For discussion on
6 July 2009

LEGISLATIVE COUNCIL
PANEL ON FINANCIAL AFFAIRS

Proposed Framework for the Establishment of a Policyholders' Protection Fund in Hong Kong

Purpose

This paper sets out a proposed framework for the establishment of a policyholders' protection fund ("PPF") in Hong Kong and the plan for taking forward the proposal. Members' views are invited.

Background

2. At the meeting of this Panel held on 7 July 2008, Members noted that there were some major issues to be addressed in the course of deliberations on setting up a proposed PPF as identified by the Task Force formed by the Hong Kong Federation of Insurers ("HKFI"). Whilst Members expressed general support for this initiative, they underscored the need for careful thoughts to be given on the level of levies and compensation involved, target fund size as well as measures to mitigate moral hazards. The Administration undertook to report progress on this subject within the 2008-09 legislative session.

Progress Achieved and Conceptual Framework for the Proposed PPF

3. With endorsement in principle given by Members, the Task Force and the Office of the Commissioner of Insurance ("OCI") have worked in close collaboration to develop guiding principles and key parameters that could form the basis of a conceptual framework for the proposed PPF.

Guiding Principles

4. There are three guiding principles in constructing the proposed PPF.

First, a reasonable balance must be struck between the level of levies to be contributed by policyholders and the level of protection to be offered to them. Secondly, the proposed PPF should enhance market stability while minimising the risk of moral hazards. Thirdly, the proposed PPF should provide certainty on the level of compensation payable to different parties when a case of insolvency occurs, and a reliable system should be put in place to facilitate the collection, custody, investment and administration of the levies.

Overseas Benchmarking

5. The Task Force and OCI have drawn reference from similar compensation schemes operating in other jurisdictions, a summary of which is at the **Annex**. While there seems to be no unified approach, a few common features are outlined below -

(a) different levy rates and compensation limits apply to the life and non-life insurance sectors respectively through the operation of a sub-scheme for each of these sectors;

(b) insurers are subject to mandatory requirements to join the compensation scheme and to render assistance in collecting levies from policyholders;

(c) apart from claims arising from compulsory insurance classes which are usually compensated in full, other policies are subject to some form of compensation limits to mitigate moral hazards;

(d) selected policyholders, such as large commercial entities in most cases, are excluded from the compensation scheme; and

(e) levies are typically pitched at 1% - 2% of policy premiums and are allowed to roll forward subject to a target sum.

Key Parameters

6. Taking into account local circumstances and overseas experience, the Task Force and OCI recommend that the key parameters spelt out in paragraphs 7 – 15 be adopted for the proposed PPF.

Structure and Coverage by Types of Policies

7. By their very nature, long term and general insurance bear unique risk profiles and are subject to different regulatory regimes. The Task Force and OCI thus suggest to follow the international trend by establishing separate sub-schemes for these two types of insurance policies under the proposed PPF. Taken together, the sub-schemes should embrace all insurance policies issued in Hong Kong, excluding the two compulsory classes of business already covered by the Insolvency Fund Scheme administered by the Motor Insurance Bureau[1] as well as the Employees Compensation Insurer Insolvency Scheme managed by the Employees Compensation Insurance Insolvency Board.

Coverage by Types of Policyholders

8. It is not an uncommon practice in overseas jurisdictions to exclude corporate policyholders from the compensation schemes, probably because commercial clients are better placed than individual policyholders to withstand the impact of an insurer's failure. In the case of Hong Kong, the Task Force and OCI consider that it is important to design the proposed PPF so that it could meet the aspirations of small and medium enterprises, while preventing the likelihood of corporate policyholders choosing to place their risk offshore to avoid payment of levies. This is an area where the insurance industry will have to conduct more in-depth discussions.

Compensation limits

9. The most common model adopted by overseas jurisdictions is to set both percentage and dollar caps on the level of compensation. In line with prevailing practice, the percentage limit could be pitched at 80% - 100% of claim amount for general business and 85% - 90% of eligible benefits like cash value and accumulated bonus, monthly payout for annuities and/or death benefits for long term business. The level of compensation could be set at 100% for the first $100,000, plus 80% on the remaining balance up to a total compensation of $1 million per policy, i.e. a $1 million worth of policy could have a maximum of $820,000 in compensation.

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[1] The Insolvency Fund is currently limited to payment for third party bodily injuries in respect of motor vehicle insurance and does not cover third-party property damage or own damage of the insured.

10. According to the Task Force and OCI, about 90% of policyholders will be fully covered under this proposed set of compensation limits.

Mode of Funding and Rate of Levy

11. Funding models typically adopted in overseas jurisdictions include pre-funding, post-funding and progressive funding. A pre-funding model offers the greatest certainty with a readily available pool of reserves but has the major drawback of locking up a substantial amount of levies. A post-funding model poses the least financial and administrative burden but could aggravate the strain borne by policyholders during an economic downturn. Both the pre-funding and post-funding models will have to be complemented by borrowing facilities to meet contingency liabilities arising either at a time before the proposed PPF reaches its optimal size for the pre-funding model, or before the collection of levy kicks in for the post-funding model. The progressive funding model represents a mixture of the two above-mentioned models and normally features an initial moderate levy rate complemented by a stepped-up levy rate upon occurrence of insolvency.

12. On balance, the Task Force and OCI consider that a progressive funding model is more appropriate for Hong Kong. It provides an upfront reserve to meet at least part of future commitments while preserving the flexibility to raise further levies to meet actual needs. On this basis, a possible option would be to impose a levy rate of 0.5% - 1% of annual premiums during the start-up of the proposed PPF, and to increase the levy rate to, say, 2% - 3% when the need to pay compensation from the proposed PPF is triggered by a prescribed event.

