

**Hong Kong Chamber of Insurance Intermediaries  
Position Paper  
Objections to the Proposed Establishment of An Independent Insurance Authority**

	Key Points	Rationale	Suggestions
1	It is a piece-meal proposal and is developed on a trial and error basis. It does not support the long-term sustainable development of the regulatory system of Hong Kong.	<p>The proposal does not provide a holistic view of the overall future regulatory system in Hong Kong and its long-term sustainable development. There are also no specific details of the future structure, rules and regulations of the proposed independent IA.</p> <p>The proposal is suffering from the repeated drawbacks of lacking an integrated design, similar to the condition pointed out by the Asian Institute of International Financial Law (established by the Faculty of Law of The University of Hong Kong) in 2009.</p> <p><a href="http://law.lexisnexis.com/webcenters/hk/Hong-Kong-Lawyer-/The-Global-Credit-Crisis-Implications-for-Financial-Regulation-in-Hong-Kong">http://law.lexisnexis.com/webcenters/hk/Hong-Kong-Lawyer-/The-Global-Credit-Crisis-Implications-for-Financial-Regulation-in-Hong-Kong</a></p> <p><i>“Hong Kong’s regulatory system lacks an integrated, purposive design, which has resulted in gaps and overlaps shown in clear relief by the fallout from the global credit crisis.” …… “the existing system in Hong Kong, developed largely through trial and error and resulting in a confusing matrix of sectoral laws and agencies with many gaps and inconsistencies.”</i></p>	<p>The current system needs improvement but does not require a drastic change without a holistic and integrated planning of the future regulatory system.</p> <p>Following are the recommendations:</p> <ol style="list-style-type: none"> <li>1) Provide a holistic view of the long-term sustainable development of the regulatory system of Hong Kong in respect of banking, securities and insurance;</li> <li>2) Make improvement in the current system instead of rebuilding a new system of independent IA. This approach does not have the downside of drastic change. Besides, it is more secure, efficient and effective.</li> </ol>
2	The proposal lacks transparency. The details	There are no details of IA’s selection criteria for the consultant “PricewaterhouseCoopers”, and the	Following are the recommendations:

	and methodology of the study of the consultant's report have not been disclosed.	methodology of their study. There is a general belief that IA has offered quite a number of their consultancy jobs to the same consultant in the past and this consultant was appointed to suggest a proposal on independency of IA after the Chief Executive has explicitly announced a clear intention to make IA independent and therefore the consultant's recommendation is biased and skewed in favor of our Chief Executive.	<ol style="list-style-type: none"> <li>1) Provide the full reports submitted by the consultant;</li> <li>2) Provide the selection criteria and name of other candidates;</li> <li>3) Provide full details of the briefing and instruction provided to the consultant before the commencement of their consultancy study.</li> </ol>
3	The proposal provides false and misleading information.	<i>e.g (Page 18 - 5.6) "there are two broker SROs, and the competition for membership may lead to perception that there is inclination towards more leniency in disciplinary matters."</i> This kind of statement can only be made by a layman of the Insurance Industry. In reality, most brokers are aware that both SROs have been continuously tightening their control and supervision. It would be more appropriate to say that broker SROs are competing to tighten their supervisory and regulatory control. We have been observing that there are a lot of similar false accusations proliferated in the proposal to mislead the general public.	<p>Following are the recommendations:</p> <ol style="list-style-type: none"> <li>1) The consultant should be familiar with the insurance industry;</li> <li>2) The consultant should make clear and objective statements.</li> </ol>
4	The quality of the proposal is fiction-like and story-telling without substance.	<i>e.g.(Page 22- 6.3) "indeed, insurance regulators in most developed markets such as the UK, Australia and Singapore are already independent entities."</i> It has been becoming a big question among the insurance industry that why a table of the G-20 or G-30 can't be prepared to reveal the	<p>Following are the recommendations:</p> <ol style="list-style-type: none"> <li>1) Provide a comparative and competitive analysis of G-20 or G-30 and also the</li> </ol>

