For discussion on
5 March 2018

Legislative Council
Panel on Financial Affairs

Policy Holders' Protection Scheme Bill

Purpose

This paper briefs Members on the key legislative proposals under the Policy Holders' Protection Scheme Bill ("the Bill"), which aims to establish a Policy Holders' Protection Scheme ("PPS") for protecting policy holders' interest by compensating policy holders or securing the continuity of insurance contracts in case an insurer becomes insolvent.

Background

2. Hong Kong currently has compensation schemes in place for non-life insurance policies covering motor vehicle third party claims (motor vehicle policies) [1] and employees' work-related injuries (employees' compensation policies)[2], which are mandated by statute.

3. Although Hong Kong has a very robust regulatory system and there were only a handful of insolvencies of small non-life insurers in Hong Kong in the past two decades, the 2008 international financial crisis highlighted the need for a more comprehensive compensation fund for protecting policy holders with a view to strengthening their confidence in the insurance market. In 2010, the then Office of the Commissioner of Insurance commissioned an actuarial study to assess the optimal levy rate, target fund size and other detailed arrangements for the proposed PPS. The Government completed the public consultation on the proposal in June 2011 and briefed this Panel on the consultation conclusions in February 2012.

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[1] Insolvency protection for motor vehicle policies is provided by the Insolvency Fund Scheme administered by the Motor Insurers' Bureau of Hong Kong.

[2] Insolvency protection for employees' compensation policies is provided by the Employees Compensation Insurer Insolvency Scheme which is administered by the Employees Compensation Insurer Insolvency Bureau.

4. There is general support from the public, the industry and the Legislative Council ("LegCo") for the establishment of a PPS and the key proposed features of the PPS. Based on the consultation conclusions, we have been working with the industry and relevant stakeholders to iron out various technical issues and fine-tune the proposals. The key legislative proposals are set out in the ensuing paragraphs.

Key Legislative Proposals

Objectives and Guiding Principles

5. In formulating the legislative proposals on the PPS, we have in mind the following objectives and guiding principles –

(a) the PPS should strike a reasonable balance between enhancing protection for policy holders and minimising additional burden on members of the insurance industry;

(b) the PPS should enhance market stability while minimising the risk of moral hazard;

(c) the PPS should provide certainty on the level of compensation payment to policy holders when an insurer becomes insolvent, and a robust system should be put in place to facilitate the collection, custody, investment and administration of levy contributions to the PPS; and

(d) the establishment of the PPS should not in any way compromise the regulatory standards and requirements laid down by the Insurance Authority ("IA") under the Insurance Ordinance (Cap. 41) ("IO").

Governance and Administration of the PPS

6. We propose to set up a statutory body named the Policy Holders' Protection Board ("the Board") as the governing body of the PPS. The Board will comprise representatives from the IA and the Financial Services and the Treasury Bureau, and professionals experienced in insurance, finance, accounting, law and consumer affairs, etc. We propose that the IA should serve as the administrative arm of the Board for cost-effectiveness and operational effectiveness.

Membership of the PPS

7. All authorized insurers, except insurers authorized to carry on only reinsurance business, captive insurers and insurers not authorized to carry on business of any protected policies (please refer to paragraph 8 on the definition of protected policies), are required to be members of the PPS ("Scheme members") unless they are exempted by the Board. A foreign-incorporated insurer may apply for exemption from the PPS if (i) protected policies written by it in Hong Kong are covered by a foreign scheme of a similar nature and (ii) the scope and level of protection available to those policies under the foreign scheme are not less than the scope and level of protection that would be available to the policies under the PPS.

Coverage

8. Policy holders eligible for protection under the PPS are individuals, Small and Medium Enterprises ("SMEs") and Owners' Corporations. Policies protected under the PPS are all in-force policies (not being reinsurance business) held by eligible policy holders and written by a Scheme member, except retirement schemes, motor vehicle policies and employees' compensation policies. Having considered the types of policies normally procured by SMEs, we further propose to fine-tune the proposal to exclude aviation and marine insurance and certain offshore risks[3].

Funding Mechanism

9. There will be two separate funds under the PPS, namely, the Life Fund and the Non-life Fund ("the Funds"), for providing a safety net for policy holders of life (long term) policies and non-life (general) policies respectively. The initial target sizes of the Life Fund and Non-life Fund are $1.2 billion and $75 million respectively. It is estimated that the Funds will be built up progressively in about 15 years. The target fund sizes will be subject to review after the PPS has commenced operation.

3 It is proposed to exclude offshore risks from the PPS except for those provided in travel, accident and health and goods-in-transit policies.

10. Scheme members are required to pay a levy of 0.07% of their premiums received from protected policies for building up the Funds. There is no cross-subsidy between the Funds. In case of an insurer insolvency, an additional levy may be collected if the Funds are not sufficient to meet all liabilities. The level of any additional levy would require LegCo approval. Having considered the practices of other jurisdictions and the need to provide more certainty to insurers in their financial planning, we further propose that any additional levy be capped at 1% at the initial stage.

Specified Event

11. A "specified event" is an event upon the occurrence of which the use of the Fund(s) will be triggered. We propose a "specified event" be defined as –

(a) winding up proceedings of a Scheme member have commenced (i.e. when the winding up petition is presented)[4];

AND

(b) if the condition in (a) is satisfied, the IA may, after consultation with the Financial Secretary, serve on the Board a written notice of its decision that the PPS Fund(s) should be triggered.

