

For the Panel meeting
on 6 January 2003

LegCo Panel on Financial Affairs

Progress Report on:

- (a) Feasibility Study on Insurance Policyholders Protection Fund**
- (b) Enhancement of the Regulation of Authorized Insurers in Hong Kong**

Purpose

This progress report updates Members on the initiatives discussed at the Panel meetings held on 3 July 2001 and 3 June 2002. They include measures to enhance the regulatory regime for authorized insurers in Hong Kong, as well as the consultancy study being conducted on the feasibility of establishing an insurance policyholders protection fund (“PPF”).

Feasibility Study on Insurance Policyholders Protection Fund

2. At the Panel meeting held on 3 July 2001, the Administration was requested to keep the Panel informed of the progress of the review on compensation arrangements for (long term) insurance business.

3. At present, there are two insolvency funds for the statutory motor and employees compensation (EC) insurance¹. Having conducted an internal review on the existing regime in Hong Kong and taking into account the arrangements in other jurisdictions, the Insurance Authority (IA) concluded that it would be desirable to conduct a more in-depth study on the feasibility of establishing a PPF. The consultancy study has just commenced.

4. The study will include a comprehensive review of the contemporary regime in Hong Kong. It will assess whether PPF is needed in Hong Kong as well as the pros and cons (such as protection for the insuring public, potential problem of moral hazard, financial cost of such a scheme, etc). It will also examine the need to have separate PPF for long term business and general business, and recommend the scope and range of protection as well as options for PPF structure and administration.

¹ For EC insurance, it has been proposed that the insurance industry should establish an EC insurer insolvency scheme to take over from the existing Employees Compensation Assistance Scheme the responsibility to protect EC policyholders from insurer insolvency. The Panel was briefed on the proposal on 2 December 2002.

5. The study is divided into two stages. The first stage will focus on the feasibility of establishing a PPF, while the second stage (*if proceeded*) will focus on developing an implementation plan. It is expected that the first stage will be completed in around mid-2003, to be followed by a public consultation exercise. The Administration will take into account the findings of the consultation exercise before deciding whether to proceed with the second stage.

Enhancement of the Regulation of Authorized Insurers in Hong Kong

6. On 3 June 2002, Members were briefed on the regulatory regime for authorized insurers in Hong Kong. Members requested the Administration to provide details of the proposed measures to improve the insurance regulatory regime. Such proposed measures include –

- (a) enhancing the corporate governance of authorized insurers;
- (b) setting admissibility limit to the amount of reinsurance recoverable by an insurer from group companies; and
- (c) enhancing transparency of long term insurers in Hong Kong.

Corporate Governance of Authorized Insurers

7. On 5 August 2002, the IA promulgated the Guidance Note on the Corporate Governance of Authorized Insurers (“the Note”). It sets out the minimum standard of corporate governance that is expected of an authorized insurer. The Note provides for, among other things, the structure of the senior management, the role and responsibilities of the board of directors, the establishment of specialized committees (e.g. mandatory establishment of an audit committee), internal controls and compliance with laws and regulations. To allow adequate time for authorized insurers to comply with the new requirements, the Note will become effective on 1 September 2003.

8. In drawing up the Note, references had been made to the relevant principles and guidelines issued by various local and overseas regulators and professional bodies, e.g. International Association of Insurance Supervisors and Hong Kong Monetary Authority. The insurance industry and relevant professional bodies, e.g. The Hong Kong Federation of Insurers (HKFI) and the Hong Kong Society of Accountants (HKSA) had been consulted and their views incorporated as appropriate.

9. Authorized insurers will be required to submit an assessment questionnaire on compliance to the IA annually. The IA will also perform compliance checks during on-site inspection visits to the authorized insurers. Non-compliance with the Note may have negative implications on whether the

directors and controllers are fit and proper persons to run the business under the Insurance Companies Ordinance (Cap. 41) (“ICO”).

