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Legislative Council
Panel on Financial Affairs

Proposed Establishment of a Policyholders' Protection Fund
Consultation Conclusions

Purpose

This paper briefs Members on the consultation feedback and conclusions on the proposed establishment of a Policyholders' Protection Fund ("PPF") in Hong Kong, and sets out the Administration's final proposals which will form the basis for preparing the enabling legislation.

Background

2. The Administration conducted a three-month public consultation exercise from March to June 2011 to solicit views from the public and stakeholders on the proposals for the establishment of a PPF, including the coverage, level of compensation, funding mechanism and governance arrangements.

3. In addition to making the consultation document available to the public and stakeholders, we have organized two public forums and held meetings with a number of industry bodies and other stakeholder groups during the consultation period. We also briefed the Legislative Council ("LegCo") Panel on Financial Affairs on 4 April 2011 on the proposals.

<u>Outcome of consultation</u>

4. We have received 49 written submissions from individuals and companies/organizations. Of the 49 submissions, 19 are derived

from three versions of identical letters. If we consider each version as a single submission, there would be 33 submissions in total. The consultation findings and our response are set out in the consultation conclusions at the **Annex**.

5. There is general public and industry support for the establishment of a PPF and most of the key proposals. Taking into account the comments received, we have finalized the proposals which would form the basis for drafting the enabling legislation for establishing the PPF. Consultation findings on the major proposals are summarised in the ensuing paragraphs.

Consultation Findings and Final Proposals

<u>Objectives and Guiding Principles</u>

6. There is general support for the following objectives and guiding principles for developing the PPF –

(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 Insurance Authority under the Insurance Companies Ordinance.

Coverage

7. We proposed in the consultation document that the PPF should comprise two independently operated schemes (i.e. the Life Scheme and the Non-Life Scheme) and should focus on individual policyholders. The PPF should also include building owners' corporations ("OCs") on account of the mandatory requirement for OCs to procure third party risks insurance.

8. Specifically, we invited views from the public on whether the PPF should cover small and medium enterprises ("SMEs"). We noted that there was considerable support, including those from the Consumer Council and the Small and Medium Enterprises Committee, for the PPF to cover SMEs, primarily on the ground that SMEs would have less resources to assess the financial ability of insurers and are less capable to protect their interests. On the other hand, some respondents from the industry considered that the PPF should focus on individuals and raised questions on the definition of SMEs and the administrative cost implications arising from the need for insurers to verify the SME status of policyholders. Having considered all views expressed and noting that exclusion of SMEs from the coverage of PPF would not have a material effect on the rates of the proposed levy[1], we propose that the PPF should cover SMEs and adopt a simple definition for SMEs[2] with user-friendly procedures, such as self-declaration of status by SME policyholders, to minimize the administrative cost impact on insurers.

9. We also proposed in the consultation document that all authorized direct life and non-life insurers should be required to participate in the PPF. Certain respondents considered that some insurers domiciled in other jurisdictions were already protected by similar policyholders' protection schemes and should thus be exempted from participating in the PPF. We consider that the comments are not

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1 The proposed levy rates set out in the consultation document (viz. 0.07% of the applicable premiums for the Life Scheme and the Non-Life Scheme respectively) have already accounted for SME policyholders. If SME policyholders were excluded, the levy rate for the Life Scheme would remain unchanged while that for the Non-Life Scheme would be reduced slightly to 0.061%.

2 In the consultation document, we proposed to define an SME 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. This definition is also adopted by the SME Loan Guarantee Scheme.

unreasonable, and thus propose that the future legislation should empower the PPF Board to consider and approve applications for exemption from the PPF by insurers, on a case-by-case basis, if they are able to demonstrate that they offer equivalent protection to their policyholders in Hong Kong via an overseas scheme of similar nature.

Level of Compensation and Compensation Basis

10. We proposed in the consultation document that the compensation limit for the PPF should be 100% for the first HKD100,000 of any claim, plus 80% of the balance up to a total of HKD1 million[3]. Some stakeholders who responded to this question considered the proposed compensation limit appropriate, while some suggested that it should be raised.

11. In determining the compensation limit, we need to strike a reasonable balance between the cost and benefit. The proposed compensation limit would already be able to meet 90% - 100% of the claims arising from some 90% of life policies, and fully meet the claims of some 96% of non-life policies[4]. An increase in the proposed compensation limit would lead to a significant surge in the target fund size and thus the levy rates but not contributing to a proportionate enhancement in protection. According to an assessment by our actuarial Consultant[5] based on industry data, raising the compensation limit from HKD1 million to HKD3 million would increase the levy of the Life Scheme substantially by 57% (from 0.07% to 0.11%) and the Non-Life Scheme by 21% (from 0.07% to 0.085%), but the number of life policies and non-life claims which would receive more compensation from the PPF would only increase by less than 1% and less than 0.5% respectively. Besides, raising the compensation limit may increase the risk of moral hazard. On balance, we propose to maintain the consultation proposal on the compensation limit.

