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Panel on Financial Affairs

Meeting on 6 February 2012

Background brief
on the proposed establishment of a policyholders' protection fund

Purpose

This paper provides background information on the proposed establishment of a policyholders' protection fund ("PPF") in Hong Kong, and a summary of the relevant views and concerns expressed by members when the subject was discussed by the Panel on Financial Affairs ("the Panel").

Background

2. At present, if an insurer becomes insolvent, compensation funds are in place to cover employees compensation[1] and motor vehicle third party claims only[2]. There are no compensation funds for life insurance and other types of general (i.e. non-life) insurance if the insurer becomes insolvent. However, the Companies Ordinance (Cap. 32) ("CO") and Insurance Companies Ordinance (Cap. 41) ("ICO") contain provisions for dealing with insurer insolvency. For insolvent non-life insurers, policyholders have a preferential claim against the remaining assets of the insurer (direct insurance claims have a higher level of preference than reinsurance claims) under CO. These preferences apply to claims, but do not apply to premium refunds. For insolvent life insurers, under ICO, the Court may approve a reduction of the amount of policyholder benefits. The Court may also approve a transfer of life insurance policies to another insurer. Under such circumstances, policyholders would have no choice but to accept the arrangements sanctioned by the Court.

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[1] For employees' compensation insurance, the Employees Compensation Insurer Insolvency Scheme is administered by the Employees Compensation Insurer Insolvency Bureau. The Insolvency Fund is financed by a levy on premiums payable in respect of employees' compensation insurance policies.

[2] For motor insurance, the Motor Insurers' Bureau of Hong Kong provides compensation to injured victims of traffic accidents where the drivers concerned are uninsured or untraceable, or the insurers concerned are insolvent. The Insolvency Fund is financed by a levy on the motor insurance premiums payable by the policy holders.

3. In 2002, the Office of the Commissioner of Insurance ("OCI") commissioned a consultancy study on the feasibility of establishing PPF(s) in Hong Kong. A public consultation exercise was conducted between December 2003 and April 2004. According to the Administration, mixed feedback was received during the consultation; some respondents expressed support for a compensation fund for policyholders to boost consumer confidence, while others, particularly members of the insurance industry, were concerned about possible moral hazards.

4. On 7 July 2008, the Administration informed the Panel that following a close dialogue between OCI and industry stakeholders, the Hong Kong Federation of Insurers ("HKFI") had indicated its agreement in principle to explore the formulation a contingency plan to protect policyholders against the insolvency of insurers. OCI would continue to work in partnership with HKFI to develop an appropriate framework for introducing a PPF in Hong Kong.

5. On 6 July 2009, the Administration briefed the Panel on the proposed framework for the establishment of a PPF in Hong Kong, with information on the guiding principles and recommended key parameters for the proposed PPF. According to the Administration, the member companies of HKFI were supportive of the guiding principles and key parameters. Meanwhile, the Administration would commission an actuarial consultancy study to assess the optimal levy rate, target fund size and detailed arrangements for the proposed PPF.

6. On March 2011, the Administration published a consultation document for a three-month public consultation on the proposed establishment of a PPF in Hong Kong. The Administration briefed the Panel on the relevant proposals on 4 April 2011. The key aspects of the proposals are set out in the **Appendix**.

Discussions at the Panel on Financial Affairs

<u>Feasibility study on establishing a PPF in Hong Kong</u>

7. The Administration briefed the Panel on the progress of the feasibility study on establishing a PPF in Hong Kong on 1 March 2004 and 7 July 2008. The major views and concerns expressed by members were as follows:

(a) The need for establishing a PPF should be critically examined, having regard to the benefit of providing protection to policyholders when their insurers became insolvent, vis-à-vis the problem of moral hazards in that a PPF might encourage imprudent operation of some insurers and make policyholders less vigilant in selecting their insurers.

(b) As a PPF would likely be funded by the insurance industry in the form of levies, the impact of such levies on insurance premiums had to be taken into account.

(c) There was a suggestion that consideration might be given to setting the levels of PPF levies payable by insurers according to the risk level of their business undertakings.

(d) If a PPF was to be established, the related compensatory mechanism and regulatory framework should be provided for by legislation.

Proposed framework for the establishment of a PPF in Hong Kong

8. The Panel discussed the proposed framework for the establishment of a PPF in Hong Kong on 6 July 2009. Panel members in general were supportive of the establishment of a PPF.

