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LEGISLATIVE COUNCIL BRIEF

EMPLOYEES' COMPENSATION AND MOTOR VEHICLE (THIRD PARTY RISKS) INSURANCE COVERAGE FOR TERRORIST ACTIVITIES

INTRODUCTION

At the meeting of the Executive Council on 18 December 2001, the Council **ADVISED** and the Chief Executive **ORDERED** that -

(a) Government would provide a facility of up to $10 billion in aggregate in the form of an agreement between Government and direct insurers underwriting employees' compensation (EC) insurance business. The facility will cover direct insurers' liability for the payment of EC for damages caused by terrorist activities; and

(b) a charge of 3% on the relevant insurers' annual EC premium would be levied on insurers for the provision of such facility. The charge could be increased in future, if necessary, to recoup the cost of providing the facility.

BACKGROUND AND ARGUMENT

Employees' Compensation Insurance

2. Under section 5 of the Employee Compensation Ordinance (the EC Ordinance)(Cap.282), an employer is liable to pay compensation to his employees who suffered personal injury in an accident arising out of and in the course of employment. To ensure employees will be able to receive adequate compensation and to protect employers when they become so liable, section 40 of the EC Ordinance also requires employers to purchase EC insurance. The required coverage is $100 million per event when the number of employees does not exceed 200, or $200 million per event when the number of employees exceeds 200. For a policy of insurance covering the employees of subcontractors as well or a group of companies, the required coverage is also $200 million per event. Before 1995, the EC Ordinance required unlimited coverage. The existing levels of coverage were introduced in that year because since then the insurance industry has ceased offering unlimited coverage.

3. The EC Ordinance clearly stipulates the responsibilities of all stakeholders. Employers are ultimately liable to pay compensation to injured employees. They are required by law to obtain insurance to cover their risks and liabilities. Direct insurers are obliged to pay compensation to victims up-front, notwithstanding any exclusion clauses in the insurance policies. Such arrangements ensure that the exclusion clauses would not nullify the objective of compulsory insurance, i.e. compensation would be rendered in the first instance. To protect the direct insurers who might have, for prudential reasons, stipulated exclusions in their relevant insurance policies, the EC Ordinance provides direct insurers with a right of recovery of the compensation paid by them against those who are ultimately liable, namely the concerned employers. It is clear from the foregoing that the primary objective of the EC Ordinance is to render appropriate and timely compensation to victims who have sustained injury from accidents in employment regardless of the cause of such accidents or whether such accidents are excluded from the relevant insurance policies.

4. The legislative provisions were drawn up at a time when insurance (including reinsurance) cover for all or most types of employment related accidents were available in the insurance market.

Motor Vehicle Third Party Risks and Vessels Third Party Risks Insurance

5. Similarly, in relation to motor vehicle and vessel third party risks insurance, direct insurers are also required to pay compensation to victims up-front, notwithstanding any exclusion clauses in the relevant insurance policies. The details are set out in paragraphs 18 to 20 below.

Absence of Reinsurance Coverage in the Market

6. Prior to the 11 September ("911") incident in the United States, most insurers only excluded war, riot or nuclear weapons from their policies. It is accepted by the Insurance Authority (IA) and the market that the possibility of such events happening in Hong Kong is very remote, hence it is very unlikely that the insurers would be required to pay up-front for such events. Terrorist activities were not excluded from the relevant policies because apart from being considered remote, the extent of losses arising from such activities were considered limited and within the insurance industry's financial capacity to absorb. Direct insurers were able to arrange reinsurance cover to limit their exposure or simply the reinsurers were not alerted to this risk before the 911 incident.

7. With the 911 incident causing unprecedented losses, the insurance industry worldwide has become alerted on the severe damages that terrorist activities may potentially cause. Reinsurers generally have difficulty in quantifying their exposure arising from terrorist activities. They (both local and overseas) have indicated that they would exclude such coverage for treaty arrangements, i.e. providing standing facility for reinsurance coverage on all businesses accepted by direct insurers during the year without individual assessment of the risks, when the present reinsurance contracts expire on 31 December 2001. Most of the EC and motor vehicle third party risks insurance fall under the treaty arrangement. This is so because it would be impracticable for all the risks accepted by direct insurers during the year to be individually assessed by reinsurers.