Life Policies and Accident and Health Policies ("A&H") with Guaranteed Renewability

12. For life policies, when a specified event occurs, the priority is to secure the continuity of contracts as premature encashment or surrender of life policies could lead to substantial losses to policy holders. For A&H policies with guaranteed renewability, the priority is also to secure continuity as policy holders may suffer a disadvantage in procuring alternative coverage, partly due to ageing or changing health conditions, and partly because the cost of guaranteed renewal has normally been reflected in the premium of the original policy. As set out in the consultation proposal, the Fund(s) would be allowed to fund the transfer of the whole or part of the above policies of the failed Scheme member to another insurer. In the unlikely event that such a transfer to a commercial insurer cannot be arranged, we further propose that the

[4] An insurer may be wound up as an ordinary company under Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap. 32) but subject to the provisions in the IO.

policies concerned would be transferred to a Special Purpose Insurer ("SPI") (see paragraph 14 for further details of the SPI) and continued until expiry. In the scenario that the policies are, for whatever reason, terminated (except by the policy holders themselves) prematurely, ex-gratia payments may be paid to policy holders at the sole discretion of the Board.

13. Currently, there are provisions under the IO dealing with insurer insolvency. Specifically, the existing section 46(2) of the IO provides that the liquidator appointed by the Court has to carry on an insolvent insurer's long term business with a view to its being transferred as a going concern to another insurer. The existing section 46(5) of the IO provides that in the course of carrying on the long term business, the Court may reduce the amount of the insurance contracts of the insurer concerned on terms and conditions as it thinks fit. Furthermore, the Court may approve a transfer of the long term business to another insurer on application of the liquidator (existing section 46(7) of the IO). Before the winding-up order is made, the Court may appoint a provisional liquidator[5].

14. Building on this existing mechanism, we propose to amend the IO to the effect that in addition to long term business, the liquidator also has the duty and power to carry on the part of general business comprising A&H policies with guaranteed renewability of a failed Scheme member with a view to transferring it as a going concern to another insurer. As indicated above, we further propose that the Board may set up an SPI to take over the policies in case a commercial buyer cannot be secured. To offer further protection to policy holders during the above process, we suggest to modify the proposal to enable the Board to use the Fund(s) in the following ways–

(a) pending the transfer of the policies to another insurer or the SPI, to compensate or provide undertaking to the liquidator to ensure that insurance claims and benefits which have become due and payable be settled with the policy holders as soon as reasonably practicable;

[5] Section 193(1) of the Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap. 32).

(b) in case the Court orders a reduction of contract amount, to provide guarantee top up payment to eligible policy holders (calculated using the compensation formula as described in paragraph 16 based on the original contract amount) in excess of that under the reduced contract for their contingent claims and benefits[6]. The guarantee top up payment will be provided until expiry of the policies;

(c) to provide a one-off payment to facilitate the transfer;

(d) to fund the operation of the SPI which will run off the policies; and / or

(e) to pay ex-gratia payment to eligible policy holders in case the policies cannot be transferred to another insurer or the SPI and have to be terminated[7].

The above items, except the item in paragraph 14(c), will be subject to the "applicable limits" as explained in paragraph 16 below.

Non-Life Policies (Other than A&H Policies with guaranteed renewability)

15. For other non-life policies, we originally proposed in the consultation proposal that the PPS will provide for continuity of coverage until expiry of the policies. Having considered the practice of other jurisdictions and that there will be alternative coverage available in the market, we propose to fine-tune the proposal under which the Board will provide compensation (e.g. claims) up to 60 days after the date of the specified event or until policy expiry, whichever is the earlier, up to the applicable limits as explained in paragraph 17. A refund of unexpired portion of premium of such policies upon the cut-off date will also be provided to enable policy holders to take out replacement policies.

6 Contingent claims and benefits mean claims and benefits which arise after the transfer.

7 The purpose of the ex-gratia payment is to facilitate the eligible policy holder's procurement of a replacement policy with similar benefits from another insurer. The Board will have the sole discretion to determine the amount of ex-gratia payment taking into account factors which include the premium differential to the eligible policy holder.

"Applicable Limits" and Refund of Unexpired Premium

16. For protected life policies, subject to the terms of the policies concerned, we propose a compensation payment of 100% (e.g. claims, annuities and surrender value) for the first $100,000 of any amount, plus 80% of the balance[8]. The aggregate amount of compensation, guarantee top-up payments and ex-gratia payments, if any, shall not exceed $1 million on a per-policy basis. Such a formula will be applied on a per-life basis for group policies. An A&H rider to a life policy, however, would be treated as if it is a separate policy and is subject to the compensation limit on a per-claim basis.

17. For protected non-life policies (e.g. household property insurance), subject to the terms of the policies concerned, the compensation payment (e.g. claims) is also proposed to be 100% for the first $100,000 of any claim, plus 80% of the balance[8], and shall not exceed $1 million on a per-claim basis. If there are multiple claims in one insured event, the cap would be applied on a per-event basis. Unexpired premiums will be refunded.

<u>Asset Recovery Mechanism</u>

18. As set out in the consultation proposal, the Board will be subrogated to the extent of any compensation and refund of unexpired premium it has made to all the rights and remedies of an eligible policy holder in relation to his protected policies with the failed Scheme member. The Board will be accorded with priority over ordinary creditors and residual claims (i.e. amount of claims not paid by any of the PPF Funds) of the policy holder in recovering assets from the property of the insolvent insurers by way of subrogation. An independent appeal board, namely the Policy Holders' Protection Appeals Tribunal, will be set up to review specified decisions of the Board.

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[8] The formula is applicable to the aggregate amount of – (i) insurance claims and benefits which have become due and payable; and (ii) guarantee top-up payments for contingent insurance claims and benefits.

Way Forward

19. We are preparing the enabling legislation for establishing the PPS, in collaboration with the IA and the Department of Justice, and will continue to engage relevant stakeholders in the process. Our target is to introduce the Bill into LegCo in the 2018-19 legislative year.

Financial Services and the Treasury Bureau
Insurance Authority
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