For discussion
on 7 December 2015

Legislative Council Panel on Financial Affairs

**Proposed Lump Sum Provision for
the Establishment of an Independent Insurance Authority and
Exit Arrangements for Insurance Officer Grade Officers**

PURPOSE

This paper seeks Members' views on -

(a) the proposed lump sum provision for funding the establishment of an independent Insurance Authority (IIA); and

(b) the proposed exit arrangements for Insurance Officers (IOs) of the Office of the Commissioner of Insurance (OCI) upon the establishment of IIA.

BACKGROUND

2. The policy objectives of establishing IIA are to modernize the insurance industry regulatory infrastructure to facilitate the stable development of the industry, provide better protection for policyholders, and comply with the requirement of the International Association of Insurance Supervisors that insurance regulators should be financially and operationally independent of the Government and industry.

3. The Insurance Companies (Amendment) Ordinance 2015 (the Amendment Ordinance) which provides for a legal framework for the

establishment of IIA was enacted on 10 July 2015. We plan to commence the Amendment Ordinance in three stages to allow for a smooth transition of regulatory powers from OCI and the Self-Regulatory Organizations (SROs) (i.e. the Insurance Agents Registration Board established under the Hong Kong Federation of Insurers, the Hong Kong Confederation of Insurance Brokers and the Professional Insurance Brokers Association) to IIA –

Stage 1 – To establish the Provisional Insurance Authority (PIA)[1] (without regulatory functions and co-exists with OCI);

Stage 2 – PIA becomes IIA to replace OCI by taking over its regulatory functions such as the prudential and conduct regulation of insurance companies and enforcing the anti-money laundering regulatory regime (the self-regulatory regime for insurance intermediaries remains unchanged); and

Stage 3 – IIA to implement the statutory licensing regime and take over the regulation of insurance intermediaries from the three SROs.

4. It is expected that the whole process will take two to three years. Our current target is to set up PIA by end 2015, and for it to be ready to replace OCI and take over its functions in about one year.

Lump Sum Provision for IIA

5. Currently, OCI incurs an annual operating cost of around $110 million and recovers some 36% of it from annual authorization fees paid by insurance companies at a fixed rate of $227,300 per insurance company and $22,600 for captive insurance company. The fees have remained unchanged since 1996. IIA is expected to fully recover its costs via income from the

[1] The new section 4AAA added by section 9 of the Amendment Ordinance provides that when IIA is established, it will be automatically renamed as PIA for the period from its inception to the disbandment of OCI.

market and become financially independent of the Government. According to the proposal we put forward in the consultation exercise[2] on key legislative proposals on establishing IIA, it is proposed that IIA's revenue would comprise the following elements -

(a) fixed authorization fees of $300,000 payable by insurance companies, and $30,000 payable by captive insurance companies;

(b) a variable authorization fee payable by all insurance companies;

(c) a fixed licence fee payable by insurance intermediaries;

(d) user fees for specific services (such as application for transfer of business, change of shareholding structure or change in key personnel); and

(e) a levy of 0.1% on insurance premiums for all insurance policies.

6. To reduce the impact on the insurance industry and policyholders, the following measures will be put in place -

(a) the licence fee for insurance intermediaries be waived in the first five years after commencement of the statutory licensing regime for insurance intermediaries;

(b) an incremental approach be adopted in achieving the target levels of variable authorization fee on insurance companies and levy on insurance policies in the first five years after

[2] Taking into account the findings of the consultancy study concluded in 2010, consultation on the proposed establishment of IIA was first launched in July 2010. Based on the detailed proposals and views received from the industry, we prepared the key legislative proposals on establishing IIA for a 3-month consultation from 26 October 2012 to 26 January 2013. The Legislative Council Panel on Financial Affairs (FA Panel) was briefed on the consultation conclusions at its meeting held on 5 July 2013.

the establishment of IIA[3];

(c) a cap be imposed on the levy on non-life insurance policies with annual premiums at or above $5 million and life insurance policies with single or annualized premiums at or above $100,000; and

(d) exemption of premiums of reinsurance contracts from the levy.

7. To help IIA meet the shortfall in cost recovery due to the incremental approach to achieving the target level of revenue in the initial years of operation, we propose to provide IIA with a lump sum provision on its inception. The long-term target is for IIA to be financially independent of the Government, with about 70% of its expenditure be met by the levy and the remaining 30% by the various authorization/licence and user fees.

