For discussion
on 3 May 2022

Legislative Council Panel on Financial Affairs

Legislative Proposals to Implement a Risk-based Capital Regime for the Insurance Industry of Hong Kong

PURPOSE

This paper seeks Members' views on the legislative proposals of the Government to implement a Risk-based Capital ("RBC") regime for the insurance industry, which seeks to align Hong Kong's regime with international standards and strengthen Hong Kong's function as an international risk management centre as set out in the National 14th Five-Year Plan.

BACKGROUND

2. At present, the Insurance Ordinance (Cap. 41) ("IO") and the guidelines issued by the Insurance Authority ("IA") under the IO set out a rule-based capital adequacy regime for insurers carrying on business in Hong Kong. Under the prevailing regime, capital adequacy is assessed on the basis of an insurer's solvency margin[1]. Generally speaking, the solvency margin for long term business[2] is calculated by reference to a percentage of the mathematical reserves and capital at risk, while that for general business[3] is calculated by reference to a percentage of premium levels and claims outstanding. However, the prevailing solvency regime does not take into account risk factors pertinent to an individual insurer, e.g. potential risks associated with the products and investments which the insurer offers and makes.

3. The International Association of Insurance Supervisors ("IAIS"), which is the global standard-setter for the insurance industry, issued in 2011 the Insurance Core Principles in relation to capital adequacy, which

[1] Solvency margin refers to the required surplus of the value of the insurer's assets over the value of its liability.

[2] Long term business includes life insurance, group insurance and annuities.

[3] General business includes business in relation to accident and health, damage to property and general liability.

prescribe principles for a risk-based approach for capital adequacy framework. Considering Hong Kong's position as an international financial centre and that of the IA as a member of the IAIS, we need to implement a practicable RBC regime to align with international regulatory requirements and further enhance the financial soundness of insurers in Hong Kong, thereby consolidating Hong Kong's position as an international financial centre. Currently, the Mainland, the European Union, United Kingdom and Singapore have already implemented RBC regimes. Furthermore, the International Monetary Fund ("IMF") recommended Hong Kong to implement a RBC regime during its Financial Sector Assessment Programme ("FSAP") in 2013/14.

LATEST DEVELOPMENT

4. As mentioned in our discussion paper[4] submitted to the Panel in January 2018, the former Office of the Commissioner of Insurance ("OCI") conducted a public consultation on the proposed RBC framework in 2014. The industry and other respondents generally supported the transition to the RBC regime and the high level principles of the conceptual framework, including the proposed regime comprising three pillars.

5. In the period between 2014 and mid-2017, we completed relevant legislative amendment work and undertook preparatory work actively for the establishment of an independent regulator for the insurance industry (i.e. the IA). With the IA taking over from the then OCI the regulation of insurers in June 2017 and the commencement of the direct regulation of insurance intermediaries in September 2019, we consider it timely to implement the RBC regime now, so as to ensure the regulatory regime of the insurance industry of Hong Kong move with the times.

6. The implementation progress of the three pillars of the RBC regime is as follows –

(a) Pillar 1 – Quantitative assessment

It involves the establishment of two new solvency control levels[5]

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[4] The discussion paper (LC Paper No. CB(1)402/17-18(06)) provides an update on the development of the RBC regime for the insurance industry in Hong Kong up to January 2018 and the proposed implementation approach of the three pillars.

[5] When an insurer's capital resources are lower than these solvency margin control levels and the insurer has not taken appropriate remedial measures, the IA will take appropriate intervention and follow up action.

(i.e. the Prescribed Capital Requirement and Minimum Capital Requirement) and amendments to the valuation methods of assets and liabilities. Under the new quantitative assessment requirements, the capital requirements imposed on insurers will be more sensitive to their asset and liability matching, risk appetite and mix of products. Also, the capital resources of insurers will be categorized into tiers based on the quality and the ability of such resources to absorb losses. In the period between 2017 and 2020, the IA conducted three rounds of Quantitative Impact Studies ("QIS") in consultation with the industry to collect detailed data of individual insurers for analysis and calibration, with a view to ensuring the proposed quantitative assessment can cater for the operating environment of the industry. After the three rounds of QIS, the IA has reached a consensus with the industry on the technical details, and is planning to conduct a consultation of the proposed rules in 2023;

