Bills Committee on Insurance Companies (Amendment) Bill 2014

Follow-up Actions Arising from the Discussion at the Meeting of 30 June 2014

Purpose

This paper sets out the information provided by the Administration in response to requests made by Members in relation to the Insurance Companies (Amendment) Bill 2014 ("the Bill") at the meeting of 30 June 2014.

(a) Work Plan

2. In light of Members' view that the Bills Committee shall first complete discussion of policy issues in relation to each of the proposed nine parts of the Bill before commencing the clause-by-clause examination of the Bill, the revised work plan is at **Annex A**.

(b) Industry Advisory Committees ("IACs")

3. As provided in new Schedule 1C, an IAC consists of the chairperson, chief executive officer ("CEO") and two of the executive directors of the independent Insurance Authority ("IIA"), and 8 to 12 other members. The purpose of including the IIA's chairperson and CEO as members of the IACs is to make them effective regular communication platforms between the highest echelon of the IIA and stakeholders, including the insurance industry.

4. The chairman and CEO of the Securities and Futures Commission ("SFC") are also statutorily required to be members of the Advisory Committee of the SFC but it is not the case under the Mandatory Provident Fund regulatory regime. Please refer to **Annex B** for a comparison with statutory advisory committees in relation to the SFC and the Mandatory Provident Fund Schemes Authority ("MPFA").

(c) Functions and Powers of the IIA

Maintaining financial stability of Hong Kong

5. At present, the principal function of the Insurance Authority

("IA") is to regulate and supervise the insurance industry for the promotion of the general stability of the insurance industry and for the protection of existing and potential policy holders. The principal function will remain in the IIA regime. To discharge its function, the IIA would take on-going actions independently to maintain the stability of the insurance industry, including –

(a) Entry gate-keeping: The IIA authorizes an insurer to carry on insurance business in or from Hong Kong only if it meets requirements in capital adequacy, solvency margin, corporate governance, viability of business plan, etc.

(b) Prudential regulation: The IIA continuously monitors the financial status of authorized insurers. Insurers are required to regularly report to the IIA their solvency ratios. The IA also conducts regular on-site inspections of insurers.

(c) Risk monitoring: The IIA conducts vigorous financial screening exercises and relevant stress tests from time to time to ensure that authorized insurers can function properly even during extremely volatile situations. It also maintains liaison with its overseas counterparts to keep track of the operating and financial situations of foreign financial institutions, in order to identify any risks to Hong Kong's financial markets.

6. In addition, the IIA will be charged with a new function to "assist the Financial Secretary ("FS") in maintaining the financial stability of Hong Kong by taking appropriate measures in relation to the insurance industry" which reflects the increasing international emphasis on the importance of monitoring systemic risks at the macro-level and management of preconditions (see paragraph 8 below) for effective supervision of the insurance industry.

7. Recent financial crises have revealed the importance of an effective systemic surveillance of financial markets in maintaining financial stability. This calls for the joint efforts of financial regulators of different sectors of the financial markets, which would require high level co-ordination. At present, the Insurance Authority ("IA"), as a public officer, already participates in the deliberations of the Financial Stability Committee ("FSC") and the Council of Financial Regulators

("CFR")[1] with a view to assisting the FS in maintaining the financial stability of Hong Kong. The IIA shall also perform this function in future as a regulator independent of the Government and hence the express function in new section 4A(2)(ee) added by Clause 12 of the Bill.

8. Specifically in the insurance sector, the International Association of Insurance Supervisors ("IAIS") points out in the Insurance Core Principles ("ICPs") that "an effective system of insurance supervision needs a number of external elements, or preconditions, on which to rely as they can have a direct impact on supervision in practice" (paragraph 19 of the ICPs). Examples of such preconditions are (a) sound and sustainable macroeconomic and financial sector policies; (b) effective market discipline in financial markets; and (c) efficient financial markets. IAIS further explains that these preconditions are normally outside the control or influence of the insurance market supervisor but "where shortcomings exist, the supervisor should make the government aware of these and their actual or potential negative repercussions for the supervisory objectives and should seek to mitigate the effects of such shortcomings on the effectiveness of supervision" (paragraph 20 of the ICPs). The new function will allow the IIA to perform this role properly. ICP 24 on Marcroprudential Surveillance and Insurance Supervision and ICP 26 on Cross-border Cooperation and Coordination on Crisis Management also mention an insurance market supervisor's responsibility to collaborate with the Government and other regulators in responding to cross-sectoral systemic risk situations and, during a crisis, implementing crisis management measures[2].