Exit Arrangements for IOs

8. At present, there are 152 staff members in OCI, including the Commissioner of Insurance[4], 48 IOs, 21 officers of the general grades and 82 non-civil service contract (NCSC) staff members. After the transfer of the regulatory functions from OCI to IIA, the civil service posts of IOs will be abolished. The 47 eligible IOs[5] who are all pensionable civil servants will be offered compulsory retirement on abolition of office (AOO) terms (see

[3]

	Proposed Rate					
	Year 1	**Year 2**	**Year 3**	**Year 4**	**Year 5**	**Year 6**
Variable fee (as a percentage on insurance liabilities)	0.0001%	0.0005%	0.0013%	0.0026%	0.0031%	0.0039 %
Market levy (as a percentage on insurance premiums)	0.04%	0.05%	0.06%	0.07%	0.085%	0.1%

[4] The incumbent Commissioner of Insurance is an Administrative Officer Staff Grade B1 officer who will be redeployed as in normal posting arrangement as with other general grades officers upon the hiving off of OCI.

[5] As one IO will have reached the normal retirement age in mid-2016 (i.e. before the target date of end 2016 for the hiving off of OCI), only 47 IOs will be affected by the AOO exercise. The 47 eligible IOs include nine Senior Insurance Officer, 24 IOs and 14 Assistant Insurance Officers.

paragraphs 13 and 14 below) upon the hiving off of OCI.

9. Under the established policy, when an officer is compulsorily retired due to AOO, he/she can indicate his/her preference to either retire on AOO terms or accept redeployment within the civil service. If an affected officer has indicated preference for redeployment, the Government will make every effort to absorb him/her within the civil service. If redeployment is unsuccessful, he/she will be compulsorily retired on AOO terms.

10. Officers of the general grades will be redeployed to other Government bureaux/departments as in normal posting arrangements. As for the NCSC staff, their contracts will be mutually resolved or terminated as appropriate.

11. IIA will recruit its own staff. The IOs and the NCSC staff in OCI may apply for openings in IIA through IIA's open recruitment exercises.

JUSTIFICATION

Lump Sum Provision for IIA

12. A consultancy study concluded in 2010 (the 2010 Study) recommended that the Government should provide IIA with a lump sum of $500 million, partly as seed money and partly as contingency reserve to support its initial years of operation. During the scrutiny of the Insurance Companies (Amendment) Bill 2014, the Bills Committee requested the Government to critically review the cashflow projection of IIA, in the light of the lapse of time since the 2010 Study. Taking into account the Bills Committee's suggestion and having regard to the additional regulatory functions undertaken by OCI since the 2010 Study (e.g. the new regulatory functions stipulated in the Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) Ordinance and the Mandatory Provident Fund Schemes (Amendment) Ordinance 2012) and the latest market conditions, we have updated the projection on the estimated cashflow of IIA. The findings concluded that IIA would now face a shortfall of about $650

million in the first four years of operation. Major reasons for the increase over the 2010 Study are the increases in the estimated size of staff[6] and accommodation cost[7], partly offset by projected increase in revenue from levy and authorization fees. A revised indicative six-year budget is at **Annex A**[8]. Subject to Members' views, we would seek approval from the Finance Committee (FC) to create a new non-recurrent commitment of $650 million to support the establishment and initial years of operation of IIA.

Exit Arrangements for IOs

13. Given all IOs are pensionable officers under the New Pension Scheme, they will be eligible, upon retirement on AOO terms, for the statutory entitlement based on the terms under the Pension Benefits Ordinance (Cap. 99), including an enhanced lump sum pension gratuity totaling about $186.2 million and an enhanced monthly pension totaling $13.3 million per annum. On top of the statutory entitlement, we propose to include a non-statutory ex-gratia payment in the exit arrangement for the affected IOs as follows -

(a) a one-off ex-gratia payment of six months' last substantive monthly salary totaling about $24 million; and

(b) a special lump sum payment, on a pro rata basis, of one month's last substantive monthly salary for every five years before an officer reaches his/her normal retirement age of 60, totaling about $7.2 million.

14. Item (a) has been granted as a compensation for the loss of non-job related benefits for officers retired on AOO terms[9] since the 1990s.

6 An increase of the staff size by 62 or 26.2% over the projection of a staff size of 237 in the 2010 Study.

7 An increase of $23.29 per square foot or 33.6% and an additional office space requirement of 8,720 square feet or 29.6% over the original projection in the 2010 Study.

