For information
on 13 January 2012

**Legislative Council Panel on Transport
and Panel on Financial Affairs**

**Joint Subcommittee on Issues Relating to Insurance Coverage
for the Transport Sector**

Supplementary Information on Authorization Requirements for Insurance Companies (including mutual insurance associations) and Overseas Experience in Tackling False or Exaggerated Claims

Introduction

This paper seeks to provide information on –

(a) solvency margin requirement;
(b) adequacy of reinsurance arrangements;
(c) Protection & Indemnity Clubs ("P&I Clubs"); and
(d) overseas experience in tackling false or exaggerated claims.

Background Information

2. At the meeting of the Joint Subcommittee on 19 December 2011, Members requested information on the computation of solvency margin and the assessment of reinsurance arrangements for insurance companies. Members also asked about P&I Clubs and overseas experience in tackling the problems of false or exaggerated claims.

Authorization requirements

3. Pursuant to section 8 of the Insurance Companies Ordinance ("ICO"), the Insurance Authority ("IA") shall not authorize an insurance company (including a mutual insurance association) unless he is satisfied, among other things, that it can meet the solvency margin requirement and will make adequate reinsurance arrangements for the risks that it will underwrite.

Solvency Margin Requirement

4. The determination of the amount of solvency margin is set out in section 10 of the ICO. In general, the amount is the higher of (a) one-fifth of an insurance company's relevant premium income and (b) one-fifth of its relevant outstanding claims liabilities, subject to a minimum of HK$20 million if the insurance company carries on motor vehicles insurance business.

5. The relevant premium income of an insurance company in a financial year is the greater of (a) an amount equal to 50% of its gross premium income in a financial year; and (b) the amount of its gross premium income less any premiums payable in respect of its reinsurance.

6. The relevant outstanding claims liabilities of an insurance company as at the end of a financial year are the aggregate of (a) an amount equal to 50% of the claims outstanding before deducting any amount recoverable from reinsurers, or the amount of claims outstanding after deducting any amount recoverable from reinsurers, whichever is the greater; and (b) the additional amount for unexpired risks. "Additional amount for unexpired risks" means the amount set aside by an insurance company at the end of its financial year, in addition to any unearned premiums, which is considered necessary to meet the cost of claims and expenses of settlement arising from risks to be borne by the insurance company after the end of the financial year under contracts of insurance entered into before the end of that year.

7. A company applying for authorization is required by the IA to submit, among other things, a 3-year business plan. The business plan shall incorporate, among other things, a budgeted revenue account, a budgeted profit and loss account and a budgeted balance sheet under different scenarios in respect of each of the three years. The applicant is required to demonstrate to the IA's satisfaction that it will be able to meet the solvency margin requirement at all times.

Adequate Reinsurance Arrangements

8. In considering whether an insurance company has made adequate reinsurance arrangements, the IA will take into account, among other things, the

following factors –

(a) reinsurance management framework of the insurance company;
(b) type of reinsurance arrangements;
(c) maximum retention of the insurance company;
(d) spread of risks among reinsurance companies; and
(e) security of reinsurance companies.

Reinsurance Management Framework of the Insurance Company

9. An insurance company should establish a sound reinsurance management framework to steer a reinsurance programme that will adequately address its risk profile and financial condition. Such a framework encompasses rules and practices to manage the selection, implementation, monitoring, control, review and documentation of reinsurance arrangements.

Type of Reinsurance Arrangements

10. An insurance company should take into account the nature and scope of risks to be underwritten and with due regard to its risk tolerance level in determining the most suitable type of reinsurance protection.

Maximum Retention of the Insurance Company

11. An insurance company should exercise due diligence in determining a maximum retention level appropriate to its risk tolerance level. The retention strategy should take into account not only single risk claims but also multi-risk events (e.g. the occurrence of catastrophic or disastrous events). The insurance company should also be mindful of possible gaps in reinsurance programmes which may cause undue exposure.

Spread of Risks among Reinsurance Companies

12. An insurance company should put in place control procedures to ensure that reinsurance is properly spread among reinsurance companies to minimize the risk of over-concentration in a small number of reinsurance companies. It should also set prudent limits in relation to its maximum aggregate exposure to any one reinsurance company.

Security of Reinsurance Companies

13. An insurance company should have due regard to the security provided by the reinsurance companies, making reference to relevant factors such as their

credit worthiness, credit risks and credit rating reports.

P&I Clubs

14. P&I Clubs are associations of ship owners, owned and controlled by the insured ship owners ("Members"). They operate on a non-profit making mutual basis. In other words, the Members pool their financial resources together in order to meet the insured losses sustained by each individual Member.

