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Panel on Financial Affairs

**Minutes of meeting
held on Monday, 7 July 2008 at 10:45 am
in the Chamber of the Legislative Council Building**

- Members present** : Hon CHAN Kam-lam, SBS, JP (Chairman)
Hon Ronny TONG Ka-wah, SC (Deputy Chairman)
Hon James TIEN Pei-chun, GBS, JP
Hon Albert HO Chun-yan
Dr Hon David LI Kwok-po, GBM, GBS, JP
Hon Bernard CHAN, GBS, JP
Hon SIN Chung-kai, SBS, JP
Hon Emily LAU Wai-hing, JP
Hon Abraham SHEK Lai-him, SBS, JP
Hon Jeffrey LAM Kin-fung, SBS, JP
Hon Andrew LEUNG Kwan-yuen, SBS, JP
Hon WONG Ting-kwong, BBS
Hon CHIM Pui-chung
- Members absent** : Ir Dr Hon Raymond HO Chung-tai, SBS, S.B.St.J., JP
Hon James TO Kun-sun
Hon TAM Heung-man
- Public officers attending** : Agenda Item III
Financial Services and the Treasury Bureau

Ms Alice CHEUNG
Principal Assistant Secretary for Financial Services and
the Treasury (Financial Services)

Securities and Futures Commission

Mr Martin WHEATLEY
Chief Executive Officer

Hong Kong Monetary Authority

Mr Arthur YUEN
Executive Director (Banking Supervision)

Mr Vincent LEE
Division Head (Securities Enforcement)
Banking Development Department

Agenda item IV

Financial Services and the Treasury Bureau

Mr Clement CHEUNG
Commissioner of Insurance

Ms Jenny CHAN
Principal Assistant Secretary for Financial Services and
the Treasury (Financial Services)

Attendance by invitation : Agenda Item IV

PricewaterhouseCoopers Hong Kong

Mr Lloyd BRYCE-BORTHWICK
Partner

Mr Harold MA
Director, Office of General Counsel,
Deputy General Counsel

Clerk in attendance: Miss Polly YEUNG
Chief Council Secretary (1)5

Staff in attendance: Ms Annette LAM
Senior Council Secretary (1)3

Ms Rosalind MA

Senior Council Secretary (1)8

Ms Sharon CHAN
Legislative Assistant (1)8

Action

I. Confirmation of minutes of meeting and matters arising

(LC Paper No. CB(1)2083/07-08 — Minutes of special meeting on 28 April 2008)

The minutes of the special meeting held on 28 April 2008 were confirmed.

II. Information papers issued since the last meeting

(LC Paper No. CB(1)2033/07-08 — Draft report of the Panel for 2007-08 for submission to the Legislative Council

LC Paper No. CB(1)2088/07-08(01) — Information note on measures to strengthen the supervision on assets of long term insurers in Hong Kong provided by the Administration)

2. Members noted that the above papers had been issued for the Panel's information.

III. Regulation of sale of structured investment or derivative products

(LC Paper No. CB(1)2082/07-08(01) — Administration's paper on regulation of sale of structured investment or derivative products

LC Paper No. IN22/07-08 — Information note on professional investors prepared by the Research and Library Services Division)

Briefing by the Securities and Futures Commission

3. The Chief Executive Officer of the Securities and Futures Commission (CEO/SFC) briefly introduced the three major components of the regulatory regime for protection of investors investing in structured investment or derivative products, as follows:

- (a) On the regulatory regime for financial products, the focus was primarily on information disclosure rather than on the commercial merits of the products. In brief, the Companies Ordinance (CO) (Cap. 32) required the issuer to include in the document for public offering of structured investment or derivative products all information an investor would reasonably require for the purpose of making an informed investment decision.
- (b) On the regulation of the conduct of licensed or registered persons, the Code of Conduct for Persons Licensed by or Registered with the SFC (the Code) required a licensed or registered person, when providing services to a client in relation to financial products, to assure itself that the client understood the nature and risks of the products and had sufficient net worth to assume the risks and bear the potential losses of trading in the products. To ensure compliance with the Code, SFC and the Hong Kong Monetary Authority (HKMA) carried out on-site examinations and would not hesitate to take enforcement actions when there were breaches of the Code. Apart from on-site examinations, SFC and HKMA followed up complaints, carried out necessary investigations and take disciplinary actions where circumstances warranted.
- (c) Investors' awareness of the need to understand the nature and risks involved in the structured investment or derivative products before making their investment decisions was very important. Through its investor education programme, SFC helped investors gain a general understanding of the key features and risks of these products and the important issues to consider before making investment decisions.