Admissibility limit for reinsurance recoverable due from related companies

10. Section 8(3)(c) of the ICO obliges an insurer to maintain adequate reinsurance arrangements to cover the risks arising out of the business he conducts. Reinsurers’ balances often constitute a material asset of an insurer. Taking into account the experience in the HIH group insolvency in 2001², the IA considers it necessary to issue a guidance note to specify an admissibility limit for the amount of reinsurance recoverable due from related companies (reinsurers)³.

11. Under the draft “Guidance Note on Reinsurance with Related Companies” issued by the IA in July 2002, the admissibility limit for reinsurance with related companies would be based on counterparty rating of reputable credit rating agencies. In short, if the reinsurer is related to the concerned direct insurer (e.g. both belong to the same company group) and the credit rating of the related reinsurer or its holding company is below the level specified by the IA, for the purpose of solvency assessment and local asset requirement, the reinsurance recoverable would be limited to 10% of the direct insurer’s Net Asset Amount plus any additional amount secured by collateral securities acceptable to the IA.

12. The IA is refining the draft Guidance Note taking into account the insurance industry’s comments and intends to issue the Guidance Note in early 2003. It is intended that the Guidance Note will apply to the reinsurance arrangements made or renewed in respect of the financial years of the insurer commencing on or after 1 January 2004.

Authorized long term insurers to submit prescribed annual business returns

13. Authorized insurers which carry on general insurance business are currently required under the ICO to submit to the IA statistics in prescribed forms relating to their Hong Kong general insurance business. However, there is no similar requirement in the ICO in the case of authorized insurers which carry on long term insurance business (“long term insurers”), they are only required by law to provide returns on their global businesses. Long term insurers have been submitting statistics relating to their Hong Kong long term insurance business on a voluntary basis since 1991.

² In 2001, three insurance companies in Hong Kong belonging to the HIH Group became insolvent following the collapse of their Australian parent.

³ In short, “related reinsurer” means one within the same grouping of companies, as defined in section 2(7)(b) and (c) of the ICO.

14. In our last submission to the Panel in June 2002, we mentioned that, to enhance the transparency of the long term insurance market, IA would make regulations to prescribe annual business returns on “Hong Kong long term insurance business”. The Third Schedule of the ICO will also be amended to provide for such a definition. Long term insurers will be required to submit to IA statistics/information on their Hong Kong business in the prescribed forms starting for the financial years ending on or after 31 December 2003.

15. The proposal will help ensure that timely and reliable information will be submitted to the IA, and thereby facilitate the regulation of long term insurers. Both HKFI and HKSA are supportive of the proposal.

Other Measures

16. IA will seek continuous improvement to different aspects of the insurance regulatory regime and review from time to time its regulatory role and work, and in the process maintain close liaison with industry bodies and overseas regulators. He is mindful of the need to tackle other possible areas for improvement in the existing regime. For example, IA will be reviewing the existing framework for the supervision of the assets of long term insurers. The review will cover two main aspects. One is the need to have a standard basis of valuation to ensure that the assets for long term business are valued on a prudent and uniform basis⁴. A standard basis would reduce the risks of overvaluation of assets or undue concentration of investment in a particular category of assets. The other aspect is to explore a suitable mechanism for safeguarding long term business assets attributable to Hong Kong policyholders. Such a mechanism would help to enhance protection for Hong Kong policyholders in the event of an insurer failure, particularly when the insurer is incorporated overseas.

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⁴ At present, unlike the case of general business, there are no explicit standards/requirements on the valuation of the assets of long term business. To monitor the assets/investment risks of long term business, the IA has been relying on the opinion as expressed by the appointed actuary on the financial condition of a long term insurer, which includes, among others, whether there is a prudent and satisfactory relationship between the nature and term of the assets and the nature and term of the liabilities of long term business. The appointed actuary is required to express his opinion in accordance with the Professional Standard I prescribed under the Ordinance and the Insurance Companies (Determination of Long Term Liabilities) Regulation.