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**Panel on Financial Affairs**  
**meeting on 4 April 2011**

**Background brief on**  
**proposed establishment of a policyholders' protection fund**

**Purpose**

This paper provides background information on the proposed establishment of a policyholders' protection fund (PPF) in Hong Kong, and a summary of the views and concerns expressed by members of the Panel on Financial Affairs (the Panel) during relevant discussions.

**Background**

2. At present, if an insurer becomes insolvent, compensation funds are in place to cover employees compensation<sup>1</sup> and motor vehicle third party claims only<sup>2</sup>. There are no compensation funds 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 provisions for dealing with insurer insolvency. 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 may approve a reduction of the amount of policyholder benefits. The Court may also approve a transfer of life insurance policies to another insurer. Under such circumstances, policyholders would have no choice but to accept the arrangements sanctioned by the Court.

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<sup>1</sup> 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.

<sup>2</sup> 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 2002, the Office of the Commissioner of Insurance (OCI) commissioned a consultancy study on the feasibility of establishing PPF(s) in Hong Kong. A public consultation exercise was conducted between December 2003 and April 2004. According to the Administration, mixed feedback was received during the consultation. Some respondents expressed support for a compensation fund for policyholders to boost consumer confidence, while others, particularly members of the insurance industry, were concerned about possible moral hazards.

4. On 7 July 2008, the Administration informed the Panel that OCI had engaged in a close dialogue with industry stakeholders with a view to alleviating their concerns and agreeing on a pragmatic way forward. The Hong Kong Federation of Insurers (HKFI) had indicated its agreement in principle to explore the formulation a contingency plan to protect policyholders against the insolvency of insurers. To this end, HKFI had set up a task force to take the matter forward. OCI would continue to work in partnership with HKFI to develop an appropriate framework for introducing a PPF in Hong Kong.

5. On 6 July 2009, the Administration briefed the Panel on the proposed framework for the establishment of a PPF in Hong Kong, with information on the guiding principles and recommended key parameters for the proposed PPF. A summary of the guiding principles and recommended key parameters is given in the **Appendix**. According to the Administration, the member companies of HKFI were supportive of the guiding principles and key parameters. Meanwhile, the Administration would commission an actuarial consultancy study to assess the optimal levy rate, target fund size and detailed arrangements for the proposed PPF. The target was to put forward detailed proposals for the proposed PPF to the Panel within the 2009-10 legislative session. The Administration would 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.

## **Discussions at the Panel on Financial Affairs**

### Progress of the feasibility study on establishing a PPF in Hong Kong

6. The Administration briefed the Panel on the progress of the feasibility study on establishing a PPF in Hong Kong on 1 March 2004 and 7 July 2008. The major views and concerns expressed by members are as follows:

- (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 some 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 levels of PPF levies payable by insurers according 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 provided for by legislation.

### Proposed framework for the establishment of a PPF in Hong Kong

7. The Panel discussed the proposed framework for the establishment of a PPF in Hong Kong on 6 July 2009. Panel members in general were supportive of the establishment of a PPF. The major concerns/views expressed by Panel members and the Administration's responses are summarized in the ensuing paragraphs.

#### *Need for establishment of a PPF*

8. A member expressed the view that the establishment of a PPF might not be necessary if the OCI could ensure proper supervision of insurers and minimize the risk of compensation. The Administration responded that experience of overseas jurisdictions had shown that compensation schemes as a safety net and an effective regulatory framework for the insurance industry were complementary in enhancing market stability and boosting consumer confidence. The problems faced by the American International Assurance Company (Bermuda) Limited in Hong Kong in September 2008 subsequent to the credit risk of its parent company American International Group Inc. had clearly demonstrated the importance of a PPF in maintaining consumer confidence.

#### *Source of funding and rate of levy*

9. Some members considered that it would only be fair to collect levies from the insurers, not the policyholders, as the proposed PPF was meant to provide compensation to policyholders upon the insolvency of an insurer. They believed that keen market competition would prevent insurers from transferring the cost of levy contributions to the policyholders. The Administration advised that the proposed arrangement of imposing a levy based on the premium of individual insurance policies drew reference from similar local and overseas

compensation schemes. Such arrangement could ensure transparency and facilitate market competition for the benefits of both policyholders and insurers.

10. A member pointed out that contributions payable by banks under the Deposit Protection Scheme were determined by the supervisory ratings assigned by the Hong Kong Monetary Authority, and doubted why the levy rate for the PPF could not be determined according to the risk ratings of the insurers. The Administration responded that in drawing up the recommendations for the proposed PPF, reference had been made to the Deposit Protection Scheme and overseas practices. The current proposal of applying a standard levy rate was in line with overseas practices for insurance compensation schemes, and was considered prudent and appropriate.

