For discussion
on 2 March 2020

Legislative Council Panel on Financial Affairs
Insurance Authority
Budget for the Financial Year 2020-21

PURPOSE

This paper highlights the main features of the budget of the Insurance Authority ("IA") for 2020-21.

BACKGROUND

2. The IA is an independent regulator established under the Insurance Ordinance (Cap. 41) in December 2015. It took over the responsibility of supervising insurance companies from the former Office of the Commissioner of Insurance ("OCI") in June 2017 and assumed direct regulation of insurance intermediaries in September 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 approved Budget on the table of the Legislative Council ("LegCo").

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

FUNDING OF THE IA

5. The IA is expected to be financially independent of the Government. In order to achieve full cost recovery in the long run and with the approval of LegCo, the IA has been receiving income from annual and 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 0.06%, will increase gradually until it reaches the target level of 0.1% in 2021-22. There is a cap on the levy[1]. The IA will also start charging licence fee five years after the direct regulation of insurance intermediaries took place. To help the IA meet the shortfall in its initial years of operation, the Government has provided seed money of $650 million to the IA in two phases, i.e. first tranche of $450 million in 2016-17 and second tranche of $200 million in 2018-19.

BUDGET FOR 2020-21

6. A copy of the Budget of the IA for 2020-21 is at the **Annex**, the main features of which are set out in paragraphs 7 to 10 below.

Income

7. The estimated total income for 2020-21 is about $339.7 million, which is $100.7 million (42.1%) above the revised estimate for 2019-20 ($239 million), derived largely from levies on insurance premiums after taking into account adjustment of the levy rate from 0.06% to 0.085% on 1 April 2020 and projected growth in insurance business.

Operating Expenditure

8. The estimated operating expenditure for 2020-21 is about $534.8 million, which is $119.1 million (28.7%) above the revised estimate for 2019-20 ($415.7 million), mainly driven by the following –

(a) "Staff costs" – the estimated expenditure for 2020-21 is about 390.5 million, which is $83.5 million (27.2%) above the revised estimate for 2019-20 ($307 million). The IA is expected to reach full strength of about 330 permanent staff in 2020-21, mainly for enhancing group-wide supervision ("GWS") and strengthening internal capacity for direct regulation of insurance intermediaries;

(b) "Office rental and related expenses" – the estimated

[1] The existing cap of $60 (for long term insurance) and $3,000 (for general insurance) will increase in tandem with the levy rate. When the levy rate reaches the target level of 0.1% on 1 April 2021, the corresponding caps will be $100 (for long term insurance) and $5,000 (for general insurance).

expenditure for 2020-21 is about $31.2 million, which is $8.2 million (35.7%) above the revised estimate for 2019-20 ($23 million), mainly due to anticipated rise in office rental level upon lease renewal in July 2020 and rental of extra office space for staff accommodation in 2020-21;

(c) "Engagement of professional services" – the estimated expenditure for 2020-21 is about $24.7 million, which is $14.5 million (142.2%) above the revised estimate for 2019-20 ($10.2 million), mainly on account of legal and consultancy fees for the GWS framework; and

(d) "Other operating expenses"[2] – the estimated expenditure for 2020-21 is about $25.5 million, which is $9 million (54.5%) above the revised estimate for 2019-20 ($16.5 million), mainly caused by the expenditure for official travel expenses and hosting of regulatory supervisory meetings under the GWS framework and increase in expenditure for staff training.

Capital Expenditure

9. The estimated capital expenditure for 2020-21 is about $33.7 million, which is $13.9 million (70.2%) more than the revised estimate for 2019-20 ($19.8 million), mainly arising from renovation of extra office space to be rented for staff accommodation in 2020-21.

Reserve

10. It is envisaged that the IA will incur an operating deficit of about $195 million in 2020-21 and experience a cash shortfall of $69 million by 31 March 2021.

COMPARISON OF THE APPROVED BUDGET WITH THE REVISED ESTIMATES FOR 2019-20

Income

[2] Other operating expenses covers mainly expenses on staff training and development, travelling expenses, events and other incidental expenses.

11. The revised total income for 2019-20 ($239 million) is slightly less than the approved budget ($243 million) by $4 million (1.6%).

Operating Expenditure

12. The revised operating expenditure for 2019-20 ($415.7 million) is $30.9 million (6.9%) less than the approved budget ($446.6 million), mainly attributable to unfilled vacancies that affect the estimate on staff costs. The revised estimate for staff costs for 2019-20 is $307 million, which is $24.4 million less than the approved budget ($331.4 million). Despite the revised projection, staff costs as a percentage of total operating expenditure for 2019-20 remain roughly at the same level of 74% in both the approved and revised estimate.

Capital Expenditure

13. The revised estimate ($19.8 million) is $2 million (9.2%) less than the approved budget ($21.8 million), mainly for funding minor office fitting-out works and IT projects including upgrading the hardware of the Insurance System and developing the Document Management System.

THE GOVERNMENT'S VIEWS

14. It is envisaged that the IA will experience a cash shortfall in 2020-21 which is likely to persist for a few years[3]. We consulted FAP at its meeting on 2 December 2019 regarding a proposal to provide additional funding of $300 million to assist the IA to tide over its projected cash shortfall in the short to medium term and maintain an appropriate level of buffer. Approval on this funding injection will be sought through the established mechanism.

15. We are studying the Budget of the IA for 2020-21 against the progress of core activities and major initiatives. We will remind the IA of the importance to continue to exercise vigilance in financial management, to ensure prudent use of public funds, and to open up new sources of income for long-term financial sustainability.