(b) Pillar 2 – Corporate governance and risk management

It involves the enhancement of enterprise risk management of insurers, which is the process of identifying, assessing, measuring, monitoring, controlling and mitigating risks for solvency purposes. Insurers have to establish a set of procedures to conduct self-assessment on the adequacy of its enterprise risk management framework and the adequacy of the current and future solvency position. After consulting the industry, the IA has issued the Guideline on Enterprise Risk Management (GL21). The relevant requirements took effect on 1 January 2020; and

(c) Pillar 3 – Disclosure

It involves periodic submission of information to the IA and periodic disclosure of information to the public by the insurers. Currently, the IA is consulting the industry on the proposed requirements in relation to the submission of information to the IA by insurers. The IA will consult the industry on the requirements in relation to disclosure of information to the public in the next phase.

7. One of the key features of the RBC regime is that it provides incentives to insurers to strengthen their risk management culture. Under

the new regime, insurers with solid risk management measures as well as better asset and liability management will shoulder lower capital requirements. With these good management measures, insurers will better manage the potential risks associated with the products and investments which the insurers offer and make, thereby instilling stability into the market. On the other hand, insurers exposed to high risks will have to possess more capital to protect policy holders.

8. During the past few years, we worked with the insurance industry to make preparation for the implementation for the RBC regime. In general, the industry understands the benefits of the new regime and looks forward to its early implementation. Besides, the IMF visited Hong Kong again in September 2019 under the FSAP. In its report issued in June 2021, the IMF noted that the implementation of the RBC regime in Hong Kong was in its final phase and recommended Hong Kong to continue to implement the regime as planned.

LEGISLATIVE PROPOSALS

9. We propose to take forward the legislative work in two phases. First, we will introduce a Bill to provide the legal basis for implementing the Pillar 1 and Pillar 3 requirements[6] under the RBC regime, remove or update certain obsolete provisions, and empower the IA to prescribe the relevant detailed requirements by way of subsidiary legislation. Subject to the passage of the Bill by the Legislative Council ("LegCo") and the conduct of industry consultation by the IA on various detailed requirements that involve relatively complex and technical matters, we will formulate the relevant subsidiary legislation.

10. In preparation for the introduction of the Bill, the IA consulted the industry on the legislative proposals in the fourth quarter of 2021 with general support received from the industry. The legislative proposals are set out in the ensuing paragraphs.

Valuation and capital requirements

11. As mentioned in paragraph 6(a), we propose to establish two solvency control levels to replace the existing rule-based capital requirements. We also propose to amend the valuation method for assets

[6] The Pillar 2 requirements have been implemented by way of guidelines. Please refer to paragraph 6(b) for details.

and liabilities as well as the tiering of capital resources, so as to better reflect the actual position of an insurer in terms of the amount of its assets, liabilities and capital. The IA will prescribe the relevant details by way of subsidiary legislation.

12. As the IA has to adjust the relevant capital requirements based on the circumstances of individual insurers (e.g. where the risk profile of an insurer cannot be reflected with the use of standard calculation method), we propose that the IA be given the power to adjust the capital requirements imposed on individual insurers. In making such adjustment, the IA must have reasonable grounds and take into consideration the risks pertinent to the insurer, and must give a notice to the insurer.

Funds requirements

13. At present, long term business insurers are required to maintain separate funds for each class of their insurance business and the net asset value of each fund must exceed a prescribed level. We propose to streamline the classification of funds set up under each class of insurance business by grouping together classes of insurance business with risks of similar nature. To reflect the characteristics of participating business[7] and enhance the protection for policy holders, we propose that insurers be required to separate funds of participating business from those of non-participating business. Moreover, some insurers are incorporated outside Hong Kong and conduct their business both in and outside Hong Kong, and this type of insurers are usually supervised by the relevant regulators in the jurisdictions where the insurers are incorporated. To enhance protection of Hong Kong policy holders and reduce regulatory overlap, we will make corresponding adjustments such that the funds of this type of insurers will only have to cover the business in Hong Kong.

14. Currently, some insurers, though incorporated outside Hong Kong, are conducting all or most of their business in Hong Kong. We propose that the IA be given the power to designate these insurers so that the valuation, capital and funds requirements imposed on these insurers would be aligned with those on insurers incorporated in Hong Kong, thereby enhancing the protection of policy holders. In making such designation, the IA must notify the insurers concerned and publish notices in the Gazette.

[7] Participating policy holders enjoy the share of business profits through dividend/bonus distribution by insurers.

