Bills Committee on Employees Compensation Assistance (Amendment) Bill 2002

Proposed Employees Compensation Insurer Insolvency Scheme and Supervision of Employees Compensation Insurers

Introduction

This paper provides the information requested by Members at the Bills Committee meeting held on 14 March 2002. This includes -

(a) information on the proposed Employees Compensation Insurer Insolvency Scheme (ECIIS), including its operations and the views of the insurance industry on the proposal;

(b) overseas experience in respect of compensation funds which cater for the insolvencies of insurers underwriting employees' compensation (EC) insurance; and

(c) supervision of insurers underwriting EC business in Hong Kong, in particular how the regulatory regime applies to such insurers with parent companies outside Hong Kong.

(A) Proposed ECIIS

2. As elucidated in the Brief for the Legislative Council on the Employees Compensation Assistance (Amendment) Bill 2002 (the Bill), insurer insolvency, by its very nature, would inevitably create sudden and substantial strain on the resources of the EC Assistance Fund (the Fund). This phenomena is borne out by the experience of the insolvency of the HIH group of insurance companies. To avoid creating a sudden strain and thus inordinate pressure on the cash flow of the Fund, we consider it appropriate to excise insurer insolvency from the scope of the Employees Compensation Assistance Scheme (ECAS) and set up a separate designated fund for the purpose. The Bill presently contains provisions to excise insurer insolvency from the ambit of the Fund but we have made it clear that these provisions will not come into effect unless and until we have put in place a separate scheme to cover such insolvency risks.

3. In October 2001, the Office of the Commissioner of Insurance (OCI) first put the ECIIS proposal to the insurance industry. Since then, it has held several rounds of discussion with the General Insurance Council (GIC) of the Hong Kong Federation of Insurers, which represents all major EC insurers in Hong Kong. The following main features of the ECIIS are proposed -

(a) ***Constitution*** – An Employees' Compensation Insurers Bureau (ECIB) would be established as a non-profit making company limited by guarantee. It would administer the ECIIS. All insurers authorized to carry on EC insurance business in Hong Kong would be required by the Insurance Authority ("IA") to join the ECIB as members and would be bound by the memorandum and articles of association of the ECIB.

(b) ***Funding*** – The ECIIS would be financed by a levy on EC insurers.

(c) ***Scope of Coverage*** – The ECIIS would only cover EC insurance claims arising from the insolvency of insurers.

(d) ***Operation*** - It is envisaged that ECIB would be responsible for handling the EC claims remaining unsettled because of the insolvency of an EC insurer. We expect ECIB to take an active role in handling the claims as if they were handled by an insurer, including defending the claims in legal proceedings as appropriate. Matters pertaining to the consistency of standards in claims assessment would be addressed when we draw up the details of the Scheme.

(e) ***Checks and balances* -** Insurers who have joined ECIIS, being a non-profit making body, would be required to contribute to the funding of the scheme. Use of the funds of the scheme would be restricted to the payment of EC claims made against the scheme arising from the insolvency of EC insurers or expenses directly related to such claims (e.g. legal fee for contesting a claim in the court). The financial position of the scheme would be subject to independent audits. A copy of the annual accounts with the auditor's report would be deposited with the OCI for scrutiny, and published as a public document. Subject to discussion with the GIC, further checks and balances would be considered.

4. In a letter of 21 March 2002 to the Bills Committee, the GIC indicated objection to the proposal of excising the insolvency element from the ECAS. The GIC is mainly concerned about different standards of claims assessment arising from two separate funds, difficulty in assessing the adequacy of the levy and additional administrative costs. It also rejected the suggestion that insurers should contribute to the insolvency fund. We understand that the GIC would separately present its views to the Bills Committee.

5. The OCI is pursuing the matter with the GIC. Maintaining the existing EC Assistance Fund system would not address the concerns over the adequacy of the level of levy. Quite to the contrary, the HIH incident demonstrated that placing EC insurer insolvency together with ordinary EC claims would create an unstable cash flow effect on the EC Fund. Segregating the two elements would solve such cash flow problems.

6. Regarding the insurance industry's concerns over the consistency of standards in claims assessment, as pointed out in paragraph 3(d) above, we would address the matter when we draw up the details of the ECIIS. We also believe that the administrative costs of the proposed ECIIS are not insurmountable and could be tackled by appropriate administrative arrangements.

(B) Overseas Experience

7. The arrangements for policyholders' protection in the United Kingdom (UK), Canada and Singapore[1] are described below. It is noted that all compensation schemes overseas are funded by the market.