15. The basic principle for the operation of a P&I Club is that the premiums ("calls") paid by the Members in relation to any one year would be adequate to meet all the claims, reinsurance costs and administrative expenses of the club for that year. If there are shortfalls because of poor underwriting results, the Members will be required to pay "additional or supplementary calls". On the other hand, if there are surpluses because of good underwriting results, the surpluses may be returned to the Members, or transferred to a contingency reserve to meet potential losses for future years.

Comparison between P&I Clubs and Traditional Insurance Companies

16. P&I Clubs differ from traditional insurance companies mainly in the following aspects –

(a) <u>Premium Uncertainties</u>
For P&I Clubs, calls are collected in advance based on pre-determined rate. Additional supplementary calls may need to be collected when there are poor underwriting results and/or large claims. Thus, there is uncertainty on premium calls. For traditional insurance companies, premiums are agreed with the insured at the inception of policies.

(b) <u>Operating Funds</u>
The operating funds of P&I Clubs must be generated amongst the ship owner members and there is no access to equity markets. On the other hand, traditional insurance companies have access to equity markets.

(c) Potential Additional Liabilities

For P&I Clubs, ship owner members are jointly and severally responsible for any unsettled claims liabilities and hence there is an uncertainty for other members to pay additional monies should a member fail to meet its obligations. There are no such liabilities for the insured who purchase insurance policies from traditional insurance companies.

(d) Control

The ultimate control of a P&I Club is in the hands of the ship owner members, whereas the ultimate control of a traditional insurance company is in the hands of its shareholders.

(e) Scope of Cover

P&I Clubs provide comprehensive liability cover to meet ship owners' operational needs, whereas traditional insurance companies might not provide cover as comprehensive as P&I Clubs, as there could be exclusions for different types of policies or different insured companies.

(f) Free Services

P&I Clubs provide various free services to their ship owner members, including information on loss prevention measures, legal advice, updated information on port regulations, etc. Traditional insurance companies normally do not provide such services to the insured ship owners.

Overseas Experience in Tackling False or Exaggerated Claims

17. We understand that there are problems of false claims/accidents, exaggeration of injuries and abuse of sick leave certificates in many other jurisdictions, including the United States, Canada, Singapore, the United Kingdom, Australia and the Mainland. Most jurisdictions do try to put in place measures to deal with the problems, although such problems continue to exist.

Medical-Related Measures

18. In the Province of Ontario, Canada, the Government of Ontario is considering whether a licensing and/or regulatory regime for clinics that provide health care services to treat automobile accident victims would make sense. In

Singapore, the insurance and medical sectors are now examining the feasibility of designating medical specialists who can diagnose non-hospitalization injuries such as whiplash and assess such claims. In Australia, medical practitioners are provided with guidelines on completing and issuing sick leave certificates and are made aware that they will be subject to disciplinary actions should they provide misleading or untrue information either deliberately or negligently.

19. In Hong Kong, some insurance companies may require claimants to attend medical examinations, which are paid by the insurance companies, by designated doctors or at public clinics, particularly when there are severe injuries or extended leaves. The Medical Council of Hong Kong has also issued a Code of Professional Conduct to medical practitioners concerning the issuance of sick leave certificates. Violation of such Code is subject to disciplinary action.

Central Database

20. In the United Kingdom, the insurance industry has funded a national Insurance Fraud Register which enables insurers to share information on known cases of frauds, and facilitates insurers to identify any claimants who fail to declare a previous fraudulent insurance claim.

21. The Hong Kong Federation of Insurers ("HKFI") is exploring the feasibility of setting up an insurance fraud detection mechanism. However, the issues related to personal data privacy of the individuals concerned would need to be addressed before the proposal could be taken forward.

Reporting Hotline and Specialized Fraud Investigation

22. Several jurisdictions including Canada, Australia, the United Kingdom and the United States provide insurance fraud hotlines for the public to report any suspected fraudulent activities. In London, there is an Insurance Fraud Enforcement Department based at the London Police's Economic Crime Directorate, which is dedicated to combating insurance fraud.

23. We understand the Hong Kong Police Force is considering providing a co-ordinated reporting system, whereby the Commercial Crime Bureau will consolidate and co-ordinate reports on traffic accident related insurance frauds referred by the HKFI.

Surveillance by insurance companies

24. In the United States, some insurance companies develop specific training programmes for their claims professionals and establish red flags processes to help them identify what may be an unusual claim. Some of them also employ a panel of medical professionals to assess dubious claims. In Australia, some insurance companies use a combination of factual and surveillance investigations to identify fraudulent activities.

25. Similarly, in Hong Kong, some insurance companies do have internal procedures to identify suspicious claims and investigate into possible fraudulent claims.

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