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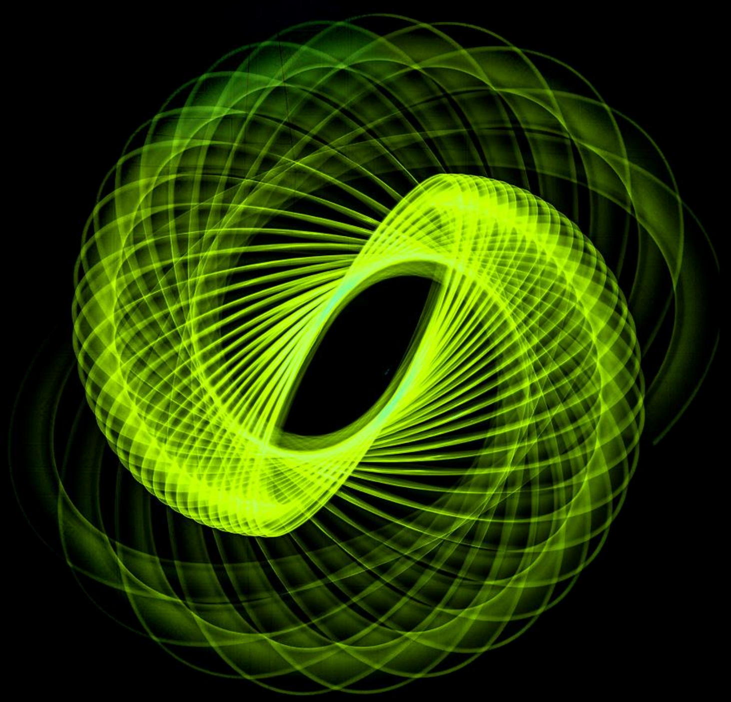


Hong Kong Insurance Risk-Based Capital Webinar

Hong Kong Insurance Amendment Bill 2023

Discussion on the impacts of the new Hong Kong Risk-based Capital Framework

6 July 2023

MAKING AN IMPACT THAT MATTERS since 1845

Agenda

1. Summary of key changes to the Insurance Ordinance

101-Clause Amendment to the Insurance Ordinance

Economic Balance Sheet & Prescribed Capital Requirement

- In line with expectations
  - Introduction of the Minimum Capital Requirement (MCR)
  - New capital tiering

Participating business requirements

- Maintain separate accounts for participating business categorized by nature of risks
- MCR to be maintained at the fund level

Enhanced Powers for the Insurance Authority (IA)

- Power of intervention to include actuarial and other investigations as well as reports to the IA
- Enhanced supervision for general business

Public disclosure and actuarial matters

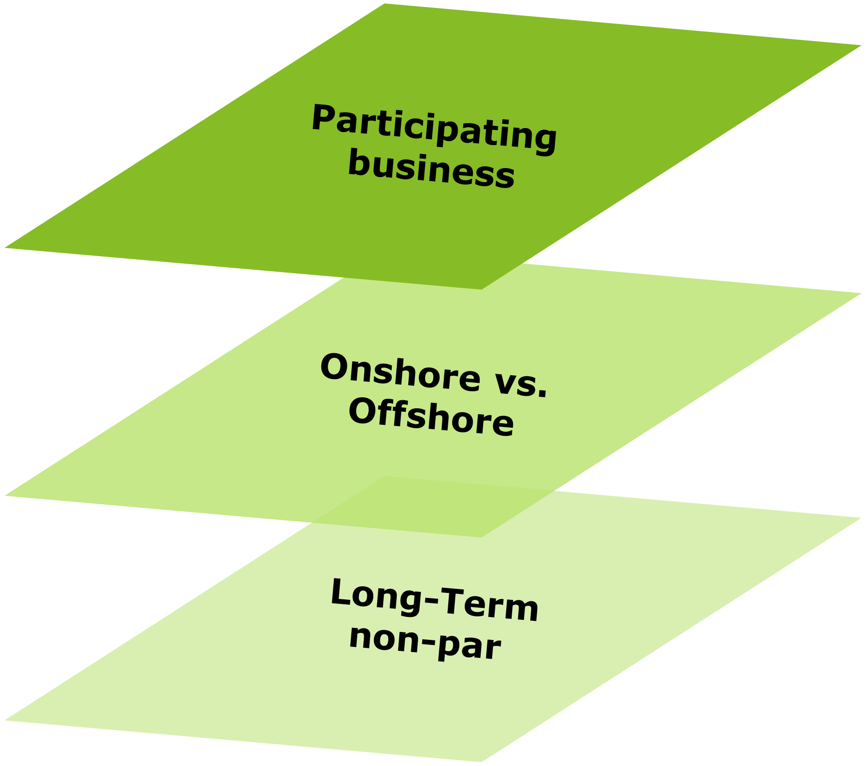
- Requirement of information that an insurer must disclose to the general public and the IA
- Appointment and approval of a certifying actuary for each insurer operating general business