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[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.

[4] Based on industry data in 2009.

[5] The Insurance Authority commissioned KPMG to carry out an actuarial consultancy study in 2010 to assess the optimal levy rate, target fund size and other detailed arrangements for the proposed PPF.

12. The compensation limit would be applied to life insurance on a per-policy basis and non-life insurance on a per-claim basis. In response to request from some respondents for clarification on the proposal for group policies, we propose that a per-life basis should be applied for group life policies, given that the PPF should protect the beneficiaries of every life insured and the compensation limit should be applied on claims arising from each deceased individual. For group medical policies and medical riders to group life policies, we propose that a per-claim basis should be applied, so that the compensation basis would align with that of other non-life policies.

Life Scheme

13. For life insurance, respondents were generally supportive of the consultation proposal that the Life Scheme should be allowed to pay up to HKD1 million per policy to facilitate the transfer of policies to another insurer. In the unlikely event that such a transfer cannot be arranged, the life policies concerned would either continue until expiry or be terminated, subject to the relevant compensation limit.

Non-Life Scheme

14. We proposed that the Non-Life Scheme should provide for continuity of coverage until expiry of the affected policies and meet claims in accordance with the compensation limit[6]. Some respondents suggested that a cut-off date should be imposed. For adequate protection of policyholders, we consider that such a proposal should be explored only if the PPF would refund the unexpired portion of premium of such non-life policies upon any cut-off date, but note that this would inevitably lead to a significant increase in the levy rates and substantial cash flow requirement by the PPF upon the cut-off date. We believe it is important to offer adequate protection to policyholders when an insurer becomes insolvent by meeting their claims until the expiry of their non-life policies, which normally run for a short period of one year or less.

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[6] For accident and health policies with guaranteed renewability, we proposed in the consultation document that the PPF should be allowed to pay up to HKD1 million per policy to facilitate transfer to another insurer. All other non-life policies are proposed to be covered by the Non-Life Scheme until expiry and their claims met in accordance with the compensation limit.

We therefore suggest that the consultation proposal should remain unchanged.

Funding Mechanism

Funding Model and Initial Target Fund Size

15. Respondents were generally in favour of the proposed progressive funding model which seeks to build up an initial target fund through a moderate levy rate, with the option of imposing a "stepped-up" levy rate as necessary when an insurer becomes insolvent. We have proposed that the initial target fund size should be HKD1.2 billion for the Life Scheme and HKD75 million for the Non-Life Scheme. The initial target fund is planned to be achieved in 15 years, and the target fund size will be subject to review in due course after the PPF has commenced operation.

Levy Rate

16. On the basis of the proposals set out in paragraph 15 above, we proposed that the initial levy rates for both the Life Scheme and the Non-Life Scheme should be 0.07% of the applicable premiums and that the PPF should collect the levies from insurers. We did not receive any dissenting views on these proposals.

17. Some respondents from the industry suggested that there should be a cap on the "stepped-up" levy rate to minimize the uncertainty of the magnitude of future increase of the levy rate. We would emphasize that the levy rate will be prescribed in statute through subsidiary legislation, and thus any "stepped-up" levy in future would require LegCo approval. We believe that any "stepped-up" levy would have to be reasonable in the circumstances without stifling market development. Besides, there are no objective yardsticks to determine any appropriate cap on the levy rates before the PPF has been implemented and an assessment is made based on actual data. We propose that the levy rates would be reviewed together with the target fund size after implementation of the PPF, and it would not be necessary or appropriate to impose a cap on the levy in the initial stage of the PPF.

18. We proposed that the office premiums (for life insurers) and the gross written premiums (for non-life insurers) reported in the audited returns should form the basis for levy calculation. Some respondents suggested that policies which would not be covered by the PPF, such as those held by non-SME corporates, should not be subject to the levy. We have no in-principle objection to this suggestion, provided that there is an effective way to assess and verify the amount of premiums attributable to policies not covered by the PPF. We are prepared to consider any proposal from the industry in this regard.

Asset Recovery

19. We proposed that, in case an insurer becomes insolvent, any claims that have been paid by the PPF should be subrogated to the PPF for recovery from the assets of the insolvent insurer, and during the winding up process, the PPF should have equal ranking with the Employees Compensation Assistance Fund and all other direct insurance claims not met by the PPF. The respondents were generally supportive of this proposal.

20. On the other hand, some respondents pointed out that this would mean that the PPF would have preferential ranking to the compensation schemes administered by the Motor Insurers' Bureau of Hong Kong ("MIB") and the Employees Compensation Insurer Insolvency Bureau ("ECIIB"), both of which are ranked as ordinary creditors. We do not consider it appropriate to lower the ranking of the PPF to an ordinary creditor, as such change would result in a hefty increase in the initial target fund size and levy rates[7] of the PPF. Taking into account the purposes of MIB and ECIIB (i.e. to offer protection to policyholders in the event of an insurer becoming insolvent), we will explore the feasibility of raising the ranking of the MIB and ECIIB compensation schemes to that of the PPF.

