ACTUARIAL SOCIETY OF HONG KONG

Actuarial Guidance Note 11:
Participating Fund Management in consideration of HKIA Guideline 34

1. BACKGROUND AND PURPOSE

1.1. The purpose of this Actuarial Guidance Note (“AGN 11"), issued by the Actuarial Society of Hong Kong, is to provide guidance to Appointed Actuaries who are responsible for providing advice regarding the management of participating business, taking into account in particular the requirements of the Hong Kong Insurance Authority’s *Guideline on establishment and maintenance of fund(s) in respect of participating business* (Guideline 34, “GL34”, “the Guideline”).

1.2. GL34 sets out the Insurance Authority’s expectations for sound and prudent business practices to be implemented and followed by authorized insurers establishing and maintaining funds in respect of participating business. It takes into account the principles of fair treatment of participating policyholders set out by the Insurance Authority in its *Guideline* o*n Underwriting Long Term Insurance Business (Other than Class C Business)* (Guideline 16, “GL16”), which first took effect on 26 June 2017.

1.3. In particular, GL34, para. 1.3, states that

> “*whenever an authorized insurer exercises its discretion in the management of its participating business, it should pay due regard to the interests of policy holders. It should also take reasonable care to ensure the policy holders are treated fairly and the participating business is managed in a sustainable manner. It should not provide any undisclosed, or otherwise unfair, advantage to shareholders or to other stakeholders of the participating fund(s)*”.

1.4. GL34, para. 6.1, also states that

> “*The allocation of distributable surplus/profits arising from the participating business to policy holders and shareholders, as well as among different groups of policy holders, should be:*
>
> *(a) fair and equitable;*
> *(b) in line with the reasonable expectations of the policy holders;*
> *(c) sustainable; and*
> *(d) compliant with the corporate policy on the governance of the participating business as approved by the Board.*”

1.5. This document is categorized as a 'Guidance Note', as defined under Article 1 in the ASHK's Articles of Association. Therefore, in advising on the management of participating business in the areas covered by this Guidance Note, the Appointed Actuary is expected to be able to demonstrate that the guidance has been followed. The Appointed Actuary should specifically highlight and provide rationale for any deviation from the guidance provided in this Guidance Note. Should there be any conflict arising from interpretation between GL34 and this or any other Actuarial Guidance Note, GL34 prevails. For the sake of clarity, this Guidance Note has been prepared to assist Appointed Actuaries in their interpretation of the requirements of GL34. It is not intended, nor should it be read, as introducing requirements additional to those set out in GL34.

1.6. In formulating advice on the management of participating business, the Appointed Actuary may need to rely upon input and analysis provided by others. For example, analysis may be provided by others regarding expenses incurred, investment returns by asset class, and other matters that affect the financial outcomes of participating funds. The Appointed Actuary should consider the reliance that can be made upon such input and analysis, and whether any additional checks may need to be performed, in line with those set out in Actuarial Guidance Note 10 (General Actuarial Practice).

1.7. An authorised insurer is required to document how it has met the requirements outlined in GL34, e.g., the insurer's basis and justification for determining the allocation of expenses and charges. Neither GL34 nor this Guidance Note specify how this should be done; how a company meets the documentary requirements of GL34 is a matter of choice, e.g., by inclusion in existing documents. Whatever form such documentation takes, they might reasonably form part of the corporate policy covering allocation of surplus/profits between shareholders and the participating pool, as well as declaration of policyholder dividends/bonuses and other discretionary benefits[1], and the annual dividend recommendation report[2]. The documentation and its form is a matter for individual companies to decide upon.

[1] As required by paragraph 2.1 of GL16.

[2] As required by paragraph 2.4 of Appendix 1 of GL16.

2. SCOPE

This Actuarial Guidance Note provides guidance in the following areas of the management of participating business:

Section 3: **Fairness considerations**

- Key considerations related to the fair treatment of participating policyholders.

Section 4: **Expenses and charges**

- Guiding principles for the allocation of expenses to (and within) participating funds, in particular
  (a) the allocation of expenses and charges between group of policyholders; and
  (b) the allocation of charges and expenses between new business and in-force business.
- Guiding principles for setting participating product charges.