11. A member suggested that premiums related to the investment components of investment-linked insurance policies should be excluded from the calculation of the levy payable under the proposed PPF. The Administration advised that consideration had been given to imposing different levy rates based on the nature of insurance policies. However, this would require clear differentiation of the types of insurance policies, which would not be conducive to the design of a simple levy structure to facilitate public understanding of the proposed PPF.

#### *Coverage of policyholders and compensation limits*

12. Some members expressed concern about the coverage of corporate policyholders, in particular the small and medium-sized enterprises (SMEs), under the proposed PPF. The Administration advised that various options were being considered, including: (a) prescribing a definition of SMEs for inclusion in PPF; (b) allowing corporate policyholders to opt for inclusion in PPF; and (c) capping the levy rate to prevent corporate policyholders choosing to place their risks offshore to avoid payment of levies. The Administration would further examine these options in consultation with stakeholder groups.

13. A member expressed concern that the proposed upper limit of total compensation at \$1 million per policy might not afford adequate protection for corporate policyholders. Another member enquired about the percentage of policyholders covered under the proposed compensation limit. The Administration advised that according to the HKFI, which represented a majority of the insurers in Hong Kong, about 90% of policyholders would be fully covered if the compensation limit was set at \$1 million. The most common model adopted by overseas jurisdictions was to set both a percentage and a dollar cap on the level of compensation payable.

#### *Legislative timetable*

14. A member pointed out that the insurance industry had suffered from a

significant drop in business in the economic downturn and looked forward to the early introduction of a PPF. He called on the Administration to expedite the work with a view to passing the relevant bill within the 2009-2010 legislative session. The Administration responded that time would be required for working out the detailed proposals in consultation with stakeholders and preparing the legislative proposals, but it would endeavour to expedite the process.

## **Recent development**

15. On 25 March 2011, the Administration published a consultation document for a three-month public consultation on the proposed establishment of a PPF in Hong Kong. The Administration will brief the Panel on the relevant proposals at the Panel meeting on 4 April 2011.

## **Relevant papers**

16. 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>

Background brief on consultancy study on the feasibility of establishing insurance policyholders' protection funds in Hong Kong prepared by the Legislative Council Secretariat

<http://www.legco.gov.hk/yr07-08/english/panels/fa/papers/fa0707cb1-2084-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>

Written question raised by Hon CHAN Kin-por on "Measures to facilitate insurance and finance sector" at Council meeting on 24 June 2009 (page 89-93)

<http://www.info.gov.hk/gia/general/200906/24/P200906240171.htm>

Administration's paper for the FA Panel meeting on 6 July 2009

<http://www.legco.gov.hk/yr08-09/english/panels/fa/papers/fa0706cb1-2095-4-e.pdf>

Minutes of the FA Panel meeting on 6 July 2009 (paragraphs 58 to 81)

<http://www.legco.gov.hk/yr08-09/english/panels/fa/minutes/fa20090706.pdf>

Background Brief on policyholders' protection fund prepared by the  
Legislative Council Secretariat

<http://www.legco.gov.hk/yr08-09/english/panels/fa/papers/fa0706cb1-2061-e.pdf>

Press Release by Government on 25 March 2011 regarding the launching  
of public consultation on Policyholders' Protection Fund

<http://www.info.gov.hk/gia/general/201103/25/P201103250338.htm>

Council Business Division 1  
Legislative Council Secretariat  
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### Summary of guiding principles and recommended key parameters for the proposed Policyholders' Protection Fund

*(based on the Administration's paper for the Panel meeting on 6 July 2009)*

#### Guiding principles

- (a) *Affordability*: reasonable balance between the level of levies and level of protection
- (b) *Reliability*: enhance market stability while minimizing moral hazard risks
- (c) *Sustainability*: certainty of compensation and associated arrangements for levy collection

#### Key parameters

- (a) Benchmarking with similar compensation schemes operating in Canada, Japan, Singapore and the United Kingdom
- (b) Two separate sub-schemes catering for long term and general insurance policies
- (c) Coverage
  - (i) Exclude compulsory businesses covered by the Motor Insurers' Bureau of Hong Kong and the Employees Compensation Insurer Insolvency Bureau
  - (ii) Extend to all individual policyholders but in-depth discussions required on corporate policyholders
- (d) Compensation limit
  - (i) 100% for the first tranche of \$100,000 plus 80% for the remaining balance
  - (ii) Maximum compensation of \$1 million per policy
- (e) Mode of Funding

The progressive funding model is considered appropriate for Hong Kong; it is a mixture of the pre-funding model and the post-funding model with an initial moderate levy rate complemented by a stepped-up levy rate upon occurrence of insolvency
- (f) Rate of levy
  - (i) Base levy rate of 0.5% to 1%
  - (ii) Stepped-up levy rate of 2% to 3% upon occurrence of an insolvency
- (g) Legislative backing
  - (i) to collect levy from in-force policies
  - (ii) to ensure high transparency
  - (iii) to enhance accountability