

Legislative Council Panel on Financial Affairs
Feasibility Study on Insurance Policyholders' Protection Funds

Introduction

This paper briefs Members on the public consultation on the feasibility of establishing insurance policyholders' protection funds (PPFs) in Hong Kong.

Background

2. The insurance regulatory regime in Hong Kong is effective and in line with international standards. Moreover, the regime is kept under regular review by the Office of the Commissioner of Insurance (OCI), in the light of market developments and the international trends. Recent enhancement initiatives include the issue of Guidance Notes by OCI on the corporate governance of insurers and the requirement to conduct actuarial review on the technical reserves for particular lines of insurance businesses.

3. Having said so, no matter how effective a regulatory regime is, it cannot totally guarantee that insurer failures would never occur, although in Hong Kong such failures are rare¹.

4. To better protect policyholders and promote the stability of the industry, OCI engaged PricewaterhouseCoopers (PwC) in late 2002 to conduct a feasibility study on establishing PPFs in Hong Kong. Background information on the study was set out in our paper issued to Members in January 2003

¹ The insolvency of three insurers of the HIH Group in 2001 was the only insurer failure in the past decade.

— (relevant extracts at Annex A). The study is divided into two stages, with Stage One focusing on a review of the current regime locally and overseas, an evaluation of feasibility of establishing PPFs and the identification of options regarding the PPF design. During this stage, PwC had also interviewed a number of stakeholders². On the other hand, Stage Two (if proceeded) would focus on matters relating to the implementation of PPFs.

5. Stage One of the study was completed in late 2003. As mentioned in Annex A, the Administration would like to consult the public before taking a view on whether to proceed with Stage Two of the study.

Findings of the Stage One

6. PwC has prepared the consultation paper at Annex B, which summarises its findings in Stage One and invites comments from the public. Salient points are highlighted as follows -

- (a) PPFs usually serve as a safety net of the last resort for the protection of policyholders. They are common in other advanced economies, although their design features vary considerably.
- (b) The existing regime in Hong Kong does not ensure comprehensive protection for policyholders in the event of insurer failure.
- (c) In other financial services sectors in Hong Kong, there are also some kinds of compensation schemes established or under consideration. For instance, a bill aiming to introduce a Deposit

² Including major insurers, bodies of insurance intermediaries, relevant Government departments, consumer protection and professional bodies and academics.

Protection Scheme in Hong Kong is being scrutinized by the relevant Bills Committee of the Legislative Council.

- (d) On the other hand, there are arguments against the PPF concept, such as concerns over the financial costs and the risk of moral hazards³.

7. As the design features of a PPF may affect its acceptance to the public, the paper also invites comments on such features, *if* PPFs were to be introduced. The key features include -

- Types of products and policyholders to be covered
- Compensation limits in percentage and money terms
- Funding arrangements, for example, pre-funding or post-funding or a combination of both.

8. For illustration purpose, the consultation paper sets out a few options regarding the above design features, each for life and non-life insurance. These options were floated by PwC, taking into account the findings of an international benchmarking and the views of the stakeholders interviewed. The main variables are the insurance products/policyholders to be covered and the compensation limits. In general, options with a broader scope of protection and a higher compensation limit would incur higher financial costs to implement.

³ An argument is that with the establishment of PPFs, potential policyholders would not need to take into account the financial condition and business reputation of the relevant insurers in the selection of insurance products. As such, PPFs would encourage imprudent behaviour in the market. On the other hand, there are counter views that the real life experience does not support this argument and, in any case, the risk of moral hazard can be addressed/mitigated by measures such as setting a limit in compensation so that policyholders have to share part of the risk.

9. Furthermore, the life PPF options have incorporated proposed mechanism to assist policy portfolio transfer. This was suggested because policy transfer may be a better alternative than payment of compensation from the perspectives of both the PPF and the policyholders.

The Consultation Exercise

10. The Administration has an open mind on the PPF proposal.

11. In order to gauge the views of the public on the subject, OCI had launched a consultation exercise on 17 December 2003. The consultation paper at Annex B has been distributed to all relevant parties including the Consumer Council and bodies of the insurance industry, and put onto the website of OCI. Moreover, OCI has formed a Working Party comprising representatives of the insurance industry and other interested parties, with a view to facilitating exchange of views on the matter.

12. The consultation will end on 31 March 2004. Views of Members are welcome.

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**Extracts of the progress report
for the Panel Meeting on 6 January 2003**

- At present, there are two insolvency funds for the statutory motor and employees compensation (EC) insurance⁴. 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.
- 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.
- 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.

⁴ 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.