[7] According to the estimation by the actuarial Consultant, in the scenario that the PPF's ranking is lowered to that of an ordinary creditor, the initial target fund sizes of the Life Scheme and the Non-Life Scheme would increase substantially to HKD4.16 billion and HKD156.1 million respectively, and the levy rates would in turn be increased substantially to 0.24% and 0.146%.

Governance Arrangements

21. Respondents were generally supportive of the proposed governance arrangements of the PPF, including the organizational structure as well as functions and powers of the PPF Board.

22. We would reiterate our proposal that the PPF Board should comprise professionals experienced in insurance, finance, accounting, law and consumer affairs etc, and ex-officio representatives from the Government. A number of respondents expressed support for this proposal, whilst there were also views from the industry suggesting that insurers and/or insurance intermediaries should be represented in the Board. In establishing the PPF in future, we would take into account the need for having appropriate industry knowledge and experience supporting the PPF Board, through appointments to the Board and its two industry committees, provided that such appointments would not give rise to perceived or real conflict of interests. We believe that the PPF Board should attach importance to industry participation to ensure that the protection regime would evolve with market development.

Next Step

23. We will proceed with the preparation of the enabling legislation for establishing the PPF, and continue to engage the stakeholders in the process. We aim to introduce the Bill into LegCo in the 2012-13 legislative session for setting up the proposed PPF in 2013-14 at the earliest.

Financial Services and the Treasury Bureau
Office of the Commissioner of Insurance
30 January 2012

Annex

Proposed Establishment of a Policyholders' Protection Fund

Consultation Conclusions

Background

On 25 March 2011, the Administration launched a public consultation exercise on the proposals for the establishment of a Policyholders' Protection Fund ("PPF"). The proposals covered areas including the coverage, level of compensation, funding mechanism and governance arrangements. The consultation period ended on 24 June 2011.

Outcome of Consultation

2. We have organized two public forums and held eight briefing sessions with various industry bodies and other stakeholder groups during the consultation period. We also briefed the Legislative Council ("LegCo") Panel on Financial Affairs on 4 April 2011 on the proposals.

3. We have received a total of 49 written submissions, of which 19 were derived from three versions of identical letters. If we consider each version as a single submission, there would be 33 submissions in total. A summary of the comments received and the Administration's response is set out in the table below. Copies of submissions received are available at the website of the Financial Services and the Treasury Bureau at http://www.fstb.gov.hk/fsb/ppr/consult/ppf_conclusion.htm.

Issues	Comments Received	Response from the Administration
Objectives and Guiding Principles		
Proposed establishment of PPF	• The majority of respondents supported the proposed establishment of PPF to better protect policyholders' interests and maintain market stability in the event of an insurer becoming insolvent.	• We are pleased to note that the majority of respondents support the proposed establishment of PPF. We will continue to engage relevant stakeholders in our next phase of work in preparing the enabling legislation.

<table>
<tr><th>Issues</th><th>Comments Received</th><th>Response from the Administration</th></tr>
<tr><td></td><td>• A few respondents were concerned about the potential moral hazard on –
(a) insurers: insurers might become more aggressive in their pricing and investment strategies, thus increasing the potential for insurers becoming insolvent;</td><td>• It remains one of our guiding principles that the proposed PPF should enhance market stability while minimizing the risk of moral hazard.
• The establishment of PPF will not compromise the regulatory standards and requirements on insurers set by the Insurance Authority (“IA”) under the Insurance Companies Ordinance (“ICO”). IA will continue to exercise prudential monitoring of insurers’ financial position.</td></tr>
<tr><td></td><td>(b) policyholders: to varying extents potential policyholders might no longer attach adequate importance to the financial standing or rating of insurers when they procure policies, but might be inclined to choose one that offers the lowest premium.</td><td>• Having taken into account the concern of moral hazard in respect of potential policyholders, we have proposed that there should be a compensation limit.
• We have also proposed to add public education as a function of the independent IA upon its establishment.</td></tr>
<tr><td colspan="3">Coverage</td></tr>
<tr><td>Small and medium enterprises (“SMEs”)</td><td>• Some respondents supported that the PPF should cover SME policyholders because SMEs –
(a) account for an overwhelming majority (98%) of the total business units in Hong</td><td>• We propose that the PPF should cover SMEs. We agree that SMEs are generally less sophisticated than large corporates and may benefit from the protection of the PPF. The proposed levy of 0.07% has already factored in the coverage of SMEs. Actuarial</td></tr>
</table>