Briefing by the Hong Kong Monetary Authority

4. The Executive Director (Banking Supervision), Hong Kong Monetary Authority (ED(BS)/HKMA) said that HKMA had been working closely with SFC in following up investors' complaints relating to accumulator contracts. Under the Securities and Futures Ordinance (SFO) (Cap. 571), HKMA was the frontline regulator for banks in relation to their securities and futures business. All the requirements under the existing regulatory regime for the selling of securities and futures products were applicable to banks and brokers alike. As the frontline regulator, HKMA applied regulatory standards stipulated by SFC in supervising the regulated activities conducted by banks. It performed on-site examinations to ensure that banks had proper internal control and management supervision in place as well as complied with the relevant statutory and regulatory requirements. Where signs of mis-selling or other wrongdoings were revealed during the supervisory process or from complaints received, HKMA would look into the cases and take appropriate actions in consultation with SFC. As far as banks' securities business was concerned, the procedures adopted by HKMA were modelled on those of SFC. There were

regular meetings between HKMA and SFC as well as formal consultation on each and every disciplinary case to ensure consistency in application of standards by both regulators.

Discussion

Regulatory requirements on the sale of structured investment or derivative products

5. Mr SIN Chung-kai noted that the regulators would carry out on-site examinations in relation to the sale of investment products by banks and non-bank intermediaries. He enquired whether there was any mechanism for the regulators to conduct random checks with individual investors to ascertain compliance of these institutions with the standards and requirements stipulated by SFC. Mr SIN was particularly concerned about the sale practice for sophisticated structured investment or derivative products such as accumulator contracts through private banking service, and sought information on how customers were apprised of the features and investment risks of these products.

6. In response, ED(BS)/HKMA advised that as part of its day-to-day supervision of the securities and futures business of banks, HKMA would conduct random inspections of transaction documents/records including contracts and records of telephone conversations between bank staff and their customers. The existing supervisory measures were considered adequate and broadly in line with the practices adopted by regulators of other advanced economies. As far as he was aware, some banks had put in place an internal control mechanism under which random testings would be conducted to ascertain adherence of their frontline staff to the regulatory requirements on the sale and distribution of investment products. While it was not HKMA's practice to contact individual bank customers, it might get in touch with the customers concerned when dealing with complaint cases.

7. CEO/SFC advised that the regulatory approach adopted by SFC was similar to that of HKMA. The two regulators maintained consistency in the application of regulatory requirements through regular meetings and pursuant to the Memorandum of Understanding. SFC would follow up complaints with the investors concerned but did not normally carry out random checks with individual investors. Responding to Mr SIN's further enquiry, CEO/SFC said that SFC did not issue directives to HKMA as to how the latter should perform its supervisory functions in relation to the regulation of the offer of structured investment products by banks.

8. Mr James TIEN declared that his company had investments in accumulator contracts. Given the complexity of structured investment and derivative products available in the market, he was concerned that it might not be easy for an average investor to understand fully the nature and risks of such products. Moreover, intermediaries would tend to emphasize the return rather than the risks of these products in the sale process. Mr Jeffrey LAM pointed out that a great variety of financial products were offered in the market to cater for different investment needs. However, as investors might have difficulties in coming to grip with such

sophisticated products, Mr LAM and Mr TIEN asked whether all financial products, notably structured investment or derivative products such as accumulator contracts, should be subject to prior vetting or approval by the regulator before being offered in the market.