Relationship between the Office of the Commissioner of Insurance ("OCI") / IIA and the FS

9. At present, the IA is a public officer (viz. the Commissioner of Insurance) who is supported by a government department, i.e. the OCI established under FSTB, which is under the oversight of the FS. Both

[1] The FSC, with members from the Financial Services and the Treasury Bureau ("FSTB") and relevant financial regulators (including the IA), monitors the functioning of the financial system of Hong Kong and deliberate on events, issues and developments with possible cross-market and systemic implications, and where appropriate, formulates and co-ordinates responses. The CFR, chaired by the FS and participated by FSTB and financial regulators (including the IA), focuses mainly on the efficiency and effectiveness of regulation and supervision of financial institutions and the maintenance of financial stability in Hong Kong with a view to minimizing regulatory gaps and duplications.

[2] From time to time, international organizations conduct peer reviews on the compliance with the regulatory standards by jurisdictions.

the IA and staff at the OCI are government employees. Under the Bill, the IIA is a body corporate, i.e. it is an insurance regulator financially and operationally independent of the Government. The IIA may employ its own staff and engage consultants, agents or advisors to assist its work. The chart at **Annex C** depicts the relationship between the OCI and FS and that between the IIA and FS.

10. Under the existing ICO, the FS is the final appellate authority of a number of regulatory decisions made by the IA[3]. Under the new regime, all IIA's regulatory decisions are subject to review by the statutory Insurance Appeals Tribunal ("IAT") (see paragraph 12(d) below). The IAT may confirm, vary or set aside any such decisions of the IIA. It should be noted that all IIA's disciplinary decisions will be taken in accordance with the due process and procedures set out in the Bill. Neither has the FS any power to intervene nor is the IIA required to consult the FS before making any disciplinary decision.

11. The IIA will play the role of an independent market regulator and is not required to be answerable to the Government on its day-to-day exercise of regulatory powers. The principal function of the FS is to ensure and enhance the accountability of the IIA so that it will effectively discharge its functions and prudently deploy its resources. Specifically, the new section 5B requires the IIA to prepare and submit its corporate plan (which includes its estimates) to the FS for approval. The new section 5D requires the IIA to keep proper accounts and records of its transactions, and prepare its annual report to the FS. The new section 5E provides that the IIA must, with the approval of the FS, appoint one or more auditors to audit its annual financial statements. The FS should lay on the table of the Legislative Council ("LegCo") the estimates, the annual report and the audited financial statements. Moreover, the IIA may only invest, in the manner approved by the FS, its funds that are not required for immediate use (see the new section 4B(2)(h)).

An independent disciplinary process

12. Unlike the self-regulatory organizations, which are run by insurance intermediaries themselves, the IIA is an independent regulator. Therefore, there is no sound justification for setting up another

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[3] For example, when the IA refuses to authorize an insurer under section 8 (see the existing section 11), the IA's objection to the appointment of an insurer's controller under different circumstances (see the existing section 13A(8), section 13B(7) and section 14(6)), the IA's decision to withdraw authorization of an insurance broker or approval of a broker body (the existing section 75), etc.

independent body to ensure that there is no conflict of interests involved when the IIA exercises its disciplinary powers.

13. Furthermore, disciplinary powers are part and parcel of the regulatory tools available to a financial market regulator for it to ensure the integrity of the licensing regime for its regulatees, i.e. to ensure that its licensed regulatees are fit and proper on an on-going basis. This duty should fall squarely with the IIA in relation to the regulation of insurance intermediaries. Fettering the disciplinary power of the IIA will compromise the integrity of the regulatory regime.

14. In exercising its disciplinary powers, the IIA would be subject to a number of checks and balances as follows –

(a) the IIA should put in place arrangements to ensure that investigators will not be involved in the determination of disciplinary sanctions;

(b) the IIA must not exercise disciplinary powers without first giving the person concerned a reasonable opportunity of being heard;

(c) the IIA must issue a fining guideline (to be published in the Gazette) before it can impose disciplinary fines; and

(d) the IIA's disciplinary decisions will be appealable to the quasi-judicial IAT which will be chaired by a former judge or a person who is eligible to be appointed as a High Court judge.

15. We fully recognize that during the disciplinary process, the IIA may need professional inputs from the insurance industry, given the complexity of insurance products and market practices. In this connection, we propose that the IIA may consult an expert panel comprising members from the industry before making a disciplinary decision. In addition, when reviewing a decision of the IIA, the IAT chairperson will be assisted by two members to be drawn from a panel of members who have relevant market experience and professional expertise.