Issues	Comments Received	Response from the Administration
	Kong and many of them do use insurance as one of the means to manage their risks; and (b) have less resources to assess the financial position of the insurers.	calculations by the Consultant indicate that the coverage of SMEs or otherwise would not have a material effect on the levy rates[1].
	• Some respondents (mainly insurers) suggested that SME policyholders should not be covered because – (a) the PPF should focus on individuals or natural persons; (b) it would be insurance intermediaries' responsibility to advise their clients on the insurance products and service providers that would best serve the interest of policyholders; (c) the proposed HKD1 million compensation limit would be lower than the sum insured of SMEs' policies; and (d) there would be additional administrative cost for the insurers in extracting information on SMEs from their	• The compensation limit of HKD1 million serves to strike a reasonable balance between the cost and benefit of the PPF and to reduce the risk of moral hazard. • To minimize the administrative cost impact on insurers, we will keep the administrative procedures user-friendly (e.g. by self-declaration of SME status by policyholders), and will not impose restrictions on the types of insurance policies procured by SMEs to be covered by the PPF.

[1] If SME policyholders were excluded, the levy rate for the Life Scheme would remain unchanged at 0.07% while that for the Non-Life Scheme would only be lowered slightly from 0.07% to 0.061%.

Issues	Comments Received	Response from the Administration
	systems. • Some of them also suggested that should SMEs be included, the PPF should only cover specified types of insurance policies such as group life, group medical, property damage for own properties and public liabilities.	
	• Some respondents expressed concern over the difficulties in identifying / verifying the SME status of their policyholders and considered that a clear definition of SME agreed by all stakeholders would be necessary. Some commented that the proposed definition of SME stated in the consultation document, which was based on the number of employees, might not reflect accurately the size of the company. Some respondents queried whether sole proprietorships and partnerships, such as professional firms, would be regarded as SMEs in the PPF proposal.	• We propose to maintain the definition of SME as set out in the consultation proposal [2], which has been adopted by the SME Loan Guarantee Scheme. • It should be noted that there is no standard definition of SME and small business internationally, and it would be costly and administratively cumbersome for insurers to identify / verify the SME status of policyholders if additional criteria such as financial position and business turnover of the policyholders are to be added to the definition of SMEs. • We propose that under the PPF legislation, SME policyholders would need to declare their number of employees at the time of procurement / renewal of policies, and any subsequent

[2] As set out in footnote 7 of the consultation document, an SME in the context of the PPF is to be defined 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.

Issues	Comments Received	Response from the Administration
		changes that may affect their SME status during the insured period will not affect their protection under the PPF.
Building Owners' Corporations ("OC")	• A few respondents commented on the proposed inclusion of OC policyholders. Most of them indicated support to the proposal, whilst one respondent objected.	• Noted. We propose no change to the consultation proposal to include OC policyholders in the coverage of the PPF, on account of the mandatory nature of the requirement for OCs to obtain third-party risks insurance.
Participation of all authorized direct life and non-life insurers except reinsurers and captive insurers	• Some respondents commented that those insurers and policies which had already been covered by similar policyholder protection schemes in other jurisdictions should be exempted from the PPF to avoid double levies.	• We consider it not unreasonable to exempt insurers domiciled in other jurisdictions with similar policyholder protection schemes from the PPF. We propose to empower the PPF Board to consider and approve applications for exemption from the PPF by insurers, on a case by case basis, if they are able to demonstrate that they offer equivalent protection to their policyholders in Hong Kong via an overseas scheme of similar nature.
Life and Non-Life Schemes	**<u>Non-Life Scheme</u>** • Some respondents suggested that the Non-Life Scheme should only protect policyholders of specific types of personal insurance policies instead of all classes of general insurance	• The specific types of policies mentioned by the respondents are mostly purchased by non-SME corporates and therefore would not be covered by the PPF. • There are insurance policies

Issues	Comments Received	Response from the Administration
	business (except motor and employees' compensation policies which are already covered by the Motor Insurers' Bureau ("MIB") and the Employees Compensation Insurer Insolvency Bureau ("ECIIB")) as defined in the ICO. Certain types of non-life insurance policies such as marine, aviation, transport, credit insurance and professional indemnity insurance should be excluded because these policyholders / beneficiaries were usually either non-SME corporates or professionals.	which are mandated by statute. We consider that the PPF should cover all these insurance policies which are not covered currently by any compensation schemes[3]. Excluding only those policies mentioned by the respondents which are not mandated by statute will complicate the design of the PPF and increase the cost of administration. In fact, the proposed HKD1 million compensation limit will address the concern of the PPF having to provide very significant compensation to the policyholders.
	• Some respondents further commented that coverage of marine, aviation and transport (collectively referred as "MAT") policies by the PPF with imposition of a levy might drive these businesses away from Hong Kong.	• We note the concern that MAT business is relatively more mobile and sensitive to pricing and levy rate. Given that these policies are mostly purchased by non-SME corporates and that the proposed levy rate is very modest (at 0.07% of the applicable premium) and will be collected from insurers, we believe that MAT business will unlikely be driven away from Hong Kong. • In light of the above, we will

[3] Such as marine insurance required under the Merchant Shipping (Local Vessels) Ordinance.