- **Pace of change** among insurers accelerated over the past 12months
  - Early adoption
  - Pillar 1 calculation
  - Pillar 3 reporting
  - ORSA
- **New / modified** disclosure, general fund management and governance **requirements** introduced by the Bill
- HKRBC requirements are in line with expectation, **further embedding** into existing business processes still necessary for **full compliance and optimisation**
- **Disproportionate impact** between GI and Life insurance industry

Enhanced Powers for the HKIA

	What does it mean to you?
Notification to the IA	• Update Capital Management Policy to formalise IA escalation regarding any non-compliance with the capital requirements and remedial actions • Need to define timeliness threshold and potential management actions and associated feasibility assessment • Down stream impacts to ORSA, Recovery Plan and governance process
Additional HKIA discretion	• Preparation for "Skilled person" appointment and review subject to HKIA request • May be subject to a different capital requirement (e.g. > 100% PCR) as deemed appropriate by the HKIA, and down stream business impacts
Enhanced supervision on General Business	• To be covered later in "General Insurance Specific Impacts"
"Designated insurer"	• Insurers incorporated or formed outside Hong Kong with all / majority of the business in Hong Kong are now subject to HKRBC requirements
Expansion of HKIA approval authority	• Update corporate governance procedure to request approval and notification to IA related to shareholder controllers • IA can object to existing controller(s)

Fund Management



What does it mean to you?

- Maintain at least one (sub-) fund of participating business. The excess asset for profit sharing should be separate from other general funds.
- Potential need for profit sharing / dividend methodology review

- Need for capability to obtain additional input /information for classifying inforce and new business as onshore and offshore
  - Relatively new concept for Long Term business
  - Action plan to address legacy issue for inforce business
- Maintain separate funds for onshore and offshore business
  - Option to opt out
- General Business capital implication to be covered later in Section 3

- No change for Class C, Class G, Class H from existing IO fund management
- Opportunity for long term insurer to maintain only one general account fund for all “Other long term business” for efficiency

Disclosure

What does it mean to you?

- System solution necessary for Pillar 3 template publication within reasonable working day timetable
  - Common challenge among early adopters
- Update governance and regulatory reporting procedure to include audited financial statements and the corresponding auditor’s report as well as the Directors’ report

- Details to be prescribed by HKIA, but likely to require cross function efforts, based on similar requirements in other markets
- Potential increased exposure to reputational risk
- Additional governance and review process required for the additional disclosure and associated resource requirement

HKRBC Implementation

The Insurance (Amendment) Bill replaces the current solvency-related provisions in the HKIO with new requirements under HKRBC. Further detail on valuation of EBS, capital resources and capital requirements will be prescribed in the Insurance (Valuation and Capital) Rules.

To be repealed / replaced

- **Insurance (Determination of Long Term Liabilities) Rules (Cap. 41E)**
- **Insurance (General Business) (Valuation) Rules (Cap. 41G)**
- **HKRBC 2020 Technical Specifications (incl. MA Technical Specifications)**
- **Insurance (Margin of Solvency) Rules (Cap.41F)**
- **HKRBC Early Adoption Technical Specifications (incl. MA Technical Specifications)**

To be newly prescribed

Insurance (Valuation and Capital) Rules

- Valuation of assets & liabilities
- Determination of capital base
- Determination of RBC capital requirement
- Different scope for HK insurers & branch insurers

