

For discussion on  
19 July 2010

## **Legislative Council Panel on Financial Affairs**

### **Proposed Establishment of an Independent Insurance Authority**

#### **Purpose**

This paper sets out the Administration's proposals for the establishment of an independent Insurance Authority ("IA"), including its governance, organisation, functions, powers and funding mechanism. We have commenced a three-month public consultation exercise from 12 July 2010 to collect views from the insurance industry and the general public on the proposals. Members are invited to offer their comments on the proposals for the establishment of an IA.

#### **Background**

2. Unlike other financial services regulators in Hong Kong and in other international financial centres, the Commissioner of Insurance, who is the Insurance Authority ("IA") responsible for the regulation of the insurance industry under the Insurance Companies Ordinance ("ICO"), is a civil servant and the Office of the Commissioner of Insurance ("OCI") is a government department under the Financial Services and the Treasury Bureau. This is not in line with international practices where regulators in the financial sector are independent, both financially and operationally, of the Government, nor is this in keeping with the core principles stipulated by the International Association of Insurance Supervisors. In addition, the OCI, being a government department that is subject to governmental rules and procedures, lacks the flexibility in resource deployment and ability to recruit and retain expertise to respond quickly to rapid changes and new challenges in the financial sector.

3. The International Monetary Fund ("IMF") has in 2003 highlighted this as the major deficiency in Hong Kong's financial regulatory infrastructure. In response to the IMF Report, the Financial Secretary stated in his 2003-04 Budget Speech that consideration was given to setting up an

IIA outside the Government. The Chief Executive also stated in his 2008-09 Policy Address that the Administration would prepare proposals on the setting up of the IIA for consultation.

4. A consultant was appointed in 2007 to formulate proposals covering the governance structure, organisation, funding and budgetary system of the IIA. The study was then based on the assumption that there would be no change to the statutory functions and powers of the OCI as reported and noted at the meeting of the LegCo Panel on Financial Affairs on 6 November 2003.

5. The study was largely completed in mid-2009. In the light of the global financial crisis in late 2008/early 2009, we commissioned an extended study in October 2009 which was necessary to examine whether the present insurance regulatory regime, particularly regarding the regulation of insurers and insurance intermediaries, should be strengthened. The Consultant has recently finalized his findings and recommendations on the extended study and our proposals having regard to the study results are set out in the following paragraphs. The detailed proposals are set out in the consultation document enclosed.

## **Proposals**

### Objectives

6. To align with international practices, we propose the establishment of an IIA to maintain the stability of the insurance industry and protect the interests of existing and potential policyholders. The IIA shall also seek to strike a reasonable balance between regulation and market development, and enhance the competitiveness of the insurance industry. It shall perform its regulatory functions on a par with international standards and having regard to local circumstances, without stifling market innovation necessary for promoting market efficiency and diversity.

### Corporate Governance

7. We propose that the IIA should be a statutory body with its functions and powers set out in legislation. The Chief Executive Officer of the IIA would be appointed by the Government. He would be accountable to a governing board in performing the statutory functions and exercising

regulatory powers of the IIA. The governing board would oversee IIA's work, and its Chairman and members would be appointed by the Government. The board would be underpinned by five committees (Audit, Finance, Remuneration, Management and Advisory).

### Organisation

8. Currently, OCI has an establishment of 123, comprising 95 professional (accountants, actuaries) and managerial staff, as well as 28 support staff. Based on consultant's assessment, we propose that the IIA should initially have a workforce of 237 staff, comprising 187 professionals (actuaries, accountants, lawyers etc) and managerial staff, and 50 supporting staff. The proposed organisation structure is at the **Annex**. This represents an increase of 93% over OCI's existing establishment. This magnitude of increase is necessary, primarily to enable the IIA to perform its new role and functions as set out in paragraphs 14 to 20 below.

