For discussion
on 8 January 2018

LEGISLATIVE COUNCIL PANEL ON FINANCIAL AFFAIRS

Risk-based Capital Regime for the Insurance Industry of Hong Kong

PURPOSE

This paper provides an update on the development of a Risk-based Capital ("RBC") regime for the insurance industry in Hong Kong.

BACKGROUND

2. Currently, the insurance industry of Hong Kong operates on a rule-based capital adequacy regime. Capital adequacy is assessed on the basis of an insurer's solvency margin, i.e. the level of surplus derived from the value of the assets of an insurer vis-à-vis the value of its liabilities. The solvency margin for long-term business is calculated by reference to a percentage of the sum insured and policy reserves, while that for general business is calculated by reference to a percentage of premium levels and claims outstanding. The risk factors pertinent to an individual insurer are not featured or quantified under the existing regime.

3. At the international level, the International Association of Insurance Supervisors ("IAIS") – the global standard-setter for the insurance industry issued the Insurance Core Principles ("ICPs") in relation to capital adequacy requirements in late 2011 which prescribe principles for a risk-based approach for capital adequacy framework. All insurance supervisors, including the Insurance Authority ("IA"), are obliged to comply with these ICPs as soon as practicable. The implementation of the RBC regime is also one of the recommendations of the International Monetary Fund ("IMF") during its Financial Sector Assessment Programme ("FSAP") for Hong Kong in 2013-14.

PROPOSED RBC FRAMEWORK

4. The former Office of the Commissioner of Insurance ("OCI") commissioned a consultancy study ("Phase I Consultancy Study") in mid-2012 to recommend a draft RBC framework for Hong Kong's insurance industry. The key recommendations are set out in paragraphs 5 and 6 below.

5. The proposed RBC regime comprises three pillars representing requirements for quantitative assessment aspects (Pillar 1), corporate governance and risk management aspects (Pillar 2) and disclosure (Pillar 3) –

(a) Pillar 1 (quantitative assessment aspects) involves the establishment of two solvency control levels, namely the Prescribed Capital Requirement ("PCR")[1] and the Minimal Capital Requirement ("MCR")[2] (collectively "capital requirements"). The determination of the two solvency control levels will involve the valuation of assets and liabilities. Tiered capital resources will be identified based on the quality and the ability of such resources to absorb losses.

(b) Pillar 2 (corporate governance and risk management aspects) involves the enhancement of enterprise risk management ("ERM")[3] by insurers and the requirement for them to conduct Own Risk and Solvency Assessment ("ORSA")[4].

(c) Pillar 3 (disclosure) involves periodic public disclosure of the capital resources and capital requirements.

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1 PCR is defined as the solvency control level above which the supervisor does not intervene on capital adequacy grounds.

2 MCR is the solvency control level at or below which the supervisor would invoke its strongest actions, in the absence of appropriate corrective actions by the insurer concerned.

3 ERM is the generic term to describe the process of identifying, assessing, measuring, monitoring, controlling and mitigating risks for solvency purposes (see ICP 16.0.2).

4 ORSA is the management board's opinion on (a) the adequacy of the ERM framework; and (b) the adequacy of current and likely future solvency position (see ICP 16.11).

6. The RBC regime will be developed in four phases –

(a) Phase I (completed) involved the development of the RBC conceptual framework, including the broad risks categories (e.g. insurance risk, market risk and credit risk) and approaches on the risk assessment (e.g. stress-based or factor-based) ;

(b) Phase II (current stage) involves the development of detailed rules and conducting Quantitative Impact Study (“QIS”) exercises, followed by a consultation exercise;

(c) Phase III will involve legislative amendments; and

(d) Phase IV will be the implementation phase with a sufficiently long run-in period, so that insurers will have adequate time to understand the requirements thoroughly, and be able to achieve full compliance incrementally.

7. Based on the consultant’s recommendations, the former OCI conducted a three-month public consultation on the proposed RBC framework in September to December 2014 (“Phase I Consultation”). The insurance industry and other respondents generally support the transition to the RBC regime and the high-level principles of the conceptual framework.

