement for an insurance broker company to carry out monthly reconciliations between its ledger balances and bank account statements for the client monies it holds?

5. Do you agree that the additional disclosures required in an insurance broker company's financial statements are appropriate?

Chapter 3 – Proposed savings and transitional arrangements

IFPHK's Submission

The views expressed in this submission paper are not necessarily simply summaries of the views taken from the industry. They have undergone independent and critical analysis and consideration by the IFPHK as a professional body. As a result, not all the views collected by the IFPHK are recorded in this submission paper. Nor have all the views expressed in this paper been directly endorsed by the industry representatives or members consulted.

In considering the various proposals of the Consultation Paper, the IFPHK's comments are based upon the following principles and beliefs:

IFPHK's Principles

Enhancing consumer protection

The IFPHK regards that the reputation of the financial planning industry has been unfairly tarnished after the financial crisis due to varying standards of sales practice and professionalism. The confidence of consumers has not been restored after the crisis. In 2016, a territory-wide study by the IFPHK with GfK found that only 18% of respondents said their confidence in the markets had been fully restored after the 2008 Lehman Brothers incident.[1] According to the latest trust barometer report of Edelman, trust in financial services has been continuously declining in Hong Kong. The index has dropped from 55% to 47% this year, representing general population distrust of financial services institutions. Meanwhile, informed public trust in financial services has seen a double-digit decline, with Hong Kong's index decreasing by 15% to 48%[2]. As financial products get more complex and sophisticated, it is of utmost importance that investors/consumers are provided with proper and adequate protection under a sound and effective regulatory system. The IFPHK supports a regulatory system that would facilitate delivering better insurance products and services to the benefit of members of the public, as well as protecting them.

Aligning with International best practice

International organizations such as the G20 and other political and supervisory bodies continue to drive financial services sector reform – both globally and at a local level. The adoption of International Association of Insurance Supervisors ("IAIS") standards in October 2011 was a

[1] The Value of Financial Planning and Awareness of CFP Certification: A Global Financial Planning Survey Hong Kong Results, FPSB and GfK, 2016
[2] 2018 Edelman Trust Barometer

catalyst for many insurance supervisors to commence reform[3]. The Insurance Core Principles, Standard, Guidance and Assessment Methodology ("ICP") provides a globally accepted framework for the supervision of the insurance sector. It contains 26 principles that IAIS members are advised to observe and adopt. In consideration of the recent development, it is necessary for the insurance industry to keep up with global standards.

Having financial requirements for brokers is common among regulators. Disciplinary actions will be taken against brokers that failed to fulfill the requirements. An insurance broker was suspended by ASIC in May 2012 for not meeting its ongoing financial requirements. It was found that the insurance broker breached its legal obligations and licence conditions by failing to maintain sufficient base level financial requirements to pay all debts as and hold at least $50,000 in surplus liquid funds when holding client money or property over $100,000. All AFS licensees are required to meet certain financial requirements in accordance with ASIC's Regulatory Guide 166 (RG166) on an ongoing basis. The surplus liquid fund requirement is in general $50,000.

Ensuring a level playing field across the financial services industry

It should be noted that the key assumption throughout this submission is that the proposed changes in legislation should be adopted consistently by all financial intermediaries servicing retail consumers operating in the IFA, banking and insurance sectors. The IFPHK believes that a failure to implement a consistent approach across the industry could result in significant negative consumer and industry consequences. The IFPHK is frequently urged by industry professionals to highlight the need for implementing a consistent approach across the industry to establish a **'level playing field'** among all financial planners/advisors in the different distribution segments, i.e. banking, insurance and financial advisors. We have already expressed our views in our responses to various consultation documents. The IFPHK strongly believes that such a consistent approach would significantly reduce any regulatory arbitrage that could potentially undermine the good intention of protecting investors.

Maintaining and enhancing the competitiveness and diversity of the insurance market

Hong Kong ranked third in 2017 globally for insurance penetration, calculated by premiums in % of GDP[4]. As Asia's insurance hub, Hong Kong has attracted many of the world's top insurance

[3] KPMG, Evolving Insurance Regulation, Time to get ahead, February 2012.
[4] Insurance premiums represented 17.94% of GDP in 2017, of which 14.58% were in the life business and 3.36% in the non-life business.

companies. As at 30 June 2018, there were 160 authorized insurers in Hong Kong, of which 93 were pure general insurers, 48 were pure long term insurers and the remaining 19 were composite insurers. As at 30 June 2018, there were 2,410 insurance agencies, 63,931 individual agents and 25,668 responsible officers/technical representatives. There were 774 authorized insurance brokers as at 30 June 2018. In addition, as at 30 June 2018, there were 8,964 persons registered as chief executives/technical representatives of these authorized brokers[5]. The insurance market in Hong Kong is very competitive, and it is somewhat surprising that such a small place is able to accommodate over 70,000 practitioners. The IFPHK has always stressed that a regulatory framework should deliver measurable benefits to the insurance industry in the medium to long term. It should also enable a healthy and sustainable business environment for the industry to thrive and develop. To preserve the fair competition and diversity of the market, the IIA should not only be progressive and adhere to international standards when formulating its supervisory principles and details, but should have an explicit responsibility to strike a balance between regulation and market growth, keeping in mind the difference in business nature and operation model of the various market participants.