Section 5: **Allocation of surplus or profit**

- Guiding principles for surplus management:
  - Allocation of surplus between policyholders and shareholders
  - Maintaining and demonstrating equity
  - Maintaining and demonstrating sustainability

Section 6: **Capital support**

- Guiding principles in relation to the management of capital support provided by shareholders to the participating fund.

3. FAIRNESS CONSIDERATIONS

3.1. Fair and equitable treatment between policyholders and shareholders, and between different groups, cohorts and generations of policyholders, is a key consideration in the establishment and maintenance of participating business.

3.2. In undertaking duties with respect to the establishment and maintenance of participating business, Appointed Actuaries should assess fairness and equity considerations across multiple aspects where discretion may be applied. These may include:

- Product design, including pricing for guarantees and capital support.
- Policy holder illustrations and other communications.
- Investment strategy.
- Surplus / profit distribution methodology.
- Grouping of policies for surplus distribution.
- Smoothing of benefits over time.
- Allocation of expenses and charges to a participating fund, sub-fund or individual cohort and / or allocation of expenses and charges between in-force and new business.
- Allocation of miscellaneous profits / losses (e.g. smoothing profits / losses on surrender).
- Sustainability of new business premiums.
- Fairness and equity of payouts between terminating and remaining policyholders.
- Significant transactions, e.g. M&A, fund mergers or closures, reinsurance and/or capital transactions.

3.3. Fairness is, inevitably, a subjective matter, but at a fundamental level fairness balances the interests of policyholders with those of shareholders, and, further, between different generations and / or status (e.g. premium paying or in-force status or levels of guaranteed benefits) of policyholders.

3.4. Potential conflicts of interest between these groups need to be identified and carefully managed so they do not impact fair treatment. The Appointed Actuary can reduce the risk of conflicts arising in future by following the requirements of GL16, GL34 and this Actuarial Guidance Note.

3.5. It is important that the company's corporate policy governing participating business management clearly sets out the approach to determining dividends / bonuses and the allocation of surplus/profits between shareholders and policyholders, allowing for expenses, charges, investment earnings, and other sources of surplus/profits.

3.6. There should be sufficient analysis in place to support the grouping of policies for surplus distribution in order that the intended fair treatment of policyholders, including the avoidance of potential future cross-subsidies, are understood and can be managed appropriately. Factors commonly used to group policies include, for example, product features, bonus type, policy issue year, premium-paying status, etc.

3.7. Fairness of historically applied approaches should be kept under regular review, as part of the ongoing tasks that the Appointed Actuary is likely to be performing. It is possible that approaches developed today with an intention of treating customers fairly may require revision in the future, e.g., due to material changes in the economic situation and/or outlook, changes in the tax treatment and/or regulation of participating products, or customer attitudes impacting policyholders' reasonable expectations. Whatever the reason for revision of approaches applied historically, due regard should be given to the impact of such changes on policy holder outcomes.

3.8. There are several general principles that should be considered by actuaries in considering fairness:

Objectivity and consistency

The approach to dividends / bonuses and the allocation of surplus/profits between shareholders and policyholders, allowing for expenses, charges, investment earnings, and other sources of surplus / profits should be set out in the corporate policy governing participating business management and should be applied objectively and consistently over time, so long as it continues to be compatible with current notions of fairness (see paragraph 3.7).

The method for determining dividends and bonus rates should be based on objective quantifications, to the extent practicable. There should be consistency between policy contracts, communications with policyholders, policies and criteria established by the board, professional standards and applicable law.

Application and transparency

Appointed Actuaries should satisfy themselves that corporate policies governing participating business management are being applied appropriately. They should satisfy themselves that verifiable processes are established, for example in relation to dividend and bonus reviews, expense analysis and allocation, etc. They should also satisfy themselves that documentation of the related controls is in place, and that the internal corporate governance process and independent review by professionally qualified and experienced reviewers are able to validate the design and operating effectiveness of these controls and bring any perceived shortcomings to their attention.