8 This is an updated version of the indicative six-year budget vide Annex C to Paper No. CB(1)2590/10-11(01) submitted to FA Panel for discussion on 4 July 2011.

9 For example, ex-gratia payment of six months' last substantive monthly salary was paid to officers in the

The inclusion of item (b) is considered justified on the following grounds -

(a) the affected IOs have been carrying out their duties with dedication and commitment during the time when the plan of establishing IIA was being contemplated, even with increasing workload during and after the global financial crisis in 2008; and

(b) it is important to maintain staff goodwill in the run-up to the setting up of IIA during which the staff have to assist in the establishment of IIA in addition to performing their current regulatory duties.

15. Since 2007, OCI has conducted several rounds of consultation with IOs regarding the exit arrangements. The majority of IOs indicated that they would take the AOO option. The latest survey in August 2015 indicates that around 10 IOs intend to seek redeployment within the civil service. The IOs are required to make a final decision about three to six months before the discharge date.

16. We shall continue to assist affected IOs who wish to stay in the civil service to find a post in the Government. In case they are unable to find alternative jobs of the same or higher pay scale in other Government bureaux/departments and have to take up posts with a lower pay scale, in line with established policy, we propose that they be allowed to retain their personal pay scales and other non-job related benefits, provided that such retention will not lead to serious staff management / staff relations problems being caused to the receiving grade/department. To effect this arrangement, subject to Members' views, we would seek the endorsement of the Establishment Subcommittee (ESC) and approval of FC to allow Controlling Officers employing the IOs concerned to have the delegated authority to create supernumerary posts to be held against permanent posts of a lower pay scale, to accommodate these officers. Upon transfer to a post with a lower pay scale, an IO holding personal pay scale will continue to receive salaries

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Airport Management Division of the Civil Aviation Department whose posts were abolished upon the closure of Kai Tai Airport in April 1998.

in accordance with his current pay scale. He/she will continue to be entitled to non-job related benefits such as medical and dental treatment, leave of absence, e.g. vacation leave, sick leave, maternity/paternity leave, education allowances, housing benefits, school passages and retirement benefits.

FINANCIAL IMPLICATIONS

Lump Sum Provision for IIA

17. We propose to seek FC's approval to create a new non-recurrent commitment of $650 million to meet the shortfall in cost recovery in the initial years of IIA's operation. Our target is that IIA would be able to fully recover its operating cost via income from the market and be financially independent of the Government within the first six years of its operation.

Exit Arrangements for IOs

18. Assuming all 47 IOs eligible for retirement on AOO terms will accept the offer to retire on AOO terms and choose to make the maximum percentage commutation of their pension into a gratuity, we estimate that the financial implications of the exit package for IOs (at the 2015-16 salary level) will be as follows –

			$ million
(a)	Non-recurrent expenditure		
	(i)	Enhanced lump sum pension gratuity (commuted pension gratuity, including enhancement)	186.2
	(ii)	Ex-gratia payment	24.0
	(iii)	Special lump sum payment	7.2
(b)	Annually recurrent expenditure (pensions, including enhancement)		13.3

19. The calculations for the amount of payments under paragraph

18(a)(i) and (b) are prescribed under the Pension Benefits Ordinance (Cap. 99). Details of the calculations are at **Annex B**. As regards the proposed payments under paragraph 18(a)(ii)& (iii), subject to Members' views, we will seek FC's approval for creation of a new non-recurrent commitment of $31.2 million for the purpose.

20. There will be additional expenditure arising from the proposal to allow the affected IOs to retain their personal pay scales if they are redeployed to a lower rank. We are unable to ascertain the amount required as this will depend on the actual number of IOs involved, the differences between their personal salaries and the salaries of the lower ranks to which they may be appointed and how long they will remain on personal pay scales before their promotion, transfer to another grade or leaving the service. However, if they are able to secure alternative employments in the Government, they will no longer be required to retire on AOO terms, resulting in government savings under the proposed exit arrangements in paragraph 18 above.

ADVICE SOUGHT

21. Members are invited to comment on the proposals. Subject to Members' views, we would submit the proposals on lump sum provision for IIA and AOO arrangements to ESC (as appropriate) and FC for approval.

