

For discussion
on 5 March 2018

Legislative Council Panel on Financial Affairs
Insurance Authority
Budget for the Financial Year 2018-19

PURPOSE

This paper highlights the main features of the budget of the Insurance Authority (“IA”) for 2018-19.

BACKGROUND

2. The IA is a new insurance regulator established under the Insurance Companies (Amendment) Ordinance 2015. On 26 June 2017, the IA took over the statutory functions of the former Office of the Commissioner of Insurance on the regulation of insurance companies. It plans to take over the regulation of insurance intermediaries from the three Self-Regulatory Organizations (“SROs”)¹ and administer a statutory licensing regime for insurance intermediaries by mid-2019.

3. Section 5B of the Insurance Ordinance (Cap. 41) stipulates that the IA must, no later than 31 December in each financial year, submit to the Financial Secretary (“FS”) for approval a corporate plan (including the estimates of its income and expenditure (“the Budget”)) for the next financial year. The law requires that FS must lay a copy of the Budget on the table of the Legislative Council (“LegCo”).

FUNDING OF THE IA

4. The IA is expected to be financially independent of the

¹ The three SROs 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.

Government. To help the IA meet the shortfall in its initial years of operation, the Government has undertaken to provide seed money of \$650 million to the IA. The first tranche of \$450 million was disbursed to the IA in 2016-17 and, subject to the approval of LegCo, the second tranche of \$200 million will be disbursed in 2018-19. For achieving full cost recovery in the long run, with the approval of LegCo, the IA has started charging authorization fees payable by insurance companies (with effect from 26 June 2017), user fees for specific services (with effect from 26 June 2017) and a levy on insurance premiums payable by policy holders (with effect from 1 January 2018). The levy rate, currently at 0.04% on premiums of insurance policies, will increase gradually until it reaches the target level of 0.1% in 2021-22. There is a cap on the levy².

5. As undertaken by the Government during LegCo's scrutiny of the Insurance Companies (Amendment) Bill 2014, the IA will brief the LegCo Panel on Financial Affairs on the main features of its Budget prior to seeking FS' approval.

BUDGET FOR 2018-19

6. A copy of the IA's Budget for 2018-19 is at **Annex**. The main features of the Budget for 2018-19 are set out in paragraphs 7 to 10 below.

Income

7. The estimated total income for 2018-19 after reflecting the full-year effect of the IA's income (as set out in paragraph 4 above) is about \$182.9 million, which is \$123.4 million (207.4%) above the revised estimate for 2017-18 (\$59.5 million).

Operating Expenditure

8. The estimated operating expenditure for 2018-19 is about \$418.1 million, which is \$207.4 million (98.4%) above the revised estimate for 2017-18 (\$210.7 million), the bulk of which is for staff costs

² A levy cap of \$100 and \$5,000 has been imposed on long term insurance policies and general insurance policies respectively.

and office rental –

- (a) “Staff costs” – the estimated expenditure for 2018-19 is about \$314.6 million, which is \$151.9 million (93.4%) above the revised estimate for 2017-18 (\$162.7 million). The IA now has about 190 staff members. It is envisaged that the IA will reach full strength of about 300 staff members in 2018-19, with new staff members coming on board to take up new and enhanced functions, such as those relating to the regulation of some 100,000 insurance intermediaries;
- (b) “Office rental and related expenses” – the estimated expenditure for 2018-19 is about \$24 million, which is \$7.1 million (42%) above the revised estimate for 2017-18 (\$16.9 million). The estimate has reflected the full-year effect of the rental and related costs of the IA’s long term office;
- (c) “IT expenses”, “Other operating expenses” and “Depreciation” – the projected increase in these items are mainly to reflect the full-year effect of the operational costs of the long term office;
- (d) “External relations expenses” – the estimated expenditure for 2018-19 is about \$4.4 million, which is \$2.9 million (193.3%) above the revised estimate for 2017-18 (\$1.5 million). The increased expenditure is required for meeting the expenditure requirement of new publicity programmes to be launched in 2018-19 for enhancing public understanding of the IA and the insurance industry; and
- (e) “Non-recurrent projects” – the estimated expenditure of \$12 million for 2018-19, which is \$11 million (1100%) above the revised estimate for 2017-18 (\$1 million), is to cater for the cashflow requirement of the consultancy projects on the development of the Risk-based Capital regime.

