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Panel on Financial Affairs

Meeting on 15 November 2016

Updated background brief on the Establishment of and financial arrangements for the independent Insurance Authority

Purpose

This paper provides background information on the establishment of and financial arrangements for the independent Insurance Authority ("IIA"). It also gives a brief account of the major views and concerns raised by Members in the Fifth Legislative Council ("LegCo") relating to the financial arrangements for IIA.

Background

2. The Office of the Commissioner of Insurance ("OCI") is the government department responsible for regulating Hong Kong's insurance industry. OCI regulates insurance companies to ensure their financial soundness, while conduct regulation of insurance intermediaries are taken up by three Self-Regulatory Organizations ("SROs").[1]

3. LegCo passed the Insurance Companies (Amendment) Bill 2014 on 10 July 2015 to amend the Insurance Companies Ordinance (Cap. 41) ("ICO") (the Bill was enacted as the Insurance Companies (Amendment) Ordinance 2015 ("the Amendment Ordinance"))[2] providing for the establishment of IIA to

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[1] The three Self-Regulatory Organizations are the Insurance Agents Registration Board established under the Hong Kong Federation of Insurers, the Hong Kong Confederation of Insurance Brokers and the Professional Insurance Brokers Association.

[2] The Insurance Companies (Amendment) Ordinance 2015 provides for, inter alia, the establishment of the independent Insurance Authority ("IIA"), the enforcement powers of IIA, the establishment of the Insurance Appeals Tribunal and a statutory licensing regime for insurance intermediaries.

take over the duties of OCI and administer an independent regulatory regime for insurance intermediaries to replace the self-regulatory regime.

4. The Amendment Ordinance is implemented in three stages to allow for a smooth transition from the existing regulatory regime to the new one. The target timeline as advised by the Administration in October 2015 is as follows:

Stage 1:	To establish the Provisional Insurance Authority ("PIA") [3] (without regulatory functions and co-exists with OCI)	December 2015
Stage 2:	PIA becomes IIA to replace OCI by taking over its regulatory functions (the self-regulatory regime for insurance intermediaries remains unchanged)	By end 2016
Stage 3:	IIA to implement the statutory licensing regime and take over the regulation of insurance intermediaries from the three SROs	Two to three years from the establishment of PIA

5. PIA was established on 7 December 2015 through tabling of the Insurance Companies (Amendment) Ordinance 2015 (Commencement) Notice 2015 before LegCo.[4] PIA is not vested with any regulatory powers before it becomes the IIA to take over the duties of OCI. On 28 December 2015, the Chief Executive ("CE") announced the appointment of the Chairperson and seven Non-executive Directors of IIA for a term of three years from 28 December 2015 to 27 December 2018.

Financial arrangements for the independent Insurance Authority

6. The new sections 5A to 5G[5] of ICO set out the accounting and financial arrangements of IIA. The main provisions include requirements for IIA to prepare and submit its corporate plan (including the estimates of income and expenditure) for the next financial year to the Financial Secretary ("FS") for approval and submit annual reports to FS; FS to table IIA's estimates, annual reports and audited financial statements before LegCo; and the Government to pay IIA out of the general revenue the monies appropriated by LegCo. As a

[3] The new section 4AAA(2) of the Insurance Companies Ordinance (Cap. 41) provides that when IIA is established, it is automatically renamed as "Provisional Insurance Authority" in English and "臨時保險業監管局" in Chinese for the period from its inception to the disbandment of Office of the Commissioner of Insurance ("OCI").

[4] The Insurance Companies (Amendment) Ordinance 2015 (Commencement) Notice 2015 ("Commencement Notice") was tabled at the Legislative Council meeting of 14 October 2015. No subcommittee was formed for scrutiny of the Commencement Notice.

[5] The sections have come into operation by virtue of the Commencement Notice.

check and balance, the Director of Audit may conduct value-for-money audit on IIA.

7. To enhance transparency in the preparation of IIA's annual estimates, the Administration has, during the scrutiny of the Bill, taken on board the Bills Committee's suggestion to brief the Panel on Financial Affairs ("FA Panel") on the main features of IIA's proposed budget prior to seeking approval by FS.

Income of the independent Insurance Authority

8. The Administration's policy objective is for IIA to fully recover its costs via income from the market and become financially independent of the Government.[6] It is the long-term target that about 70% of the expenditure of IIA will be met by levy and the remaining 30% by various authorization/licence and user fees ("70:30 split").[7] In respect of the levy, IIA will impose 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), which will be implemented through an incremental approach,[8] and exempt premiums of reinsurance contracts from the levy. As regards licence and user fees, they will be payable by all insurers and licensed intermediaries. To help meet part of IIA's expenses in the initial five years before it achieves the target levels of fees and levy, the Administration's proposal is to provide a lump sum provision to IIA on its inception.