### Annex

### Recruitment and Remuneration

9. We propose that the IIA should recruit its staff from the open market. To enable the IIA to attract, retain and motivate people with the right skills, calibre and experience, the Consultant recommends a market-driven approach in setting the remuneration package. This would include a "base pay" benchmarked against similar jobs in the local market and an "incentive pay" for staff that exceed the performance requirements. The base pay should be reviewed annually, whilst the incentive pay should be given to no more than 50% of staff in a given year to create a real incentive for people to excel in performance.

### Funding Mechanism

10. Currently, OCI recovers some 37% of its operating costs of around \$110 million per annum from annual licence fees<sup>1</sup> paid by insurers. The fees have remained unchanged since 1996.

11. Based on the proposed staffing level mentioned in paragraph 8 above, the IIA's annual operating cost would be around \$240 million. We propose that the full cost should be recovered from the insurance industry and the market over time. We propose to have a new fee structure comprising –

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<sup>1</sup> The annual fees are HK\$227,300 each for general or long-term insurers and HK\$22,600 each for captive insurers.

- (a) fixed licence fees payable by all insurers and intermediaries;
- (b) a variable licence fee payable by insurers only and calculated on the basis of their individual liabilities;
- (c) user fees for specific services such as application for transfer of business, change of shareholding structure or change in key personnel; and
- (d) a levy of 0.1% on insurance premiums to be introduced for all insurance policies.

The eventual target is to have about 70% of the expenditure of the IIA met by the levy and the remaining 30% by the various licence and user fees.

12. To reduce the impact on the insurance industry and policyholders, we propose to pursue the following mitigating measures in the initial five years after the establishment of the IIA –

- (a) the licence fee for insurance intermediaries be waived (if they are to be licensed directly by the IIA as proposed); and
- (b) an incremental approach be adopted in achieving the target levels of variable licence fee on insurers and levy on insurance policies.

13. Before achieving full cost recovery in the sixth year of the IIA's operation, we propose that the Government should provide a lump sum of \$500 million to the IIA on its inception –

- (a) to help meet part of its expenses in the initial five years before the target levels of variable licence fee and levy are achieved; and
- (b) as contingency reserve in the event of poor market conditions which would lead to low levy income.

### *New Role and Functions*

#### *(A) Regulation of Insurers*

14. There are 170 authorised insurers in Hong Kong. The IA regulates them through examination of their financial statements and business

returns, as well as on-site inspections. Under the ICO, the IA can impose intervention measures on insurers, such as restricting their underwriting and investing activities, removing their directors /controllers, taking over the company, and petitioning to the Court for winding up etc. However, unlike other overseas and local regulators, IA does not have explicit powers to enter into the premises of insurers to conduct inspections and investigations, issue reprimands, impose fines or prosecute offences summarily.

15. Although the existing regime has worked well in the past decades, rapid changes in the international financial market, particularly during the global financial crisis in 2008, have highlighted the need to enhance IA's regulatory powers in order to better regulate the insurance industry and safeguard the interests of policyholders. The Consultant recommends giving express powers to the IIA to initiate investigations, search and seize materials upon warrant, prosecute offences summarily, share information with overseas regulators and impose supervisory sanctions such as reprimands and fines, etc.

#### *(B) Regulation of Insurance Intermediaries*

16. Currently, there are 68,500 insurance intermediaries<sup>2</sup> in Hong Kong. They are regulated by three self-regulatory organisations ("SROs")<sup>3</sup>. While the IA has certain powers over these SROs, such as instructing them to issue and amend codes of practices and requiring them to produce information, she does not regulate the intermediaries direct. The SROs handle complaints against individual intermediaries, and conduct investigations and impose disciplinary sanctions as appropriate.

17. Such a regime is far from satisfactory. First, there is conflict of interests, both perceived and real, as the SROs are also trade bodies financed by their respective members. Secondly, there are inconsistencies among the three SROs in regard to their complaints handling mechanism, disciplinary procedures, and severity of sanctions. Moreover, a self-regulatory regime is not in line with international practices in the insurance sector where

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<sup>2</sup> The breakdown of insurance intermediaries as at end April 2010 is -  
(a) 31,997 are appointed individual insurance agents;  
(b) 2,352 are appointed agency companies and 25,955 are responsible officers/technical representatives of appointed agency companies; and  
(c) 569 are authorised brokers and 7,696 are chief executives/technical representatives of authorised brokers.