Capital Expenditure

9. The estimated capital expenditure for 2018-19 is about \$27 million, which is \$35 million (56.5%) below the revised estimate for 2017-18 (\$62 million). The decrease is mainly due to the completion of

the fitting-out and IT infrastructure projects of the IA's long term office in 2017-18. To facilitate its regulatory operation, the IA is developing several major IT systems which include the systems for the collection of returns on insurance levy as well as the licensing of insurance intermediaries. The projected cashflow requirement of these systems for 2018-19 is about \$23.2 million.

Reserve

10. Taking into account the Government's provision of the balance of the seed money, i.e. \$200 million subject to LegCo approval in 2018-19 (paragraph 4 above), it is projected that the IA will have an unspent operating balance of about \$240 million by 31 March 2019. The balance is required to fund the IA's initial years of operation until it achieves breakeven.

COMPARISON OF THE APPROVED BUDGET WITH THE REVISED ESTIMATES FOR 2017-18

Income

11. The revised total income for 2017-18 (\$59.5 million) is \$7 million (10.5%) less than the approved estimate (\$66.5 million). Less amount of authorization fees and user fees were collected as the transition took effect in late June 2017 instead of early May 2017 as originally estimated.

Operating Expenditure

12. The revised operating expenditure for 2017-18 (\$210.7 million) is \$35.4 million (14.4%) less than the approved estimate (\$246.1 million)³, mainly due to reduced spending on—

- (a) "Staff costs" – \$17.1 million (9.5%) less than budgeted (\$179.8 million); and
- (b) "Office rental and related expenses" - \$18.1 million (51.7%)

³ Taking into account the reclassification of \$6.4 million for IT systems and equipment and \$0.2 million for website design and development (originally grouped under operating expenditure items "Non-recurrent projects" and "Miscellaneous expenses" in the approved budget respectively) as capital expenditure.

less than budgeted (\$35 million) as the office rental for the premises⁴ subsequently selected by the IA cost less than the approved estimate.

Capital Expenditure

13. The revised estimate (\$62 million) is \$23.8 million (62.3%) more than the approved estimate (\$38.2 million). This item includes mainly one-off expenses (\$56.5 million) in respect of office renovation and fitting-out works, acquisition of furniture as well as office and IT equipment for the IA's long term office. The discrepancy is mainly due to the fact that the approved estimate was based on outdated figures used in a consultancy study in 2015, the rise in fitting-out costs and the need to accommodate up-to-date IT infrastructure in the office premises.

THE GOVERNMENT'S VIEWS

14. The IA has only assumed its statutory functions on the regulation of insurers since 26 June 2017 and it is empowered to collect levy on insurance premiums with effect from 1 January 2018. The IA is still in the transition process for setting up a statutory licensing regime for direct regulation of insurance intermediaries in mid-2019. The proposed Budget for 2018-19 is the best estimate worked out by the IA based on the operational experience acquired so far.

15. We are studying the IA's proposed Budget for 2018-19 having regard to the progress of the preparatory work for the year. We trust that the IA would deploy its resources and control its expenditures in a prudent manner to achieve long term financial sustainability.

ADVICE SOUGHT

16. Members are invited to note the proposed Budget of the IA for 2018-19.

Financial Services Branch
Financial Services and the Treasury Bureau
February 2018

⁴ In Wong Chuk Hang.