Issues	Comments Received	Response from the Administration
		maintain the consultation proposal of covering all non-life insurance policies written in Hong Kong, except those covered by the schemes administered by MIB and ECIIB and, subject to approval by the PPF Board, those with equivalent protection in overseas jurisdictions.
	<u>Jointly-owned policies</u> • Some respondents requested for a clear definition of jointly-owned policies or elaboration of the approach to handle policies jointly-owned by non-SME corporates and individuals. They also enquired whether the PPF would cover a policy where the policyholder, beneficiary and/or the insured comprise both an individual and a corporation.	• On the basis that the policyholders who are individuals or SMEs would be entitled to compensation under the PPF, we propose that the PPF should cover jointly-owned insurance policies and split the compensation amongst the policyholders according to their share of ownership when claims arise. • Where information on the share of ownership is not available, for simplicity and ease of administration, we propose that equal shares of the claim amongst the policyholders would be assumed. • We propose the levy be calculated based on the total premiums of the policies concerned to avoid the complications in splitting the premiums in case there are non-SME corporates (which are

Issues	Comments Received	Response from the Administration
		not covered by the PPF) amongst the policyholders.
Level of Compensation		
Compensation limit	• Some respondents considered the proposed compensation limit appropriate, while some suggested that the compensation limit in terms of dollar cap or percentage cap should be higher than the proposed HKD1 million or 80% after the first HK$100,000. Some further commented that the compensation limits for compulsory classes of business (e.g. OC third party liability and marine liability insurance) should be increased or removed, on a par with the protection provided by the compensation schemes of MIB and ECIIB for motor and EC insurance. • Some respondents suggested a higher compensation limit (ranging from HK$2 million to HK$5 million) for life policies and public liability insurance, and full compensation for compulsory third party risk insurance policies.	• One of the guiding principles for the PPF proposal is to strike a reasonable balance between enhancing protection for policyholders and minimizing additional burden to the insurance industry. • The proposed HKD1 million compensation limit would already be able to meet 90%-100% of the claims arising from some 90% of life policies, and fully meet claims of some 96% of non-life policies. If the compensation limit is set at a level which is too high, the target fund size and levy rates will need to increase substantially but with only minimal enhancement of protection to policyholders from the overall perspective. According to an assessment by the actuarial Consultant based on industry data, raising the compensation limit from HKD1 million to HKD3 million would increase the levy rates of the Life Scheme substantially by 57% (from 0.07% to 0.11%) and the Non-Life Scheme by 21% (from 0.07% to 0.085%), but the number of life policies and

Issues	Comments Received	Response from the Administration
		non-life claims which would receive more compensation from the PPF would only increase by less than 1% and less than 0.5% respectively. • Raising the compensation limit may also increase the risk of moral hazard. • On balance, we will maintain the consultation proposal on the compensation limit of HKD1 million.
Compensation basis	**<u>Overall</u>** • Some respondents suggested that rather than defining the compensation basis for payment of claims under the PPF, all claims should be settled as per the claim definition in the original policy. • Some respondents requested for an elaboration on the treatment of insurance riders, noting that under the consultation proposal, it is possible that two compensation bases would be invoked for the same policy. For example, a life insurance policy may have a medical insurance (i.e. non-life) rider which should adopt a different compensation basis.	• In deciding the amount of compensation, the PPF will first assess the claims according to the terms of the policies, and any claims to be paid by the PPF will also be subject to the HKD1 million compensation limit. • As set out in the consultation proposal, when an insurer becomes insolvent, the PPF will first seek to transfer life policies and the attached accident and health ("A & H") riders with guaranteed renewability to another insurer. In the unlikely event that these policies cannot be transferred and should PPF need to settle any claims, the A & H rider will be settled on a per-claim basis, while the life policy to which the rider is attached will be

Issues	Comments Received	Response from the Administration
		settled on a per-policy basis, until expiry of the A & H rider.
	<u>Life Scheme</u> • A few respondents advocated a "per-life" compensation basis instead of "per-policy" basis for life insurance. • Some respondents were concerned that under the proposed "per-policy" compensation basis, policyholders may split their policies, which might increase the compensation amount by the PPF.	• It is policyholders' own discretion to procure multiple individual life policies from an insurer based on their own considerations or financial planning purposes, not only from the perspective of maximizing the protection from the PPF. It would not be appropriate to change the proposed "per-policy" compensation basis to a "per-life" compensation basis. • On the other hand, we note that there are group life policies which are usually procured by employers for a group of employees under one policy. If a "per-policy" basis is adopted for group life policies, the amount of compensation that each claimant receives will be relatively small in case of multiple deaths. Taking also into account that claims of such policies are paid on a "per-life" basis, coupled with the fact that the financial impact on the PPF will not be significant given that the number of group life policies to be covered by the PPF (i.e. only those procured by SMEs but not larger corporates) are relatively small,