Introduction of Economic Balance Sheet and Prescribed Capital Requirement

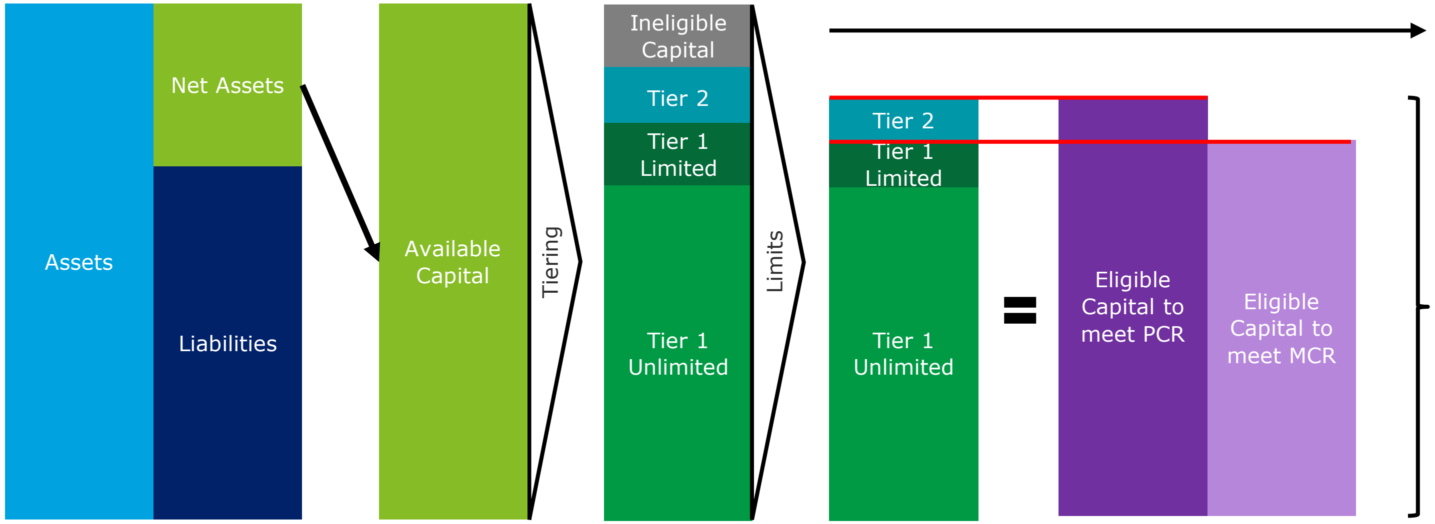
HKRBC Regime: Capital Resources

Under HKRBC, capital resources shall be classified into two Tiers: Tier 1 (with sub-tiers of Tier 1 Unlimited and Tier 1 Limited) and Tier 2.

Key principles (from ICP 17)	Tier 1 Unlimited	Tier 1 Limited	Tier 2 Paid-Up
Loss absorbing capacity	Absorbs losses on both a **going concern basis** and in **winding-up**	Absorbs losses on both a **going concern basis** and in **winding-up**	Absorbs losses in **winding-up**
Level of subordination	**Most subordinated** (i.e. is the first to absorb losses); subordinated to policyholders, other non-subordinated creditors and holders of Tier 2 financial instruments	Subordinated to policyholders, other non-subordinated creditors and holders of Tier 2 financial instruments	Subordinated to **policyholders** and **other non-subordinated creditors**
Availability to absorb losses	Fully paid-up	Fully paid-up	Fully paid-up
Permanence	**Perpetual**	Perpetual – no incentives to redeem; issuer may redeem after a minimum period of five years after issuance or repurchase at any time, subject to prior supervisory approval	**Initial maturity of five years** – may have incentives to redeem but first occurrence deemed to
Absence of both encumbrances and mandatory servicing costs	Insurer has full discretion to cancel distributions (i.e. distributions are non-cumulative); the instrument is neither undermined nor rendered ineffective by encumbrances	Insurer has full discretion to cancel distributions (i.e. distributions are non-cumulative); the instrument is neither undermined nor rendered ineffective by encumbrances	The instrument is neither undermined nor rendered ineffective by encumbrances

HKRBC Regime: Capital Resources

Under HKRBC, capital resources shall be classified into two Tiers and subject to regulatory adjustments / deductions



Ineligible capital refers to balance sheet items excluded for the purpose of eligible capital under HKRBC

Eligible Capital to meet PCR = Tier 1 (Unlimited + Limited) + Tier 2

Eligible Capital to meet MCR = Tier 1 (Unlimited + Limited)

	Tier 1	**Tier 2**	**Ineligible capital**

Examples	• Paid-up ordinary share capital
	• Share premium account
	• Retained earnings net of dividends
	• AOCI
	• Unrestricted reserves
	• Equity-settled stock options
		• Capital items reallocated from Tier 1 to Tier 2 such as
		  o Net deferred tax assets
		  o Encumbered asset
		  o Restricted capital within with-profits fund
			• Investment in insurance / regulated non-insurance subsidiaries
			• Investment in affiliates
			• Direct investment in own financial instruments
			• Capital shortfall in insurance / regulated non-insurance subsidiaries