Insurance Authority

Estimates of Income and Expenditure for 2018-19

	Note	Estimates 2017-18 HK\$ <u>million</u>	Revised Estimates 2017-18 (ii) HK\$ <u>million</u>	Proposed Estimates 2018-19 (iii) HK\$ <u>million</u>	Variance Proposed Estimates vs. Revised Estimates (vi)=(iii)-(ii) HK\$ <u>million</u>
A. <u>Income and Expenditure Statement</u>					
<u>Income</u>	1				
(a) Interest income	2	1.0	2.0	0.7	(1.3)
(b) Levy and Fees	3	65.5	57.5	182.2	124.7
Total Income		66.5	59.5	182.9	123.4
<u>Operating Expenditure</u>					
(a) Staff costs	4	179.8	162.7	314.6	151.9
(b) Office rental and related expenses	5	35.0	16.9	24.0	7.1
(c) Engagement of professional services	6	12.1	10.3	9.2	(1.1)
(d) Information Technology ("IT") expenses *	7	1.9	2.5	7.2	4.7
(e) External relations expenses *	8	2.6	1.5	4.4	2.9
(f) Remuneration to Members		2.5	2.5	2.5	-
(g) Other operating expenses *	9	5.7	5.8	16.9	11.1
(h) Depreciation	10	2.5	7.5	27.3	19.8
(i) Non-recurrent projects **	11	4.0	1.0	12.0	11.0
Total Operating Expenditure		246.1	210.7	418.1	207.4
Result for the year		(179.6)	(151.2)	(235.2)	(84.0)
B. <u>Capital Expenditure Statement</u>					
(a) Office set-up	12	31.6	56.5	3.8	(52.7)
(b) IT systems and equipment **	13	6.6	5.5	23.2	17.7
Total Capital Expenditure		38.2	62.0	27.0	(35.0)

Note

* Operating expenditure items (d), (e) & (g) were originally grouped under a single item "Miscellaneous expenses" in the Approved Estimates for 2017-18 with a total sum of \$10.4 million.

** \$6.4 million originally grouped under an operating expenditure item "Non-recurrent projects" and \$0.2 million under another operating expenditure item "Miscellaneous expenses" in the Approved Estimates for 2017-18 for IT systems and equipment and website design and development respectively were reclassified as capital expenditure under the item "IT systems and equipment".

Notes to the Proposed Estimates for 2018-19

1. Income

According to the consultancy study¹ commissioned by the Government, income of the IA in the first four years of operation is not sufficient to cover its expenditure and will face a deficit of about \$650 million. Of the \$650 million, it is expected that there will be a deficit of \$450 million in the first two years. The Government has therefore proposed to provide the provision in two instalments to help the IA meet the shortfall in its initial years of operation. On 13 May 2016, the Legislative Council (“LegCo”)² approved the provision of \$450 million to the IA in the context of the Appropriation Bill 2016. The provision was received in early June 2016 and was recognized as capital upon receipt in the statement of financial position and it is provided by the Government without related costs. The remaining \$200 million will be sought in 2018-19.

2. Interest income

With the approval of the Financial Secretary, the IA has adopted an interim investment arrangement whereby funds not required for immediate use would be invested in the form of placement of Hong Kong Dollars fixed deposits to earn interest income. A long term investment strategy of the IA’s reserve funds will be worked out when there is more certainty on the IA’s cash flow requirements.

3. Levy and Fees

Starting from 1 January 2018, a levy of 0.04% on premiums of insurance policies will be payable by policy holders. The levy rate will gradually increase until it reaches its target level of 0.1% in 2021-22. A cap will be imposed on the levy on general insurance policies with annual premiums at or above \$5 million and long term insurance policies with single or annualized premiums at or above \$100,000. Captive insurance, contracts of reinsurance and marine, aviation and goods in transits are exempted from the levy.

¹ The consultancy study was carried out by the PricewaterhouseCoopers.