Issues	Comments Received	Response from the Administration
		we propose that the PPF should adopt a "per-life" compensation basis for group life policies.
	<u>Non-Life Scheme</u> Some respondents commented that on a "per-claim" basis, a policyholder might submit multiple claims, topping up the aggregate amount of compensation for each policyholder which may be higher than the policy limit.	• Although compensation is on a "per-claim" basis, in deciding the amount of compensation, the PPF will first assess the claims according to the terms of the policies (hence subject to the policy limit), and any claim to be paid by the PPF will also be subject to the HKD1 million compensation limit. • For bundled insurance products such as travel insurance and domestic helper insurance, there are multiple insurance risk elements in one policy. Since insurers handle claims arising from such policies on a "per-claim" basis and the policies specify the different limits of compensation for each risk element (e.g. different compensation limits for loss of luggage and death under a travel insurance policy), we consider it appropriate to retain a "per-claim" compensation basis for such bundled policies.
Transfer of life policies and A & H policies with guaranteed	• In general, respondents did not object to the proposed transfer of life policies and A & H policies with guaranteed renewability to	• Noted. We will proceed with the consultation proposal.

renewability	another insurer in the event of an insurer becoming insolvent.	
	• A respondent suggested that the limit of facilitation fee for transfer of such policies should be increased to HKD3 million per policy.	• As the facilitation payment is an alternative form of compensation, we consider that it should be subject to the same limit for the PPF to pay out compensation (proposed to be HKD1 million per policy).
	• Some respondents suggested that the Administration should provide more information – (a) to facilitate policyholders' decision on whether they should terminate the policies or accept a transfer to another insurer; (b) on the transfer mechanism, including the selection criteria for the solvent insurer to whom the policies would be transferred, circumstances and conditions for the facilitation payment, etc.	• When an insurer becomes insolvent, the PPF and the liquidator will provide the relevant information to the concerned policyholders.
	• A few respondents opined that the proposed transfer mechanism would involve high administration cost.	• The consultation proposal is based on the assessment by the Consultant who has taken into account the administration cost that may be incurred in a transfer of policies. We consider that, when an insurer

		becomes insolvent, it will be in the best interest of policyholders of life policies and A & H policies with guaranteed renewability if their policies are transferred to a replacement insurer, since their pre-mature termination may place policyholders in a disadvantageous position when procuring alternative coverage due to aging and changing health or financial conditions.
Continuity of non-life policies until expiry	• Some respondents had reservation on the proposed continuity of coverage by the PPF until expiry of the non-life policies. They felt that this proposal would lead to high liquidation fees which would ultimately erode the remaining assets of the insolvent insurer. They also pointed out that other jurisdictions rarely provide for such arrangement. • Some respondents suggested that PPF should provide coverage of non-life policies only up to the date of insolvency because – (a) the period of coverage for some non-life policies would be longer than 12 months. Some further suggested that	• In drawing up the consultation proposal, we have considered the following factors - (a) Termination of non-life policies before their expiry will lead to policyholders' loss and leave them unprotected until replacement policies have been purchased. It should only be considered if the PPF could refund the unexpired portion of premiums to policyholders upon the cut-off date. (b) However, refund of the unexpired portion of premiums to policyholders has the following implications - (i) The Consultant's actuarial modeling results show that the initial target fund size of the Non-Life Scheme will have to be doubled, leading to a significant increase in the

	the policies should be terminated within a certain period, say, three or 12 months, after the insolvency event; (b) it would be more convenient for policyholders to purchase alternative coverage in the market; and (c) it was usually the responsibility of the liquidator rather than the PPF to administer the policies, or issue notice of cancellation to policyholders. • A few respondents suggested that upon occurrence of an insurer being insolvent, long tail non-life policies (i.e. those with period of coverage exceeding one year) and monthly automatically renewed accident and home insurance policies should be transferred to another insurer.	levy rate. (ii) There will be significant cash outflow by the PPF within a short period of time. (iii) The refund process will involve a huge volume of administrative work and cost. (c) Transfer of non-life policies to another insurer would not be cost-effective, as non-life insurance policies normally run for a short period of one year or less, and should have expired before completion of the liquidation process. (d) We have proposed to transfer A & H policies with guaranteed renewability to another insurer since their pre-mature termination may place the policyholders in a disadvantageous position when procuring alternative coverage due to aging and changing health or financial conditions. (e) Overseas practices are diverse. Canada and Japan operate schemes which cover claims for a limited period and refund (all or part of) the unexpired portion of premium to policyholders. The scheme in Singapore covers claims incurred up to 30 days after insolvency.
Regular	• Some respondents	• In the consultation document,