Financial Services Branch
Financial Services and the Treasury Bureau
November 2015

Annex A

Updated Indicative Budget for the Independent Insurance Authority (2015)

	Year 1 ($m)	Year 2 ($m)	Year 3 ($m)	Year 4 ($m)	Year 5 ($m)	Year 6 ($m)
(A) IIA's estimated operating costs Note 1 (assuming a constant staff size of 299)	399.5	406.8	421.6	450.8	466.9	484.6
(B) IIA's estimated cashflow Note 2	459.1	407.2	422.3	452.3	472.8	485.5
(C) Estimated income to be recovered from the industry	186.6	230.9	292.9	374.8	474.4	596.5
(i) Fixed fee (assuming no increase) Note 3 $300,000 for General/Long Term insurance companies $600,000 for Composite insurance companies	52.2	52.2	52.2	52.2	52.2	52.2
(ii) Variable fee (as a % on liabilities) Note 4 (assuming 10% and 5% annual growth of liabilities for long term and general business respectively)	1.3	7.3	20.8	45.6	59.8	82.7
(iii) User fee (5% of cashflow)	23.0	20.4	21.1	22.6	23.6	24.3
(iv) Levy (as a % on premiums) Note 5 (assuming 10% and 7% annual growth of premiums for long term and general business respectively)	132.5	181.6	238.8	305.4	406.5	524.3
(v) Registration fee Note 6	0.0	0.0	0.0	0.0	0.0	0.0
(vi) Estimated Income foregone with proposed concessions on levy Note 7	(22.4)	(30.6)	(40.0)	(51.0)	(67.7)	(87.0)
(D) Estimated Surplus/Deficit = (C) - (B)	(272.5)	(176.3)	(129.4)	(77.5)	1.6	111.0
(E) Shortfall to be covered by Government subsidy = (B) - (C) Total $(m) 655.7	272.5	176.3	129.4	77.5	N/A	N/A

Note 1: Based on the revised estimated operating costs provided by PricewaterhouseCoopers, consultant appointed to update the indicative budget for IIA, in November 2015. The consultant has assumed that all positions of IIA will be filled up upon the establishment of IIA but this might not be the case.

Note 2: The estimated cashflow includes capital expenditure (IT etc.), increase in working capital and rental deposit.

Note 3: Based on no. of insurance companies as at 31.3.2015.

Note 4: Based on the net liabilities (long term business) and outstanding claims provision (general business) for 2013 and the incremental charging rates as set out in the 2010 Consultation Document.

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Variable Fee (as a % on insurance liabilities)	0.0001%	0.0005%	0.0013%	0.0026%	0.0031%	0.0039%

Note 5: Based on the total office premiums (long term business) and gross premiums (general business) for 2013 and the incremental charging rates as set out in the 2010 Consultation Document.

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Market Levy (as a % on insurance premiums)	0.040%	0.050%	0.060%	0.070%	0.085%	0.100%

Note 6: Registration Fees for intermediaries to be waived for the first 5 years (Year 2 to Year 6) after the commencement of the statutory licensing regime (earliest by Year 2 of IIA establishment)

Note 7: Levy capped at long term policies with premiums≧$0.1m and general policies with premiums≧$5m and waiver of levy on re-insurance premiums.

<u>Annex B</u>

Calculation of the Enhanced Lump Sum Pension Gratuity and Monthly Pension for Insurance Officers to be Retired on Abolition of Office (AOO) Terms

1. Calculation of annual pension

Highest annual pensionable emoluments	x	Length of pensionable service	x	Pension factor *

* 1/675

2. Calculation of commuted pension gratuity

Annual pension	x	50%*	x	14

* maximum percentage

3. Calculation of monthly pension

Annual pension	x	(1 - 50%*)	/	12

* percentage of annual pension to be commuted into the lump sum pension gratuity

4. Enhanced pension benefits due to AOO

An additional pension is granted to an officer who retires from service on AOO if he has completed qualifying service of not less than two years. The rate for additional pension is 10/675 of an officer's highest pensionable emoluments for each completed three-year period of his pensionable service, provided that the addition does not exceed 100/675 of his highest pensionable emoluments.

5. Total amount of items (1) and (4) is capped by the amount of

pension which an officer would have been granted if he had continued to serve until the date on which he would have reached his retirement age, having received all the increments in his present rank for which he would have been eligible by that date.

6. Total amount payable under items (2) – (4) above

(a) Commuted pension gratuity (50%)	**$ million**
- normal retirement benefits	152.9
- additional benefits due to AOO	33.3
Total	**186.2**
(b) Monthly pension per annum	
- normal retirement benefits	10.9
- additional benefits due to AOO	2.4
Total	**13.3**