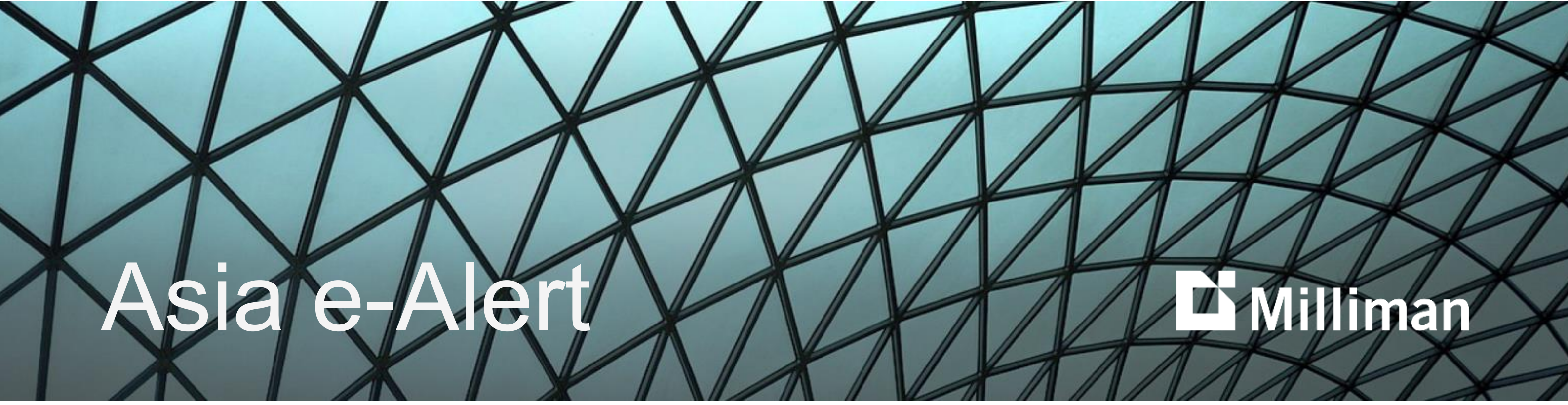

Hong Kong: Illustration rate cap for participating products

The sales illustrations and product disclosures for participating (par) products sold in Hong Kong are primarily regulated by the Guideline on Underwriting Long Term Insurance Business (Other than Class C Business) (GL16) and the Guideline on Benefit Illustrations for Long Term Insurance Policies (GL28) issued by the Hong Kong Insurance Authority (HKIA) in 2016 and 2020, respectively. Additionally, insurers in Hong Kong must adhere to the principles outlined in the Actuarial Guidance Note (AGN) AGN 5 Principles of Life Insurance Policy Illustrations issued by the Actuarial Society of Hong Kong (ASHK), as well as the Standard Illustration for Participating Policies issued by the Hong Kong Federation of Insurers (HKFI). Unlike other markets, such as Singapore, these guidelines do not prescribe specific limitations on the underlying investment return assumptions used in the illustrations or the resulting illustrated customers' internal rate of returns (customers' IRR).

In early 2025, the HKIA introduced a new regulatory requirement regarding benefit illustrations for par products, which are among the most popular products currently sold in the territory. The HKIA's latest Practice Note, Illustration Rate Caps in Benefit Illustration for Participating Policies (the Practice Note), effective from 1 July 2025, aims to establish a set of minimum expectations for the illustration rates insurers should use in benefit illustrations for par policies at the point of sale.

The key details of the Practice Note are summarised in Figure 1, with the main point being the introduction of a cap to the illustrated customers' IRR of 6.0% for policies denominated in Hong Kong Dollars (HKD) and 6.5% for policies denominated in other currencies. These caps, which aim to help manage policyholders' reasonable expectations (PRE), will be applied across all payment modes, policy terms, policy options (such as withdrawals) and scenarios, including base, optimistic and pessimistic scenarios.

In this article, we will explore the potential implications of this Practice Note and examine the illustration caps that apply in other territories. Additionally, we will highlight relevant overseas experiences for reference and discuss the practical concerns for Hong Kong insurers moving forward.