[5] Statistics from the Insurance Authority

Questions raised in the Consultation Paper

Chapter 2 – Discussion of the Draft Rules

A. Share Capital and Net Assets

Given the important role insurance broker companies play in acting for and serving policy holders, regulation requires them to maintain a minimum level of share capital and net assets. The purpose of these requirements is to ensure that an insurance broker company is financially sound, adequately resourced to meet its operational needs to serve policy holders and sufficiently resilient to withstand the vagaries of the business cycle. Under the current self-regulatory regime, the existing Guideline requires insurance brokers to maintain a minimum capital and net assets value of not less than HK$100,000. The current minimum amounts of paid-up capital and net assets (i.e. HK$100,000) have been in place (and not been increased) for over two decades. The current minimum amounts are therefore well overdue for revision. The new proposed minimum amounts take account of inflation in the two decade time period since the existing requirements were set and its impact on the operating costs of insurance broker companies. In addition, insurance broker companies are expected to maintain sufficient financial resources which are sufficient to cover a few months of operating expenses in order to provide continuous services to their customers.

In view of the above, the IA proposes to raise the minimum amounts of paid-up capital and net assets from HK$100,000 to HK$500,000.

Question 1:

Do you agree with the proposal to raise both required minimum amounts of paid-up capital and net assets from HK$100,000 to HK$500,000?

IFPHK's Response

The IA proposes to increase the minimum paid-up share capital requirement from $100,000 to $500,000. From investor protection perspective, we agree that a higher paid-up share capital could provide better assurance to investors. In the past, few mis-selling cases have unfairly tarnished the reputation of the financial planning industry. IFPHK thinks that a reasonable increase in paid-up share capital did help to restore consumer's trust. Nevertheless, majority of insurance brokerages are small in sizes. Statistics provided by HKCIB and PIBA shown that about 50-60% of insurance brokerages members are comprised of 5 or less staff. In this essence, an increase in required capital did have an impact on the small sized firms. We urge the IA to find a balance between enhance investor protections and increase burden to the industry.

In respect of reasonable amounts of increments, the IFPHK has studied the requirements of SFC for Type 4 Regulated Activities. For corporation that is subject to the licensing condition that it shall not hold client assets, the SFC does not required minimum paid-up share capital and the required minimum liquid capital is $100,000. For any other case, the required minimum paid-up share capital and minimum liquid capital are amounting to 5 million and 3 million respectively.

In view of the above, holding client asset is one of the key risks that required higher capital. As we understand from insurance brokerage practitioners that they seldom hold any client's money or assets especially for life insurance products (they may still act as nominee for General Insurance products). Hence, the risks associated with insurance brokerage in this regard are comparatively low. Certain insurance brokerage members explore the possibility of lowering the proposed paid-up share capital requirement to $300,000.

B. Professional Indemnity Insurance

Professional Indemnity Insurance ("PII") policies provide coverage for professionals against claims for professional negligence. Requiring an insurance broker by regulation to have in place a minimum amount of PII coverage, operates as a way of ensuring the insurance broker has the means to meet claims for professional negligence made against it. This in turn helps reinforce the confidence policy holders can have in their dealings with insurance brokers and hence trust in the insurance sector.

Under the current self-regulatory regime, the minimum limit of indemnity is calculated as the greater of:

- 2 times the aggregate insurance brokerage income relating to 12 months immediately preceding the date of commencement of the PII cover (applicable to an insurance broker who has been in business for more than one year); and
- 2 times the projected insurance brokerage income for 12 months for the period of the PII cover (applicable to an insurance broker who has been in business for less than one year), subject always to the minimum limit of indemnity being no less than HK$3 million and not requiring the minimum of limit of indemnity to be more than HK$75 million.

The IA proposes to maintain the requirement to have in place PII cover in the Rules, but it proposes an increase to the amount of the minimum limit of indemnity under such cover. The IA also proposes to retain in the Rules the minimum reinstatement requirements for the PII cover stated in the existing Guideline. Further, the IA proposes to introduce a cap on the amount of deductible an insurance broker company may have under its PII cover.

In addition to the above proposals, the IA proposes to simplify the PII requirements in respect of a licensed insurance broker company which is in its first 12 months of operation as a licensed insurance broker company. It is proposed to set the applicable minimum limit of indemnity for such companies at a flat HK$5 million.