9. CEO/SFC explained that at present, the public offering of unlisted structured notes had to meet the information disclosure requirements under the CO. If the structured note offered to the public was also proposed to be listed on the Stock Exchange of Hong Kong Limited (SEHK), then, in addition to satisfying the requirements under CO, the issuer would need to comply with the relevant provisions of the Main Board Listing Rules on structured products. The SFO also contained provisions on certain authorization requirements if the documents constituted an invitation to the public to enter into an investment agreement or to acquire securities. CEO/SFC pointed out that structured investment or derivative products such as accumulator contracts were a narrow class of products privately sold to sophisticated investors rather than to ordinary small investors. The issuance of these privately placed products was not subject to the approval of SFC or HKMA. Similar to the practice adopted in other advanced markets, a lighter regulatory regime would apply in relation to activities carried out by licensed intermediaries in connection with professional investors who should have the requisite experience and knowledge to make their own investment decision. Therefore, pre-approval of these products by the regulator was not required.

10. The Chairman and Mr CHIM Pui-chung expressed concern about investor protection in the investment in highly sophisticated financial products. They doubted the efficacy of the criteria for designating certain investors as "professional investors" based on the size of an investment portfolio of not less than HK\$8 million. Mr CHIM pointed out that the terms and conditions of the contracts of these investment products were usually lengthy and difficult to understand. He was of the view that the lighter regulatory regime governing the sale and distribution of financial products to professional investors had in fact been abused by some international banks assuming the dual role of "issuer" and "distributor" of these products. He called on SFC and HKMA to step up their supervisory and enforcement efforts.

11. In response, CEO/SFC assured members that SFC attached great importance to investor protection and would not hesitate to take necessary actions against licensed intermediaries for breaches of regulatory requirements. In determining whether an individual was a professional investor under the Code, a licensed or registered person had to fulfil a number of obligations. In addition to the criterion of an investment portfolio of not less than HK\$8 million or its equivalent in any foreign currency, the Code required licensed or registered persons to assess and be reasonably satisfied that the client was knowledgeable and had sufficient expertise in the relevant products and markets, having regard to the types of products the client had traded, the frequency and the size of the trades (not less than 40 transactions per annum), the client's dealing experience in the relevant market (at least two years) and the client's awareness of the risks involved in trading in the relevant markets.

Furthermore, the licensed or registered person needed to provide a written explanation to the client explaining the risks and consequences of being treated as a professional investor and to obtain a signed declaration, which had to be re-confirmed annually, from the client confirming the latter's acceptance of his being treated as a professional investor.

12. The Chairman and Mr CHIM Pui-chung requested SFC to review the HK\$8 million threshold. The Chairman opined that the current threshold might be on the low side given the increase in the variety of investment products and the growth in the volume of market transactions in the past years. Mr James TIEN suggested that, to enhance protection for investors, SFC/HKMA should ascertain whether licensed or registered persons had complied fully with the requirements of the Code for determination of professional investors during their on-site examinations. In response, CEO/SFC re-stated that the size of the investment portfolio was only one of the criteria. SFC would review the various defining factors, including whether the threshold of HK\$8 million should be revised, later in 2008.

13. The Chairman commented that the current arrangements, which did not require issuers to obtain prior approval of the regulators on the documentation and offering of structured investment or derivative products privately sold to professional investors, had given rise to concern about inadequate regulation. He opined that improvements should be made to the regulatory regime for these privately placed products. In reply, CEO/SFC said that as these products were not meant for wide public offering and were traded in a relatively smaller market, it was the usual practice for regulators to adopt a reactive enforcement stance and would only take action when there were regulatory concerns arising from the sale or distribution of these products.

14. Mr Ronny TONG was of the view that while prior approval or vetting by SFC was not currently required before private banks sold structured investment or derivative products (such as accumulator contracts) to their clients, SFC should at least make enquiries on the nature and packaging of the products. Mr TONG also suggested that SFC should revise the disclosure requirement under the Code to require licensed or registered persons to disclose to their customers that these privately sold products had not been approved by SFC.

