

## FAIR TREATMENT OF POLICY OWNERS

### Introduction

Consumers who buy tangible goods, are generally well informed about the product, its benefits and are able to make meaningful comparisons on pricing. They are able to enjoy the benefits of the product immediately and if it is faulty, they can rely on the manufacturer's guarantee for a replacement or repair. However, such simplicity in decision-making is not the same for some financial products particularly long-term life insurance products where the benefits are not immediately visible and are only payable upon the occurrence of a specified event in the future. Moreover, such financial products often involve asymmetry of information between consumers and financial service providers. Given the relative complexity of life insurance products, individual consumers may not be in a strong position to detect and address inequitable or unfair business practices because they are either unaware of the pertinent issues or they lack the requisite bargaining power.

### General Principles of Fair Treatment

In order to ensure the fair treatment of policy owners, life insurers should be flexible, dynamic and sensitive to the requirements of consumers. The general principles which should be observed by insurers in ensuring fair treatment to policy owners would, amongst others, include:-

- adopting appropriate pricing and bonus determination bases that are equitable to policy owners;
- ensuring disclosure and transparency of material policy information to policy owners;
- honouring representations, assurances and guarantees which create policy owners' reasonable expectations;
- acting with integrity, competence and in good faith; and
- dispensing proper advice to prospective policy owners at the point of sale.

### Concept of Participating Life Insurance

It is important that the above principles are observed in the conduct of life insurance business, especially participating or with-profits life insurance contracts with non-guaranteed benefits. For participating policies, although the sums assured are guaranteed, the payments of bonus are non-guaranteed and fluctuate with the performance of the life fund. The illustration of these non-guaranteed benefits in the sales illustration at the point of sale forms the basis of policy owners' reasonable expectations of the benefits. It is essential that insurers manage these expectations, especially in an adverse investment environment where the earnings of the life fund fall short of the projected benefits to the policy owners.

### Equitable Treatment

Prior to the 1997 financial crisis, life insurers were able to illustrate high bonuses in view of the buoyant financial environment then. However, the low interest rate environment for an extended period has resulted in an overall reduction in investment earnings of life insurers, thus reducing their ability to sustain the illustrated bonus rates.

In markets abroad, depressed economic conditions have also forced bonus cuts on participating life insurance products. In the United Kingdom, such bonus cuts have led to controversies over mortgage endowment plans as maturity benefits were not able to meet the outstanding mortgage repayments. In Japan, changes were made to the legislation to allow life insurers to cut their guaranteed yield on policies in view of the unsustainable negative spread between guaranteed yield and returns on investments.

Although these bonus reductions may be justified under the prevailing economic conditions, the quantum and manner in which the bonuses are cut must be equitable with due regard to different generations of policy owners. The methodology of bonus declaration must be transparent and

consistently applied to ensure fair treatment and equitable return on the contributions made by the policy owners.

One of the actuarial techniques used for the determination of the appropriate share of the benefits due to policy owners is the asset share study. The asset share methodology, which is widely accepted in the developed markets essentially represents the fair share of the accumulated premiums, which should be returned to the policy owners after allowing for deductions of the actual costs incurred by insurers which include expenses, commissions and cost of insurance coverage.

In the absence of such actuarial investigation, a bonus cut may be unjustified especially if it is based on the judgement and sole discretion of the insurer. Very often, underpayment of the asset share to the policy owners results in the creation and build-up of 'estate', which does not rightfully belong to the shareholders of the insurer. Such estate accumulated from previous generations of policy owners have been subject to criticism and prompted regulatory measures in some jurisdictions to ensure proper reattribution of the estate.

### **Measures to Ensure Fair Treatment of Participating Policy Owners**

In its continuous effort to foster a sound and progressive life insurance sector, Bank Negara Malaysia (the Bank) has initiated various safeguards to ensure fair treatment of participating policy owners. Under the Code of Good Practice for Life Insurance Business, insurers are required to adequately highlight in the sales illustration of life insurance products to prospective policy owners that the bonus benefits of participating life insurance policies are non-guaranteed in nature. The interest rate assumption used in the sales illustrations is also subject to certain limits so as to avoid unrealistic illustrations, which create false expectations among policy owners. Participating life insurance contracts are also required to be designed and priced in an equitable and fair manner.

In addition to proper product design and equitable bonus declaration, the role of insurance intermediaries in dispensing proper advice in order to help consumers make informed decisions cannot be over-emphasised, especially with regard to complex financial products such as participating life insurance policies. As part of efforts to promote good sales practices, the Guidelines on Proper Advice Practices for Life Insurance Business were issued in 2003 to ensure intermediaries properly assess the financial circumstances of prospective policy owners before providing them advice on suitable insurance products.

More recently in 2004, the Bank required the Appointed Actuary of an insurer to conduct an in-depth investigation and actuarial study before making any recommendation on the revision of policy owners' bonus. In the investigation, the Appointed Actuary is required to consider the following:

- **Legal Basis**  
Whether the insurer has the legal right to revise bonuses based on sales and marketing materials, policy documents as well as agency training materials used in the past for the promotion of participating life insurance products.
- **Asset Share/Equivalent Study**  
Results of an asset share study by the Appointed Actuary in order to justify any revisions made to the existing level of bonus. The Appointed Actuary is also required to ensure that for any particular class of policy, the policy owners will not get less than the policy's asset share on average as cash surrender values as this represents the fair share of the policy monies owing to policy owners.
- **Communication Policy**  
In order to manage policy owners' reasonable expectations, insurers should ensure that policy owners are duly informed of the bonus revision and take the necessary steps to prepare or forewarn policy owners on possible future bonus revisions.

The application of the asset share methodology would improve equity in the distribution of surplus to policy owners. This will result in better policy values and further promote life insurance as an attractive long-term savings instrument.

**Conclusion**

The implementation of the various initiatives aims to enhance consumer benefits and fair treatment of policy owners as part of the efforts to nurture an enabling environment for the sound development of a competitive insurance marketplace. As the market evolves and financial products become more complex, financial service providers need to continuously strive towards adopting best practices in the fair treatment of policy owners. With such best practices, the insurance industry will be able to grow on a more solid foundation supported by strong consumer confidence.