<sup>3</sup> The 3 SROs are the Insurance Agents Registration Board under the Hong Kong Federation of Insurers, the Confederation of Insurance Brokers and the Professional Insurance Brokers Association.

intermediaries are mostly subject to direct oversight by the independent regulator<sup>4</sup>.

18. We believe that the proposed IIA should be responsible for the licensing and regulation of insurance intermediaries, and take over the investigation and disciplinary functions from the three SROs. The SROs could continue to perform trade body functions like industry promotion, organisation of training courses, and setting best practices, etc.

*(C) Conduct of Intermediaries Selling Insurance Products in Banks*

19. Of the insurance intermediaries, about 18,000 are bank employees. They are registered with the Insurance Agents Registration Board (“IARB”) for engaging in the sale of insurance products in banks. The IARB monitors their compliance with conduct requirements and handles complaints referred by the Hong Kong Monetary Authority (“HKMA”) via OCI. HKMA does not have direct power to discipline those bank employees.

20. Following from our proposal of IIA’s taking over the regulation of insurance intermediaries, the proposed IIA should be the primary regulator for the sale of insurance products. Taking into account the client profile of banks as well as the sale environment in banks which is different from that of other insurance intermediaries, we consider that there are merits to vest in the HKMA powers similar to those for the IIA to enable HKMA to conduct proper regulation of bank employees selling insurance products. This would allow HKMA to impose specific conduct requirements additional to those set by IIA, in order to cater for the specific circumstances in banks.

*Checks and Balances*

21. A system would be put in place to provide adequate checks and balances to ensure proper exercise of powers by the IIA. In addition to the corporate governance arrangements set out in paragraph 7, the IIA would be required to submit its annual report to the Legislative Council (“LegCo”); its annual budget would be subject to the approval of the Financial Secretary; an independent appeals tribunal would be established to handle appeals from insurers and intermediaries against the IIA’s relevant decisions; and an independent Process Review Panel would be established by the Chief Executive to review internal operating procedures, including those for

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<sup>4</sup> In the UK, Singapore and Australia, the regulation of insurance intermediaries is done by the insurance regulator.

ensuring consistency and fairness<sup>5</sup>.

### **Next Steps**

22. The public consultation exercise will last until 11 October 2010. We will take into account Members' comments and public views received in the consultation exercise when preparing detailed legislative proposals for the establishment of an IIA. We aim to introduce a bill into LegCo in 2011.