In summary, it is proposed that the minimum limit of indemnity under an insurance broker company's mandatory PII cover be –

- 2 times the aggregate of the insurance brokerage income in the 12 consecutive months immediately preceding the date of commencement of the PII cover, subject to a floor of HK$5 million and a cap of HK$75 million; or
- in respect of an insurance broker company which is in its first 12 months of operation as a licensed insurance broker company, HK$5 million.

Question 2:

Do you agree with the proposal to raise the floor amount of the minimum limit of indemnity from HK$3 million to HK$5 million?

IFPHK's Response

We have no strong view on the increase in the minimum limit of indemnity for professional indemnity insurance. At present, many insurance brokers took on PII at similar amounts.

Proposed introduction of a maximum deductible

A deductible under a PII policy is the amount of any loss or claim covered under the policy that a company, as the insured, must itself bear in accordance with the policy's terms and conditions. From a regulatory perspective, the inclusion of a deductible in a PII Policy (whilst encouraging better risk management) potentially adversely impacts clients of the professional as the payments under the deductible would have to be met from the professional's own resources. It is for this reason that regulations in other jurisdictions which mandate insurance brokers to purchase PII cover, place controls on the amount of the deductible which may be included under the terms of the cover. For instance, in Singapore, the deductible allowed under a PII policy taken out by an insurance broker must not be more than 20% of its paid-up capital/net assets. The IA considers that it would be appropriate to include a maximum deductible requirement, but at a level which balances the benefits of a deductible (better risk management/ availability of lower premium) with the interests of insurance broker's clients (reduced prospect of strain on the insurance broker's financial resources in the event of a claim).

Having regard to the general financial resources of insurance brokers in Hong Kong and the net assets as a source of funds for the PII's deductible, the IA proposes to introduce a cap on the amount of the deductible under PII cover which an insurance broker company is required to have in place under the Rules. This cap will be set at 50% of the net assets of a licensed insurance broker company as at the end of its financial year immediately preceding the date of commencement of the PII cover. In relation to a licensed insurance broker company which is in its first 12 months of operation, the cap on the amount of the deductible will be set at 50% of the company's paid-up share capital as at the date of commencement of the PII cover.

Question 3:

Do you agree with the proposal to introduce a cap on the amount of the deductible which may be included under the terms of a licensed insurance broker company's PII cover, and setting that cap at 50% of a licensed insurance broker company's net assets or, in the case of a licensed insurance broker company in its first 12 months of operation, at 50% of its paid-up share capital?

<u>IFPHK's Response</u>

No further comments on the proposed cap on the deductible amount under PII.

C. Keeping of separate client accounts

Proposed new requirement for client monies reconciliation

It has long been a requirement that an insurance broker must keep client monies in a bank account separate from its own monies and must not use client monies relating to a client for any purpose other than for the purposes of the client. This is a vital policy holder protection measure, which aims to safeguard and protect policy holder funds held by the insurance broker. To reinforce this important requirement, it is proposed to adopt an additional measure to require an insurance broker company to carry on a monthly reconciliation exercise to reconcile its ledger for client monies and its bank statements for its client accounts. As such, the IA proposes the following new requirements:

- The insurance broker company must conduct a reconciliation between the bank statements for its client accounts and the ledger balances for its client monies at least once a month; and
- The insurance broker company must prepare a reconciliation statement showing the cause of the difference (if any) of the above reconciliation.

Question 4:

Do you agree with the proposed introduction of a requirement for an insurance broker company to carry out monthly reconciliations between its ledger balances and bank account statements for the client monies it holds?

<u>IFPHK's Response</u>

From enhancing consumer protection point of view, IFPHK thinks it is reasonable to require insurance broker company to carry out monthly reconciliations between its ledger balances and bank accounts statements for the client monies it holds.

Proposed additional disclosure requirements on financial statements

The audited financial statements which an insurance broker company will be required to submit to the IA are a key tool for regulatory supervision. To this end, to promote levels of consistency and enable better comparability of financial statements of licensed insurance broker companies and to facilitate the supervision process, the IA proposes that insurance broker companies be required to make the following additional disclosures in their audited financial statements -

The audited income and expenditure account must, in particular, include -

- the insurance broker company's insurance brokerage income distinguishing between general business and long term business;
- referral income; and
- referral expense

The insurance broker company's audited balance sheet must, in particular, include

- total sum of balances of client account(s);
- insurance premiums receivable; and
- insurance premiums payable.

Question 5:

Do you agree that the additional disclosures required in an insurance broker company's financial statements are appropriate?

<u>IFPHK's Response</u>

Additional disclosure would certainly enhance transparency and to a certain extent enhance consumer protections. Selected members remark that additional disclosures may incur costs in changing the financial reporting system. It may add onerous costs to insurance brokers that might exceed the benefits of enhancing consumer protection.