15. In this connection, CEO/SFC highlighted that a robust regulatory regime under SFO was already in place to regulate the information disclosure and documentation approval process of investment products to be sold or distributed publicly. However, the category of products under discussion was sold privately to a selected group of individuals considered by the banking/financial institutions as of high net worth and well-versed in sophisticated investments. The interests of the investors were safeguarded through relevant requirements under the Code on the intermediaries to act properly, fairly and to disclose necessary information relating to the products. Nevertheless, CEO/SFC agreed to consider Mr Ronny TONG's suggestion in the upcoming review of the criteria for and requirements on dealing with professional investors.

(*Post-meeting note* : The written response provided by SFC on paragraph 15 above was issued to members vide LC Paper CB(1)2255/07-08(01) on 11 August 2008.)

16. Noting that intermediaries were required under the Code to provide clear explanation on the nature and risks of the products recommended to their clients, Mr Jeffrey LAM enquired whether there were guidelines for the intermediaries to follow in fulfilling this obligation. In reply, CEO/SFC advised that guidelines had been issued to intermediaries listing the matters they should have regard to when making recommendations or solicitations to their clients. In brief, the intermediaries should provide their clients with sufficient information on the potential benefits and risks of the product to help clients make informed investment decisions. On the question of distinguishing between good and bad investment advisers, CEO/SFC responded that this was primarily a matter of commercial judgment for the investors.

17. The Chairman said that under a highly competitive business environment, some bank staff had simply persuaded retirees with sufficient net worth to sign the declaration consenting to being treated as professional investors without taking all the requisite steps to ascertain whether the individual could meet the criteria as a professional investor. He therefore called on the regulators to pay special attention to the compliance of bank staff with the relevant regulatory requirements.

18. In response, CEO/SFC pointed out that any intermediary who asked the client to sign the declaration without going through the required steps would be in breach of the Code. Where necessary, SFC would investigate into alleged breaches and take disciplinary actions. ED(BS)/HKMA added that in addition to the written declaration signed by professional investors, HKMA would look into the internal control of banks in its day-to-day supervision. Where certain bank staff had failed to follow the required procedures when designating certain clients as professional investors, HKMA would follow up with the bank concerned.

Regulation of securities and futures business of banks and non-bank institutions

19. The Chairman noted that under the current regulatory framework, the securities and futures business of banks and broker firms were subject to the regulatory oversight of two different regulators, i.e. HKMA and SFC respectively. While both regulators adopted the same regulatory standards and requirements as stipulated under SFO, the Chairman said that licensed brokers under the supervision of SFC had expressed the view that they were subject to more stringent licensing requirements than registered persons of banks under the supervision of HKMA. Moreover, the investing public might find it difficult to decide which regulator to approach for lodging complaints. The SFC and HKMA would also need to examine the complaints for the purpose of deciding which regulator should follow up. As such, the Chairman was of the view that consideration should be given to streamlining the regulatory framework so that a single regulator would oversee the compliance of licensed or registered persons engaged in securities or

investment-related business in both the banking and securities sectors. Mr CHIM Pui-chung expressed similar concern and opined that the regulators and the Administration should follow up complaints in a more proactively manner.

20. In this regard, CEO/SFC re-affirmed that SFC attached importance to investigating into complaints of alleged breaches. Cases which were found to be outside the jurisdiction of SFC would immediately be referred to the appropriate authority for follow-up. During the past six months or so when issues related to structured investment or derivative products had aroused much public concern, SFC had received a total of 15 complaints from investors, among which 12 had been referred to HKMA for follow-up.

21. ED(BS)/HKMA pointed out that the current regulatory framework, under which HKMA acted as the frontline regulator of the securities and futures business of banks, had been in place since the implementation of SFO in 2003. The current arrangement was noted and supported by the industry and the relevant Bills Committee at that time, which had examined the legislative proposals at length. More importantly, HKMA had all along worked in close collaboration with SFC in the supervisory process, including conducting on-site examinations and in handling complaint and disciplinary cases, thereby maintaining consistency in supervisory and enforcement standards. As regards concerns about the difference, if any, in regulatory standard applicable to banks and brokers in their securities and futures business, ED(BS)/HKMA said that both categories of practitioners were subject to the same set of requirements and "fit and proper" test prescribed by SFC. The Principal Assistant Secretary for Financial Services and the Treasury (Financial Services) (PAS(FS)) added that the regulatory regime for structured investment or derivative products focused on the conduct of the intermediaries in the sale and distribution process rather than on the merits or issuance of the products per se. She assured members that the regulators would take necessary enforcement actions to ensure compliance by intermediaries with relevant requirements under the Code.