Tiering limit	• Tier 1 Limited capped at 10% of PCR	• Tier 2 capped at 50% of PCR	N/A

HKRBC Regime: Capital Resources

Insurers will need to assess and monitor the quality of their capital resources, both under base and stress scenarios

Example of the capital base composition

HKD'm	Tier 1 Unlimited	Tier 1 Limited	Tier 2	Total
Net Assets	**5,500**	-	-	**5,500**
Regulatory adjustments / exclusions	**(1,700)**	-	**1,300**	**(400)**
Investment in insurance and regulated non-insurance subsidiaries	(100)	-	-	(100)
Investment in affiliate	(100)	-	-	(100)
Direct investment in own financial instruments	(200)	-	-	(200)
Net DTA / DTL	(200)	-	200	-
Encumbered assets	(100)	-	100	-
Restricted capital (with-profits fund)	(1,000)	-	1,000	-
Tiering limit	-	-	-	
Eligible Capital to meet PCR (a)	**3,800**	-	**1,300**	**5,100**
Eligible Capital to meet MCR (b)	**3,800**	-	-	**3,800**
PCR (c)				**4,500**
MCR = 50% of PCR (d)				**2,250**
PCR Ratio (e = a / c)				**113%**
MCR Ratio (f = b / d)				**169%**

- Both Tier 1 and Tier 2 capital can be used to meet the PCR.
- Only Tier 1 capital can be used to meet the MCR.

What does it mean to you?

1. Assess quality of capital resource

- May impact all insurers who have not early adopted
- Document approach including interpretation / expert judgment
- Good practice to get the auditors on board early

2. Monitor quality of capital resources

- Monitor the eligible capital to meet PCR and MCR
- Explanation of material movements in capital base composition between periods

3. Review capital and business planning

- Project and assess quality of capital over the business planning period
- Both base and stressed scenarios

HKRBC Regime: Capital Requirements

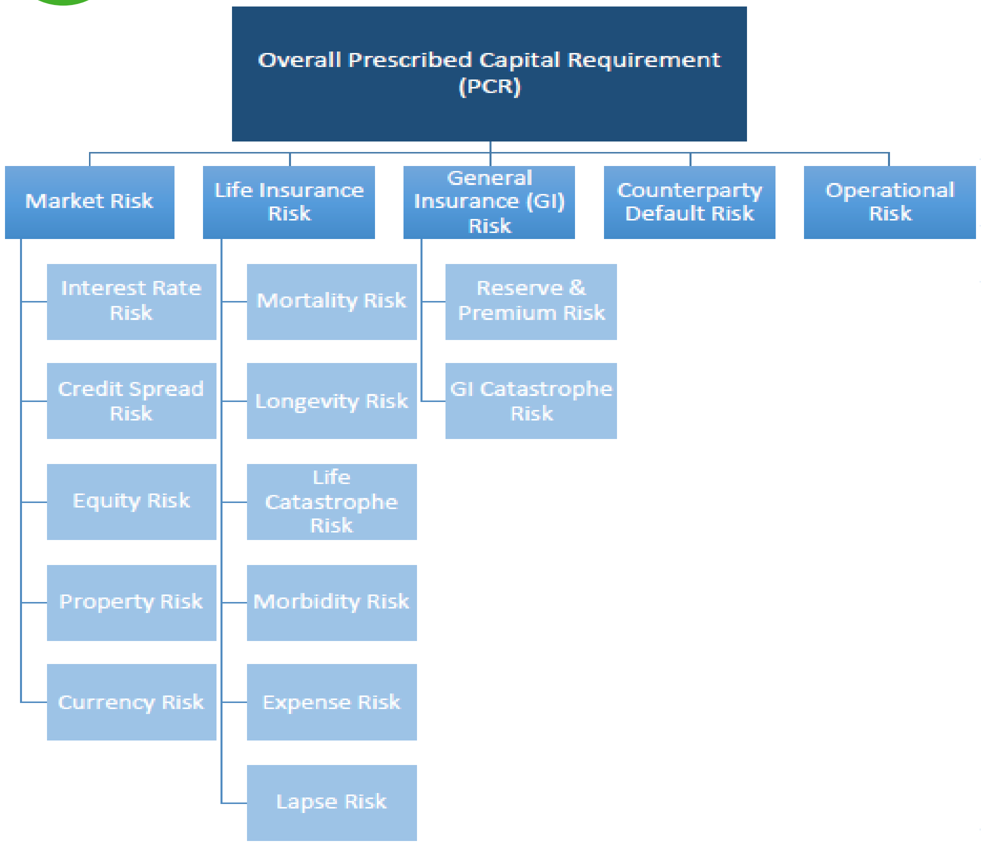
HKRBC prescribes two levels of solvency: PCR and MCR upon which the HKIA may take action when the insurer fails to meet the respective level of capital.