9. On the proposed arrangements of imposing a levy based on the premium of individual insurance policies and applying a standard levy rate, some members considered that it would only be fair to collect levies from insurers instead of policyholders, because the proposed PPF was meant to provide compensation to policyholders upon the insolvency of an insurer. A member doubted why the levy rate for the PPF could not be determined according to the risk ratings of the insurers, as in the case of the Deposit Protection Scheme where the contributions payable by banks were determined by the supervisory ratings assigned by the Hong Kong Monetary Authority. The Administration advised that the proposed arrangements were in line with overseas practices for insurance compensation schemes and were considered prudent and appropriate.

10. A member suggested that premiums related to the investment components of investment-linked insurance policies should be excluded from the calculation of the levy. The Administration responded that imposing different levy rates based on the nature of insurance policies would require clear differentiation of the types of insurance policies, and this would not be conducive to the design of a simple levy structure to facilitate public understanding of the proposed PPF.

11. Panel members also expressed concerns about the coverage of corporate policyholders, in particular the small and medium-sized enterprises (SMEs), the appropriateness of the proposed upper limit of total compensation at $1 million per policy, the protection for policyholders in case of misconduct of insurance intermediaries, and the legislative timetable.

Public consultation on the proposed establishment of a PPF in Hong Kong

12. The Panel discussed the consultation proposals for the establishment of a PPF in Hong Kong on 4 April 2011. The major concerns/views expressed by Panel members and the Administration's responses are summarized in the ensuing paragraphs.

Initial target fund size

13. Regarding the proposed target fund size for the Life Scheme (i.e. $1.2 billion) and the Non-Life Scheme (i.e. $75 million), a member enquired about the factors taken into consideration in calculating the target fund size and the build-up period (i.e. 15 years). Another member expressed concern that the assumption of low to medium growth rate in the insurance sector (i.e. 5 to 10% growth rate, trending to 2.5 to 5% growth rate in 10 years) was too conservative.

14. The Administration advised that the target fund size had been worked out based on the industry data in 2009 and the actuarial models prepared by the consultant, while the target period of 15 years had been worked out based on the estimated amount of levies collected and the estimated investment return of the funds. The assumptions for the actuarial models were worked out based on data of the general economy and the insurance sector in the past years, and they would be reviewed every few years.

Levy rate

15. Regarding the proposed maximum compensation of $1 million per policy/claim and the proposed uniform levy rate of 0.07%, a member expressed concern that holders of insurance policies with a claim exceeding $1 million would be required to pay a higher levy incompatible with the compensation limit and suggested that the levy rate be adjusted based on the premium level.

16. The Administration advised that that based on the industry data as at end 2009, the compensation limit of $1 million would be able to meet 90 to 100% of the claims arising from some 90% of life policies, and to fully meet the claims of over 90% of non-life policies. Given the low levy rate of 0.07%, insurance companies probably would not transfer the levy payment to insurance policyholders.

17. Some members considered that a mechanism should be in place to adjust the levy rate as and when necessary (e.g. the PPF had amassed a large reserve or there had been a large pay-out). The Administration responded that there would be flexibility to review the levy after the target fund size had been achieved, taking into consideration the market situation at the time. On the other hand, it would be difficult to predict the arrangement for revision of the levy in case of a

large pay-out from the PPF as a result of the insolvency of an insurance company, because there were a number of unpredictable factors.

Premature termination of insurance policy

18. Noting that insurers might have to transfer their insurance policies to another insurance company due to insolvency of the original insurance company, members expressed concern that the relevant policyholders (particularly those whose policies were in the initial years and had very small cash/account values) might suffer loss in insurance protection. The Administration advised that arrangement would be made to transfer the life policy of a policyholder to another insurance company, and the PPF might consider providing a payment to facilitate the transfer of such policy, and/or to grant ex-gratia payment to the policyholder if the policy could not be transferred, up to a cap of $1 million in total.

Governance arrangements

19. A member opined that the Director of Audit should be empowered to carry out audit reviews of the PPF at any time, without requiring the appointment by the Financial Secretary to conduct such reviews. The Administration responded that the proposal was to allow flexibility for the Financial Secretary to appoint the Director of Audit or an external auditor to conduct audit reviews of the PPF as and when required. The member's view would be taken into account in finalizing the proposals.

