For discussion on
3 April 2023

Legislative Council
Panel on Financial Affairs

Proposal on Establishing a Policy Holders' Protection Scheme

PURPOSE

This paper briefs Members on the key features of the proposed policy holders' protection scheme ("PPS") as set out in a public consultation document published by the Government in December 2022.

BACKGROUND

2. The Insurance Ordinance ("IO") (Cap. 41) provides for the regulation of the insurance industry, including functions and powers of the Insurance Authority ("IA") to supervise insurers for the protection of policy holders. Apart from prudential supervision of insurers, the IO and the Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap. 32) have further prescribed protective arrangements for policy holders in case of insurer insolvency. Furthermore, sectoral protection schemes have been established in Hong Kong for motor vehicle and employees' compensation policies[1].

3. Since the late 1990s, there have been three insurer insolvencies in Hong Kong, all of them involving small-to-medium insurers in the general sector. There have not been any insolvency involving of long-term insurers or large general insurers.

4. Nevertheless, 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

[1] The two sectoral schemes are administered by the Motor Insurers' Bureau of Hong Kong and the Employees Compensation Insurer Insolvency Bureau respectively.

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 subsequently carried out a public consultation exercise in 2011 to solicit views on the proposal for establishing the PPS and received general support, but there were diverse views regarding the scope and compensation level. This was followed by a series of legislative work on the establishment of an independent regulator for the insurance industry (i.e. the IA).

5. Following the IA's take-over of the statutory functions from the then Office of the Commissioner of Insurance in 2017, we briefed the Panel on Financial Affairs of the Legislative Council ("LegCo") in March 2018 on the key legislative proposal for establishing a PPS. While Members generally welcomed the establishment of a PPS, some expressed concern that the proposed design might not provide sufficient protection for policy holders. At the same time, there was concern about covering small and medium enterprises ("SMEs") under the PPS. In 2019, we engaged the IA to commission a consultancy study to update the relevant parameters and review implications of the prevailing business environment on the design of the PPS, including the target fund size, lead time for accumulation and level of compensation.

6. On 30 December 2022, we launched a three-month public consultation on our latest proposal, which has taken into account findings of the latest consultancy study. The consultation document can be found at https://www.fstb.gov.hk/fsb/en/publication/consult/doc/Consultation_PPS_Dec_2022_e.pdf, with the key features of the proposal summarised below.

KEY FEATURES OF LATEST PROPSOAL

Guiding principles

7. In formulating the proposal on the PPS, we are guided by the following 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 on insurers and policy holders;

(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 compromise the regulatory standards and requirements laid down by the IA under the IO.

Coverage and operational framework

8. The proposed PPS will focus initially on individual policy holders. Two separate funds, namely the Long Term Fund and the General Fund, will be set up to collect levies from insurers based on the applicable premium income from the protected policies. All in-force policies will be covered except reinsurance business, long term business of managing contributions under a retirement scheme[2], general business subject to alternative protection, general business focused on specialty risks and business which are unusual for individuals[3]. All authorized insurers are required to join the proposed PPS except captive insurers, reinsurers, special purpose insurers and other insurers not authorised to carry on business protected by the proposed PPS. Foreign-incorporated insurers protected by a similar scheme in other jurisdictions may be exempted on a case-by-case basis.

2 Such as the Occupational Retirement Schemes and Mandatory Provident Fund Schemes which are held in trust arrangements that would protect assets in the event of the insurer concerned becoming insolvent.

3 Including motor vehicle policies; employees compensation policies; aviation insurance and marine; credit insurance written by the Hong Kong Export Credit Insurance Corporation; risk of war and strike, riots and civil commotion in goods in transit insurance; offshore risks of policies other than travel, accident, sickness and goods in transit.

9. The proposed PPS will be triggered once winding up proceedings of an insurer has commenced and the IA declared a "specified event" so that compensation could be paid to claimants. Such compensation will be capped for cost-effectiveness and reduced risk of moral hazard. Based on latest available data in 2019 and the initial levy rate of 0.07% as originally proposed in the 2011 consultation exercise, three options are set out below –

	Compensation limit[4]	Policies within the cap on claim amount	
		% by count	% by claim amount
<u>Option 1</u> $ 1 million (previous proposal in 2011)	Maximum of $1 million – 100% of the first $100,000 + 80% of the remaining amount	Long Term: 99.1% General: 99.9%	Long Term: 62.5% General: 62.3%
<u>Option 2</u> $2 million	Maximum of $2 million – 100% of the first $200,000 + 80% of the remaining amount	Long Term: 99.6% General: 99.9%	Long Term: 72.5% General: 69.0%
<u>Option 3</u> $4 million (Note)	Maximum of $4 million – 100% of the first $400,000 + 80% of the remaining amount	Long Term: 99.9% General: 100%	Long Term: 81.6% General: 77.5%

Note: Under Option 3, the level of protection in terms of claim amount for long term policies is comparable to the level in the proposal in 2011.