16. The proposed procedural requirements for the disciplinary process are in line with those adopted by other financial regulators like the SFC and MPFA in Hong Kong. In fact, insurance intermediaries are

subject to these existing regulatory regimes when they provide financial intermediary services in the securities, retirement investment and related fields. We are also not aware of any direct involvement of the industry in the disciplinary processes of financial regulators in major overseas jurisdictions such as Australia, Singapore and the United Kingdom.

(d) Accounting and Financial Arrangements

17. OCI commissioned a consultant to study the financing mechanism of the IIA in 2009. According to the recommendations of the consultant, the long-term target is to have about 70% of the expenditure of the IIA met by the levy and the remaining 30% by the various licence and user fees. An indicative six-year budget of the IIA proposed by the consultant is at **Annex D**.

18. To ensure financial independence, the IIA will have the following major sources of income –

(a) licence fees payable by all insurers and intermediaries. To reduce the impact on the insurance industry, the licence fee for insurance intermediaries will be waived in the first five years after the establishment of the IIA;

(b) a variable fee payable by insurers on the basis of their individual liabilities. An incremental approach is adopted for introducing this fee (see note 5 of Annex D);

(c) user fees for specific services (such as application for transfer of business, change of shareholding structure or change in key personnel); and

(d) a levy of 0.1% on insurance premiums for all insurance policies (capped at $100 for life policies and $5,000 for non-life policies). We will adopt an incremental approach for introducing the levy on insurance premiums (see Note 6 of Annex D) and exempt premiums of reinsurance contracts from the levy. Due to the various proposed concessions on levy, the consultant estimated that there would be a shortfall of about $78 million arising from the levy forgone (item (F) of Annex D).

All fees and levies are to be stipulated in subsidiary legislation subject to LegCo scrutiny.

19. The consultant recommends that the Administration should provide a lump sum of HK$500 million to the IIA on its inception to help meet part of its expenses in the initial five years before the IIA achieves the target levels of fees on insurers and insurance intermediaries and levy on insurance policies, and as contingency reserve.

20. New section 133 added by Clause 84 of the Bill prescribes that the IIA will be required to review the levy levels once its reserve has reached a level equivalent to 24 months of its operating expense (after deducting depreciation and all provisions), with a view to recommending a levy reduction.

Financial Services and the Treasury Bureau
July 2014

Annex A

Work Plan for the Bills Committee on Insurance Companies (Amendment) Bill 2014

Matters to be discussed	Clause / Section of the Bill	Timing / Suggested timing
Policy Discussion		**30 June to mid-November 2014**
1. Constitution of the IIA • IIA and provisional IIA • functions • governance	Clause 1 / Short title and commencement Clause 2 / Enactments amended Clause 3 / Long title Clause 4 / Section 1 Clause 5 / Section 2 [Note: Some of the definitions may be discussed in other parts] Clause 6 / Section 3 Clause 8 / Part IA heading Clauses 9 – 15 / Sections 4AAA – 5G Clause 86 / Schedules 1B, 1C, 1D	30 June 2014
2. Enhancement of existing regulatory powers on insurers • appointment of controllers, directors and key persons in control functions • other amendments	Clauses 16 – 54 / Sections 5H, 7 – 41 Clauses 56 – 63 / Sections 49B – 51 Clause 68 / Section 53E	21 July 2014
3. New regulatory powers on insurers • inspection / investigation powers[1] • disciplinary powers and procedures[1]	Clause 55 / Sections 41A – 41W Clause 62 / Section 50G	21 July 2014 September 2014[2]
4. Licensing regime for insurance intermediaries • regulated activities and exemptions • application procedures and eligibility criteria • inspection / investigation powers[1] • delegation of powers to the Monetary Authority	Clause 7 / Section 3A Clause 13 / Section 4G Clause 69 / Section 53F Clauses 71 – 83 / Sections 64F – 78 Clause 84 / Section 121 Clause 86 / Schedule 1A	September to October 2014
5. Transitional arrangements for insurance intermediaries • deeming provisions • handling of outstanding cases of self-regulatory organizations	Clause 84 / Section 137 Clause 94 / Schedule 11	October 2014
6. Disciplinary sanctions on licensed insurance intermediaries • conduct requirements • disciplinary powers and procedures[1]	Clause 84 / Sections 79 – 93	Early November 2014
7. Insurance Appeals Tribunal • establishment, composition and powers of the Tribunal • specified decisions	Clause 84 / Sections 94 – 115 Clause 94 / Schedules 9, 10	Early November 2014

[1] The detailed provisions in relation to inspection/investigation powers and the disciplinary process for insurers are similar to those for insurance intermediaries under items 4 and 6.