Calculations of PCR and MCR will be prescribed by HKIA

1 PCR needs to be calculated by funds

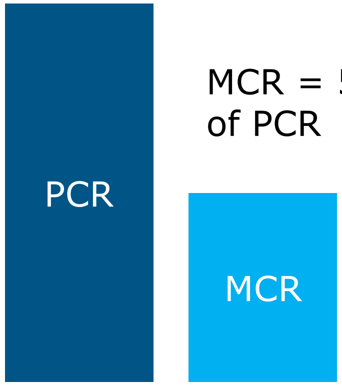
- LT Class C
- LT Class G
- LT Class H
- LT Par restricted
- LT Par others
- Other LT business
- GI business
- Shareholder surplus & non-insurance operations

2 PCR needs to be calculated at sub-risk module



3 Calculate notional MCR by 3 groups

- LT business
- GI business
- Shareholder surplus & non-insurance operations

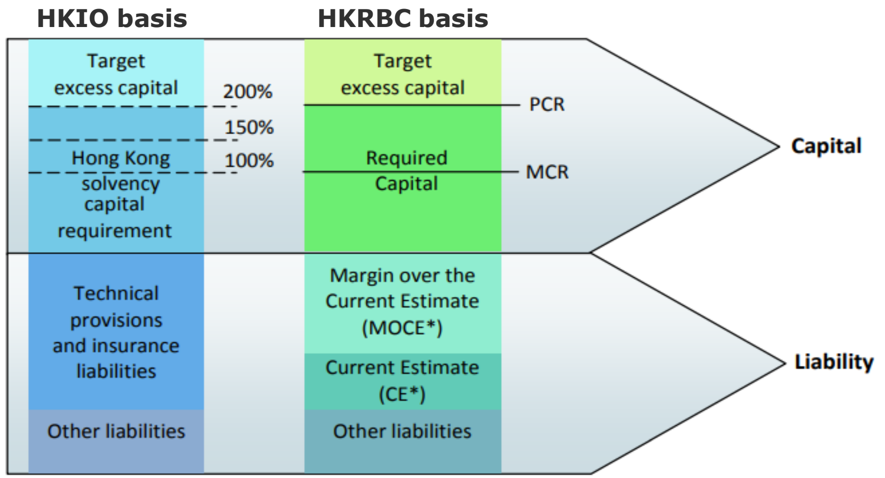


MCR = 50% of PCR

HKRBC Regime: Capital Requirements

Insurers will need to assess PCR & MCR, align risk appetite framework and Capital Management Plan with the HKRBC capital requirements, and regularly monitor their solvency positions

Solvency ratios



Solvency level	HKIO basis	HKRBC basis	HKRBC regulatory actions
Solvency control level	150% (Life) 200% (GI)	PCR	Submit a restoration plan
Minimum solvency requirement	100%	MCR	Submit a short-term finance scheme

HKIA will have the powers to vary an insurer's capital requirements under HKRBC subject to certain criteria

What does it mean to you?

1. Enhance calculation of PCR and MCR

- May impact all insurers who have not early adopted
- PCR by funds, MCR by 3 groups

2. Review risk appetite framework & Capital Management Plan (CMP)

- Add in PCR and MCR capital thresholds
- Consider regulatory actions (restoration plan & financial scheme)

3. Regular monitoring and reporting of PCR and MCR

- Add HKRBC metrics into the existing MI reports / dashboards such as
  - i. Total PCR, total MCR
  - ii. PCR by funds, MCR by group
  - iii. Eligible capital to meet PCR and MCR
  - iv. PCR solvency ratio, MCR solvency ratio

General Insurance Specific Impacts

Separation of Fund for Onshore and Offshore Business

Definition of the Onshore and Offshore risks

HKIO basis		HKRBC basis
Based on places where risks are underwritten	→	Based on risk location e.g. Insured property in HK or the HK resident

- Exemption on the GI treaty reinsurance business

Separation of Fund for Onshore and Offshore Business

- Maintain of separate accounts and funds constituting assets and liabilities for onshore and offshore (re)insurance business carried on in or from Hong Kong.
- Notice to IA if firms decide to opt out

What does it mean to you?