22. The Chairman reiterated his view that if the securities and futures business of banks and broker firms were subject to the same set of standards and requirements, the regulatory framework should be simplified by placing the regulatory responsibility under a single regulator. He also enquired about the progress of and timeframe for completion of HKMA's investigation on the 12 complaint cases referred by SFC.

23. In response, ED(BS)/HKMA assured members that HKMA would deal with the complaint cases in a prudent and fair manner, with a view to completing investigation as soon as possible. He nevertheless pointed out that it would be difficult to specify a timeframe for completion of investigation due to the complexity of the issues involved. CEO/SFC highlighted that the current system underpinned by two regulators to oversee the business of two different sectors and applying a unified set of regulatory standards and requirements had operated effectively all along. Whether or not the status quo should be changed was a policy issue which had to be further examined. PAS(FS) advised that the current regulatory system had been in

place since the implementation of SFO in 2003. Whether the securities and futures business of banks and other non-bank institutions should be put under the oversight of a single regulator had to be considered carefully, having regard to market developments. For example, it was also noted that in recent years, banks were also engaged in businesses such as insurance and Mandatory Provident Funds.

24. The Chairman called on the Administration to review the current regulatory regime for securities and futures business conducted by banks and non-bank institutions, taking into consideration members' views and the latest market developments.

Safeguards against conflict of interests

25. Mr Albert HO noted that while many banks acquired structured investment or derivative products from international fund houses or financial institutions, some banks took on a dual role of being both the issuer and the distributor of these products. In such cases, Mr HO was concerned about the conflict of interests that might arise and whether this could be effectively addressed by the establishment of "Chinese Walls" between the frontline business arm and the investment banking division arm of the bank concerned.

26. In response, CEO/SFC advised that banks/financial institutions taking on the dual role as issuer and distributor would not give rise to conflict of interests, provided that there was adequate upfront disclosure to investors and the establishment of effective "Chinese Walls" between the frontline business function and the investment banking division. If a bank/financial institution considered that it could not effectively manage the conflict of interest arising from its dual role by way of "Chinese Walls" or through upfront disclosure, it should not engage in the promotion and sale of the products issued by it.

27. Responding to Mr Albert HO's further enquiry on the consequences faced by an intermediary who had failed to make sufficient disclosure to the client, CEO/SFC said that he was not in a position to make a generic comment as it was necessary to consider the specific circumstances of individual cases. In enforcing the Code, SFC or HKMA would investigate into complaints and assess whether there were any breaches of the Code. If a client considered that the intermediary had not complied with the disclosure requirements under the Code, he should lodge a complaint with SFC or HKMA, depending on whether a bank or a non-bank institution was involved.

28. Mr Albert HO enquired whether SFC/HKMA had the power to compel disclosure of information such as the profits gained by the intermediary in the transactions and the commission charged. In reply, CEO/SFC advised that an intermediary was obliged to disclose their fees and commission but not the profitability of its position in a transaction. As a general requirement, an intermediary must disclose reasonable and adequate information to its client before advising on or dealing in the product.

29. Mr Abraham SHEK pointed out that apart from concerns about the conflict of interests, the question of whether an intermediary owed a fiduciary duty to its clients should also be examined. Mr SHEK opined that where an intermediary acted as the investment adviser of its customers and offered investment products issued by its parent financial institution, the question of fiduciary duty would likely arise. He doubted whether the regulators had given any consideration to fiduciary duty in their investigation of complaints. Mr SHEK called on the regulators to make reference to the fiduciary duty of investment advisers under the regulatory regime of the United States. He also noted with concern cases where investors with net worth below HK\$8 million had been persuaded to apply for loans to top up their net worth in order to invest in privately placed structured investment products.