[2] We assume that no/fewer meetings will be held during (a) the summer recess of 2014 and (b) the period from mid-February to mid-April 2015 due to the Budget, the meetings of the National People's Congress and the Chinese People's Political Consultative Conference and Chinese New Year/Easter holidays. How meetings should be scheduled during these periods will be subject to Members' views and progress of deliberation of the Bill.

Matters to be discussed	Clause / Section of the Bill	Timing / Suggested timing
8. Miscellaneous • power to make rules and codes etc. • levy • secrecy provisions • immunity • savings provisions	Clauses 64 – 67 / Sections 53A – 53D Clause 70 / Part IX Clause 84 / Sections 116 – 120, 122 – 137 Clauses 85, 87 – 93 / First, Second to Eighth Schedules Clause 94 / Schedule 11	Mid-November 2014
9. Consequential and technical amendments	Clauses 95 – 165 Schedules 1 and 2 to the Bill	Mid-November 2014
Clause-by-clause Examination of the Bill		**December 2014 to mid-June 2015**[2]
Committee Stage Amendments		**Mid-June to end June 2015**

Annex B

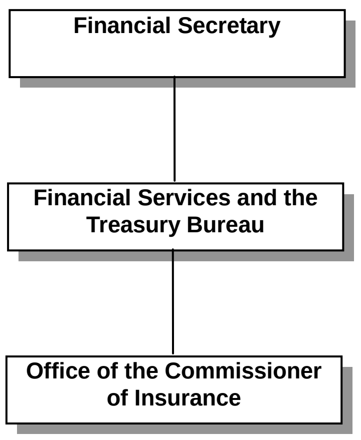
Comparison of Statutory Advisory Committees in relation to Financial Services Regulators

Financial Regulator	Composition of Advisory Committee	Quorum for Meeting
Independent Insurance Authority ("IIA")	• Chairperson of the IIA • Chief executive officer ("CEO") of the IIA • Not more than 2 other executive directors of the IIA • 8 to 12 other members appointed by the Financial Secretary[1] after consultation with the IIA	• The chairperson of the IIA, CEO of the IIA, or any 3 other members
Securities and Futures Commission ("SFC")	• Chairman of the SFC • CEO of the SFC • Not more than 2 other executive directors of the SFC • 8 to 12 other members appointed by the Chief Executive ("CE") after consultation with the SFC	• The chairman of the SFC, CEO of the SFC, or any 3 other members
Mandatory Provident Fund Schemes Authority ("MPFA")	• 1 executive director of the MPFA • 9 to 11 other members appointed by the CE	• A majority of members

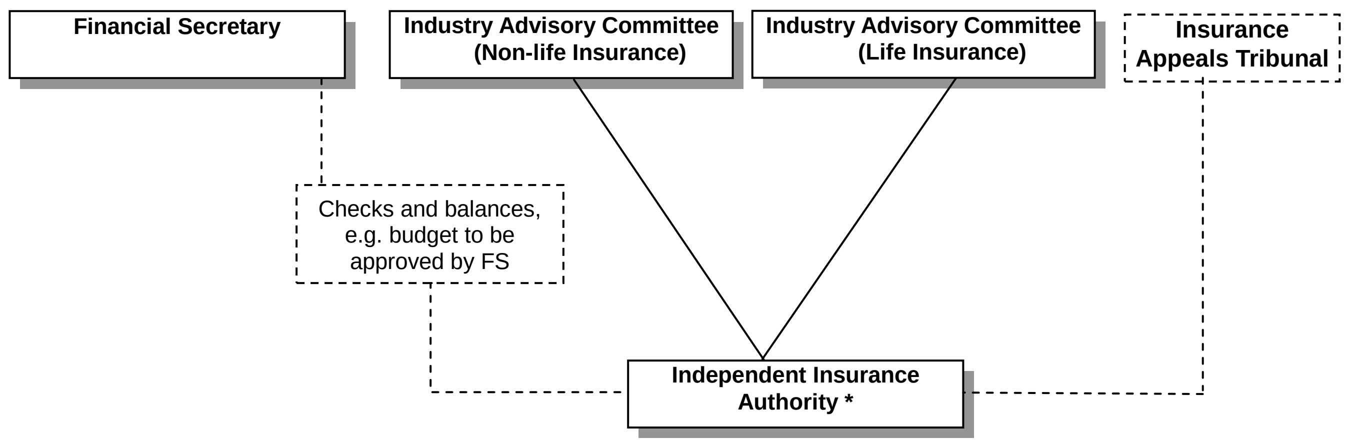
[1] An appointed member should have knowledge of, or experience in, the insurance industry, and the conduct of regulated activities and consumer affairs.