² Before obtaining LegCo’s funding approval, the Government approved in February 2016 a small sum of \$3 million in 2015-16 for the IA to meet mainly the cash flow requirement of the essential consultancy services. The allocation was received by the IA in early March 2016.

The new annual authorization fees payable by insurance companies effective from 26 June 2017 consist of two elements, namely, (a) a fixed fee of \$300,000 (for captive insurance company, \$30,000; and for composite insurance company, \$600,000); and (b) a variable fee, subject to a cap of \$7 million on insurance liabilities (\$14 million for composite insurer). The variable fee rate pitches at 0.0001% and will increase gradually until it reaches its target rate of 0.0039%.

With effect from 26 June 2017, the IA has been charging user fees to recover the cost of providing 11 specific services. Of them, ten are applicable to insurance companies.

4. Staff cost

The staff cost involves mainly salary, contributions to Mandatory Provident Fund schemes, staff insurance and employees' compensation insurance. The revised estimate for 2017-18 is mainly based on the actual profile of serving staff. We envisage that we would have full strength of about 300 staff members on board in 2018-19.

5. Office rental and related expenses

This item includes mainly office rental, management fees, utility charges, government rent/rates as well as other related expenses such as general office insurance and telephone rental. The IA's staff have been accommodated in the long term office in Wong Chuk Hang in December 2017. The estimate for 2018-19 reflects the full-year effect of the office rental and related expenses.

6. Engagement of professional services

This item involves mainly executive search services for staff recruitment, project management of office accommodation, legal and audit services. The estimate for 2018-19 is lower than the revised estimate for 2017-18 mainly due to the anticipated decrease in service fees for staff recruitment.

7. IT expenses

IT expenses cover maintenance fees of server infrastructure, security protection system and various IT application systems. The estimate

for 2018-19 reflects the full-year effect of various IT operating costs in the long term office.

8. External relations expenses

The revised estimate for 2017-18 takes into account the actual expenditure for the first six months of the year and the estimated costs of publicity programmes to be conducted in the remainder of the year. The estimate for 2018-19 mainly covers enhanced publicity initiatives such as launching of promotional campaigns to enhance public knowledge about insurance and related topical issues as well as to help promote the IA's work and the importance of the industry in society.

9. Other operating expenses

Other operating expenses covers mainly expenses on staff training and development, travelling expenses and other incidental expenses. The estimate for 2018-19 reflects the full-year effect of such expenses.

10. Depreciation

Depreciation is calculated to write off the cost of fixed assets (such as furniture and fixtures as well as office and IT systems and equipment) using the straight-line method over their estimated useful lives of either three or five years.

11. Non-recurrent projects

This item is for conducting consultancy studies related to the development of the Risk-based Capital ("RBC") regime³. Having developed a RBC framework and key approaches, we launched the first quantitative impact study ("QIS 1") in July 2017 with a view to collecting data from the industry by early December 2017. We shall conduct further consultancy studies to examine the outstanding issues from QIS 1, and prepare for the launch of QIS 2 in mid-2018. The estimated cost of the consultancy studies is \$12 million.

12. Office set-up

This item includes one-off expenses in respect of office renovation and

³ The RBC regime aims to enhance the prudential regulatory system for insurance companies with a view to aligning the capital requirements for insurance companies with the risks to which they are exposed and strengthening their enterprise risk management system. The RBC regime is being developed in phases.

fitting-out works, acquisition of furniture and office equipment, as well as IT infrastructure and equipment for the long term office. The revised estimate for 2017-18 takes into account the contract sums finalised after the tender procedures. The estimate for 2018-19 will decrease since the relevant works will largely be completed in 2017-18.

13. IT systems and equipment

We have embarked on developing several major IT projects to facilitate the regulatory operation since 2017-18. Examples are systems for the collection of returns on insurance levy as well as supervising insurance intermediaries. The estimate for 2018-19 will be higher taking into account the cash flow requirements of the IT projects.

December 2017