Appointed Actuaries should also satisfy themselves that the results of experience studies and other objective data used in the setting of dividends and bonus rates are documented. The policies should be reviewed regularly and the Appointed Actuary should verify that they have been updated as appropriate.

In addition to the corporate policies themselves, transparency internally within the company is enhanced through documented support of the fairness opinions including a description of areas where judgment has been applied in the application of the policies and criteria, and support for the conclusions; and controls that are in place to ensure that the application of the policies and criteria are appropriate.

Materiality

Fairness should be judged from the individual policyholders' perspectives, but subject to considerations of materiality and practical constraints in terms of applying the policies and criteria. Practical expedients and approximations may be used to accomplish fairness objectives while keeping the cost of dividend and bonus determination at reasonable levels. This will be a particularly relevant consideration when determining the grouping of policyholders for surplus distribution.

The Appointed Actuary should review, and ensure the appropriateness of, any practical expedients and approximations that may have been used to mitigate the risk that individual policyholders may be systematically and materially disadvantaged. For example (and for illustration of this point only), consider a situation where the assessment of the impact of a proposal (e.g. a change in investment strategy) on potential future bonus / dividends is initially conducted at an overall participating fund level and indicates on average no adverse impact to policyholders. However, if the analysis is then undertaken at a more granular level, it may indicate that there are groups of policyholders, or individual policyholders, who will materially benefit (e.g. large increase in future bonus / dividends) and groups of policyholders, or individual policyholders, who will be materially disadvantaged (e.g. large decrease in future bonus / dividends). In this example the Appointed Actuary would have been expected to conduct the analysis at the more granular level required to better understand the material nature of the potential cross-subsidies arising from the proposal.

Policyholders' Reasonable Expectations ("PRE")

PRE can arise from many different sources, for example the company's communications in marketing literature, policy illustrations, post-sale disclosures, from company's past practices, from its current policies and from market and industry practice.

Appointed Actuaries should take PRE into account when assessing fairness. The interpretation of PRE may be straightforward when the company's recent practice has been clear, unvarying, consistent with communications, consistent with general market and industry practices. The interpretation of PRE may not be straightforward if circumstances have changed materially over a longer period of time. Where the interpretation of PRE is not straightforward, the Appointed Actuary would need to apply judgment, which could be enhanced by discussions which should be documented, with other key individuals within the company to clarify PRE to the extent practicable. The Appointed Actuary should document the considerations taken into account in determining whether his or her recommendation is consistent with the interpretation of PRE. Notwithstanding this point on interpretation of PRE, the broader considerations and principles set out in GL34 and this AGN also need to be considered by the Appointed Actuary in assessing and opining on fairness issues.

Appointed Actuaries, in order to support their management of PRE aspects, should refer to additional guidance set out in:

- GL16 Appendix 1 (Requirements Applicable to Participating Products)
- GL28 Guideline on Benefit Illustrations for Long Term Insurance Policies
- AGN 5 Principles of Life Insurance Policy Illustrations issued by the ASHK
- AGN 9 Best Estimate Assumptions issued by the ASHK
- AGN 10 General Actuarial Practice by the ASHK

4. EXPENSES AND CHARGES

4.1. Under GL34, an authorised insurer is required to set out the basis for its allocation of costs to its participating business, whether as expenses or charges. This section of the Actuarial Guidance Note sets out areas for the Appointed Actuary to consider in determining the appropriateness of expenses and charges being allocated to an applicable participating fund.

4.2. Whilst the determination of expenses or charges to cover the operating costs of a participating fund may have elements of subjectivity and therefore require the use of judgement, and different companies will reasonably have different practices and approaches, the overall aim of any expense allocation and/or charging methodology is to ensure that all cost allocations are appropriate between policyholders and shareholders, as well as between different sub-funds and different generations / groups of policyholders.

4.3. GL34 stipulates that an authorised insurer needs to be able to demonstrate that the allocation of expenses and charges to an applicable participating fund is "fair, equitable and reasonable". The Guideline elaborates that these conditions are met, if:

- "the allocation is in line with the interests of the relevant policyholders;
- the costs are necessary to cover the ongoing operations of the fund or sub-fund; and
- the costs are justified by the expected benefit to the relevant policyholders".