Requirement of maintaining assets in Hong Kong

15. Under the existing primary legislation, save for professional reinsurers and captive insurers, other general business insurers are required to maintain part of their assets in Hong Kong. With the implementation of the RBC regime, general business insurers generally hope that the current requirement of maintaining assets in Hong Kong can be relaxed, so that they could have greater flexibility in asset allocation. However, the existing requirement can offer some protection to policy holders under certain circumstances (e.g. where an insurer incorporated outside Hong Kong goes into liquidation). We propose to amend the relevant provisions of the existing primary legislation and empower the IA to prescribe by way of subsidiary legislation the detailed requirement of maintaining assets in Hong Kong, including the circumstances under which insurers can be exempted from the requirement (e.g. where an insurer is subject to the liquidation rules and proceedings in Hong Kong).

Actuarial matters

16. Currently, the IA requires insurers by way of guidelines to provide actuarial reports in respect of specified classes of general insurance business. To tie in with the implementation of the RBC regime, we propose to require general business insurers to appoint an actuary and obtain the approval of the IA for such appointment. In line with the existing arrangement where actuarial reports have to be submitted for long term business, the actuary have to submit regular actuarial reports on general insurance business. We also propose to empower the IA to prescribe by way of subsidiary legislation the circumstances under which insurers can be exempted from the requirement (e.g. where the business operated by an insurer is of a relatively small scale).

Submission of information to the IA and disclosure of information to the public

17. At present, detailed requirements on the submission of information by an insurer to the IA are prescribed in the primary legislation. There is a need to update these requirements under the new regime. We propose to remove the relevant provisions under the primary legislation and empower the IA to specify the new detailed requirements by way of subsidiary legislation. Meanwhile, for the purpose of implementing the Pillar 3 requirements, we propose to empower the IA to specify by way of

subsidiary legislation the requirements of disclosing information (e.g. information on finance, capital and risk) to the public by insurers.

Regulatory and intervention powers

18. To effectively implement the RBC regime, we consider it necessary to suitably strengthen the regulatory and intervention powers of the IA. We propose to extend the existing power of the IA to require long term business insurers to submit actuarial investigation reports to cover general business insurers. We also propose that the IA be allowed to require insurers to engage at their own expense persons with specified skills to submit reports on specified matters, so as to enable the IA to better understand the unique or complicated situations of some insurers and prevent escalation of risks, while recommending appropriate follow-up actions. In addition, the IA currently has power to require long term business insurers failing to comply with solvency requirements to submit plans or proposals for the restoration of a sound financial position. We propose to extend such power to cover general business insurers.

Approval of and objection to controllers

19. Currently, a person intending to acquire 15% or more of the voting power of an insurance company has to obtain prior approval of the IA. However, after obtaining the IA's approval, the person may increase his/her voting power to 50% or more without having to seek further approval from the IA. To enhance regulation for the protection of policy holders, we propose that a person has to seek further approval of the IA if he/she intends to acquire 50% or more of the voting power of an insurance company, even though he/she has obtained prior approval from the IA for the acquisition of the 15% or more of the voting power of that company. We also propose that the IA be allowed to object to an approved controller if it considers that he/she is not, or is no longer, a fit and proper person for being a controller.

Transitional arrangements

20. To assist the industry in migrating to the new regime, we plan to make appropriate transitional arrangements regarding the capital and disclosure requirements. Our current thinking is to allow insurers to comply with the specified requirements on a progressive basis upon implementation of the new regime.

Taxation arrangements

21. The valuation method for determining the liabilities of an insurer will change under the RBC regime. As the tax assessment of some insurers involves the calculation of liabilities, their taxation arrangements are expected to be affected. The Government is discussing the matter with the industry with a view to addressing the taxation implications as appropriate. The option being considered is to amend the Inland Revenue Ordinance (Cap. 112) to provide for the spreading over of the taxation implications brought by the implementation of the new regime.

LEGISLATIVE TIMETABLE

22. We are now drafting the legislative amendments with the aim of introducing the Bill into the LegCo in the fourth quarter of 2022. Subject to the approval of the Bill by the LegCo, the IA will formulate the implementation details and related subsidiary legislation in consultation with the industry. Our current target is to implement the RBC regime in the first half of 2024.

ADVICE SOUGHT

23. Members are invited to comment on the legislative proposals.

Financial Services and the Treasury Bureau
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