The United Kingdom

8. Before December 2001, the Policyholders' Protection Scheme (PPS) in the UK was the industry scheme provided cover to the UK policyholders in

[1] Australia does not have a compensation system. As far as we understand, the regulatory authority there is exploring the feasibility of setting up one.

the event of an insurance company became insolvent. The scheme covered all classes of life and non-life business and was financed by a levy on insurers.

9. On 1 December 2001, the Financial Services Compensation Scheme (FSCS) was established under the Financial Services and Markets Act 2000 to replace the various compensation schemes in the financial services sector including PPS. The FSCS meets the claims against insolvencies of financial services institutions including insurance companies, banks and investment houses. It is funded by levies on the market, i.e. the relevant insurance companies, banks and investment houses.

10. Policyholders are protected if they are insured by authorized insurance companies under contracts of insurance issued in the UK. The maximum level of compensation depends on the type of insurance policy. For compulsory insurances, the compensation will be up to 100% of the claim. For other classes of insurances, the compensation will be up to 90% of the claim.

Canada

11. In Canada, the Property and Casualty Insurance Compensation Corporation (PCICC), an industry funded, non-profit organization, responds to claims of policyholders in the event of the insolvency of a property and casualty (i.e. non-life) insurance company. The maximum protection offered to a policyholder is 250,000 Canadian dollars with respect to all unpaid claims for losses arising from a single occurrence. Policy deductibles are applied to the total amount of insured loss. Property and casualty insurance companies are required to contribute to the PCICC.

Singapore

12. The Monetary Authority of Singapore (MAS) establishes and maintains a Policy Owners' Protection Fund for the purposes of protecting insurance policyholders (both life and non-life but restricted to compulsory classes) against the insolvency of registered insurance companies. A life insurance policy will be compensated up to 90% of the amount of the liability. A non-life insurance policy will be compensated to the full amount of the

entitlement under the terms of the policy. The Fund is funded by a levy made on registered insurance companies.

(C) Supervision of EC insurers

13. The Insurance Companies Ordinance (Cap. 41) (the Ordinance) stipulates that the principal function of the IA is to regulate and supervise the insurance industry for the promotion of the general stability of the insurance industry in Hong Kong and for the protection of existing and potential policy holders. Towards this objective, the OCI has put in place an effective system which is in line with international standards for regulating and supervising insurers authorized in Hong Kong.

14. Under the Ordinance all insurers carrying on general insurance business, including EC business, in Hong Kong are subject to the same regulatory requirements and whether such insurers are stand alone companies or are subsidiaries of parent companies overseas is irrelevant. The regulatory requirements, as set out in the Ordinance, include those on minimum paid-up capital, solvency margin, fit & proper management, adequacy of reinsurance arrangements and annual reporting of financial information. On the basis of the periodic returns submitted by insurers, the IA assesses on a regular basis whether or not they comply with the statutory requirements. On-site inspections and interviews are also conducted. Where there is any cause for concern, more frequent assessment would be conducted and where the situation warrants, the IA would invoke the power of intervention provided for in the Ordinance. Such powers included restricting an insurer to take on new businesses and maintaining assets in Hong Kong.

15. All insurers authorized in Hong Kong are subject to the same prudential supervision. Where an insurer is a subsidiary of an overseas parent company, the local subsidiary is a separate legal entity and its soundness is assessed independently of its parent.

16. To ensure a prudent spread of assets, the Insurance Companies (General Business) (Valuation) Regulation places a limit on the amount of debts due from all companies, including parent companies, to 10% of the value of an insurer's total assets. This limitation currently does not apply to insurance

debts, e.g. reinsurance recoverable from parent companies. While such practice is in line with that in many other places such as the UK, Singapore and Malaysia, OCI considers that there is room for further enhancement, in the light of the experience in HIH case. At present, in line with the practice recommended by the International Association of Insurance Supervisors, where an insurer reinsures substantially with its parent company, OCI communicates with its home regulator and examines the parent company's audited accounts and the reports prepared by credit agencies to ascertain the financial position of the parent company. To enhance the system, OCI is considering to set an admissibility limit to the amount of reinsurance recoverable from the parent company. This means that this type of assets, if exceeding the limit, would be disallowed in assessing the solvency position of the insurer. In this connection, OCI is finalizing its proposal and will consult the insurance industry shortly.

Financial Services Bureau / OCI
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