30. In response, CEO/SFC advised that general principles governing the conduct of intermediaries in dealing with their clients were set out in the Code. For example, the intermediaries should operate in accordance with the principles of honesty, fairness and in the best interest of their clients. Regarding the protection of investors through imposing fiduciary duty on the intermediaries, CEO/SFC said that SFC had issued clear suitability requirement guidelines, in the form of questions and answers, to enhance intermediaries' understanding as well as assist them in meeting the suitability obligations under the Code. Thematic examinations on investment advisory activities were carried out as part of SFC's regular on-site examination. Where breaches were identified during the examinations, SFC would take enforcement actions against the intermediaries as appropriate. CEO/SFC reiterated that an investment portfolio of not less than HK\$8 million was only one of the many tests for the determination of an individual's status as a professional investor. He took note of Mr SHEK's view about the fiduciary duty of intermediaries.

31. Mr Albert HO was of the view that even professional investors with the expertise and knowledge in investment might not have sufficient time to manage their wealth and had to rely on the advice of their intermediaries. As such, the independence and fairness of the intermediaries would be of paramount importance in avoiding the conflict of interests and protecting investors. Mr HO was concerned whether the disclosure requirements in the Code included any specific requirements for the banks to disclose to their clients the open positions they held in the investment of a structured investment or derivative product. He also enquired about the measures adopted by HKMA to ensure the establishment and effective operation of internal control system and "Chinese Walls".

32. ED(BS)/HKMA responded that on the avoidance of conflict of interest, paragraph 10.1 of the Code stipulated that unless a licensed or registered person had disclosed the material interest or conflict, if any, they had in a transaction with or for a client, and taken all reasonable steps to ensure fair treatment of the client, he or she should neither advise nor deal in relation to the transaction. HKMA would examine the adequacy and suitability of the internal control systems of banks and compliance with the requirements of the Code by bank staff during its day-to-day supervision. He advised that among the 22 banks which sold structured investment or derivative

products such as accumulator contracts to their clients, only two were also issuers of these products. HKMA would focus its supervisory attention on ascertaining whether there was any conflict of interest in the transactions between these two banks and their customers. If breaches of the Code were substantiated, HKMA would take actions accordingly.

33. Mr Ronny TONG doubted whether banks would follow strictly the requirements on avoidance of conflict of interest and the restriction on staff engaging in regulated business. He also asked whether only bank staff registered with HKMA could provide investment advisory service. In response, ED(BS)/HKMA said that HKMA took effective enforcement actions to ensure banks' compliance with the statutory conditions imposed as part of their licensing conditions. HKMA maintained a register of bank staff engaged in regulated activities, which was available for inspection on HKMA's website. Cases would be referred to HKMA for investigation if bank staff not registered with HKMA were found to be engaging in regulated activities.

IV. Consultancy study on the feasibility of establishing insurance Policyholders' Protection Funds in Hong Kong

(LC Paper No. CB(1)2082/07-08(02) — Administration's paper on feasibility study on the establishment of insurance policyholders' protection funds in Hong Kong

LC Paper No. CB(1)2084/07-08 — Background brief on consultancy study on the feasibility of establishing insurance policyholders' protection funds in Hong Kong prepared by the Legislative Council Secretariat)

Briefing by the Office of the Commissioner of Insurance

34. At the invitation of the Chairman, the Commissioner of Insurance (C of I), of the Office of the Commissioner of Insurance (OCI), briefed members on the background and the latest development of the feasibility study on establishing policyholders' protection funds (PPFs) in Hong Kong. The key points highlighted in the presentation were as follows:

- (a) A consultancy study on the feasibility of establishing PPFs in Hong Kong was commissioned by OCI in 2002. In the ensuing public consultation conducted between December 2003 and April 2004, mixed feedbacks were received from a wide spectrum of stakeholders including insurers, practitioners, consumer advocate groups and professional bodies. While the setting up of PPFs was welcomed as a safety net for policyholders and would boost consumer confidence,

many respondents affiliated with the insurance industry were concerned about the potential moral hazards in that PPFs might encourage imprudent operation of insurers and make policyholders less vigilant in selecting their insurers. Views were expressed that resources could be spent more gainfully in strengthening the present regulatory regime as a direct means to mitigate the risk of insolvency. Concerns were also expressed over the impact of PPFs on the level of premiums, the undue stress on insurers having to inject funding into PPFs in the event of a major insolvency, and the equity or otherwise of cross-subsidization between policyholders and insurance companies.

