

POLICYHOLDER DIVIDENDS AND DISCLOSURE FOR PARTICIPATING BUSINESS

INTRODUCTION

This paper discusses policyholder dividends on participating policies and the actions the HKFI and its member companies to be implemented to ensure equity & to provide customer information.

BASIC PRINCIPLES

Participating policies (also known as "par" or "with profits" policies) are a major class of business in Hong Kong. The assets in respect of these policies are a block of identifiable assets managed on the behalf of participating policies. We refer to these assets as the "Pooled Fund".

When customer agrees to buy a par policy with a life insurance company they buy a policy with guaranteed cash values (if applicable) plus policyholder dividends. This is a contractual arrangement that clearly states that the insurer may adjust dividends from time to time (generally based on the advice of the Appointed Actuary and approved by the Board).

Policyholders participate in the experience of the Pooled Fund through dividends. How much dividends an insurer distributes or pays depends on how well the Pooled Fund has fared with regard to investment yields, expenses, claims, etc. If the experience is better than expected, then dividends paid would increase and if the experience is worse than expected then dividends paid would reduce.

In general investment returns on the Pooled Fund have the largest impact on dividends distributed, which may not be consistent with the overall business performance of the insurer.

Currently, in the Hong Kong market, policyholder dividends are generally distributed in three ways: -

1. As a cash dividend (many policyholders choose to leave these amounts on deposit with the life insurance company).
2. As a reversionary bonus where the benefits under the policy are permanently increased with the accrued reversionary bonus.
3. As a terminal bonus such that the payout value is usually targeted to be close to the asset share of the fund (the policyholders' notional share of the par fund), taking into account the total return of the underlying assets.

As a general rule, these dividends/bonuses will be smoothed out in order to reduce large short-term fluctuations. Smoothing can take many different forms and vary from one insurer to another depending on the terms of the policy contract and the policy of the insurance company. However the primary aim is to achieve an equitable distribution of the fund's performance among participating policyholders over a certain period of time instead of allocating bonuses based on actual annual fund performance.

Cash dividends and reversionary bonuses are usually declared on an annual basis while terminal bonuses are usually declared at policy maturity or when the policy has been in-force for a certain number of years.

In Hong Kong the majority of companies used method (1), with a few companies using method (2). Method (3) can be a supplemental dividend to methods (1) & (2). Whilst the above is a description of typical dividend philosophy it is important to note that each individual insurance company may have variations on this. Member companies of the HKFI publish information about their particular dividend philosophy on their company websites.

HOW ARE POLICYHOLDER DIVIDENDS DECIDED?

Every year the Appointed Actuary makes a recommendation to the Board as to what the dividends for the next year should be. He or she will consider the experience of the Pooled Fund, the economic outlook and the equity between different classes and generations of policyholders that coexist within the Pooled Fund. The Appointed Actuary has to consider the professional standards applicable to themselves and the Professional Standard PS1 issued by the Actuarial Society of Hong Kong and recognized by the Insurance Authority.

The Board is responsible to make the final decision.

ADVANTAGES OF PAR POLICIES AND DIFFERENCES WITH OTHER TYPES OF POLICY

The main advantage of par policies is that in addition to the guarantee cash values and death benefits, the policyholder can participate in experience that is better than the underlying guarantees in the form of dividend payments. The better the experience, the more the dividend distribution will be and vice versa.

A second advantage is that the policyholder's risk is less than with investment-linked policies as the life company has to deliver the guarantees. With investment-linked policies the policyholder selects the underlying investments and has the full upside if they do well but also the full downside if they do badly. There are generally no guarantees with investment-linked policies.

Another class of policies is non-participating policies where the life insurance company guarantees the death (and/or disability) and other related benefits. In order to cover the higher risk and cost of the guarantee feature(s) of non-participating policies, the life insurance company, in determining the pricing structure of non-participating policies, has to either assume a "prudent" rate of interest or build in an additional charge into the premium.

Other features include that the returns on par policies are generally smoothed.

TRANSPARENCY OF LIFE INSURANCE COMPANIES WITH REGARD TO DIVIDENDS

As an industry we do try hard to be transparent. However, as can be seen from this paper it is not easy to explain the methodology, and as dividends vary between policies this can create even more confusion. The current practices adopted by most companies in helping policyholders to better understand dividend distribution under the relevant participating policies are:

1. **Point of Sale Illustrations :** At the point of sale (and later on at the request of the customer) we provide the customer with an illustration of benefits at the proposal stage of the life policy. This clearly shows benefits that are guaranteed and those that are not.

The Actuarial Society of Hong Kong, with the encouragement and support of the Insurance Authority, has issued a Guidance Note regarding illustrations (AGN5: Principles of Life Insurance Policy Illustrations), which aims to provide standards and principles in preparing the illustration documents.

Most companies provided illustration assuming the declared cash dividends will be left on deposit with the company to accumulate with interest. The accumulation interest rate is not guaranteed and will fluctuate with the market interest level. This is explicitly mentioned in the sales illustrations.

As an industry with high integrity we go out of our way to make it clear that policyholder dividends are not guaranteed. Policyholders sign the illustrations so that we can be sure that the customer has read the illustrations and that the illustrations have been explained to the customer. The notes recommended by HKFI are: -

- *"The projected dividends included in the above are based on the current dividend scales and are not guaranteed. The actual dividends paid may change and the actual values may be higher or lower than those illustrated."* An alternative note used by at least one Company is *"When experience is worse or expected to be worse than the current situation, dividends may be reduced or vice versa."*
- *"As illustrated in the above, you can leave the amount of projected dividends to accumulate with the Company at an interest rate that will be reviewed and adjusted by the Company from time to time. The current interest rate used to illustrate the effect of accumulation in the above is x% p.a. This rate is not guaranteed. You can also cash all or part of the amount of projected dividends without affecting the face amount but the values shown above will be reduced accordingly."*
- *If the interest rate and assumed dividend scales remain unchanged throughout your policy term, then the future premium on the Basic Plan can be paid out of accumulated dividends (and cash payments) from policy year XX onwards. This is not guaranteed: a change in either interest rate or projected dividend scale may require you to pay extra premiums to maintain the basic plan.*
- A note on the front page of the illustration which states *"Dividend or bonus amounts depend on how well the fund has fared with regard to investment yield, expense, claims etc"*.

To assist the potential policyholders in better understanding and assessing the impact of changing investment rates of return, some companies are illustrating projected policy benefits in the sales illustration based on an alternate dividend scale and/or accumulation interest rate that assumes different investment earnings in future while some other companies will provide similar illustrations upon request. However, some companies feel that it is better to give the customer the best estimate of future experience on one basis only and to add a statement that dividends will vary from the proposal depending on actual experience.

2. **Annual Statements:** In the annual statement some companies send to customers any changes to policyholder dividends are highlighted with broad reasons for the change. On request companies will generally prepare a revised illustration using current dividend rates after an adjustment. From the next dividend rate change after December 2008, HKFI members companies will provide such an illustration on request.

3. **Premium Offset:** For some customers the annual cash dividends plus interest on these if left on deposit, are enough to pay their premiums and so they stop paying premiums. This is known as "premium offset". However, when dividends are reduced this might require the policyholder to recommence paying premiums or risk policy lapse or reduced benefits. In these cases many companies make sure that the situation is fully explained to the customers so that they can make an informed decision.
4. **General Information on Dividends:** This document provides general background information on participating policies. In addition, from 31st December 2008, all HKFI members will include on their websites an explanation of their philosophy with regards to declaring dividends. This philosophy will be expected to vary somewhat between companies.

For further information, please contact the HKFI or your life insurance provider.