13. As in the case of pre-funding and post-funding models, an effective means has to be devised to bridge any funding gap caused by a major case of insolvency occurring before the proposed PPF reaches its target size.

Legislative Backing and Governance Arrangements

14. From a technical perspective, the proposed PPF could operate either on an administrative basis or with full legislative backing. At present, operation of the two compensation schemes set up to cater for third party motor vehicle and employees' compensation insurance respectively is governed by agreements

entered into between the Government and industry bodies[2]. On the other hand, similar schemes catering for the securities and banking sectors are prescribed by legislation stipulating the objectives and payment criteria, levy rates and contributions, as well as contingency arrangements to meet any shortfall of accumulated reserves to meet outstanding claims.

15. Since the proposed PPF is an initiative that affects a wide segment of the population in Hong Kong, and in order to provide a feasible basis for levies to apply on in-force policies and to ensure clarity, transparency and accountability, the Task Force considers that the proposed PPF should be established by legislation. A detailed governance structure will be mapped out when a detailed proposal is drawn up for the PPF.

Consultations Conducted

16. The member companies of HKFI are in support of the guiding principles and key parameters outlined above. The Insurance Advisory Committee[3] also endorsed the same at its meeting held on 8 June 2009.

Advice Sought and Next Steps

17. Members are invited to offer their comments on the guiding principles and key parameters of the proposed PPF outlined in paragraphs 4 - 15 above.

18. To take this matter forward, the Government will commission an actuarial consultancy study to assess the optimal levy rate, target fund size and detailed arrangements for the proposed PPF. We aim to complete the tendering procedures within this year so as to commence the study in early-2010 and put forward detailed proposals for the proposed PPF to this Panel within the next legislative session. Meanwhile, we will engage relevant stakeholder groups, including the Consumer Council and political organizations, to solicit their views on the broad approach taken and proceed in parallel to formulate detailed governance arrangements for the proposed PPF to facilitate legislative drafting.

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[2] Both schemes are funded by contributions from insurers engaged in the respective business at a rate calculated as a percentage of policy premiums.

[3] The Insurance Advisory Committee is established under section 54 of the Insurance Companies Ordinance ("ICO"). Its function is to advise the Chief Executive on matters relating to the administration of the ICO and the carrying on of insurance business in Hong Kong.

Financial Services and the Treasury Bureau/
Office of the Commissioner of Insurance
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Summary of Policyholders' Protection Funds in Selected Jurisdictions

Jurisdiction / Features	Canada	Japan	Singapore*	United Kingdom
Funding Basis	Progressive funding	Pre-funding	Post-funding	Progressive funding
Scope of Coverage	*Life Insurance* • All life insurance held by Canadian citizens or residents *Non-Life Insurance* • Most property and casualty policies	*Life Insurance* • All policies *Non-Life Insurance* • All auto and health policies as well as fire and hull policies taken out by individuals and SMEs.	*Life Insurance* • All Singapore policies or offshore policies not being contracts of reinsurance *Non-Life Insurance* • Compulsory policies – this refers to any policy which satisfies the requirements of the Motor Vehicles (Third-Party Risks and Compensation) Act or the Work Injury Compensation Act.	• Private individuals and small business.
Levy Mechanism	*Life insurance* • Pre-funded: special levies raised on insurers during period 1998-2000. • Post-funded: up to 1.33% of solvency capital required. *Non-life insurance* • Pre-funded: 0.5% of gross direct premiums written per	*Life insurance* • Annual levy based on a percentage of the premiums and reserves, with total fund size capped at ￥460 billion. *Non-life insurance* • Annual levy fixed at ￥5 billion, to be shared among insurers according to their	*Life insurance* • Limit to 1% of total annual income of the insurer for the previous financial year. *Non-life insurance* • Limit to 1% of total annual income of the insurer for the previous financial year.	• Split into five classes (deposits, life and pensions, general insurance, investments, home finance) with different levy rates fixed annually and subject to annual levy limits.

* Resulting from a public consultation exercise in December 2005. this framework will be revised when the Singapore Insurance Act is next amended to extend coverage to all accident & health policies and selected policies (e.g. personal motor, personal property and foreign domestic worker policies) as well as to set up a pre-funded PPF by imposing risk-based levies on insurers subject to certain prescribed limits.

Jurisdiction / Features	Canada	Japan	Singapore*	United Kingdom
	annum. • Post-funded: up to a cap of 0.75% of annual gross direct premiums written.	premiums and reserves, with total fund size capped at ￥50 billion .		
Compensation Limits	*Life insurance* A guarantee of at least 85% of insured benefits or the following limits: • Death benefits of CAD200,000 • Cash value and accumulated bonus of CAD60,000 • Health expense of CAD60,000 • Monthly income of CAD2,000 *Non-life insurance* • CAD250,000 • 70% of unearned premiums capped at CAD700 per policy.	*Life insurance* • 90% for all policies *Non-life insurance* • 90% for personal accident, medical and nursing care policies • 100% for compulsory motor and earthquake policies • 100% for claims of other classes for three months and 80% thereafter and for surrender value.	*Life insurance* • 90% for all policies *General Insurance* • 100% for compulsory motor third party bodily injury as well as workmen's compensation policies.	Compensation limits for: • *Long-term insurance* 100% for the first £2,000 plus 90% for rest of the remaining claim. • *General insurance* 100% for compulsory policies and 100% for the first £2,000 plus 90% for rest of the remaining claim in respect of other policies.