review of compensation limit	suggested regular review (e.g. every three to five years) of the adequacy of compensation limit in light of the development of the industry and prevailing circumstances.	we have proposed to review the target fund size and levy rate on a regular basis. We also intend to review the compensation limit after the PPF has been in operation for a few years in light of developments in the industry and economy.
Funding Mechanism		
Progressive funding approach	• Most respondents were supportive of adopting the progressive funding approach. A few respondents from the industry favoured the post-funding approach for a lower cost.	• As set out in the consultation document, we have studied three possible funding models i.e. the pre-funding model, the progressive funding model and the post-funding model. We consider that the progressive funding model is the most pragmatic, as it enables the building up of an upfront reserve to meet at least part of future liabilities at an affordable level of levy which will neither be likely to put pressure on the premium levels nor affect the sustainability of the industry. It will also maintain the flexibility to increase the levy rate to meet actual needs. The pre-funding model will lock up a huge amount of levy which in turn will put pressure on the premium levels, while the post-funding model may require a very deep levy which could undermine the financial position of insurers, especially if the event of insolvency

		occurs during an economic downturn. • Taking into account the majority views received, we will proceed with the progressive funding model.
Initial target fund size	**<u>Non-Life Scheme</u>** • The majority of respondents did not have comments on the initial target fund size, while several respondents had reservation on the adequacy of the proposed initial target fund size since multiple claims might arise from one single event and there might be catastrophic events.	• According to the assessment made by the actuarial Consultant, with the proposed compensation limit of HKD1 million, the PPF would be able to fully meet claims of some 96% of non-life policies. The Consultant's actuarial modeling results show that the target fund size of HKD75 million can cope with claims arising from multiple claim scenarios. • We will proceed on the basis of the consultation proposal i.e. the initial target fund size to be set at HKD75 million. In future, we will conduct regular review on the target fund size with updated assumptions and industry data.
Levy	**<u>Initial levy rate</u>** • The respondents did not object to the proposed levy rate in general. **<u>Applicable premium</u>** • Many respondents opined	• Noted. We will proceed on the basis of the consultation proposal i.e. the levy rates to be set at 0.07% of the applicable premium for both the Life Scheme and the Non-Life Scheme. • We have no in-principle

	that the levy should only be charged on policies covered by the PPF i.e. excluding policies that would not benefit from the PPF (e.g. policies held by non-SME corporates).	objection to this suggestion, provided that there is an effective way to assess and verify the amount of premiums attributable to policies not covered by the PPF. We are prepared to consider proposals from the industry in this regard.
	• Several respondents opined that a clear methodology should be developed to determine levy on the paid-up policies.	• We propose that for paid-up policies that are in-force at the introduction of the PPF, the levy will not be charged retrospectively, although the PPF will cover them. Since the proportion of such policies will diminish gradually while the fund is building up, the impact is considered insignificant.
	Cap on levy • Some respondents commented that a cap on levy should be applied to those policies with sum insured / premiums over HKD1 million to avoid unfairness.	• According to industry data, less than 1% of claims arising from life insurance policies exceed the proposed HKD1 million compensation limit of the PPF. For non-life insurance policies, the amounts of claims cannot be estimated. There are no objective yardsticks to determine any appropriate cap before the PPF has been implemented and an assessment is made based on actual data. • We also note that imposing a cap on levy is not a common practice among overseas compensation plans for policyholders.

		• Taking account of the above, we do not consider it necessary or appropriate to impose a cap on the levy when PPF commences operation. • We proposed in the consultation document that the levy rates would be reviewed together with the review of the target fund size after implementation of the PPF.
	• Two respondents commented that in determining the levy for PPF, the Government should also take into account the proposed levy for the independent Insurance Authority ("IIA") and consider the combined impact on the industry.	• The aggregate levy rate for IIA and PPF will amount to 0.17% of premium (0.1% for IIA and 0.07% for PPF), which should be modest. Moreover, the levy rates for the PPF are low compared to that of other local and overseas compensation schemes in Hong Kong. It should not have significant financial impact on the industry.
"Stepped-up" levy	• The majority of the respondents had no comments on the proposal to allow the PPF to collect a "stepped-up" levy in the case of an insurer becoming insolvent. • Some respondents were concerned about the uncertainty of the magnitude of any "stepped-up" levy, which might impose pressure on insurers and thus policyholders. Some of them suggested to impose a	• The "stepped-up" levy rate will be prescribed in the statute through subsidiary legislation and thus any "stepped-up" levy in future would require LegCo approval. We believe that any "stepped-up" levy would have to be reasonable in the circumstances without stifling market development. • There are no objective yardsticks to determine any appropriate cap before the PPF has been implemented and an assessment is made based on actual data.