FIGURE 1: KEY DETAILS OF THE PRACTICE NOTE

ITEM	DESCRIPTION
APPLICABLE PRODUCTS	▪ Contracts of insurance that are 'participating business' as defined in section 21B of the Insurance Ordinance (Cap. 41) will be subject to this Practice Note. ▪ Qualifying Deferred Annuity Policies and universal life policies are not subject to the requirements.
BENEFIT ILLUSTRATION CAP	▪ The cap will be applied to customers' IRR, which is commonly used for product comparisons and promotions in the Hong Kong insurance market. ▪ The IRR, at a certain policy duration, is defined as the annualised rate of return based on the projected total cash value upon surrender in relation to the total premiums paid over the policy duration. ▪ Based on the current prevailing market and economic conditions, the caps are 6.0% per annum (p.a.) for products denominated in HKD and 6.5% p.a. for products denominated other than in HKD. ▪ The caps will be applied across all payment modes, policy terms and policy options (such as withdrawals). ▪ If campaign and promotional offers are not included in the projected policy values for benefit illustration at the point of sale, then they are not subject to the requirements outlined in this Practice Note.
EFFECTIVE DATE	▪ The cap on customers' IRR is applied for the benefits illustration **at the point of sale** for the sales of par products effective from 1 July 2025. ▪ In-force re-illustrations are not subject to the requirements of this Practice Note, but the use of any re-illustrations to engage in aggressive or unethical selling practices is prohibited.
UNDERLYING INVESTMENT RETURN	▪ This Practice Note restricts only the benefit illustrations at the point of sale, without directly affecting the underlying investment returns (although the setting of such assumptions is governed by AGN 9 of the ASHK).
REVIEW OF THE ILLUSTRATION CAPS	▪ The HKIA does not provide a specific timeline or frequency for reviewing the caps. ▪ However, the review process will consider several factors, including the latest economic outlook in the region, evolving market practices and the underlying investment portfolio.

Implications of the Practice Note

AFFECTED PRODUCTS

The implications will be more significant for some par products than others. Based on the point of sale benefit illustrations for current on-shelf products, one type of par product, commonly referred to as 'high-illustrated par whole life' shows customers' IRR exceeding 6.8% for USD-denominated policies in the long term, which surpasses the proposed cap of 6.5% p.a. These products are 'guarantee-lite' meaning they include a relatively small amount of guaranteed benefits over the policy period, while offering potentially significant value enhancement in the form of nonguaranteed benefits upon surrender or policy maturity in the long term.

As a result of this product proposition, which focuses on long-term value enhancement, insurers are able to invest in growth assets such as public and private equity. These assets offer the potential for higher long-term returns, although they may be volatile in the short term. Consequently the underlying investment returns used in the benefit illustrations for these products are often supported by these relatively high-risk assets, which can make up to 70% of the long-term strategic asset allocation (SAA) of the products, with remaining assets typically invested in fixed income securities. The assumed long-term returns for these high-risk assets are higher and include a risk premium compared to their fixed-income counterparts.

DECISION TO REPRICE OR NOT

The current benefit illustrations provided at the point of sale for these products may not comply with the Practice Note. Insurers will need to revise these illustrations, either by repricing the products or by applying caps to the illustrations without repricing them, before the middle of this year.

Technically, the Practice Note only limits benefit illustrations, but repricing the products offers an opportunity for a comprehensive reassessment of all the underlying assumptions, SAA and risks. As an example, with the new illustrations, insurers may look to adopt a less aggressive SAA as returns required to meet new illustration rate are reduced. Ideally, this would be a beneficial exercise for the insurer, but it may require significant resources to re-examine all the products currently available, especially within such a short time frame. However, redesigning these products (e.g., to improve short-term customer IRRs whilst keeping the long-term IRRs under the prescribed caps) could enhance product attractiveness.

Capping the benefit illustrations to keep IRRs under the cap may seem straightforward, but it may present operational challenges, such as the need to change the policy values directly in the policy illustration system for all policy options, including policy withdrawal, which may require additional verification for each potential policy option. More importantly, considerations are needed for the potential implications of lower illustrated benefits should the underlying SAA remain unchanged.

Illustration caps in other territories

CAPS ON INVESTMENT RETURN ILLUSTRATIONS

Addressing such measures imposed on benefit illustrations can be a daunting task for insurers selling par business, as these changes could significantly impact sales practices and potentially product propositions. However, from an international perspective, we observe that similar restrictions are already in place in various territories. Although there are certain similarities in these regulations across different territories, there are also some significant differences in their specifics and implementation.

In the UK, policyholder disclosure requirements for most par products are covered by the Packaged Retail and Insurance-based Investment Products (PRIIPS) Regulation (as retained and amended in UK law), which was amended under Policy Statement 22/2: PRIIPS – Final scope rules and amendments to Regulatory Technical Standards (PS22/2), effective from 1 January 2023. Amongst other things, PS22/2 removed the requirement to provide illustrations of policy benefits and replaced this with providing narrative information on performance instead of explicit performance scenarios themselves. Some par products (e.g., pension products) are not covered by PRIIPS, and the illustrations for these products would be key features illustrations (KFIs), which would have also applied to all par products prior to the introduction of PRIIPS on 1 January 2018.

As illustrated in Figure 2, other markets typically impose caps or prescribe specific rates for the underlying investment return assumptions to be used in benefit illustrations for par products, which differs from the HKIA approach of directly capping the customers' IRR. Malaysia and India use prescribed investment returns, while Singapore and the UK KFIs use caps on investment returns for benefit illustrations. The UK (KFIs) employs three different returns, whereas the others use two. The variation between the upper and lower prescribed investment return assumptions is greatest in India, followed by Malaysia, the UK (KFIs), and then Singapore. Fixed rates and caps on underlying investment returns in these markets aim to limit over-optimism and ensure comparability when the caps are enforced, but they do not account for differing investment strategies of insurers, other than if insurers assume rates that are lower than the caps.