4.4. In meeting the requirements set out in paragraphs 4.2 and 4.3, an Appointed Actuary should consider the following general principles in arriving at their advice to the Board of Directors on the level of expenses incurred in the ongoing operations of the fund, and the charges to meet those costs:

- The principles of expense allocation to participating funds should be clearly documented in relevant corporate policies.
- The methodology used to determine more complex charges, e.g., stochastic or other analysis performed to determine charges to recover the costs of guarantees, should also be clearly documented.
- The proposed allocation approach should meet policyholders' reasonable expectations, e.g., the approach to expense allocation should be consistent with sales illustrations, product marketing materials and other information provided at both point of sale and subsequently.
- Any proposed allocation approach is applied consistently in the management of the participating fund, including in regular expense analysis and dividend recommendations; and

It is also recommended that the approach(es) used by the Appointed Actuary to assess the reasonableness of the outcomes of the expense allocation principles and/or methodology should be documented.

4.5. The Guideline requires that an authorised insurer can demonstrate based on appropriate analysis whether certain expenses or charges are commensurate with the costs that are required in operating the participating fund, having regard to the principles outlined in paragraph 4.3.

4.6. In considering the level and nature of expenses or more complex charges to a participating fund, an Appointed Actuary should be able to justify that such charges follow the economic substance of the relevant matters, are consistent with the outcomes of appropriate analysis, and are aligned with the costs of operating the participating business. The types of analysis that might typically be performed to justify expenses and charges being allocated to participating funds are discussed below.

4.7. Any expense analysis would typically consider the following expense categories: (a) acquisition expenses; (b) maintenance expenses; (c) overhead expenses; (d) investment expenses; and (e) one-off or exceptional expenses.

4.8. Whilst some expenses are directly attributable to a particular policy such as commissions or policy issuance costs, others (such as general overhead costs) must be appropriately allocated. In this case, any allocation should consider:

a) the functional activities to which the expense relates;
b) whether the functional activities are incurred in operating the participating fund and/or in line with policyholders' interests;
c) whether and how the functional activities will benefit policyholders; and
d) an appropriate relationship between the functional activities and the expense categories and the product groups to which they relate.

4.9. The process of the determination of expenses or charges to cover the operating costs of a participating fund will require the use of judgement, following the principles outlined in the previous paragraph, and there are some circumstances that will require greater judgement and more rigour in the documentation of ultimate conclusions. Examples of such circumstances include but are not limited to:

a) the costs associated with corporate strategic initiatives, e.g., organisational restructuring that does not impact the sale and operation of participating business.
b) the costs associated with the establishment of a new distribution channel that may not sell participating products, at least initially.
c) expense variances associated with any deliberate under-provisioning of expense loadings in the pricing of participating business.
d) marketing-related payments or other incentives paid to distributors (in addition to commissions) if these are not related to the sales of participating business. This contrasts with the costs of campaigns related to corporate branding which can be allocated to participating business, if this is done in a fair and reasonable manner.
e) the costs associated with administration systems development or replacement costs.

Allocation of such expenses will, therefore, need to be based on analyses of expected costs and benefits, such as analysis of how the costs will be expensed over time, how participating policyholders will benefit from such spending and whether all participating products will be impacted in the same way. The sources for such analyses are likely to be drawn from a mixture of expense studies, business plan and ORSA results and the results of stress and scenario testing. In performing their analysis, the Appointed Actuary can use suitable groupings to ensure their analysis remains manageable whilst providing the basis to determine an appropriate allocation across all groups of products.

4.10. Acquisition expenses arise from activities related to the acquisition of new business. Such activities might include advertising, marketing, sales, underwriting and administration, undertaken prior to and at the point of issuing a policy. Any expense analysis should allow for the allocation of expenses to acquisition activities, and the amount to be absorbed by shareholders compared with that to be absorbed by different cohorts of participating policyholders including new policyholders.