	cap on the "stepped-up" levy rate. • A few respondents considered that the detailed mechanism of triggering and determining the stepped-up levy should be established and agreed by the industry.	• We propose to review the levy rates together with the target fund size after implementation of the PPF, rather than to impose a cap on the levy arbitrarily at this early stage.
Risk-based levy approach	• Some respondents expressed the need for a risk-based approach in charging levy to minimize cross subsidization between soundly managed, prudent insurers and those who were not.	• OCI will conduct consultancy studies on the adoption of a risk-based capital regime for the regulation of the insurance industry. We will review the funding mechanism of PPF after implementation of the risk-based capital regime.
Ranking of creditors in claiming from the estate of insolvent insurer	• The majority of respondents had no comments on the ranking of creditors in claiming from the estate of an insolvent insurer. • Some respondents noted that the proposed preferential creditor status of PPF was inconsistent with that of MIB and ECIIB, which currently were ranked as ordinary, non-preferential creditors. This might be	• We will proceed with the consultation proposal i.e. the PPF will have equal ranking with the two classes of creditors specified in section 265 of the Companies Ordinance ("CO"), viz. the Employee Compensation Assistance Fund and all other direct insurance claims not met by the PPF. • At present, MIB and ECIIB are ordinary creditors according to section 265 of the CO. As the purposes of MIB and ECIIB are also to offer protection to affected policyholders when an insurer becomes insolvent, we would explore the feasibility of raising the ranking

	disadvantageous to MIB and ECIIB when claiming from the estate of the same insolvent insurer. A few industry respondents suggested that PPF should not enjoy preferential creditor status.	of the MIB and ECIIB compensation schemes to that of the PPF. • The proposed creditor status of the PPF is in line with overseas practices. We do not consider it appropriate to lower the ranking of the PPF to an ordinary creditor. The actuarial Consultant's assessment shows that the financing costs will increase and the recovery rate will be lowered significantly, resulting in a hefty increase in the target fund size and levy rates of the PPF[4].
Governance Arrangements and Related Matters		
Establishment by legislation	• All respondents either concurred with or had no comments on the proposed legislative backing for PPF.	• Noted. We will proceed with preparing the enabling legislation for the establishment of the PPF.
PPF Board structure	• In general, respondents did not object to the proposed structure of the PPF Board i.e. comprising professionals experienced in insurance, finance, accounting, law and consumer affairs etc, and ex-officio Government representatives. • Some respondents suggested limiting the	• In establishing the PPF in future, we would take into account the need for having appropriate industry knowledge and experience supporting the PPF Board, through appointments to the Board and its two industry committees, provided that such appointments would not give rise to perceived or real conflict of interests. We believe that

4 According to the estimation by the Consultant, in the scenario that the PPF's ranking is lowered to that of an ordinary creditor, the initial target fund sizes of the Life Scheme and the Non-Life Scheme would increase substantially to HKD4.16 billion and HKD156.1 million respectively, and the levy rates would in turn be increased to substantially 0.24% and 0.146%.

	involvement of the Government (since PPF was funded by industry) and having representatives from insurers and/or insurance intermediaries on the PPF Board.	the PPF Board should attach importance to industry participation to ensure that the protection regime would evolve with market development. • We will ensure that there is a balanced membership of the PPF Board for it to perform its functions effectively.
Functions and powers of PPF Board	• Some respondents supplemented that the PPF Board should – (a) cooperate with IA for early warning system; (b) establish a dedicated team or conduct rehearsals to familiarize with the payout procedure; (c) provide guidance to policyholders and educate the general public; and (d) be able to approve the set-up and expenditure of the statutory body. • Some respondents supplemented that the PPF Board should – (a) be well distinguished from the responsibilities of a liquidator; and (b) assess claims and reach settlements according to policy terms in the same manner as MIB and ECIIB.	• Noted. We will take into account the comments in developing the modus operandi for the PPF in due course. • During the liquidation process, the main role of the PPF is to liaise closely with the (provisional) liquidator on claims management, make payments, and to ensure that the fund is used properly. The PPF will not take over the responsibilities of the liquidator who will handle the claims and inform the PPF of the outcome for payment.

	• A few respondents commented that the PPF Board should be subject to a Code of Conduct and maintain independence and integrity.	• In deciding the amount of compensation, the PPF will first assess the claims according to the terms of the policies, and any claims to be paid by the PPF will also be subject to the HKD1 million compensation limit. • Noted. We will attach importance to ways to ensure proper corporate governance of the PPF. Reference will be drawn from other statutory compensation funds (e.g. the Deposit Protection Scheme)
Guidance on investment	• Some respondents recommended that the investment should be made prudently and wisely by means of expertise, investment policy and investment committee. However, excessive restrictions might minimize the investment returns.	• Noted. The enabling legislation for the PPF will require the PPF to perform its investment functions prudently. Reference will be drawn from other statutory compensation funds (e.g. the Deposit Protection Scheme).
Daily operations	• The majority of the respondents either supported or had no comments on the proposal for a small team structure of the PPF and the flexibility to hire additional staff when necessary.	• Noted. We will proceed with the consultation proposal in setting up the PPF.
Appeal mechanism	• The majority of the respondents either supported or had no	• Noted. We will proceed with the consultation proposal in setting up the PPF.

	comments on the proposed appeal mechanism.	