Existing Relationship between the Office of the Commissioner of Insurance ("OCI") and the Financial Secretary ("FS") and the Relationship between the Independent Insurance Authority ("IIA") and the FS

<u>Existing Relationship between the OCI and FS</u>



<u>Proposed Relationship between the IIA and FS</u>



* The IIA will be financially and operationally independent of the Government. We do not propose appointment of public officers to the IIA.

Annex D

Indicative Budget for the Independent Insurance Authority ("IIA") (based on a consultancy conducted in 2009/10)

	Year 1 ($m)	Year 2 ($m)	Year 3 ($m)	Year 4 ($m)	Year 5 ($m)	Year 6 ($m)
(A) IIA's estimated operating costs Note 1 (assuming a constant staff size of 237)	240.2	248.3	257.1	279.1	288.6	298.5
(B) IIA's estimated cashflow Note 2	271.2	248.7	257.6	280.1	289.1	299.0
(C) Government's lump-sum (% of cashflow) Note 3 Total (Year 1 - Year 5): $397.3m	135.6	99.5	77.3	56.0	28.9	0.0
(D) IIA's operating income to be recovered from the industry = (B) - (C)	135.6	149.2	180.3	224.1	260.2	299.0
(E) Estimated income to be recovered from the industry	143.8	166.4	194.8	229.2	267.4	333.2
(i) Fixed fee (assuming no increase) Note 4 $300,000 for General/Long Term insurers $600,000 for Composite insurers	55.2	55.2	55.2	55.2	55.2	55.2
(ii) Variable fee (as a % on insurers' liabilities) Note 5 (assuming 2% annual growth of liabilities)	0.8	4.1	10.8	22.1	26.9	34.5
(iii) User fee (5% of cashflow)	13.6	12.4	12.9	14.0	14.5	15.0
(iv) Levy (as a % on premiums) Note 6 (assuming 2% annual growth of premiums)	74.2	94.7	115.9	137.9	170.8	204.9
(v) Licence fee Note 7	0.0	0.0	0.0	0.0	0.0	23.6
(F) Estimated Income foregone with proposed concessions on levy Note 8	9.8	12.5	15.3	18.2	22.5	26.7
(G) Estimated Surplus/(Deficit) = (E) - (D) - (F) Total (Year 1 - Year 6): ($18.9m)	(1.6)	4.7	(0.8)	(13.1)	(15.3)	7.2

Note 1: Based on estimated operating costs provided by the consultant appointed by the Office of Commissioner of Insurance to carry out a consultancy study on establishing the IIA.

Note 2: The estimated cashflow includes capital expenditure (IT etc.), increase in working capital and rental deposit.

Note 3: Assuming a subsidy descending by 10% each year from 50% of the estimated cashflow in Year 1 to 0% in Year 6.

Note 4: Based on the no. of insurers as at 31.3.2011 (i.e. 165). As at 31.5.2014, there were 158 authorized insurers in Hong Kong.

Note 5: Based on the total net liabilities (long term business) and outstanding claims provision (general business) of 2009 and the rates below are proposed by the consultant.

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Variable Fee (as a % on insurance liabilities)	0.0001%	0.0005%	0.0013%	0.0026%	0.0031%	0.0039%

Note 6: Based on the total office premiums (long term business) and gross premiums (general business) of 2009 and the rates below are proposed by the consultant.

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Market Levy (as a % on insurance premiums)	0.04%	0.05%	0.06%	0.07%	0.085%	0.1%

Note 7: Licence fees for intermediaries will be waived from Year 1 to Year 5. The licence fee for Year 6 is based on the assumption that the level of fees as at 2011 is adopted.

Note 8: Levy will be capped at $100 for life policies and $5,000 for non-life policies. We will adopt an incremental approach for introducing the levy on insurance premiums (see Note 6 above) and exempt premiums of reinsurance contracts from the levy