Get Ready for Indexed Universal Life

Implementation considerations for Hong Kong insurers

April 2025

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Indexed Universal Life is the Next Life and Wealth Offering from Hong Kong Insurers

Get Ready for Indexed Universal Life in Hong Kong

Indexed Universal Life ("**IUL**") is an emerging life insurance offering in the high net worth ("**HNW**") segment, in addition to Universal Life ("**UL**") and Participating Life ("**Par**").

A key feature of an IUL product is to provide a share of investment performance linked to a financial index or indices. Similar to UL, an IUL would typically provide features like a guaranteed minimum credit rating and maximum charges, alongside death benefit protection.

Beyond time-to-market and sales compliance, as insurers consider selling IUL, they should strategically assess **accounting considerations, derivatives operations and controls, modelling and assumptions, and risk governance**, to build capabilities and maintain competitiveness in the market.

The IUL Circular

To support the industry in its development, the Insurance Authority ("**IA**") and the Hong Kong Monetary Authority ("**HKMA**") issued a circular ("**IUL Circular**") on 13 March, 2025 aiming to provide clarity on applying the relevant insurance regulatory framework to IUL insurance products.

IUL as a Class C product

The regulatory framework applicable to Class C (linked long term) business will apply to IUL given its market-linked features. The Guidelines ("**GLs**") applicable to Class C products include:

- GL15 (Guideline on Underwriting Class C Business);
- GL26 (Guideline on Sale of Investment-linked Assurance Scheme Products)
- GL28 (Guideline on Benefit Illustrations for Long Term Insurance Policies)
- GL30 (Guideline on Financial Needs Analysis).

Given the specific features of IUL, the IA and HKMA noted that specific amendments to GL15 could be required. Certain provisions of GL16 (Guideline on Underwriting Long Term Insurance Business (Other than Class C Business)), rather than GL15, should be applied to IUL products. The applicable provisions in GL16 include governance, provision of adequate and clear information, and disclosure on non-guaranteed benefits.

IUL for Professional Investors

The circular issued by the IA provides specific direction for designing, offering, and selling IUL products to professional investors ("**PIs**"), as defined under the Securities and Future Ordinance ("**SFO**").

The PI definition is expected to support insurers to develop an IUL proposition for the HNW segment. The specific regulatory requirements are set out in an annexure ("**Annex**") issued together with the IUL Circular.

Capabilities Uplift Beyond Sales Compliance

The Annex provides specific requirements on product design and the distribution approach of IUL for PIs. Insurers should also consider appropriate infrastructure for long-term product management needs.

The Annex

The requirements covered in the **Annex** are:

- Product Design
- Governance
- Provision of Adequate and Clear Information, and Disclosure on Non-Guaranteed Benefits
- Suitability Assessment, Advice to Customers, Fair Treatment of Customers in the Sale, Advice to Customers
- Risk Profile Questionnaire ("**RPQ**") Process
- Important Facts Statement ("**IFS**"), Applicant's Declaration
- Appropriate Remuneration Structure / Avoidance of Conflict of Interest
- Post-sale Control
- Ongoing Monitoring
- Clients' Investments and Assets
- Specific Requirements for Benefit Illustration Documents
- Supplementary Illustration
- Greenlight Process and Submission Requirement

Insurers will need to make considerable efforts to meet these requirements from both a product design and distribution perspective. We anticipate the product, distribution, and sales compliance functions will take the lead in this process.

Matters Beyond Time to Market and Sales Compliance

At the same time, insurers should also strategically assess the following **implementation topics across investment, risk, finance and actuarial**:

1. Accounting considerations
2. Derivatives operations and controls
3. Modelling and assumptions
4. Risk governance

1. Accounting Considerations

During product design, insurers should consider the accounting implications, which will differ significantly depending on whether IFRS 17 *Insurance Contracts* or IFRS 9 *Financial Instruments* applies.

Applying IFRS 17 to IUL products

IFRS 17 would apply to IUL contracts if they transfer **significant insurance risk** to the insurer, which happens if the insurer is required to pay significant additional amounts and could suffer a loss as a result of the insured event.

In this case, the insurer should consider:

- Whether any index-linked feature is an **embedded derivative** that is required to be separated and measured at fair value through profit or loss under IFRS 9.
- Whether the separation of index-linked features and the crediting mechanism mean that the contracts would **not qualify as direct participating contracts**.
- How **mutualisation**, if any, may affect the grouping and the measurement of the contracts.
- Whether the choices the insurer has already made for existing products mean that the option to **disaggregate insurance finance income or expenses** should (or should not) be applied to IUL contracts as well.
- How any **accounting mismatches** with related financial assets (e.g. debt investments that are held to fund the IUL liabilities) can be addressed using the options in IFRS 17 and IFRS 9.

Applying IFRS 9 to IUL products

The Annex explains that the death benefit of an IUL contract could be below 105% of its account value. This means that, depending on the facts and circumstances, IUL contracts **could be investment contracts** instead of insurance contracts. Investment contracts without discretionary participation features are in the scope of IFRS 9, and IFRS 17 does not apply to them.

In this case, the insurer should consider:

- Whether any index-linked feature is a separable **embedded derivative.**
- What options are available under IFRS 9 to reduce **accounting mismatches** with financial instruments (e.g. derivatives) the insurer uses to achieve its desired risk profile.
- When option-type derivatives are used for risk management, whether **hedge accounting** would help reduce volatility in profit or loss by allowing option premiums to be accounted for under the concept of ‘costs of hedging’.
- Whether any ‘**reinsurance**’ solutions employed would also be in the scope of IFRS 9, rather than IFRS 17, even though those solutions may have the legal form of reinsurance.