DEVELOPMENT OF DETAILED RULES

Pillar 1 (Quantitative Assessment Aspects)

8. The former OCI commissioned another consultancy study in September 2016 (“Phase II Consultancy Study”) to develop detailed rules in respect of the quantitative assessment and corporate governance and risk management requirements, together with technical specifications and templates for data collection from insurers for the first Quantitative Impact Study (“QIS 1”) exercise. The objective of QIS exercise is to collect granular data from individual insurance companies for the purpose of conducting analysis and calibration, so as to ensure that the new RBC regime is viable and practicable.

9. During the course of the Phase II Consultancy Study, four Industry Focus Groups ("IFGs")[5] were established, involving representatives from the Hong Kong Federation of Insurers and the Actuarial Society of Hong Kong. A total of 23 IFG meetings were held to discuss various technical issues, mainly concerning the approaches and methodologies in determining the valuation of assets and liabilities, capital requirements for each risk category, and the quality of capital resources, etc.

Quantitative Impact Studies

10. The IA launched the QIS 1 exercise on 28 July 2017 for collecting data from the industry by December 2017. Analysis on the industry data collected will be conducted in the first half of 2018. In view of the complexity of the project and the experience of other jurisdictions, the IA expects at least two more QIS exercises will have to be conducted before the comprehensive rules of the RBC regime can be developed and their impact on the industry can be fully assessed. The IA expects that the QIS exercises would only be completed in 2019 at the earliest.

11. After completing the analyses of the QIS exercises, the IA would conduct public consultation on the draft rules of the RBC regime, tentatively in 2020. The IA will continue to engage the insurance industry, professional bodies and other stakeholders throughout the development of the detailed rules.

PROPOSED IMPLEMENTATION APPROACH

Pillar 2 (Corporate Governance and Risk Management Aspects)

12. The IA proposes to issue a new Guideline on ERM and ORSA ("new Guideline") to set out the principles for enhanced ERM requirements on insurers and to require each active insurer to –

[5] To facilitate the engagement of the industry, four IFGs were established to discuss and gauge views on various technical aspects. IFG on Pillar 1 Life Insurance and IFG on Pillar 1 General Insurance focus on the quantitative assessment aspects (i.e. valuations and capital requirements) on solo basis in respect of long term insurance business and general insurance business respectively. IFG on Pillar 2 focuses on the corporate governance and risk management aspects on solo basis e.g. enterprise risk management and own risk and solvency assessment. IFG on Groups focuses on the consideration in relation to insurance groups and subgroups and the corporate governance and risk management requirements applicable to them.

(a) enhance risk management with a goal to identify, measure, report and manage risks on a continuous basis and in an integrated manner; and

(b) establish an ORSA process to assess from time to time the adequacy of its risk management and current, and likely future, solvency position.

13. The IA aims at conducting public consultation on the draft new Guideline in early 2018, with a view to issuing the new Guideline by end 2018.

Pillar 1 (Quantitative Assessment Aspects)

14. Existing provisions under the Insurance Ordinance (Cap. 41) ("the Ordinance") empower the IA to make rules for the determination of solvency margin and the valuation of assets and liabilities by way of subsidiary legislation. The Ordinance also allows the IA to impose interventions when insurers fail to meet the capital requirement. Specifically, section 8 requires insurers to maintain value of assets not less than the aggregate of the liabilities and relevant amount (i.e. solvency margin). Sections 129(1)(a) and 129(1)(b) empower the IA to make rules for the determination of the value of assets and amount of liabilities as well as rules for determination of any amount required to be prescribed and determined which include solvency margin and capital requirement. Sections 26(1)(f) and 35AA prescribe IA's power to exercise regulatory actions and intervention actions in the case an insurer fails to meet the solvency margin.

15. With the above enabling provisions, similar to the current regime, the IA plans to implement requirements under Pillar 1 of the RBC regime, by prescribing the detailed rules on valuation and capital requirements by way of subsidiary legislation. Consequential amendments to the principal legislation to remove or update obsolete provisions are necessary. Our current target is to submit the above legislative amendments to the Legislative Council in 2020 – 21, after the public consultation exercise mentioned in paragraph 11 above. The tentative timeline of the RBC regime is at **<u>Annex</u>**.

ADVICE SOUGHT

16. Members are invited to comment on the proposal to implement the RBC regime.

Financial Services and the Treasury Bureau
December 2017

Annex

Tentative Timeline of the Risk-based Capital Regime