		<p>independency of different countries. Why the situation of U.S.A is not highlighted?</p> <p>There are many examples of story-telling phenomenon without substance found in the proposal such as (Page 18 - 5.6) <i>“in other major international financial centers, intermediaries are regulated directly by a regulator independent of the trade.”</i></p>	<p>adjacent countries;</p> <ol style="list-style-type: none"> <li>2) Provide details of the situation in U.S.A;</li> <li>3) Provide current ranking of HK among these countries.</li> </ol>
5	<p>The focus of the proposal is trendy but not IA's core function of prudential and conduct of business regulation</p>	<p>It looks like that it is a trendy move towards independency. However, this is not a compelling reason to make the IA of Hong Kong independent, as there are country-specific differences. Hong Kong should adopt the appropriate recommendation according to its own historical evolution, financial system, political structure and tradition, and the size of the financial sector. According to the study of Bauhinia Foundation Research Centre, <a href="http://www.bauhinia.org/ESA-Bauhinia-Part2-Report.pdf">http://www.bauhinia.org/ESA-Bauhinia-Part2-Report.pdf</a> the competitiveness of Hong Kong Financial Services Industry depends on many factors such as low tax regime, strong rule of law, cleanliness of government, no exchange controls, no restrictions on capital flow, geographical location, local management skills, etc. However, trendy does not matter.</p> <p>There is a general belief that some international organizations such as IMF or IAIS wish to engage the regulatory system of China through HKSAR. This phenomenon is particularly obvious in the</p>	<p>Following are the recommendations:</p> <ol style="list-style-type: none"> <li>1) Provide details of the consequence of not in keeping with international insurance supervisory principles stipulated by the International Association of Insurance Supervisors, e.g. its effect on credit rating, membership, jurisdiction sanction;</li> <li>2) Focus on the competitive, regulatory and supervisory factors instead of just a trendy desire in keeping with international insurance supervisory principles;</li> <li>3) Strengthen the activities and the core function of prudential and conduct of business regulation;</li> </ol>

		<p>interference of China's currency.</p> <p><i>Remarks: Occasionally, some government officials advised us that some regulators of China such as China Insurance Regulatory Commission (CIRC) would request tuition classes from HKSAR before they were interviewed by the international organizations such as IMF or IAIS.</i></p> <p>What have made the difference should be that there are still more critiques against the "independent" HKMA and SFC than that of the "dependent" IA after the financial tsunami. It seems that the root of the evil is the inadequate level of supervision being exercised but not the rules and regulatory framework.</p>	<p>4) Exercise adequate level of supervision.</p>
6	<p>The proposal misleads the consumer that the proposed regulation system is a kind of free good.</p>	<p>Most customers will perceive the levy of 0.1% on insurance premium has no direct bearing on them. In fact, it mainly affects the operating cost of the insurers and insurance intermediaries. Thus, the proposal has created a perception to customers that the proposed regulatory regime is a kind of free good. There is almost an inherent tendency towards over-regulation because regulatory and supervisory services are not provided through a market process but are imposed by the regulators. In this case customers will rationally perceive the proposed regulation is a kind of free good and hence will over-demand it. Coupled with a risk-averse regulator, it is almost inevitable that over-regulation will emerge and there will be over-supply of regulation. This will create an independent IA</p>	<p>Following is the recommendation:</p> <p>1) Give up the levy system, as it will affect the operating cost of insurers and insurance intermediaries.</p>

		without competitive advantages and operational efficiency.	
7	The levy system will weaken the operational efficiency and competitiveness of the insurance industry.	<p>A. Some customers, insurance intermediaries, or regional office of insurers will avoid paying large amount of levies on high premiums policies by arranging their insurance overseas (<i>This type of business may account for 20% of the overall premium</i>);  Examples:  <ul style="list-style-type: none"> <li>• Large local projects,</li> <li>• Umbrella policies of multi-international customers,</li> <li>• Reinsurance policies arranged by regional office of insurers,</li> <li>• Single premium policies for high net worth customers</li> </ul> </p> <p>B. There are also many low premium policies such as travel, domestic helper, home, cargo, basic life protection etc. The calculation and processing of numerous trivial amounts of levies on these low premium policies will be very cumbersome which will affect the overall operational efficiency of the insurance industry. (<i>This type of business may account for 80% of the total number of policies</i>).</p>	<p>Following is the recommendation:</p> <ol style="list-style-type: none"> <li>1) Give up the levy system, as it will affect the competitiveness and operational efficiency of the industry;</li> <li>2) Provide detail of levy system using by other countries.</li> </ol>
8	The proposal does not support the stability of insurance industry	The stability and efficiency of a regulatory system has both supply-side and demand-side effects on the economy. The value-chain involves insurance intermediaries as well. Obviously, there has not been adequate consultation on the supply-side	<p>Following is the recommendation:</p> <ol style="list-style-type: none"> <li>1) The supply-side should be consulted thoroughly and</li> </ol>