2. Derivatives Operations and Controls

Insurers should make strategic assessments of investment and hedging operations, which will drive future financial and operating performance.

Initially, insurers may opt for a **reinsurance solution** to introduce their **first IUL product**. While reinsurance can effectively alleviate the initial burden of setting up hedging operations and the associated accounting requirements, establishing **proprietary hedging operations** with banks as **direct counterparties** can provide insurers with **greater control over future product innovation** and profitability.

When **contemplating whether to set up their own hedging operations**, insurers will need to consider the costs and benefits of such an operation, as well as the operating model suitable to manage the risks associated with the hedging operations. The initial planning and operationalisation considerations are covered in more detail below:

Initial planning

- **Cost-Benefit Analysis:** Weigh the upfront and long-term costs against the benefits of implementing a direct hedging operation.
- **Operational Setup:** Determine how to integrate hedging operations and systems within the insurer's investment and Asset-Liability Management ("**ALM**") functions. IULs would often require an annual **over-the-counter ("OTC")** "call spread" strategy managed for each sales cohort (e.g. monthly). Customised indices (e.g. volatility controlled) could be involved as well.
- **Target Operating Model**: Define the model for trade execution, deciding between in-sourcing or outsourcing these functions.

Operationalisation

- **Pricing Validation:** Develop in-house models to validate the pricing provided by banks for **base valuation** and perform **stress valuation** calculations for Hong Kong Risk-Based Capital ("**HK RBC**"). Understand how **OTC derivatives** are treated in the RBC capital charge.
- **Risk Management:** Assess how to manage the risks associated with derivatives. This includes understanding the types of derivatives used (e.g. options) and **the associated market, credit, and liquidity risks**.
- **Transparency and Reporting:** Consider the transparency of derivatives trading activities and the reporting practices surrounding them**. Clear disclosures** are essential for stakeholders to understand the company's exposure and strategies.
- **Counterparty Credit Risk Management:** Ensure the counterparty risks associated with derivative contracts, including **credit assessments and diversification of counterparties**, is robust.

Over time, insurers should identify and cultivate the necessary capabilities to maintain competitiveness in the market.

3. Modelling and Assumptions

The actuaries and risk managers responsible for IUL product development and management will need to look into a number of specific areas in managing the risks and profitability of IUL products.

Pricing and reserving for IUL will require **new capabilities**, with some insurers able to leverage the models and experience gained from relevant existing products. Below we set out more detailed thoughts on modelling, assumptions and capital requirements for IUL products:

Modelling

To develop efficient process for timely decision making, insurers will also need to consider the following decisions in relation to model development:

- **Conversion approach** of existing UL pricing and reserving models for IUL.
- Opportunities to explore **next-generation asset and liability modelling** for pricing and reserving.
- **Practical simplifications** in the stochastic model based on materiality. For example, the financial impact of full versus simplified modelling on derivatives for hedging, future discretions, and switch in/out from the index fund.

Assumptions

Pricing and reserving for IUL would also require a number of new assumptions:

- **Potential persistency and dis-intermediation** that should be linked to the product proposition – e.g. protection, wealth accumulation, or regular income.
- **Future switching behaviors** between the general account and index account.
- **Asset allocation, target duration, and re-investment risk** for the underlying accumulation components.

Capital requirements and stress testing

Insurers should think beyond HK RBC in testing the variability of IUL shareholder financial outcomes by considering:

- Stresses and scenarios not in HK RBC, such as **equity volatility shocks**.
- **Stressed management actions** under principles of "fair treatment of customers".
- **Analysis of liquidity stress** on different lapse and market scenarios. This needs to include an analysis of the derivatives position (if any).

Insurers will also need to set up appropriate **portfolio monitoring tools and dashboard** in order to manage the experience and subsequent product enhancements.

4. Risk Governance

Insurers will need to review and enhance their risk and governance framework in order to manage IUL product series in a sustainable way.

The risk function will need to work with first line functions to assess the adequacy and suitability of existing risk policies and procedures to cover the **new risks related to IUL**.

To manage the risk relating to IUL prudently, insurers should consider the following aspects of risk and governance processes, and enhance those as appropriate:

Fit for purpose policies

- Whether the current investment policy and derivatives policy can adequately cover the **higher operational requirements of IUL**.

KPIs, KRIs and reporting

- What IUL-specific KPI and KRIs should be introduced for monitoring.
    - **Financial performance** covering both new business and in-force,
    - **Market indicators and competition –** e.g. volatility, interest rate, cap / floor offering,
    - **Hedging effectiveness**,
    - **Capital and liquidity**, and
    - **Behavioral indicators** covering both distribution and policyholders**.**
- Whether the **existing management committees** – e.g. product management, asset and liability, and risk, can adequately cover the IUL-related monitoring and decision making.

Governance

- What update to the **corporate policies** are required to ensure:
    - **Fair treatment of customers** and appropriate **governance on future discretion** made, in line with the expectations from GL16.
    - Proper oversight over **customer communication, benefit illustrations and performance disclosure**.
    - **Responsiveness to pricing changes** – e.g. the extent of price commitment that can be provided versus the accepted level of equity volatility and interest rate risk taking,
    - **Oversight of derivative trading** – e.g. to have a clear structure, including risk committees and policy guidelines, supporting accountability and decision-making.

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