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For Discussion
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LegCo Panel on Financial Affairs

Monitoring of the Financial Position of Authorized Insurers in Hong Kong and Compensation Arrangements for Insurance Policyholders

Introduction

This paper sets out the regulatory regime for authorized insurers in Hong Kong, including the monitoring of their financial position, and the compensation arrangements for insurance policyholders in the event of insurer insolvency.

Regulatory Regime for Authorized Insurers

2. The principal function of the Insurance Authority (IA) is to regulate and supervise the insurance industry for the promotion of the general stability of the industry and for the protection of the insuring public. Towards this end, the Office of the Commissioner of Insurance (OCI) has put in place an effective regulatory system, which is in line with international standards. The OCI has adopted the insurance supervisory standards promulgated by the International Association of Insurance Supervisors[1] and will continue to review our regulatory regime in the light of developments, both locally and internationally.

3. The Insurance Companies Ordinance (Cap. 41) ("the ICO") provides the legal framework for the prudential supervision of authorized insurers in Hong Kong.

4. All insurers are required by law to comply with the provisions of the ICO before they may be authorized by the IA to operate in Hong Kong. The major requirements include -

[1] The International Association of Insurance Supervisors (IAIS) is the most important international body of insurance supervisors worldwide. As at end of March 2002, it has 110 members, including the insurance supervisor of virtually all the advanced economies.

(i) *Minimum paid-up capital* – the minimum paid-up capital is $10 million, or $20 million for a composite insurer (i.e. carrying on both general and long term businesses) or for an insurer carrying on statutory classes of insurance business, e.g. motor third party liability and employees' compensation (EC) insurance businesses;

(ii) *Minimum solvency margin* – the solvency margin is the amount of excess in value of the assets of an insurer over its liabilities required to be maintained at all times.

For general business, the solvency margin is determined according to an insurer's relevant premium income or relevant claims outstanding, whichever is the greater. For long term business, the solvency margin is determined according to the reserves and the aggregate amount of the sums insured under the policies;

(iii) *Management by fit and proper person* – the ICO requires that any person who is a director or controller (including the chief executive) of an insurer must be "fit and proper" to hold such a position;

(iv) *Adequate reinsurance arrangements* – the ICO requires that adequate reinsurance arrangements are in force, or will be made, for the reinsurance of risks written by the insurer; and

(v) *Appointed actuary system* – an insurer who carries on long term business is required to appoint an actuary with prescribed actuarial qualification. This actuary shall comply with the prescribed professional standards in conducting annual investigation of the financial condition of the insurer for reporting to the IA.

On-going Supervision

5. Upon authorization, an insurer will be subject to the on-going prudential supervision of the IA. It is principally carried out through examination of the audited financial statements, actuarial investigation reports and business returns submitted by it on an annual basis. Where necessary, the IA may require such returns to be submitted more frequently (e.g. quarterly). The IA also conducts regular on-site inspections on the insurer to ensure that it complies with the relevant statutory requirements,

such as the minimum solvency margin as well as the fit and proper management requirements.

6. Moreover, there are a number of regulatory requirements to ensure a prudent spread of assets. For example, 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 a general insurer's total assets. Besides, there are limits in the valuation of the insurer's assets that are held in the form of investments such as land, building, shares, securities, etc. Apart from the statutory requirements, the OCI and the Hong Kong Federation of Insurers also issue from time to time guidance notes and codes of practice. Non-compliance with such notes or codes may render the management of an insurer to be considered as not fit and proper, and thereby may affect its authorization.

7. Where the IA has concern over the affairs of an authorized insurer, it may exercise its powers of intervention under Part V of the ICO for the purpose of protecting the interests of policyholders. These powers include –

- (i) Restriction on new business
- (ii) Restriction on investments
- (iii) Acceleration of submission of financial information
- (iv) Custody of assets by a trustee / maintenance of assets in Hong Kong
- (v) Limitation of premium income
- (vi) Special actuarial investigation of long term business
- (vii) Making of bank deposits in the name of the IA

Where the financial position of an insurer is considered to be in serious difficulties and where the IA considers that the exercise of the above powers is not adequate in safeguarding the interests of policyholders, the IA may appoint a Manager under the ICO to take full control of the insurer concerned. As a last resort, the IA may also present a petition to the Court for winding up the insurer.

8. All insurers authorized in Hong Kong are subject to the same level of prudential supervision regardless of their place of incorporation or whether they are set up as a subsidiary of an overseas parent.