- We observed **challenges on the Pillar 3 disclosures** of onshore and offshore risks.
- **Various approaches** taken to split the liabilities and assets for onshore and offshore funds. Liabilities arising from offshore location is not subject to the Cat shock and may result **in lower capital requirements**
- If firms opt to keep separate funds, the next step is to consider **the impact to the monitoring and the ORSA process for the Onshore and Offshore funds**

Periodic Actuarial Reviews

The Convergence of GL9 and HKRBC Requirement

- Approach on discounting liabilities
- Change of the Premiums Liabilities to align with the URR, rather than the max of the URR and UPR
- Quarterly reporting supplemented by annual reserve review report
- Statutory requirement for the appointment of certifying actuaries and review of all lines of business

Periodic Actuarial Review

- Once in every 12 months or at any shorter interval that IA requires

Deloitte View

- Consider the appropriateness and data sufficiency to support the reserving for lines of business other than Motor and EC.
- Consider the approach and methodology for the quarterly reserving and report process to Insurance Authority.
- Consider the reporting process in future state when HKRBC and HKFRS17 run in parallel.

What does it mean to you?

- Engage with the actuarial team early on to discuss the future actuarial process
- Engage audit at early stage for areas where expert judgement is applied for HKRBC

*general business under the Ordinance would refer to insurers except for captive insurers, marine mutual insurers and insurers with small business portfolio.

Qualification of Appointed Actuary

Enhanced Requirement on the Local knowledge

Current Requirement in HKIO

The prescribed qualifications of an appointed actuary to an authorized insurer can be fellow of either

- Actuaries Institute Australia
- Casualty Actuarial Society, US
- Institute and Faculty of Actuaries, UK

Proposed Change in RBC

To enhance the competency of appointed actuaries and certifying actuaries **on local knowledge**, they are proposed to be follow members of a recognized overseas professional actuarial organization **and the Actuarial Society of Hong Kong***.

- A **6-month transition** on the appointment of the **general insurance** certifying actuaries is proposed.

Q&A

2. Key Changes to Inland Revenue Ordinance

Taxation landscape for insurers in Hong Kong

Pillar 2 or Global Minimum Tax

- This effectively overshadows the local tax regime in HK and many other parts of the world
- The key challenges posed by this regime are tax technical in nature and data related

Basis of taxation issues

- Recent discussion around how insurers should be taxed has created divergence among the sector

RBC changes

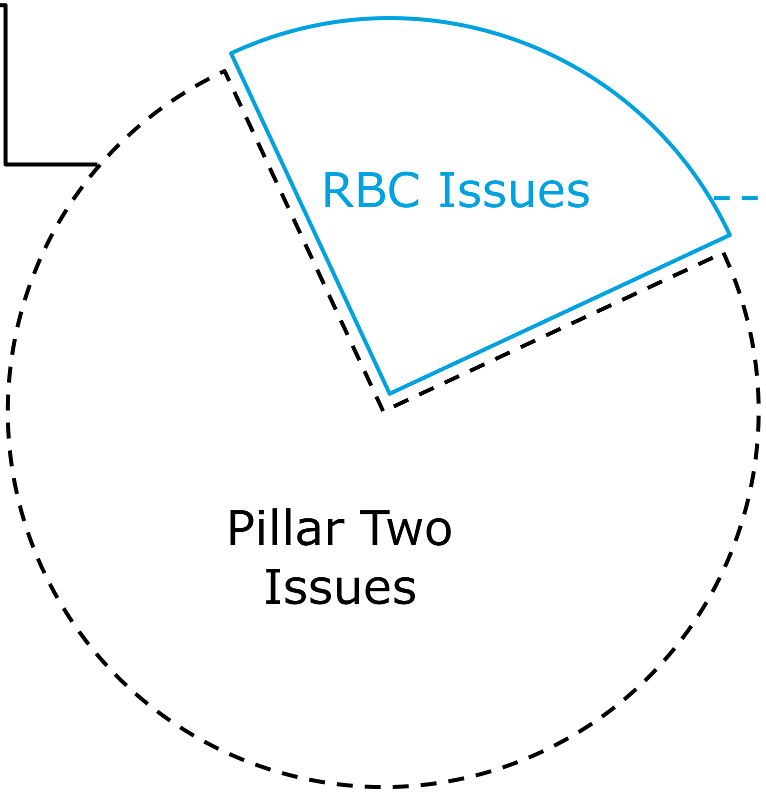
- To be discussed during this session.
- The changes are relatively discrete and their interaction with Pillar 2 should be considered

