For discussion on
4 April 2011

Legislative Council Panel on Financial Affairs

Proposed Establishment of a Policyholders' Protection Fund

Purpose

This paper sets out the Administration's proposals for the establishment of a Policyholders' Protection Fund ("PPF"), including the proposed coverage, level of compensation, funding mechanism and governance arrangements. We will commence a three-month public consultation exercise from 25 March 2011. The consultation document is attached at the Annex. Members are invited to offer their comments on the proposals.

Background

2. The existing prudential regulatory regime, administered by the Insurance Authority ("IA") under the Insurance Companies Ordinance ("ICO") (Cap 41), seeks to promote financial stability of the insurance industry and minimize insolvency risk of insurers. Under prudential supervision by the IA, insurers with business in Hong Kong are mandated to comply with statutory capital requirements and reserving requirements. While the effectiveness of this regulatory regime was evidenced by the stability of our insurance market, the possibility of insurer insolvency in future cannot be totally ruled out.

3. In many advanced economies, compensation funds are in place as a safety net for policyholders against insurer insolvency. Currently in Hong Kong, there is no such compensation fund[1].

[1] Other than compensation funds administered by the Employees Compensation Insurer Insolvency Bureau and the Motor Insurance Bureau, specifically for employees' compensation and motor vehicle third party claims respectively.

4. Following the in-principle support from this Panel on 6 July 2009 to the conceptual framework for the PPF which was developed by the Administration in collaboration with the Hong Kong Federation of Insurers ("HKFI"), the IA commissioned an actuarial consultancy study in 2010 to assess detailed arrangements of the proposed PPF, including the optimal levy rate and target fund size, among others. A Steering Committee represented by both the Administration and HKFI has been established to oversee the study which was completed recently.

Proposals

5. Details of the proposals for a PPF are set out in the consultation document at the Annex. The following highlights the key aspects of the proposals.

Objectives and Guiding Principles

6. The proposed PPF is intended to better protect policyholders' interest, maintain market stability in the event of insurer insolvency and enhance public confidence in and competitiveness of the insurance industry. In developing the parameters of the PPF, we are guided by the following principles:

(a) the PPF should strike a reasonable balance in enhancing protection for policyholders and minimising additional burden to the insurance industry;

(b) the PPF should enhance market stability while minimizing the risk of moral hazard;

(c) the PPF should provide certainty on the level of compensation payment to policyholders when an insurer becomes insolvent, and a reliable system should be put in place to facilitate the collection, custody, investment and administration of levy contributions to the PPF; and

(d) the establishment of the PPF should not in any way compromise the regulatory standards and requirements laid down by the IA under the ICO.

Coverage

7. We recommend that the PPF should focus on individual policyholders. All authorized direct life and non-life insurers should be mandated by statute to participate in the PPF. The PPF would comprise two separate schemes, namely the Life Scheme and the Non-Life Scheme, to cover life and non-life products respectively. The two Schemes will be operated independently of each other without cross-subsidy.

8. We note that different small and medium enterprises (“SMEs”)[2] may have different views on the need of relying on the PPF in enhancing their risk management. We welcome views on whether the coverage of the PPF should be extended to cover SME policyholders.

9. On account of the mandatory nature of the building owners’ corporations (“OCs”) to procure third party risks insurance, we recommend to include OC policies in the coverage of the PPF.

Level of Compensation and the Application

10. Considering the moral hazard concern and the need for a reasonable balance between the cost and benefit, there should be a limit on the compensation level of the PPF. We recommend that it should be 100% for the first HKD100,000 of any claim, plus 80% of the balance up to a total of HKD1 million[3]. The compensation limit would be applied to life insurance on a per-policy basis and non-life insurance on a per-claim basis.

11. Based on industry data as at end 2009, this compensation limit would be able to meet 90%-100% of the claims

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[2] An SME is defined in the context of the PPF as a manufacturing business which employs fewer than 100 persons in Hong Kong, or a non-manufacturing business which employs fewer than 50 persons in Hong Kong.

[3] For example, a claim for HKD1.225 million would hit the compensation limit of HKD1 million, computed as: HKD100,000 × 100% + HKD(1,225,000-100,000) × 80% = HKD1,000,000.

arising from some 90% of life policies, and to fully meet claims of some 96% of Non-life policies.

Life Scheme

12. For life insurance, it would be in the policyholders' interest to continue their policies upon an insurer insolvency. We therefore recommend that the Life Scheme should be allowed to pay up to HKD1 million per policy to facilitate the transfer of life policies to another insurer.

13. In the unlikely event that such a transfer cannot be arranged, the life policies concerned would be treated under one of the following two possible scenarios: (a) continuation until expiry; and (b) termination. For (a), the Life Scheme should settle any claims arising, subject to the compensation limit set out in paragraph 10 above. For (b), the Life Scheme should pay the affected policyholders the cash / account value plus declared dividends / bonuses, and it may also pay a possible "ex-gratia" payment[4] for losses having regard to premature termination of policies. The total payment should be capped at HKD1 million per policy.