8. In relation to EC, we estimate that $10 billion would be needed to cover the liabilities of direct insurers in the worst case scenario assuming the total destruction of a skyscraper in Hong Kong. Although Hong Kong is regarded as a low risk territory in terms of terrorists activities, such potential risk cannot be totally discounted. Without reinsurance cover, direct insurers have no choice but to exclude terrorist activities from the policies they offer. However, exclusion does not solve the problem because –

(a) In case of a terrorist attack, the direct insurers would be obliged to pay compensation to victims up-front. Notwithstanding the statutory right of recovery against the policy holders, it might be difficult, if not impossible, for a direct insurer to recoup the amount already paid, particularly as the policy holders may have sustained considerable damage in the attack and thus become insolvent. The 911 incident has demonstrated that the cumulative losses arising from terrorist activities, in particular in EC cases, could be enormous. Therefore the present system, coupled with the absence of reinsurance coverage, may impose severe strain on the direct insurers' financial position and could drive some of them into an insolvent position. Direct insurers have argued that it is unfair to require them to take such insolvency risk.

(b) Even if the direct insurers were willing to take the resulting insolvency risk, they would unlikely be able to comply with the requirements of the Insurance Companies Ordinance (ICO). Under the ICO, an insurer would not be allowed to carry on insurance business if there is no proper reinsurance arrangement in place to spread the risks and thus minimise his financial exposure. This is an important requirement recognised by both the insurance industry and regulatory authorities worldwide.

(c) Thus, to protect themselves, direct insurers would probably have to stop underwriting EC insurance altogether.

Overseas experience

9. The absence of reinsurance coverage for terrorist activities is a worldwide problem which has arisen following the 911 incident. Different measures have been adopted by other jurisdictions.

10. In the United States, a Bill which aims to ensure the continued financial capacity of insurers to provide coverage for risks from terrorism is now being considered by Congress. In the UK, there is already in existence a permanent Pool Reinsurance Company Limited (Pool Re) which was set up by law as a reinsurer to cover terrorism risks. The Government of South Africa has established a fund for property damage and consequential loss against riots, strikes and public disorder. In France, an unlimited guarantee is provided by the French Government to a state owned reinsurer in respect of terrorism cover for property damage. A fund financed by extra levy on property policies has also been established for bodily injuries caused by terrorism.

Principles

11. In considering the options to resolve the present deadlock, the following principles have been borne in mind -

(a) The system must be fair to all relevant parties, recognising the rights and limitations of players; and

(b) Erosion of the protection rendered to employers and employees should be avoided.

Options Considered

12. To address the imminent problem, we have considered the following options -

(a) Amending the law to remove the duty upon employers to compensate employees for injury caused by terrorist activities: Such an approach would not be consistent with the spirit of the relevant Ordinance (para. 3 above is relevant) and go against the principles stipulated in paragraph 11 above.

(b) Amending the law to remove the paying up-front requirement for compensation arising from terrorist activities: This approach would remove the insolvency risks of insurers and is the preferred approach from their perspective. Nonetheless, this would leave victims of terrorists activities without compensation in the first instance. Victims would have to go through the difficult and time consuming route of seeking compensation directly from employers. In the event of terrorist attacks, it is doubtful whether employers would be able to compensate the victims concerned, not to mention giving such compensation in a timely manner. In fact, insurers should not be encouraged to exclude terrorist cover from their EC insurance policies, as this would leave both employers and employees without protection.

(c) To ask the insurance industry to set up a fund, financed by a levy on employers, to cover insurers' terrorism risk. Such an arrangement would not be viable because it would take a long time before an adequate amount can be accumulated in the fund to provide adequate cover against terrorism risk. Without cover, direct insurers would not be able to comply with the requirements of the Insurance Companies Ordinance (paragraph 8(b) above is relevant).

Solution to Tackle the Problem

13. The gist of the problem is that some form of cover for insurers is needed so that they can continue to offer the compulsory EC policies and that they would not exclude terrorist activities from such policies. To address this problem, we consider that a viable solution could be worked out through the joint efforts and cooperation of the industry, employers and Government.

14. It is important that direct insurers underwriting EC should not exclude terrorist activities from the insurance policies. To cover such risks, Government will provide a facility of up to $10 billion in aggregate to general insurers writing EC insurance policies. In the event of injury or death of employees caused by terrorist activities, insurers will pay compensation to the relevant employee or eligible claimant in accordance with the EC Ordinance, and can resort to the facility provided by Government for funding such payment. On the other hand, as Government has provided such a facility, an insurer will be required to pay a charge of 3% on the gross premium of EC insurance policies to Government. The details will be set out in an agreement between Government and the insurers underwriting EC business.

15. The purpose of providing the facility is to ensure that there is an adequate level of protection for employees and that employers will not be left with

the difficult position of being liable for an uninsurable risk. The charge on insurers (i.e. 3% of the total premium of the relevant EC insurance policies) will act as an incentive to encourage the re-insurance market to come back so that Government can withdraw the facility. In the event of injury caused by terrorist activities, and when the facility is drawn down, Government will then adjust the charge to a level to reflect the actual cost of providing such a facility, with a view to recovering the facility within a reasonable period of time.