[3] This shortfall is mainly attributed to a longer time required to complete the takeover of responsibilities from the former OCI that led to delayed collection of levies on insurance premiums and authorization/user fees from insurers as well as lower actual levy income as compared with the estimate adopted in preparing the indicative budget used to work out the initial capital injection of $650 million.

ADVICE SOUGHT

16. Members are invited to note the Budget of the IA for 2020-21.

Financial Services Branch
Financial Services and the Treasury Bureau
February 2020

Annex

Estimates of Income and Expenditure for 2020-21

		Note	Estimates 2019-20 (i) HK$ million	Revised Estimates 2019-20 (ii) HK$ million	Proposed Estimates 2020-21 (iii) HK$ million	Variance Proposed Estimates vs. Revised Estimates 2019-20 (vi) = (iii) - (ii) HK$ million
A.	**Income and Expenditure Statement**					
Income		1				
(a)	Interest income	2	3.2	4.6	4.5	(0.1)
(b)	Levy and fees	3	239.8	234.4	335.2	100.8
	Total Income		**243.0**	**239.0**	**339.7**	**100.7**
Operating Expenditure						
(a)	Staff costs	4	331.4	307.0	390.5	83.5
(b)	Office rental and related expenses	5	23.1	23.0	31.2	8.2
(c)	Engagement of professional services	6	10.4	10.2	24.7	14.5
(d)	Information Technology (“IT”) expenses	7	14.3	13.7	21.1	7.4
(e)	External relations expenses	8	7.1	6.4	10.5	4.1
(f)	Remuneration to Members		2.6	3.2	3.7	0.5
(g)	Other operating expenses	9	18.1	16.5	25.5	9.0
(h)	Depreciation	10	35.4	31.3	27.7	(3.6)
(i)	Non-recurrent projects	11	4.1	4.4	-	(4.4)
	Total Operating Expenditure		**446.6**	**415.7**	**534.8**	**119.1**
	Result for the year		**(203.6)**	**(176.7)**	**(195.1)**	**(17.6)**
B.	**Capital Expenditure Statement**					
(a)	Office set-up	12	4.8	3.8	13.7	9.9
(b)	IT systems and equipment	13	17.0	16.0	20.0	4.0
	Total Capital Expenditure		**21.8**	**19.8**	**33.7**	**13.9**

Notes to the Proposed Estimates for 2020-21

1. Income

According to the consultancy study[1] commissioned by the Government, income of IA in the first four years of operation is not sufficient to cover its expenditure and will face a deficit of about $650 million. Two instalments have been received from the Government to help 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 IA. On 10 May 2018, LegCo approved the remaining provision of $200 million to IA. The provision of $450 million and $200 million received in June 2016 and June 2018 respectively were recognized as capital upon receipt in the statement of financial position and they are provided by the Government without related costs.

The deficit of 2020-21 is estimated to reach the amount of some $200 million and the IA expects to face a cash shortfall in the year and in the short to medium term. Given the need to tide over its projected cash shortfall in the short to medium term and maintain an appropriate level of reserve, the IA has secured support from the Government for an additional funding injection of $300 million in 2020-21.

2. Interest income

With the approval of the Financial Secretary ("FS"), IA has adopted an interim investment arrangement where 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 IA's reserve funds will be worked out when there is more certainty on 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 policyholders. 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.

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[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 IA to meet mainly the cash flow requirement of the essential consultancy services. The allocation was received by IA in March 2016.

Captive insurance, contracts of reinsurance and marine, aviation and goods in transits are exempt from levy.

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% in 2022-23.

With effect from 26 June 2017, the IA has been charging user fees to recover the cost of providing 11 specified services. The number of user fee items has been increased to 23 starting from 27 May 2019, of which 22 are applicable to insurance companies.

4. Staff costs

The staff costs involve mainly salary, contributions to Mandatory Provident Fund schemes, staff insurance and employees' compensation insurance. The revised estimate for 2019-20 is mainly based on the actual profile of serving staff. We envisage that we would have full strength of about 330 permanent staff members on board in 2020-21. There will be increase in staff costs in 2020-21 arising from additional staff for new initiatives.

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 increase in rental expenses is mainly due to projected rise in rental on renewal of lease of existing office premises and the need to rent additional office space to accommodate additional headcounts.

6. Engagement of professional services

This item represents mainly executive search services for staff recruitment, consultancy, legal and audit services. The estimate for 2020-21 is higher than the revised estimate for 2019-20 mainly due to the anticipated increase in fees for legal advice and consultancy resulted from the group-wide supervision.

7. IT expenses

IT expenses cover maintenance fees of server infrastructure, security protection system and various IT application systems. The estimate for 2020-21 is higher than the revised estimate for 2019-20 mainly due to the additional expenses related to the document management system and maintenance of newly implemented IT systems.

8. External relations expenses

The revised estimate for 2019-20 comprises mainly PR campaigns, the Asian Insurance Forum, online news and social media monitoring. An increase in the estimate for 2020-21 is mainly related to a public education campaign.

9. Other operating expenses

Other operating expenses covers mainly expenses on staff training and development, travelling expenses, events and other incidental expenses. The estimate for 2020-21 is higher mainly because expenses increase in line with more staff members coming on board. There will also be more duty visits arising from the group-wide supervision.

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") regime[3] which will complete in 2019-20.

12. Office set-up

The estimate for 2020-21 represents mostly the renovation of additional office space.

13. IT systems and equipment

The estimate for 2020-21 included the phase 2 implementation of the document management system.

December 2019

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[3] The RBC regime is aimed 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.