Non-Life Scheme

14. Transfer of non-life policies would not be cost-effective as they are of much shorter term and normally would have expired before the completion of the insolvent insurer's liquidation process. We recommend that the Non-Life Scheme should provide for continuity of coverage until the expiry of non-life policies and meet claims in accordance with the limit set out in paragraph 10 above.

15. For accident and health policies with guaranteed renewability, we recommend that the PPF should be allowed to pay up to HKD1 million per policy to facilitate transfer to another insurer. If a transfer cannot be arranged, the PPF may pay the affected policyholders

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[4] The PPF Board referred to in paragraph 22 (or a committee established by the PPF Board as provided by law) would decide the amount of "ex-gratia" payment on a case-by-case basis, taking into account the circumstances of individual policies and policyholders, the availability of alternative coverage in the market and actuarial assessment of the loss to the policyholders etc.

an "ex-gratia" payment to enable them to procure similar replacement policies from another insurer, subject to a limit of HKD1 million per policy.

<u>Funding Mechanism</u>

Funding Model

16. We recommend a progressive funding model which seeks to build up an initial target fund through a moderate levy rate, with the option to impose a "stepped-up" levy rate as necessary upon occurrence of an insurer insolvency. Unlike the pre-funding model, it would not lock up a significant amount of levies upfront which in turn will put pressure on the premium levels. On the other hand, it softens the deep levy required by the post-funding model when an insurer insolvency occurs.

Initial Target Fund Size

17. Based on the Consultant's actuarial modeling using the current data of the local insurance business and relevant assumptions[5], we recommend that the initial target fund size should be HKD1.2 billion for the Life Scheme and HKD75 million for the Non-Life Scheme. The plan is to build up the initial target fund in 15 years. As the underlying assumptions may change over time, the target fund size will be subject to review in due course after the PPF has been in operation for a certain period of time.

[5] With the industry data, the Consultant ran the actuarial model based on a large number of simulations (50,000) and major modeling assumptions adopted in formulating the proposal include:
- (a) a confidence level of 99%, i.e. having a 99% probability of meeting compensation payments of all protected liabilities (subject to the compensation limit set out in paragraph 10) in any one year;
- (b) asset recovery rate of 50-90% for life insurers and 40-80% for non-life insurers;
- (c) default rate of insurers based on the credit rating assigned to them by major rating agencies;
- (d) investment of the fund in low-risk vehicles, i.e. investment return of 2% per annum;
- (e) low to medium growth rate in the insurance sector (i.e. 5-10% growth rate), trending to 2.5-5% growth rate in 10 years;
- (f) inflation of 2% per annum;
- (g) running cost amounting to 0.2% of the initial target fund size; and
- (h) lending rate of 3% in case third-party lending is needed to fill a funding gap.

Levy Rate

18. On the basis of the above, we recommend that the initial levy rates for both the Life Scheme and the Non-Life Scheme should be 0.07% of the applicable premiums. The levy rates would also be reviewed as part of the review of the target fund size.

19. We recommend that the PPF collect the levies from insurers, as the PPF seeks to promote industry competitiveness and address issues arising from insurer insolvency. Given the affordable levy rates and the keen competition among insurers in Hong Kong, we believe that the impact on the premium levels would be minimal.

Asset Recovery

20. In the event of an insurer insolvency, we recommend that any claims that have been paid by the PPF should be subrogated to the PPF for recovery from the assets of the insolvent insurer. In the winding up process, the PPF should have equal ranking with the Employee Compensation Assistance Fund and all other direct insurance claims not met by the PPF.

Financing Arrangement to Bridge Liquidity Gap

21. In order to ensure that the PPF would be able to make timely compensation payment even in its formative years, we recommend that the PPF should be allowed to borrow from a third party to bridge any liquidity gap. For example, the PPF may borrow from commercial lenders guaranteed by the Government, or from the Government direct. Approval of the Legislative Council would be required for either case. We expect that with the statutory levy requirement, the PPF should be able to obtain financing on competitive terms.

<u>Governance Arrangements</u>

22. With this Panel's support of a statutory approach for establishing the PPF, to ensure certainty and transparency in its operation, we recommend that the PPF should be established by legislation and

administered by an independent statutory body (viz. the PPF Board) appointed by the Financial Secretary. The PPF Board should maintain a small team of staff and be empowered to engage additional manpower or advisers in the event of an insurer insolvency. An Appeal Board should be established to handle appeals against any relevant decisions made under the PPF.

Next Step

23. The public consultation exercise will last until 24 June 2011. We will take into account Members' comments and views received from stakeholders and the public in the consultation exercise in finalizing the proposals which will form the basis for preparing legislation for the establishment of a PPF. We aim to announce the finalized proposals within this year.

Financial Services and the Treasury Bureau
Office of the Commissioner of Insurance
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