10. Due to the complexities involved, the PPS will be expanded to cover SMEs at a later stage. We will continue to listen to views from the insurance industry and other sectors to formulate proposals on this as and when conditions are ripe.

<u>Relief for policy holders</u>

11. When a long term insurer becomes insolvent, it is often in the interest of policy holders to keep their policies in force. The proposed PPS should –

[4] Under Option 1, a policy within the cap refers to one with claims within $1.225 million; under Option 2 and 3, a policy with claims within $2.45 million and $4.9 million respectively.

(a) facilitate transfer of long term policies to a commercial insurer[5], make payment to facilitate such transfer, settle claims and pay benefits for protected policies pending such transfer;

(b) set up a dedicated insurer to run off the business portfolio if a transfer in (a) above cannot be arranged (i.e. provide coverage for protected policies until expiry, without effecting any new contracts);

(c) for those policies terminated by the liquidator or policy holders, refund unexpired premiums, settle claims and pay the related benefits; and

(d) where the Court has reduced the amount of insured contracts[6] or where the liquidator has terminated the policies, make "ex-gratia" payment so that policy holders could procure alternative coverage.

12. As most general insurance policies are valid for no more than one year, they are unlikely to survive a liquidation process. The proposed PPS will provide interim coverage of up to 60 days after declaration of a specified event or until expiry/termination of the policies involved and refund the unexpired premiums. Those accident and health ("A&H") policies with guaranteed renewability will be treated like long term policies and those without guaranteed renewability treated like general policies.

<u>Funding arrangement</u>

13. The cap on compensation will be applied to long term policies on a per-policy basis and to general policies on a per-claim basis with certain exceptions[7]. The levies will be collected from insurers in a progressive

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[5] Under the IO, the liquidator must carry on the long term business of an insolvent insurer with a view to transferring it as a going concern to another insurer.

[6] The Court may reduce the amount of insurance contracts of an insurer which is unable to pay its debt, instead of making a winding-up order.

[7] The cap on compensation will apply to group long term policies on a per-life basis, A&H riders to long term policies (with or without guaranteed renewability) on a per-claim basis, and multiple general insurance claims arising from one insured event on a per-event basis.

manner, starting at 0.07% and stepped up to include an additional levy of no more than 1% upon occurrence of an insolvency[8] with no cross-subsidy between the two funds. The initial fund size and accumulation period are illustrated below –

Compensation Limit	Initial Levy Rate	Target Fund Size	Lead Time
<u>Option 1</u> $1 million	0.07%	Long Term: $1.48 billion General: $78 million	Long Term: 6 years General: 9 years
<u>Option 2</u> $2 million		Long Term: $2.08 billion General: $95 million	Long Term: 9 years General: 11 years
<u>Option 3</u> $4 million		Long Term: $2.88 billion General: $112 million	Long Term:13 years General: 14 years

14. If the Long Term Fund and General Fund are insufficient to meet all the liabilities of an insolvent insurer, the proposed PPS could facilitate borrowing from a third party subject to approval by the LegCo. The levy rate may be suspended or reduced when the accumulated sum exceeds the target fund size and two years of operating expenses. Furthermore, the proposed PPS may take over the right of claimants and seek recovery from the estate of an insolvent insurer for the part of the claim met by PPS.

<u>Governance and administration</u>

15. We propose to set up a statutory body named the Policy Holders' Protection Scheme Board ("PPS Board") as the governing body of the PPS. The PPS Board will comprise representatives from the Government and the IA, as well as professionals with relevant expertise (e.g. insurance, actuarial science, finance, accounting, law and consumer affairs). The IA will serve as its administrative arm and an independent tribunal will handle appeals lodged against decisions made by the PPS Board.

<u>Way forward</u>

16. We will review and consolidate the views received in the public

[8] With a minimum annual levy of $10,000 for each insurer

consultation. We will make public the consultation conclusion and draw up the detailed legislative time table in due course.

ADVICE SOUGHT

17. Members are invited to comment on the proposed PPS.

Financial Services and the Treasury Bureau
Insurance Authority
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