Enhancement of Regulatory Measures

9. An effective regulatory system is one which would protect the

interests of the insuring public and at the same time provide latitude for the market to develop. The IA has adopted a proactive approach in the regulation of the insurance industry. The regulatory framework is kept under constant review in the light of operational experience, market development and the international trends to ensure its effectiveness. New initiatives are introduced from time to time and the following measures have been implemented recently -

(i) Actuaries' Standards

In October 2000, the Insurance Companies (Actuaries' Standards) Regulation was made to prescribe the Professional Standard 1 (PS1) issued by the Actuarial Society of Hong Kong as the standards to be complied with by an appointed actuary of a long term business insurer;

(ii) Reserving for Mortgage Guarantee Insurance

In November 2000, the OCI issued a Guidance Note setting out the minimum standard expected of an insurer in reserving for mortgage insurance business;

(iii) Reserving Standards for Investment Guarantees

In January 2001, the OCI has issued a Guidance Note on Reserving Standards for Investment Guarantees to ensure that insurers carrying on retirement scheme management business with investment guarantees will set aside sufficient funds to meet their obligations in respect of such guarantees;

(iv) Actuarial Review of Insurance Liabilities

In January 2002, the OCI issued a Guidance Note requiring actuarial review of the technical reserves of EC and motor third party risk insurance businesses. This requirement aims to ensure that sufficient reserves are set aside by insurers in respect of these two classes of businesses;

(v) Enhanced Transparency of Insurers

The OCI has commenced releasing quarterly statistics of the insurance industry on an aggregate basis since the first quarter of 1998, and releasing individual insurers' annual statistics through its Annual Report since 1998. The release of these statistics ensures greater transparency of the industry.

Further Enhancement under Consideration

10. The insurance regulatory regime is closely monitored by the OCI. Enhancement measures will be introduced in consultation with the industry. New initiatives currently under consideration by the OCI include -

(i) Enhancing Corporate Governance

The insurance industry and other interested parties are being consulted on a Guidance Note on Corporate Governance of Authorized Insurers. The Guidance Note will set out matters such as the roles and duties of the directors and controllers and will provide guidance on good practices for insurers to follow;

(ii) Setting Admissibility Limit for Reinsurers' Balances

Taking into account the experience gained in the HIH incident in 2001, the OCI is considering to introduce an admissibility limit to the amount of reinsurance recoverable by an authorized insurer from group companies, including 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. The OCI will consult the insurance industry on its proposal shortly;

(iii) Enhancing Transparency of Long Term Insurers

The OCI plans to introduce a statutory definition of "Hong Kong long term insurance business" into the ICO together with a prescribed set of annual business returns relating thereto. The information so obtained would further increase the transparency of the long term insurance market and thereby facilitate the prudential supervision of the relevant insurers.

Compensation Arrangements for Policyholders in Insurer Insolvency

11. At present, compensation arrangements for policyholders in the event of insurer insolvency are provided for the compulsory motor and EC insurance policies.

12. Under the Employees Compensation Assistance Scheme ("ECAS"), the Employees Compensation Assistance Fund ("ECAF") renders relief in case of insolvency of an EC insurer. The ECAF is established under the Employees Compensation Assistance Ordinance. It is financed by a levy on the EC insurance premiums payable by policyholders.

13. The Government however sees a need to overhaul the ECAS and has recently introduced the Employees Compensation Assistance (Amendment) Bill 2002 into the Legislative Council. The Bill proposes, among other things, to excise insurer insolvency from the ambit of ECAF. To ensure proper protection for employers and employees, we propose that the insurance industry to set up a separate Employees Compensation Insurer Insolvency Scheme (ECIIS). This proposed scheme would have a dedicated and clear objective of covering claims arising from insurer insolvency. Discussion between the OCI and the insurance industry on the ECIIS proposal is in progress.

14. For motor insurance business, the Motor Insurers' Bureau of Hong Kong formed by the insurance industry administers an Insolvency Fund, which takes over the vehicle owner'/drivers' liability and provides compensation to injured victims of traffic accidents where the insurers concerned are insolvent. The Insolvency Fund is financed by a levy on the motor insurance premiums payable by policyholders.

15. Apart from the above two compensation funds, in case of the winding up of an insurer, insurance claimants are ranked as preferential creditors over ordinary creditors in the distribution of the assets under the Companies Ordinance.

16. With a view to exploring possible measures to further enhance the protection for policyholders, the OCI will commission a consultancy study to assess the feasibility of establishing a comprehensive policyholders' protection scheme. The study is expected to commence in late 2002 and would be completed in about 12 months.

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