9. Under the new sections 128 to 134 of ICO, all fees and levies of IIA are to be stipulated in regulations and orders to be made by CE which are subsidiary legislation subject to negative vetting of LegCo. The new section 135 of ICO provides for the mechanism for reduction of IIA's levies. The policy intent is that when the reserves of IIA are more than twice its estimated operating expenses for the financial year (after deducting depreciations and all provisions) and that IIA has no outstanding borrowing, IIA has to consult FS with a view to recommending to CE in Council that the rate or amount of a levy be reduced.

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6 According to the Administration, OCI recovers part of its annual operating cost from the annual licence fees paid by insurers. The remaining cost is subsidized by the Government. OCI currently does not impose any levies on insurance premiums.

7 Authorization fees are payable by insurance companies, licence fees are payable by insurance intermediaries and user fees are charged for provision of specific services. Levies are collected from insurance premiums.

8 IIA's target level of levy in the first five years after its establishment will be in accordance with the following schedule –

	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%

Funding for the establishment of the independent Insurance Authority

10. On 7 December 2015, the Administration briefed FA Panel on its funding proposal for the establishment of IIA and the exit arrangement for the existing Insurance Officers in OCI. A lump sum provision of $650 million[9] was proposed for meeting the first four years of operation of IIA. During the examination of the Estimates of Expenditure 2016-2017 in April 2016, the Administration explained that $450 million of the lump sum provision for meeting the shortfall of IIA's budget for the first two years had been included in the Estimates of Expenditure 2016-2017. The Administration plans to provide the remaining $200 million to IIA tentatively in 2018-2019, subject to the progress of the transitional work from the existing regulatory regime to the new one.

Budget of the independent Insurance Authority for the financial year 2016-2017

11. The Administration and IIA briefed FA Panel on IIA's proposed budget for 2016-2017 at the Panel meeting on 6 June 2016. According to the Administration, the estimated income of IIA in 2016-2017 was $457.8 million (including the lump sum provision of $450 million as mentioned in paragraph 10 above) and the estimated operating and capital expenditure were $100.2 million and $28.7 million respectively. It was projected that there would be an operating reserve of some $350 million.

Concerns and views expressed by Members

12. The major views and concerns expressed by the Bills Committee on the Insurance Companies (Amendment) Bill 2014 ("the Bills Committee") and FA Panel relating to the financial arrangements for IIA, the funding proposal for the establishment of IIA, and IIA's proposed budget for 2016-2017 are summarized in the ensuing paragraphs.

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9 Based on a consultancy study conducted by the Administration in 2010, a lump sum of $500 million was required as seed money and contingency reserve to support IIA's initial years of operation. The Administration updated the estimates in November 2015 and revised the lump sum to $650 million having regard to the additional regulatory functions of OCI (including enforcement of the anti-money laundering regulatory regime) since the study in 2010 to be taken over by IIA. The Administration also advised that based on 2010 consultancy study, IIA would have an establishment of about 250 staff members at its inception. As for OCI, the number of staff members was 150 as in mid-2014. As indicated in the updated consultancy study in November 2015, IIA will have an initial establishment of 299 staff members.

Financing mechanism and estimates of the independent Insurance Authority

13. Members of the Bills Committee noted that IIA was empowered to appoint its staff and consultants, and determine their remuneration and terms and conditions. They stressed the need to put in place a mechanism for regulating the size of IIA to prevent over-expansion, and suggested specifying clearly in the Amendment Ordinance that IIA must decide on the above matters according to its "actual needs" and in a "reasonable manner". Moreover, with a view to enhancing financial prudence and discipline of IIA, the Bills Committee considered that part of the proposed start-up funds provided by the Government to IIA should be in the form of a loan.

14. The Administration explained that IIA would have a larger establishment than OCI mainly because IIA would take up the additional responsibility of administering the licensing system for insurance intermediaries. The Amendment Ordinance required that IIA's annual estimates, which included estimated staff costs and professional service fees, to be approved by FS and the approved estimates must be tabled before LegCo. These measures would provide an effective check and balance. The Administration stressed the need to provide IIA with operational flexibility in employing and engaging suitable talents and determining the appropriate level of remuneration having regard to the actual circumstances and prevailing market situations in order to cope with regulatory challenges effectively and respond swiftly to market changes. This was in line with the practice of other financial regulators, such as the Securities and Futures Commission ("SFC") and the Mandatory Provident Fund Schemes Authority ("MPFA"). The Administration also took note of Bills Committee members' suggestion that part of the proposed start-up funds for IIA should be provided in the form of a loan, and undertook to consult FA Panel before seeking the relevant funding approval from the Finance Committee.

15. During the discussion of the funding proposal for the establishment of IIA at the FA Panel meeting on 7 December 2015, members enquired whether the Administration would top up the shortfall should the proposed lump sum provision of $650 million for IIA was insufficient. The Administration advised that if the proposed lump sum provision turned out to be inadequate, the Administration might consider different options including the provision of additional funding to IIA in the form of a loan. There were provisions in the Amendment Ordinance enabling IIA to borrow money with the approval of FS. Given the healthy and stable development of the insurance industry in the previous years on which basis the income projection of IIA had been worked out, it was envisaged that the proposed $650 million would be sufficient to support the operation of IIA in the initial five to six years.