- (b) The consultancy study concluded that the feasibility and success of a PPF scheme would depend heavily on the scope and nature of the scheme as well as the extent of industry and community support. Recommendation was made for the Government to reach a broad understanding with the insurance industry on the need for PPFs and the governing framework. In pursuance of this, the OCI had engaged in a close dialogue with industry stakeholders with a view to alleviating their concerns and agreeing on a pragmatic way forward.
- (c) The Hong Kong Federation of Insurers (HKFI) had indicated its agreement in principle to explore the establishment of a contingency plan to protect policyholders against the insolvency of insurers. A task force was set up to consider the main issues identified, including the rationale for establishing PPFs, their mode of operations, and options for scheme design, etc.
- (d) OCI would continue to work in partnership with HKFI to develop an appropriate framework for introducing PPFs in Hong Kong, taking into account the concerns and issues identified. In parallel, OCI would seek to strengthen prudential supervision on underwriting discipline, capital adequacy and investment strategy of insurers as the first line of defense against insolvency.

Discussion

Legal backing for the establishment of Insurance Policyholder' Protection Fund

35. Mr SIN Chung-kai expressed support for establishing PPFs in Hong Kong as he considered that this would better protect policyholders and promote market stability in the event of insolvency of an insurer. Referring to existing legislation governing bank depositors and securities investors, he considered that the establishment of PPFs as well as the related compensatory mechanism and regulatory framework should be backed up by legislation. He was aware that the success of the scheme would depend heavily on the extent of industry and community support and that it took time for the industry to canvass the views of stakeholders on key issues before a consensus could be reached on the way forward.

Mr SIN urged the industry and the Administration to seriously consider providing a legal framework for the establishment and operation of PPFs.

36. C of I recapped that despite their initial concern about moral hazards, the industry had become increasingly appreciative of the positive role of PPFs in promoting general market stability and securing public confidence in the event of an insurer's insolvency. He said that OCI would endeavour to reach a broad understanding with industry stakeholders as soon as possible. As regards the mode of operation, he advised that while some compensation funds such as the Deposit Protection Scheme Fund (DPSF), the Investors Compensation Fund and the Mandatory Provident Fund (MPF) Schemes Compensation Fund had their respective governing legislation, the Employees Compensation Insurer Insolvency Scheme (ECIIS) and two existing funds administered by the Motor Insurance Bureau (MIB) were industry initiatives financed by levies imposed on insurance premiums. C of I added that the Administration, in conjunction with industry stakeholders, would examine and make reference to the aforementioned compensation funds in developing the regulatory framework for PPFs.

Strengthening the existing regulatory regime

37. Ms Emily LAU indicated her support for establishing PPFs and urged the Administration and the industry to reach an early consensus on the way forward to enhance protection for policyholders. Noting that OCI would place increased vigor on prudential supervision to reduce the risk of insolvency, Ms LAU sought details on the enhancement measures that were implemented or under planning to strengthen the supervisory framework.

38. In reply, C of I pointed that PPFs were no substitutes for prudential supervision of the insurance industry, nor could the establishment of PPFs guarantee that no insolvency would occur in the insurance industry. OCI would continue to discharge its responsibility to regulate and supervise the industry for the promotion of market stability and the protection of policyholders. To this end, measures were undertaken to strengthen the monitoring of underwriting discipline, capital adequacy and investment strategy of insurers. He advised that long term insurance policies with elements of bonus payout/savings/investments usually involved assets overseas. To effectively monitor overseas assets and to facilitate accurate identification and continuous monitoring of assets on which local policyholders had a legitimate claim, OCI had introduced a new requirement on long term insurers to segregate, for reporting purpose, the portion of assets held by them which were attributable to local policyholders. Where necessary, they would also be required to submit returns more frequently than the normal annual cycle. To improve stress testing and sensitivity analysis, Dynamic Solvency Testing was deployed by OCI as a tool to assess the impact of different economic scenarios. Long-term insurers were required, on a trial basis, to submit supplementary returns covering asset/liability valuation, investment yield, valuation interest rate, guarantees and options reserve, currency mismatching reserve and the risk assessment models that they used. In

addition, regular on-site inspections would be conducted by OCI to monitor compliance with various regulatory measures.