		especially the insurance intermediaries before the release of the proposal.	properly.
9	The proposed regulatory structure is considered as fragmented and convoluted	<p><i>(Page 21-5.14)</i> There has been a lot of teasing and criticism on the conspiracy between proposed HKMA and IA relationship regarding the supervision of the sale of insurance products in banks. The proposed regulatory structure is extremely confusing as IA is sparing its rod. HKMA looks like claiming to use its moss punishment is in fact a subject of the risk of regulatory capture (please refer to attachment for meaning of regulatory capture).</p> <p>Many insurance products sales in bank often take place in a high-pressure environment. The client might have walked into a bank to make a time deposit and walked out with an investment linked insurance product, never having had time to properly read or understand the product leaflet and the prospectus.</p> <p>There is a segregation of the banking activities and securities activities at the point-of-sale of the banks but not the investment linked insurance activities.</p>	<p>Following are the recommendations:</p> <ol style="list-style-type: none"> <li>1) IA should directly supervise the sale of insurance products in bank;</li> <li>2) There should also be a segregation of the banking activities and investment linked insurance activities at the point-of-sale of the bank.</li> </ol>
10	Scary incentive system	<p><i>(Page 24-6.8)</i> The proposal does not provide details of the incentive pay. However it is a scary proposal to those insurance practitioners who relate this remuneration as a kind of incentive pay to policemen to encourage them over-aggressively to catch those misbehavers.</p>	<p>Following is the recommendation:</p> <ol style="list-style-type: none"> <li>1) This type of incentive scheme should be avoided.</li> </ol>

11	Why Option 1 ( <i>enhance supervision by independent IA under a strengthen SRO system</i> ) is not considered?	<i>(Page 19-5.11)</i> SROs exist in many professions, such as accounting, legal, and medical practitioners. The current system is effective and efficient enough and there is no reason to select Option 2. Should Option 2 is selected, there is danger that expertise, collective experience can be lost forever when changes are made.	Following are the recommendation:  <ol style="list-style-type: none"> <li>1) IA should strengthen their oversights on SROs;</li> <li>2) The three SROs should be combined into one;</li> <li>3) The disciplinary actions of SROs should be made transparent;</li> <li>4) The rules, regulation, procedures, and mandates of the SROs should be concurred by IA;</li> <li>5) The board of directors especially those independent directors should be appointed with the consent of the IA;</li> <li>6) SROs should try to share / benchmark their experience / performance with SROs in other countries such as Registered Insurance Brokers of Ontario  <a href="http://www.ribo.com/">http://www.ribo.com/</a></li> </ol>
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Patrick Ho – President  
Hong Kong Chamber of Insurance Intermediaries  
30 September 2010

## 監管俘獲

獨立後的監管機構，在政治上的考慮較為自由。獨立的監管機構，將受到受監理之業界機構極大影響。更甚者，受監理之機構會“捕捉”監管機構，進而利用監管機構之職權，追求私人機構之利益。其結果，獨立的監管機構，勢將逐漸為受監理之機構所掌握，監理之內容與規劃亦將優先考慮受監理機構之利益。

<http://kelty.org/epit/documents/dan/Dan-Comment-EK3.doc>

### Regulatory Capture: Ebru Kayaalp

What does regulatory capture mean?<sup>1</sup> In the *Economist*, it is defined as such:

“Gamekeeper turns poacher or, at least, helps poacher. The theory of regulatory capture was set out by Richard Posner, an economist and lawyer at the University of Chicago, who argued that “Regulation is not about the public interest at all, but is a process, by which interest groups seek to promote their private interest ... Over time, regulatory agencies come to be dominated by the industries regulated.” Most economists are less extreme, arguing that regulation often does good but is always at RISK of being captured by the regulated firms.”

Richard Posner’s approach to regulation exactly echoes Chicago School’s traditional attitude to market economy. The Chicago School of Economics became famous with the theories of Milton Friedman, who had been influenced by the ideas of Hayek. Friedman and his colleagues in Chicago support the deregulation of market, free trade and retreat of state intervention. It was an assault on the macroeconomic assumptions of Keynes, which ended up as a thoroughgoing critique of antitrust law, administrative regulation, tax policy, trade and monetary theory. In brief, they support the theory of a competitive market as a regulatory system. Elsewhere Posner wrote that “The evils of natural monopoly are exaggerated, the effectiveness of regulation in controlling them is highly questionable, and regulation costs a great deal.”<sup>2</sup>

According to the Chicago School of Economics, governments do not accidentally create monopoly in industries. Rather, they too often regulate at the insistence, and for the benefit of interest groups who turn regulation to their own ends. For them administrative regulation serves the regulated entities rather than the consumers.

We can simply define ‘regulatory capture’ as the capture of ‘regulators’ by the regulated<sup>3</sup>. ‘Capture’ means that responsible authorities act to protect the same illegal practices that they are charged with ‘policing’. ‘Regulator’ is the class of professionals and authorities within corporations, organizations or jurisdictions having formal administrative and legislative responsibilities for maintaining accountability within those units. Examples of the ‘regulator’ class might include auditors and accountants, lawyers and police, medical practitioners and nurses, government and private industry ‘watchdog’ authorities, researchers and scientists. The ‘captors’ are supposed to be ‘regulated’. They might include major industries, important customers, large corporations, political associations, professional elites, community leaders, and organizations.