Recent development

20. The Administration will brief the Panel on 6 February 2012 on the consultation conclusions on the proposed establishment of a PPF.

Relevant papers

21. The relevant papers are available at the following links:-

Meeting of the Panel on Financial Affairs on 1 March 2004	Administration's paper Minutes (paragraphs 53-65)
Meeting of the Panel on Financial Affairs on 7 July 2008	Administration's paper Background brief Minutes (paragraphs 34-42)
Meeting of the Panel on Financial	Administration's paper

Affairs on 6 July 2009	Administration's PowerPoint Background brief Minutes (paragraphs 58-81)
Meeting of the Panel on Financial Affairs on 4 April 2011	Administration's paper Consultation paper on proposed establishment of a PPF Administration's PowerPoint Background brief Minutes (paragraphs 43-48) Follow-up paper

Council Business Division 1
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Appendix

Consulation proposals for establishment of Policyholders' Protection Fund

(based on the Administration's papers for the Panel meeting on 4 April 2011)

Guiding principles

(a) Strike a reasonable balance in enhancing protection for policy holders and minimizing additional burden to the insurance industry;

(b) Enhance market stability while minimizing the risk of moral hazard;

(c) 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) No compromise of the regulatory standards and requirements laid down by the Insurance Authority under the ICO.

Coverage

(a) Two separate schemes, namely the Life Scheme and the Non-Life Scheme;

(b) Focusing on individual policyholders, while views from SMEs are welcome on whether the PPF should be extended to cover them;

(c) Third party liability insurance of building owners' corporations;

(d) All authorized direct life and non-life insurers should be mandated by statute to participate except –

(i) Reinsurers;

(ii) wholesale retirement schemes;

(iii) captive insurers;

(iv) motor vehicle and employees compensation policies; and

(e) All in-force policies as at the date of the introduction of the PPF & new policies issued thereafter will be covered.

Level of compensation

(a) Provide 100% compensation for the first $100,000, plus 80% of the balance of the claim, up to a total of $1 million per-policy for life insurance policies and per-claim for non-life insurance policies;

(b) Life Scheme would be allowed to pay up to $1 million per policy to facilitate the transfer of life policies to another insurer; and

(c) Non-Life Scheme would provide for continuity of coverage until the expiry of non-life policies and meet claims up to the compensation limit of $1 million per policy.

Funding mechanism

(a) Progressive funding approach

  (i) The initial target fund size will be HKD 1.2 billion for the Life Scheme and HKD 75 million for the Non-Life Scheme;

  (ii) The initial target fund will be built up in 15 years;

  (iii) The initial levy rate for both the Life Scheme and the Non-Life Scheme will be 0.07% of the applicable premium; and

  (iv) Collect levies from insurers.

(b) Asset recovery mechanism

  (i) PPF will take over the protected element of policyholders' claims and seek recovery from the estate of the insolvent insurer; and

  (ii) PPF should have equal ranking with the two classes of creditors specified in section 265 of the CO, i.e. the Employee Compensation Assistance Fund and all other direct insurance claims not met by the PPF.

(c) Financing arrangement to bridge liquidity gap

(i) Borrow from a third party to bridge any liquidity gap, e.g. from commercial lenders for which the Government may act as the guarantor, or from the Government direct; and

(ii) Approval of the Legislative Council will be required.

Governance and related matters

(a) Legal and organizational structure

(i) Established by legislation and be administered by a statutory body (the PPF Board), appointed by the Financial Secretary (FS); and

(ii) Establish two industry committees for Life Scheme and Non-Life Scheme.

(b) Governance arrangements

(i) Annual budget of the PPF subject to approval by FS;

(ii) Prepare and publish an annual report (including the audited statement of accounts) for both Schemes and laid before the Legislative Council; and

(iii) FS should have the power to appoint the Director of Audit or an external auditor to perform audit reviews on the PPF.

(c) Invest in low-risk vehicles, e.g. deposits with banks, Exchange Fund Bills and sovereign bonds with good credit rating;

(d) Maintain a small team of staff for daily operations and be empowered to engage additional staff or advisers in the event of insurer insolvency; and

(e) Set up an Appeal Board to deal with appeals against the decisions of the PPF Board.