39. In response to Ms LAU's enquiry on whether additional manpower resources were required for strengthening the present regulatory regime, C of I said that while the additional workload could presently be absorbed by internal staff deployment, more actuarial and accounting expertise would be required by OCI owing to the need for greater vigilance in asset-liability matching under evolving market conditions.

Other issues

40. Mr Bernard CHAN remarked that the insurance regulatory regime in Hong Kong was generally effective and the risk of insolvency of local insurers was relatively low. He recapped that the insolvency of the three insurers of the HIH Group in 2001 was mainly due to the insolvency of their parent company overseas. Since then, OCI had stepped up its liaison with overseas regulators. In the wake of widespread public concern arising from the incident, the Administration saw the need to study the feasibility of establishing PPFs in Hong Kong and commissioned a feasibility study in late 2002. Mr CHAN noted that the introduction of PPFs could enhance the protection for policyholders and promote the stability of the insurance industry. Given that compensation funds were currently in place catering for banking depositors, securities investors, and members of MPF Schemes, Mr CHAN saw no strong reasons why similar arrangements should not be provided for the insurance industry. He was pleased to note that after much discussion in the past few years, HKFI had agreed in principle to explore the establishment of PPFs and had set up a task force to take the matter forward. On funding arrangements, in consideration that PPFs in other jurisdictions were typically funded by the industry in the form of levies on insurance premiums, Mr CHAN noted the possibility of adopting a similar funding mechanism currently in place under the ECIIS and the two existing funds administered by MIB. Nevertheless, he pointed out that the increased cost might eventually be transferred to and borne by policyholders. On the mode of operation, he remarked that industry feedbacks were in favour of a model similar to DPSF.

41. The Chairman referred to a host of industry and public concerns that needed to be addressed, such as the level of levies and whether PPF levies should be paid by insurers or policyholders; whether the level of compensation to be received by each policyholder should be subject to an upper limit; whether a ceiling should be set for the pooled fund and if yes, the appropriate level; as well as concerns about cross-subsidization between policyholders and insurance companies, risk assessment and asset management, etc. He urged the Administration and the industry to examine the issues in the light of the findings of the consultancy study and finalize the framework as soon as practicable. He also enquired whether a comprehensive public consultation would be conducted following the consultancy report. In this connection, Ms Emily LAU asked when HKFI's task force would complete its report.

42. In reply, C of I advised that policyholders' protection schemes were in place in

a number of advanced overseas economies. Most of the major long term insurers in Hong Kong were subsidiaries of overseas insurers in jurisdictions where PPFs were already in place. As regards concerns about cross-subsidization, C of I said that reference would be made to overseas experience on different funding models. Regarding public consultation, C of I advised that the consultancy study had recommended that the Government should engage relevant parties in deliberating on options for scheme design and to reach a broad understanding with the industry on the need for PPFs and the governing framework. To this end, OCI would continue to work in conjunction with HKFI with a view to developing an appropriate framework taking into account all relevant issues and concerns raised. When an initial draft framework was ready, OCI would consult a wider group of stakeholders and seek the Panel's views before deciding on the way forward. On the implementation timeframe, C of I added that it was difficult to advise on a specific timetable at the present stage. He however undertook to make a progress report to the Panel in the 2008-2009 legislative session and highlighted that continuous effort would be made to strengthen the present regulatory regime as a direct means to mitigate the risk of insolvency.

Admin

V. Any other business

43. There being no other business, the meeting ended at 12:45 pm.

Council Business Division 1
Legislative Council Secretariat
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