4.11. It is possible that two insurers faced with the same set of facts and circumstances may arrive at different conclusions as to an appropriate charging structure. For example, should acquisition costs be recouped in the first year of a policy or throughout the premium paying period? In a growing fund, is it reasonable to allow for anticipated growth of the fund and the potential impact of such growth on expense assumptions? Whatever charging structure is selected, the Appointed Actuary should be able to justify their conclusions in light of the requirements of Guideline 34.

4.12. There may be circumstances in which an expense derives from an activity outside the normal business activities of the company and is not recurrent in nature, i.e., they are believed to occur only once and not happen again. The Appointed Actuary should consider the underlying nature of such expenses, and if any accelerated, one-off or exceptional costs are being allocated to a participating fund, they should be clearly identified in any expense analysis and justified.

4.13. Conversely, there may also be situations in which insurers need to increase the expenses being allocated in their expense analysis, for example, if their previous year's expenses were unusually low. Such adjustments would need to be clearly documented and justified.

4.14. Expenses should be allocated to sub-funds or cohorts using drivers including but not limited to numbers of in-force policies, premiums, sums assured, policy reserves or assets under management. Whatever approach is used to allocate expenses to a particular sub-fund or cohort, any allocation should be justifiable in the context of the considerations listed in paragraph 4.3 as allocating an appropriate level of expense to that sub-fund or cohort.

4.15. The Guideline requires the Appointed Actuary to form a view on whether the allocation of certain costs to participating business is justified by their expected benefit to relevant policyholders. For example, if a new system is developed to administer a new participating product, considerations should be given on whether it is reasonable to allocate associated expenses to participating business only, or whether it should also be borne fully or partly by shareholders given shareholders may benefit from it through process efficiencies and associated cost reductions. Whatever approach is adopted, it should be documented and consistent with corporate policy.

4.16. When allocating costs arising from related party transactions, e.g., third party investment management fees, performance fees and transaction costs associated with asset management or intragroup expenses, an assessment should be made by the company to demonstrate whether such costs are charged on an arm's length basis. The basis for charges arising from related party or intragroup transactions should be justified and documented.

One way of ensuring this might be to perform analysis of underlying costs and risks taken by the related party and related capital requirements. Another is to consider the results of benchmarking or other analysis, where available, e.g., transfer pricing analysis performed internally.

4.17. GL34 sets out that any analysis performed should be proportionate to the nature, scale and complexity of charges. Examples of more complex charges that are given in the Guideline are guarantee charges (i.e., charges to cover the costs associated with the provision of minimum interest rate guarantees or the costs of guarantees biting) and capital charges (i.e., charges to cover the opportunity costs associated with holding capital to meet regulatory capital requirements).

4.18. The methodology used to determine such charges may require stochastic or scenario analysis to be performed to consider the costs of providing guarantees or meeting capital requirements under a range of potential economic outcomes. The aim of these charges is to cover the expected costs of providing guarantees or holding capital to back the participating business reflecting, for example, a particular product's features or a particular company's risk appetite.

Documentation and reporting

4.19. Under GL34, an authorised insurer is required to document its basis and justification for determining the allocation of expenses and charges and include this in relevant corporate policies together with any supporting documents, including on governance of its participating business, as approved by its Board of Directors (as required, inter alia, by GL16). Such documentation should specify the frequency of more comprehensive reviews and, if necessary, establish intervals for narrower reviews between these more comprehensive reviews. Material changes in the insurer's circumstances may warrant an off-cycle review being performed in a prompt manner.

4.20. Such documentation might include the following:

- Analysis of the types of expenses that can be and cannot be charged to the participating fund.
- The basis for the allocation of charges and expenses to the participating fund, which should explain how the expenses arise, how they are charged to the participating / shareholder fund and the criteria used to allocate expenses between different groups.
- The methodology for conducting any expense study and changes to that methodology since the prior study.
- Whether there have been any material changes to the insurer's circumstances since the prior study, e.g., a material acquisition.
- Where discretion has been applied in allocating expenses to certain sub-funds or cohorts, and the extent of that discretion, e.g., the allocation of any accelerated, one-off or exceptional costs to a participating fund or sub-fund should be clearly documented and justified.
- The methodology for conducting any analysis of more complex charges, e.g., stochastic or other analysis performed to determine charges to recover the costs of guarantees or capital.
- Discussion of the appropriateness and reasonableness of charges considering the results of the above.
- Demonstration of compliance with Sections 5.1 to 5.5 of GL34.