There are many examples of ‘regulatory capture’ in different sectors, such as medicine and banking. An example might be given in e-voting system as well: As the *Los Angeles Times* reported on Nov. 10, former California Secretary of State Bill Jones is now a paid consultant to Sequoia. As secretary of state until 2003, he regulated the company's voting related services; now he works for them. Or

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<sup>1</sup> My aim here is not to map out the genealogy of the concept “regulatory capture.” However, I think that it is necessary to cite some of the basic usages of this concept to shed light on how Wallach uses it in a different meaning as it has been originally used in economics and law.

<sup>2</sup> One of his law students tells the story of Posner, as a part-time professor at the University of Chicago Law School, coming into the first day of class and writing the word “Justice” on the blackboard. He then turned and said to his class that he did not want to hear that word in his course. Posner's approach is not a deliberative, but a cost-benefit analysis of law. This information is taken from Ralph Nader’s article “Microsoft Mediation,” *In the Public Interest*, November 22, 1999.

<sup>3</sup> This definition is taken from the article “Regulatory Capture: Causes and Effects”, by G.McMahon at [www.iipe.org/conference2002/papers/McMahon.pdf](http://www.iipe.org/conference2002/papers/McMahon.pdf)

Diebold employs Deborah Seiler, who was chief of elections under California Secretary of State March Fong Eu<sup>4</sup>.

In the interview, Dan Wallach first uses the concept “regulatory capture” while arguing that check and balances should come from the independent testing authorities. He then carries the argument to a different level. He suggests that people (regulators) are setting their own standards and defining their own terms. The standards they have are weak standards. “The people who certify them don’t *know* what they are doing.” “Election officials don’t understand computer security, they don’t understand computer security, they don’t understand computers. They don’t *know* what computer *is*” (emphases are mine) (1727-34). Therefore, he shifts his criticism from “independent testing” to “expertise testing”. In other words, he criticizes the lack of knowledge of officials about the computers rather than the “objective”, “independent” or “self-interest” oriented testing.

If the problem here is defined in terms of “regulatory capture”, it should not matter whether the officials have adequate knowledge about computer or not. Even if they know *everything* about the computers, they can still manipulate this knowledge simply for their interests. And it would be easier if they know more about computers, which simply gives them power to manipulate the others.

Interestingly while Wallach was explaining the case of Avi Rubin (who was on a technical advisory board and who was claimed to have a potential conflict of interest in his criticism of Diebold,) Wallach simply supports him by suggesting that Rubin “had no financial benefit (2104)”. Wallach never mentions the concept of “regulatory capture” in this case. Instead, he says that “We hear a lot that [we have a conflict of interest]. What we don’t hear is how many of these election officials were given campaign donations by members of the election industry, like Diebold (2109-10).” I believe that Wallach’s attitude cannot be simply explained as a contradiction. It signifies more than that.

First of all there is no normative situation in his description. His argument depends mainly on the motivations of the actors. When he uses terms such as ‘independent test’, ‘conflict of interest’, ‘self-interest’, he does not mention the concept of ‘regulatory capture.’ For Wallach these concepts (self-interest and regulatory capture) refer to different problems. For example, just being in the advisory board of a company is not necessarily bad if the guy is a “good guy.” Wallach appears to be much more focused on the knowledge of people in defining “regulatory capture.”

Second, Wallach’s explanation of “regulatory capture” diverges from the original meaning of concept radically. There is nothing wrong with it, but it is necessary to note that when his usage of the word is deconstructed it raises an interesting point about regulation. As I mentioned before, his understanding of the concept is more about not *knowing* the computers. Therefore, what he proposes is to leave this task to the *experts* in this area. Therefore, what he criticizes is not the attempt of *regulation* itself (as Chicago School criticizes) or the “self-interested” motivations of actors (he criticizes this in a different context) but the regulations done by *non-experts*. Nevertheless, regulation of the experts, as I mentioned before, might be corrupt and be defined as “regulatory capture” as well. Therefore, the trouble for Wallach is not the regulation but the regulation -whether self-interested or not- done by the non-experts. This is similar to the way arguments about objectivism and “truth” are combined and mixed in many cases as if they were mutually exclusive, and how subjectivism always comes with the idea of ‘ignorance’ and the non-scientific. Does regulatory capture mean regulation by the experts? Or does it also mean deregulation in computer science as originally defined by economists?

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<sup>4</sup> It is Diebold's president, Bush contributor Walden O'Dell, who stated in an Aug. 14 fund-raising letter to Ohio Republicans: "I am committed to helping Ohio deliver its electoral votes to the president next year." O'Dell has since stated that he regrets the wording in the letter: "I can see it now, but I never imagined that people could say that just because you've got a political favorite that you might commit this treasonous felony atrocity to change the outcome of an election." See [www.diebold.com/whatsnews/inthenews/executive.htm](http://www.diebold.com/whatsnews/inthenews/executive.htm).