KEY DIFFERENCES IN HONG KONG

Setting a cap on the total investment return assumption used in benefit illustrations could have an impact on insurers' SAAs if they felt there was no benefit to taking more investment risk if they are unable to illustrate a higher potential return for taking that risk. The proposed Hong Kong approach, which sets a limit on the customers' IRR for benefit illustrations while allowing each insurer to determine their own investment return assumptions, accommodates the specific characteristics of each company's funds and investments. However, this raises concerns that higher investment return assumptions could potentially enable insurers to offer higher commissions while still providing the same guaranteed and nonguaranteed benefits. Alternatively, a higher investment return assumption could support higher actual nonguaranteed benefits than have been illustrated under the cap, which would then be reflected in higher fulfillment ratios (Hong Kong is the only market in our comparison that requires this disclosure). Fulfillment ratios are defined as the actual aggregate nonguaranteed benefits paid out divided by aggregate nonguaranteed benefits that would have been paid out based on the benefits illustrated when customers purchased the policy. Fulfillment ratios are discussed in more detail in our previous e-Alert.

Equally important as the underlying methods for illustration caps is the ongoing review of the cap mechanisms. This requires special attention, and we will explore the practical concerns involved in reviewing these caps, as well as how insurers respond to them.

FIGURE 2: ILLUSTRATION BASIS FOR CAPS ON PAR PRODUCT OF DIFFERENT MARKETS

	HONG KONG	SINGAPORE	MALAYSIA	INDIA	UK (KFI)
PRESCRIBED INVESTMENT RETURNS	No, only on customers' IRR	Yes	Yes	Yes	Yes, but not specific for par
PRESCRIBED RATES	Customers' IRR caps of 6.0% and 6.5% for HKD and non-HKD policies for all scenarios, respectively	Caps of 3.00% / 4.25% (net of investment expenses)	2% / 5% used for all insurers	4% / 8% (gross) used for all insurers	Caps of 2% / 5% / 8% (for tax exempt)
WHEN THE RATES LAST CHANGED	n/a	2021	2017	2013	2013
WHAT WERE THE RATES PREVIOUSLY	n/a	3.25% / 4.75%	Not prescribed, but typically 4%–5% and 6%–7%	6% / 10% (but were caps)	5% / 7% / 9% (for tax exempt)

Ongoing review of illustration caps and what we can learn

THE SINGAPORE APPROACH

The Life Insurance Association (LIA) in Singapore conducts an annual review of the investment return caps applicable to benefit illustrations for par business through an internal review process that incorporates input from its members, consisting of life insurers. The caps reflect the views of LIA's members, taking into account several factors, including typical asset class mix and long-term expected returns for each asset class.

One significant advantage of this approach is that it ensures the caps are consistent and stable, reflecting the collective views of LIA members while avoiding unusual results that could occur with a purely scientific method (e.g., simply taking the yield on x-year government bonds plus y%). However, this approach also has drawbacks, such as potential conflicts of interest and impartiality, the challenge of achieving consensus among all members and the subjectivity of the assumptions used.

The issues related to the subjectivity of setting assumptions could be mitigated by establishing some objective references within the process. For instance, actual company-specific information, such as SAA and features of fixed interest portfolios, could be coupled with external independent assumptions regarding return assumptions for different asset classes. However, consideration would be required to address the issue of more alternative asset classes for which external independent assumptions are not readily available.

Another key issue is the frequency of reviewing the caps. Although the LIA reviews the rate caps annually, actual experience indicates that the rates themselves are only changed quite infrequently. This is likely due to balancing the desire to have investment return assumptions reflective of current market conditions with the costs associated with repricing when rates change. Given the cost and effort involved in repricing, it is important to consider the underlying factors that influence investment return assumptions at any point in time and whether any changes are expected to be short term or of a more persistent nature.

Another factor to consider is the lag between the data and analysis upon which new cap rates are set and when they are implemented. To allow companies time to reprice, changes to caps would likely be communicated at least six months before they take effect. If it also takes six months to collect and analyse data and then agree on any changes to the caps, then it would be a total lag of a year between the economic outlook on which the new caps have been set and the change to illustrations. By this point, the economic conditions could have changed again.

All of these factors have to be considered before changing the illustration rate caps, which becomes a combination of expert judgment and commercial considerations.

While practices in Singapore may provide a useful reference framework for the ongoing monitoring of illustrations caps, significant differences in the mechanisms for imposing these caps may require additional modifications. Ultimately, the goal is to avoid over-optimism and better manage PRE.

What's next

With the introduction of this Practice Note, the full impact on the par product landscape—encompassing sales practices, underlying pricing and the overall management of par products—remains to be seen. One certainty is that regulatory measures on the selling of par products will likely become a focal point for the regulator. On the other hand, this development may present an opportunity for the industry to reassess and rethink its product propositions. This could lead to innovations in product design, adjustments in sales strategies and potential improvements in how par products are managed to better align with regulatory expectations and market demands.

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