4.21. The above documentation may be part of various existing documents or become part of those documents. How a company elects to meet this requirement is a matter of choice. Once prepared, this documentation will also assist the Appointed Actuary in providing, at least annually, a written opinion to the Board as to whether expenses and charges that are being allocated to each applicable participating fund remain fair, equitable and reasonable. Such an opinion might reasonably form part of the annual dividend recommendation report required under paragraph 2.4 of Appendix 1 of GL16, but again this is a matter for individual companies to decide upon.

5. ALLOCATION OF SURPLUS OR PROFIT

5.1. Section 6.1 of the Guideline requires the allocation of surplus/profits arising from the participating business to be “fair and equitable”. Section 6.3-6.5 of the Guideline further sets out that the allocation should be in line with the interest of the policyholders, ensure “a fair balance of risk and reward between participating policyholders and shareholders”, in a systematic and rational manner and not to accelerate the distribution asymmetrically to shareholders unless the distributions, individually or cumulatively, are unlikely to result in “any material adverse effect on the security of policyholders’ contractual rights and their reasonable benefit expectations”.

5.2. The Appointed Actuary should establish policy groups at an appropriate level for the determination of surplus/ profit allocation. The policy groups should generally contain policies with similar product features, investment strategy, risk profiles and characteristics, balancing the practical constraints. The policy groups for surplus/ profits allocation should generally be consistent with the level at which policy returns are tracked and profits are determined.

5.3. The Appointed Actuary should assess the relative size of expected surplus/ profits allocation to policyholders and shareholders to ensure the objectives in paragraph 5.1 are met. Scenario testing or other techniques may be applied to ensure the allocation represents a fair balance of risk and reward between participating policyholders and shareholders over the duration of the contract. The allocation of surplus between policyholders and shareholders should be done systematically and consistently, taking into consideration factors such as fairness, PRE, bearing of risks, product features, commercial environment, etc. Different levels of risk borne by an insurer for different products may lead to different levels in surplus allocation to shareholder. Different commercial environments may also drive different levels of participating product profits and profit-sharing allocation between policyholders and shareholders. An insurer should properly reflect the resulting implication of this to policyholders both qualitatively and quantitatively, with due consideration of fairness and PRE.

5.4. The Appointed Actuary should assess the pace of surplus/ profits allocation and its distribution out of the participating fund. Where the pace of allocation of surplus/ profits is different between the shareholder and policyholders, the Appointed Actuary is expected to provide the justification for such difference, and ensure that the distribution, individually or cumulatively, are unlikely to result in any material adverse effect on the security of policyholders’ contractual rights and their reasonable expectations, including the prospects for non-guaranteed benefits, or the financial soundness of the fund as a whole. For example, if all surplus to the shareholder is allocated and distributed at inception of the contract which results in a significant reduction in assets for supporting the illustrated benefits or a material adverse impact on the ability to maintain the target investment strategy, the likelihood of future management action to reduce non-guaranteed benefits may increase and this would not be considered as appropriate

5.5. The Appointed Actuary should apply the methodology of surplus/ profits allocation consistently and systematically across different policy groups, and across times. A systematic manner does not preclude differences which are justified with respect to the nature of the products or other specific facts and circumstances. For example, when an allocation methodology that distinguishes between profits from insurance service and profits from investment service is applied to a block of participating business, the pattern of surplus/ profits allocation for a protection-oriented product could potentially be different from a saving-oriented product due to different nature of the products.

5.6. One feature of participating business is that a smoothing mechanism is applied to reduce volatility in policyholder dividend scales and payouts to exiting policyholders. The Appointed Actuary should consider the impact of smoothing on the fairness and equity of surplus/ profits allocation. For example, the Appointed Actuary should ensure that:

- the smoothing mechanism should be cost neutral over time i.e. any overpayments and underpayments should balance over time;
- the granularity of the smoothing mechanism would not result in any material cross-subsidization among policy groups or generations of policies;
- the size or the time horizon of the smoothing mechanism would not on average result in any material and systematic cross-subsidization among policies exiting at different times.