16. The above decision represents a combination of efforts of Government, employers and insurers. Government provides a facility at a charge, insurers can continue to provide cover for injury caused by terrorist activities by paying a charge to Government, employers will also be able to enjoy insurance protection. Most important of all, there will not be any erosion to the protection rendered to employees.

Motor Vehicle Third Party Risks Insurance

17. Under section 4 of the Motor Vehicles Insurance (Third Party Risks) Ordinance (Cap.272), no person shall use, or cause or permit any other person to use, a motor vehicle on a road unless there is in force in relation to the use of the vehicle a policy of insurance, which insures such person against liability in respect of death of or bodily injury to any person caused by or arising out of such use. The required coverage for the time being is $100 million per event. Similar to the case of EC insurance, the existing level of coverage was introduced in 1995 because of the withdrawal of unlimited coverage in the market. As indicated in paragraph 5 above, direct insurers underwriting such insurance policies are obliged by law to pay compensation to victims up-front, notwithstanding any exclusion clauses in the relevant policies.

18. At present, in respect of motor vehicle third party risks insurance, there is already in existence a Motor Insurers’ Bureau of Hong Kong (MIB). It administers two funds which are financed by a levy payable on the premium of the relevant insurance policies. The two funds provide compensation respectively for victims of traffic accidents where the owners and drivers concerned are uninsured or untraceable, or the insurers concerned are insolvent. One of MIB's Funds, the Insolvency Fund has accumulated a balance of about $900 million as at mid November 2001. To address the problem of direct insurers having to pay up-front for third party injuries caused by terrorist activities, MIB will be requested to amend its Memorandum and Articles of Association to enable the Bureau to provide a facility to direct insurers. As in the case of the Government facility, a charge could be levied for providing such facility. The size of the MIB facility could be much smaller as the extent of losses is estimated to be relatively limited. Assuming that two separate terrorist attacks involving two vehicles occur, the maximum amount of the facility

would be $200 million only and this could be covered by MIB's Insolvency Fund.

Vessels Third Party Risks Insurance

19. Apart from EC and motor vehicles 3rd party risks insurance, under the Merchant Shipping Ordinance (Cap.281), the user of a launch, ferry or pleasure vessel operating in Hong Kong has to obtain third party risks insurance coverage. The Ordinance also requires insurers to pay compensation to victims up-front. However, since the required coverage is only $3 million per event, the exposure to an insurer will still be at an acceptable level even without reinsurance coverage. Therefore, both the IA and the insurance industry consider that the lack of reinsurance coverage will not cause problem in the case of vessel third party risks insurance.

Way Forward

20. We are liaising with the direct insurers so that they can make the necessary preparation for the new insurance policies to be issued on 1 January 2002. We will also seek the approval of the Finance Committee on 11 January 2002 for Government to provide a facility of up to a maximum of $10 billion in aggregate.

BASIC LAW IMPLICATIONS

21. The Department of Justice advises that the decision is consistent with the Basic Law.

HUMAN RIGHTS IMPLICATIONS

22. The Department of Justice advises that the decision has no human rights implications.

FINANCIAL AND STAFFING IMPLICATIONS

23. The decision in paragraph 1 above requires Government to provide a facility of up to $10 billion in aggregate. The staffing resources required for implementing the decision will be absorbed by relevant bureaux and departments.

24. As Government usually self-insures, it will not be affected by the new charge/levy on EC and motor vehicle third party risks insurance.

ECONOMIC IMPLICATIONS

25. The charge of 3% in respect of direct EC insurers' premium would not cause much of a cost burden on business in overall terms. Besides, this additional cost burden should be viewed in context. In the absence of the facility and the entailing charge, the claims stemming from the damage by any terrorist attacks would fall directly on the businesses or individuals concerned. The arrangements we now propose will enable them to cover the respective risks as in the past. Cost for the cover is increased mainly because of the risk reassessment by the insurance industry in the wake of the 911 incident.

PUBLIC CONSULTATION

26. The General Insurance Council which represents all major insurers in Hong Kong holds the view that Government should provide some form of guarantee for their liability to pay up-front.

PUBLICITY

27. A Legislative Council brief and a press release will be issued on 19 December 2001, and a briefing for Legislative Council Members will be held on 20 December 2001. A spokesman will also be available for answering media enquiries.

ENQUIRIES

28. For any enquiries, please contact Mr Alan Lo, Principal Assistant Secretary for Financial Services (Retirement Schemes and Insurance), at 2528 9016.

Financial Services Bureau
19 December 2001