IFRS 17 changes

- No proposed tax changes in respect of IFRS 17
- However, IFRS 17 will come back into relevance for Pillar 2

Taxation landscape for insurers in Hong Kong

1. Divergence in treatment of policyholder taxes
2. Transparency of investment funds
3. Asset / liability mismatches
4. Instrument by instrument investment tracking challenge
5. Matching unit linked expenses with excluded equities
6. Late transition or exceptions re: IFRS 17
7. Divergence in aggregation of share class rights
8. Global regulation versus local regulation
9. Non-taxable fixed income
10. "Low ETRs arising from: “
    - 5% premium basis
    - 8.25% concessions
    - offshore treatment
11. Deferred tax recasting and tracking
12. Forecasting, modelling, provisioning and compliance challenges
13. Tracing and accounting for intra-group and 3rd party WHT
14. Many many more challenges



1. Non-life long term taxation
2. Spreading of transitionary adjustment
3. Related apportionment and filing issues

Technical updates from the Insurance (Amendment) Bill 2023

Non-life long term insurance business

A **new category** that includes businesses of
- Class D (permanent health)
- Class F (capital redemption)
- Class I (retirement scheme)

- The assessable profits of these business classes were previously ascertained under section 23A of the IRO (i.e. gross premium with adjustments in reserve for unexpired risks).

Government **rejects the choice to maintain the existing section 23A ascertainment approach.**

- The Bill provides that it should now be ascertained based on the adjusted surplus basis per section 23 of the IRO (i.e. life insurance fund minus estimated liability).

The **switch from gross premium to adjusted surplus** completely alters the taxation basis for insurers.

Technical updates from the Insurance (Amendment) Bill 2023

Spreading over arrangement over 5 years for one-off increase

- Change of the valuation method for determining an insurer's liabilities under the proposed RBC regime
- May be a **one-off increase / decrease in assessable profits arising from the implementation of the RBC regime**.
- Allows **five-year spreading**

- **Does not apply to Class G and H businesses**
- The change of capital regime should not affect their accounting profit or loss.
- Treated as investment management under the financial reporting standard
- Ascertained in accordance with section 14 of the IRO for profits tax purposes.

- Reduces assessable profits by 4/5th in the transition year and adds back 1/5th for each subsequent year.
- Spreading likely applicable to both profits and losses

- Irrevocable election – consideration should be given to how this election is used

Consideration must be given to Pillar 2 overlay. The end outcome could differ substantially for US, European, APAC, HK headquartered groups.

Technical updates from the Insurance (Amendment) Bill 2023

Apportionment formula for life insurers using adjusted surplus basis

- **One-off transitional adjustment apportionment**
- **Adjusted surplus basis:**
  - an apportionment formula
  - uses premiums of life and non-life long term business, and HK vs non-HK business, to allocate apportion transitional adjustment

- Industry requested to
  - identify and substantiate the surplus for life and non-life long term insurance businesses within an insurance fund; or
  - maintain separate books for HK and overseas life insurance businesses.

- The Government rejected this approach
- A consistent methodology will be adopted, albeit potentially inaccurate and could negatively affect some more than others

Technical updates from the Insurance (Amendment) Bill 2023

Acceptance of unaudited supporting documents for 2022/23 filing

- Insurers adopting RBC in the middle of a year faced some uncertainty in filing procedures
- The adjustment would not be substantiated with audited returns or financial information.
- **Supporting documents used to ascertain assessable profits of the 2022/23 profits tax return are not required to be audited** unless stated otherwise in other legislation.

Filing extension for early adopters

- Insurers who have implemented the RBC regime for the year of assessment 2022/23 can apply for **an extension of time for filing the profits tax return**
- This applies if the Bill has not been passed by the due date of the return.

Q&A

Save the date

Please join us….

Next RBC Webinar

Exact date to be announced later

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