5.7. Where a participating fund is open to new business, the Appointed Actuary should consider the extent to which the existing policies would finance the new policies. If the extent is not reasonable to the Appointed Actuary, the introduction of new cohorts, shareholder seed capital, or other actions should be considered. For example, if the issuance of new policies is expected to result in a materially adverse impact to fulfilment of dividend scale illustrated to the existing policies, such extent of financing would not be considered as reasonable.

5.8. An exiting policyholder or one who is taking a partial withdrawal should receive a fair share of profits that is commensurate with their contribution to such amounts, and the security of the guarantees and expected benefits to continuing policyholders should not be significantly impacted as a result of any unfair share of payment to exiting policyholders or those taking withdrawals.

5.9. Where a participating fund is closed to new business, the Appointed Actuary should consider actions to avoid the effect of tontine, i.e., disproportional amount of profits allocated to policies that survive last, such as the review of existing policyholder dividend scale and time horizon of smoothing mechanism. The actions should be planned ahead with reasonable lead time for execution and refinement. For example, if the identification of management action only starts when the fund is going to deplete to a level that becomes too small to manage, it would not be considered as reasonable.

5.10. Section 6.1 of the Guideline requires that the allocation of surplus / profits arising from the participating business is sustainable.

5.11. The Appointed Actuary should assess the projections of the financial condition of the participating fund and sustainability of the allocation of profits / surplus, under a range of plausible adverse scenarios (for example, with reference to ORSA solvency projections) in order to assess its ability to continue to meet existing policyholders' reasonable expectations.

5.12. The Appointed Actuary should assess the pattern of surplus / profits allocation and not only the present value of distributable surplus / profits. For example, assess the pattern of surplus / profits allocation against the projected amount of assets attributable to the participating fund. This is to ensure that the ongoing sustainability of the allocation is maintained, and systematic over- or under-distribution to either the policyholders or shareholders does not occur in the long term.

5.13. The Appointed Actuary should consider the impact of regulatory capital requirements and / or fund solvency requirements on the sustainability of the surplus / profits allocation. Sufficient assets should be held to ensure that regulatory capital requirements or solvency requirements are met, to the extent that there is no material adverse effect on the benefit security and reasonable expectation of the participating policyholders.

5.14. The Appointed Actuary should consider the impact of smoothing when evaluating the sustainability of the surplus / profits allocation. The smoothing mechanism should not subject the fund's regulatory solvency to risk.

5.15. Where the participating fund is open to new business, the Appointed Actuary should assess the impact of future new business on the sustainability of the surplus / profits allocation. The Appointed Actuary should consider how the new business strain, if any, is supported to ensure it would not unduly impact the sustainability of the allocation of surplus/profits and the solvency of the fund.

5.16. The Appointed Actuary should consider to what extent (if any) maturities and surrenders impact the sustainability of the participating fund and sustainability of the allocation of profits / surplus to policyholders who hold their policies for longer. Processes should be established to ensure that leaving and continuing policies receive a fair share of their surplus / profits, commensurate with their contribution to the performance of the fund.

5.17. Where any riders, funds on deposit, prepaid premiums or other benefits attached to a base policy of any long term business is expected to have a substantive impact on the dividend / bonus determination of the participating policies, the Appointed Actuary should assess the impact of benefits (and losses) from those policies to the sustainability of the participating fund and sustainability of the allocation of profits / surplus. Corporate policies should be clear on how profits and losses from these riders, funds on deposit, prepaid premiums or other benefits would affect policyholder distributions.

5.18. The Appointed Actuary should be satisfied that the investment strategy of the participating fund takes into consideration the sustainability of the surplus / profits allocation, and liquidity of the fund. Regular reviews should be in place to ensure that the level of risk taken is appropriate. The Appointed Actuary should take into consideration differences in investment strategy and risk profiles of different blocks of participating business. Investment strategy should be formed, taking into consideration the risk profile of the business.