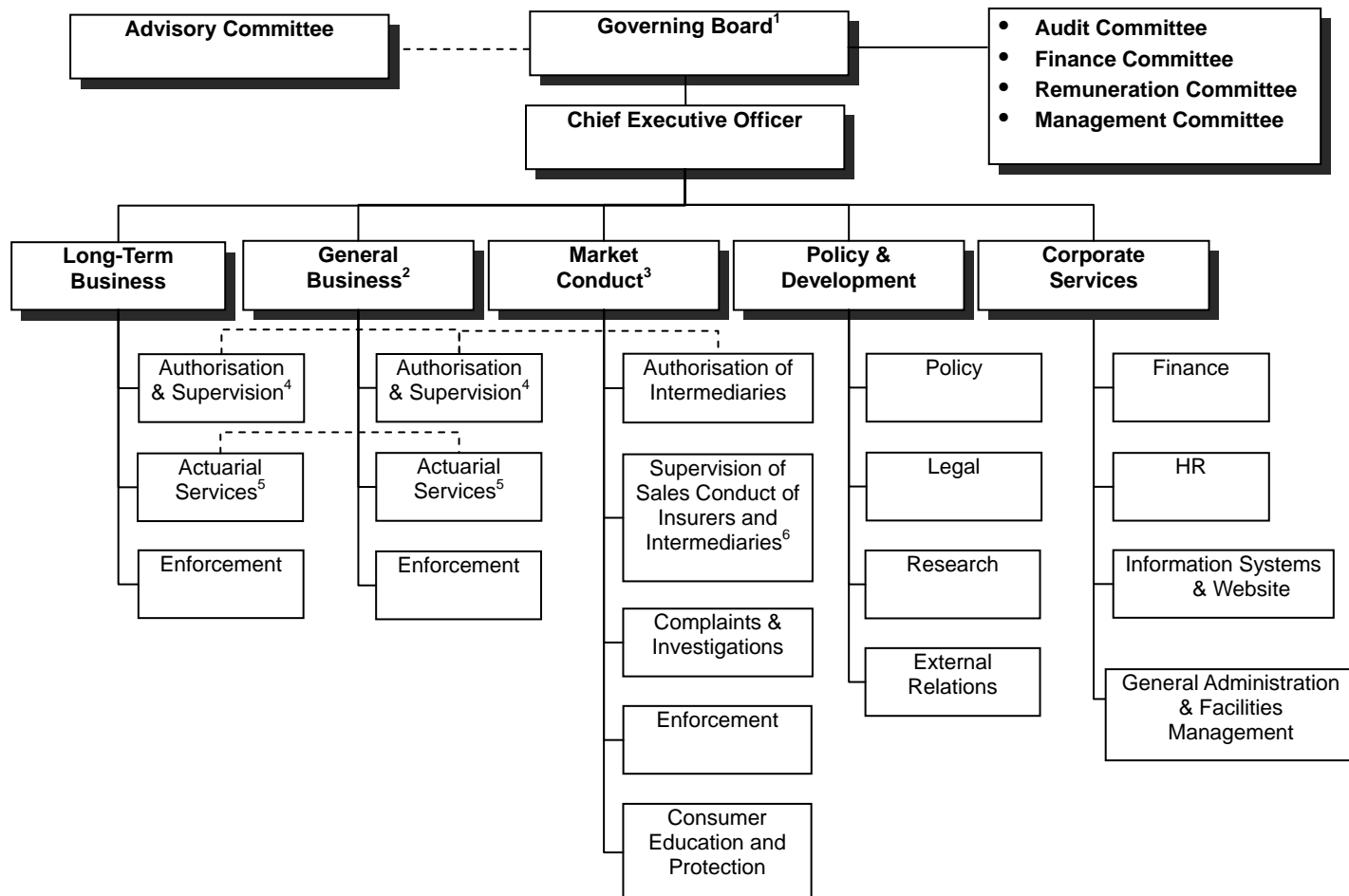
23. In pursuance of this major initiative, we propose that a supernumerary team be created in the Financial Services Branch for a period of three years to take forward the preparatory and legislative work required for the proposed establishment of an IIA. We will seek approval for the proposed additional staffing support in accordance with established procedures.

Financial Services and the Treasury Bureau  
Office of the Commissioner of Insurance  
July 2010

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<sup>5</sup> The proposed independent appeals tribunal and the Process Review Panel would apply to decisions made and procedures adopted by HKMA in respect of its supervision of banks' insurance sale business.

### Proposed Organisation Structure of the Independent Insurance Authority



Notes

- (1) Governing Board comprises predominantly non-executive directors selected from a cross-section of the community including relevant professional fields, the Consumer Council, the academia and Government; a Chairman appointed from amongst them and the Chief Executive Officer of the independent IA.
- (2) Might include the operation of the current Government Terrorism Facility in relation to employees’ compensation insurance.
- (3) Supervision of market conduct of insurers (Long-Term Business and General Business) and insurance intermediaries.
- (4) The dotted-line denotes that one of the team leaders will take on an additional role of overseeing the continuous professional development needs of the Authorisation & Supervision staff across the independent IA.
- (5) The dotted-line denotes that one of the team leaders will take on an additional role of overseeing the continuous professional development needs of the Actuarial Services staff across the independent IA.
- (6) Includes the implementation of the Insurance Intermediaries Quality Assurance Scheme.