Levy on insurance premiums

16. On levy collection, members of the Bills Committee noted some public views that the levy should not be borne by policy holders on concern that this might increase the price of insurance products. As regards the levy reduction mechanism, members opined that the concept of "net reserves of IIA" for considering the need of levy reduction should be expressly stipulated in the Amendment Ordinance, in particular to prevent the situation where IIA might raise debt unnecessarily in order to avoid triggering the mechanism for levy reduction.

17. The Administration responded that one of the main objectives of IIA was to protect policy holders, and based on the "user-pay" principle it would be justified to collect levies from policy holders. It was also important for IIA to be financially independent to perform its statutory regulatory functions in an equitable and impartial manner. As regards levy reduction, the Administration explained that the wording of the relevant provisions had clearly reflected the concept of "net reserves". Furthermore, IIA could only borrow money with the approval of FS. Together with other financial arrangements stipulated in ICO, there would be sufficient safeguards against IIA making unnecessary borrowings simply to avoid triggering the mechanism for the reduction of levies.

18. At the FA Panel meeting on 7 December 2015, some members expressed concern about the propriety of the 70:30 split on IIA's expenditure between levy and licence and user fees as they considered that insurers and insurance intermediaries should bear IIA's expenditure because they would benefit from the new regulatory regime. When FA Panel was briefed on the IIA's proposed budget for 2016-2017 on 6 June 2016, some members reiterated the need for IIA to exercise vigilance in controlling its expenditure so as to contain the levels of levy and fees to be collected from policy holders and the industry.

19. The Administration explained that the 70:30 split was set out in the consultation paper on the establishment of IIA published in 2010. The proposal aimed to enable IIA to have stable sources of income for achieving financial independence after several years of operation. To reduce the impact on policyholders, an incremental approach would be adopted in achieving the target level of levy on insurance policies in the first five years after the establishment of IIA. Moreover, under the new regulatory regime, insurance companies were required to pay variable authorization fee in addition to fixed authorization fee.

Recruitment policies of the independent Insurance Authority

20. At the FA Panel meetings on 7 December 2015 and 6 June 2016, some members enquired about the recruitment policies of IIA, including how IIA

would benchmark the remuneration of its staff. The Administration advised that IIA would formulate its own recruitment policies, including staff salaries and employment terms. IIA might engage a human resources consultant for advice, and consider adopting arrangements similar to those of other statutory regulatory bodies like SFC and MPFA. IIA would also make reference to the wage levels of other financial regulators in determining the remuneration of its own staff. IIA would recruit its staff in phases and explore arrangements for experienced staff members in the industry and other financial regulators to be seconded to IIA.

Latest development

21. The Administration will brief FA Panel at the meeting on 15 November 2016 on the legislative proposals for IIA to collect levy on insurance premiums from policy holders, authorization fees from insurance companies, and other fees on specific services provided by IIA.

Relevant papers

22. A list of relevant papers is in the **Appendix**.

Council Business Division 1
Legislative Council Secretariat
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Appendix

List of relevant papers

Date/Period	**Event**	**Paper/Minutes of meeting**
May 2014 to July 2015	The Bills Committee on Insurance Companies (Amendment) Bill 2014 was in action	Report of the Bills Committee (LC Paper No. CB(1)1055/14-15) Legislative Council Brief (File Ref: C2/2/50C) Legal Service Division report (LC Paper No. LS50/13-14)
10 July 2015	The Legislative Council ("LegCo") passed the Insurance Companies (Amendment) Bill 2014	Hansard
14 October 2015	The Insurance Companies (Amendment) Ordinance 2015 (Commencement) Notice 2015 gazetted on 9 October 2015 was introduced into LegCo	Legislative Council Brief (File Ref.: INS/2/3C(2015)) Legal Service Division Report (LC Paper No. LS2/15-16)
7 December 2015	The Panel on Financial Affairs ("FA Panel") was briefed by the Administration on its funding proposal relating to the establishment of an independent Insurance Authority	Administration's paper (LC Paper No. CB(1)209/15-16(04)) Minutes (LC Paper No. CB(1)540/15-16)
28 December 2015	The Chief Executive announced the appointment of the Chairperson and seven Non-executive Directors of the Provisional Insurance Authority	Press release

Date/Period	Event	Paper/Minutes of meeting
5 April 2016	Special meeting of the Finance Committee for examination of Estimates of Expenditure 2016-2017	Written questions raised by Members and Administration's replies for the session on "Financial Services" (Reply serial numbers: FSTB(FS)001, 009, 010, 011, 012, 013, 014, 024, 033, 035, 037, 038, 039, 044, 060, 092, 098, 099 and 103)
6 June 2016	FA Panel was briefed by the Administration and IIA on IIA's proposed budget for the financial year of 2016-2017	Administration's paper (LC Paper No. CB(1)987/15-16(04)) Minutes (LC Paper No. CB(1)1162/15-16)