5.19. The Appointed Actuary should also take into consideration PRE from a risk and return perspective when setting investment strategy. If the proposed investment strategy for an in-force portfolio is materially different from the existing PRE, the actuary should take appropriate measures to align the investment strategy with PRE by means of appropriate policyholder communication and / or modification to the investment strategy. An example of occasions where it may be appropriate to manage PRE through communication and other means is when, after careful consideration and analysis of the benefit to the policyholders, the investment strategy is modified to achieve a higher risk-adjusted return against the backdrop of a volatile market.

5.20. Section 6.1 of the Guideline requires that the allocation of surplus / profits arising from the participating business is in line with the reasonable expectations of the policyholders.

5.21. The corporate policy governing participating business should maintain clear documentation on the interpretation of policyholders' reasonable expectations, with reference to the principles set out in GL16. The Appointed Actuary should ensure that the allocation of surplus / profits is consistent with the stated PRE principles.

6. CAPITAL SUPPORT

6.1. Additional capital, over and above surplus capital already existing within a participating fund, may be provided from shareholder resources. Such resources may include shareholder resources within a non-participating fund or shareholder resources that have previously been allocated to or identified for distribution from another participating fund, to support a participating fund in meeting its objectives. As well as solvency objectives, shareholder capital support may be provided to enable broader objectives related to the fair treatment of participating policyholders, including meeting policyholders' reasonable expectations – which may include objectives such as maintaining a particular investment strategy or continuing to provide temporary additional smoothing of bonuses, dividends, or payouts in adverse conditions.

6.2. A decision to provide such additional capital support should be supported by the advice of the Appointed Actuary. The capital support should be subject to terms and conditions governing its use, including any charges that may be made for its use, and withdrawal, and subject to oversight and governance by the Board. Capital should not be transferred from any other fund if doing so would lead to a risk of that fund breaching its regulatory solvency requirements, or, in the case of shareholder resources allocated to a participating fund, failing to meet its objectives for policyholders of that fund.

6.3. In the event that a participating fund cannot meet its regulatory solvency objectives, and no capital support can be provided from elsewhere, the provisions of the Insurance Ordinance in relation to reporting and recovery from breaches of solvency will apply.

6.4. Any proposal for withdrawal of capital support that has been provided to participating funds under the terms and conditions of the support should be supported by the advice of the Appointed Actuary.

6.5. In considering such a proposal, the Appointed Actuary must ensure, above all, that the fund's regulatory solvency requirements under the Insurance Ordinance are met following the proposed withdrawal. If there is reasonable doubt about the ability of the fund to meet its regulatory solvency requirements, the Appointed Actuary should flag this clearly and should not endorse the proposal.

6.6. In addition to regulatory solvency requirements, the Appointed Actuary should consider other objectives of the capital support that had been envisaged and documented in the agreed terms and conditions of the capital support such as those related to the delivery of policyholders' reasonable expectations over and above those required in the regulatory solvency assessment.

6.7. In giving advice on a proposal to withdraw capital support, the Appointed Actuary should quantitatively assess whether these other objectives have now been met, and – to the extent they still form part of policyholders' reasonable expectations – can continue to be met without creating an impairment to the prospects of existing policyholders of the fund following withdrawal of the capital support. The Board should consider carefully whether the actions that were enabled by the capital support in the particular circumstances of the fund have themselves already become part of policyholders' reasonable expectations going forward, and the Appointed Actuary should therefore give due consideration to this possible addition to policyholders' reasonable expectations in giving advice.

6.8. In performing quantitative assessments, the Appointed Actuary's investigation will need to consider the specific nature of the objectives of the capital support. For example, if the capital support was intended to enable a particular investment strategy to be applied to the assets backing certain groups of policyholders and that investment strategy forms those policyholders' reasonable expectations, then the assessment should be over whether this investment strategy can continue to be followed, without impairing the security of guarantees or prospects for non-guaranteed benefits for other policyholders after the capital support is withdrawn.

6.9. The quantitative analysis required to support this advice is similar in nature to the analysis set out in section 5, including scenario testing, which would form part of the Appointed Actuary's investigation to support fair distributions of surplus from the participating fund while ensuring sustainability of prospects for existing participating policyholders.

Effective date 24 February 2025