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Panel on Financial Affairs
meeting on 6 July 2009

Background brief on policyholders' protection fund

Purpose

This paper sets out the background and summarizes the views and concerns expressed by members of the Panel on Financial Affairs (FA Panel) on the consultancy study in 2002 and public consultation in 2003-2004 on the feasibility of establishing insurance policyholders' protection funds (PPFs) in Hong Kong.

Background

2. At present, if an insurer becomes insolvent, compensation funds are in place to cover employees compensation¹ and motor vehicle third party claims only². There are no compensation funds/PPFs for life insurance and other types of general (i.e. non-life) insurance if the insurer becomes insolvent. However, the Companies Ordinance (CO) (Cap. 32) and Insurance Companies Ordinance (ICO) (Cap. 41) contain specific provisions for dealing with insolvency of insurers. For insolvent non-life insurers, policyholders have a preferential claim against the remaining assets of the insurer (direct insurance claims have a higher level of preference than reinsurance claims) under CO. These preferences apply to claims, but do not apply to premium refunds. For insolvent life insurers, under ICO, the Court can approve a reduction of the amount of policyholder benefits. Under such circumstances, the policyholders would have no choice but to accept the arrangements sanctioned by the Court. The Court can also approve a transfer of life insurance policies to another insurer.

¹ For employees' compensation insurance, the Employees Compensation Insurer Insolvency Scheme is administered by the Employees Compensation Insurer Insolvency Bureau. The Insolvency Fund is financed by a levy on premiums payable in respect of employees' compensation insurance policies.

² For motor insurance, the Motor Insurers' Bureau of Hong Kong provides compensation to injured victims of traffic accidents where the drivers concerned are uninsured or untraceable, or the insurers concerned are insolvent. The Insolvency Fund is financed by a levy on the motor insurance premiums payable by the policy holders.

3. In order to provide better protection for policyholders and promote general market stability in the event of insurer insolvency, the Office of the Commissioner of Insurance (OCI) commissioned in 2002 a consultancy study on the feasibility of establishing PPFs in Hong Kong. In the ensuing public consultation conducted between December 2003 and April 2004, mixed feedbacks were received from a wide spectrum of stakeholders including insurers, practitioners, consumer advocate groups and professional bodies. While the setting up of PPFs was welcomed as a safety net for policyholders and would boost consumer confidence, many respondents affiliated with the insurance industry were concerned about the potential moral hazards in that PPFs might encourage imprudent operation of insurers and make policyholders less vigilant in selecting their insurers.

4. The consultancy study concluded that the feasibility and success of a PPF scheme would depend heavily on the scope and nature of the scheme as well as the extent of industry and community support. Recommendation was made for the Government to reach a broad understanding with the insurance industry on the need for PPFs and the governing framework. In pursuance of this, OCI had engaged in a close dialogue with industry stakeholders with a view to alleviating their concerns and agreeing on a pragmatic way forward. After discussion, the Hong Kong Federation of Insurers (HKFI) had indicated its agreement in principle to explore the establishment of a contingency plan to protect policyholders against the insolvency of insurers. A task force was set up to consider the main issues identified, including the rationale for establishing PPFs, their mode of operations, and options for scheme design, etc. OCI would work in partnership with HKFI to develop an appropriate framework for introducing PPFs in Hong Kong, taking into account the concerns and issues identified.

Major views expressed by Panel members

5. The Administration briefed the FA Panel on the progress of the consultancy study on 1 March 2004 and 7 July 2008. Members expressed the following views and concerns:

- (a) The need for establishing a PPF should be critically examined, having regard to the benefit of providing protection to policyholders when their insurers became insolvent, vis-à-vis the problem of moral hazards in that a PPF might encourage imprudent operation of insurers and make policyholders less vigilant in selecting their insurers.
- (b) As a PPF would likely be funded by the insurance industry in the form of levies, the impact of such levies on insurance premiums had to be taken into account.
- (c) There was a suggestion that consideration might be given to setting the PPF levies payable by insurers to the risk level of their business undertakings.

- (d) If a PPF was to be established, the related compensatory mechanism and regulatory framework should be backed up by legislation.
- (e) There was concern whether a ceiling should be set for the proposed PPF and if yes, the appropriate level. Concern was also raised about cross-subsidization between policyholders and insurance companies, risk assessment and asset management.

Recent development

6. According to press reports on 15 June 2009, HKFI has recently presented its proposal for establishing PPFs to the Government, which is similar to the deposit protection scheme operated in the banking sector.

7. The Administration has proposed to brief the FA Panel on PPF at the meeting on 6 July 2009.

Relevant papers

8. The relevant papers are available at the following links:-

Administration's paper for the FA Panel meeting on 1 March 2004

<http://www.legco.gov.hk/yr03-04/english/panels/fa/papers/fa0301cb1-1094-6e.pdf>

Minutes of the FA Panel meeting on 1 March 2004 (paragraphs 53 to 65)

<http://www.legco.gov.hk/yr03-04/english/panels/fa/minutes/fa040301.pdf>

Administration's paper for the FA Panel meeting 7 July 2008

<http://www.legco.gov.hk/yr07-08/english/panels/fa/papers/fa0707cb1-2082-2-e.pdf>

Minutes of the FA Panel meeting on 7 July 2008 (paragraphs 34 to 42)

<http://www.legco.gov.hk/yr07-08/english/panels/fa/minutes/fa080707.pdf>