Feasibility of Establishing Policyholders' Protection Funds in Hong Kong

Consultation Paper

December 2003

NOTICE: Use of this Consultation Paper

This Consultation Paper has been prepared by PricewaterhouseCoopers Hong Kong ("PwC") solely for the use of the Government of the Hong Kong Special Administrative Region ("Government") for the purpose of considering the feasibility of establishing policyholders' protection funds ("PPFs") in Hong Kong, in accordance with a Consultancy Agreement dated 29 November 2002 ("the Study").

This Consultation Paper is not intended to provide advice to any other recipient or reader of the report, and PwC does not accept any liability to these other parties. These parties should obtain their own advice if such advice is required. PwC (including its partners, officers, employees, agents and affiliated entities) does not owe a duty of care to any recipient of this report either in relation to this Study or in relation to any information that is provided at any time, other than that which may arise from a separate written agreement.

For the purposes of the Study, PwC has obtained information from various stakeholders and other sources, but has not sought to verify this information. Consequently, PwC does not make any express or implied representation or warranty as to the accuracy or completeness of such information set out in the Consultation Paper. This Consultation Paper is not intended to set out definitive conclusions and any findings are subject to amendment or withdrawal after the public consultation process.

(This Consultation Paper is also available in Chinese, at http://www.info.gov.hk/oci)

INDEX

1. EXECUTIVE SUMMARY

This section of the Consultation Paper provides a summary of the matters set out in sections 2 to 8. Section 9 lists key questions for public comment and section 10 provides contact details for submitting comments.

1.1 The Government has engaged PricewaterhouseCoopers Hong Kong ("PwC") to perform a consultancy study on policyholders' protection funds ("PPFs"). As part of the consultancy study, PwC has prepared this Consultation Paper for release by the Insurance Authority. The Consultation Paper invites comments from the public on whether PPFs should be introduced in Hong Kong, and if they are introduced in Hong Kong, what the design features of PPFs should be.

1.2 At this stage of the consultancy study, no firm recommendations on PPF have been made to Government, and no decisions have been taken on whether to introduce PPFs.

1.3 In Hong Kong and in other jurisdictions, the system of prudential regulation cannot totally guarantee that no insurer insolvencies will occur. If an insurer insolvency occurs in Hong Kong, policyholders may suffer financial loss.

1.4 PPFs provide a safety net for such contingencies. They can pay compensation to policyholders if an insurer runs into financial difficulties and is unable to make payments under its insurance policies. In some jurisdictions, PPFs can also provide financial support to an insolvent insurer so that insurance policies can be continued.

1.5 Hong Kong already has compensation funds in place for non-life insurance policies covering third party motor vehicle accident victims and employees' work-related injuries, both of which are compulsory under the relevant legislation. There are no PPFs for other types of insurance policies, that is, all life insurance policies and all other types of non-life insurance policies.

1.6 There have not been many large insurer insolvencies over the last twenty years in Hong Kong, in particular there has not been a large insurer insolvency affecting a large number of private individuals and households in Hong Kong.

1.7 Although it is impossible to predict future insurer insolvencies, and how these will affect consumers in Hong Kong, the recent growth of the Hong Kong insurance market indicates that a large insurer insolvency could result in significant financial losses for consumers.

1.8 PPFs are common in many advanced economies; however, the protections offered by PPFs are very different in each jurisdiction.

1.9 In other financial services sectors in Hong Kong, compensation funds are in place to provide protection in certain circumstances for securities investors and members of Mandatory Provident Fund ("MPF") schemes. Legislation has been drafted for a compensation scheme for bank depositors.

1.10 In light of the technical and complex nature of PPFs, as part of the consultancy study, interested parties such as insurers, industry associations for insurance brokers and agents, government departments and certain other organisations were interviewed by PwC regarding (i) whether a PPF should be established in Hong Kong, and (ii) if so, what the design features of the PPF should be. These interviews were separate and distinct from the public consultation process, and provided valuable information that assisted us in preparing this Consultation Paper. This Consultation Paper is not intended to include all of the comments received during these interviews.

1.11 Views received during these interviews on whether to establish PPFs in Hong Kong were mixed, but several insurers did not believe that a PPF should be implemented. These insurers were concerned that establishing a PPF might increase "moral hazard" risk in that some consumers and some insurers may be encouraged to take greater risks. Insurers, insurance agents and brokers were also concerned about the additional costs of a PPF scheme.

1.12 Irrespective of their views on the need to introduce a PPF in Hong Kong, most insurers and insurance intermediaries were prepared to comment on the design features of a PPF, if it were to be implemented.

1.13 Comments on the design features of a PPF varied.

1.14 There were mixed or different views as to:

a) Whether all types of insurance policies should be covered, or only some types of policies;
b) Whether life insurance savings products, in particular, should be covered;
c) Whether a non-life PPF should also protect corporate policyholders; and
d) What types of compensation limits should be applied.

1.15 If a large insurer became insolvent in Hong Kong, it could be complex and difficult for everyone involved, and it may be many months, even years, before it is known what should be done with the company. In these situations, it is important to appreciate the limitations of a PPF scheme. For example, even if a relatively comprehensive PPF were introduced in Hong Kong, there may be uncertainty and delay in agreeing and paying claims as a result of the insolvency administration process, and certain policyholders may receive reduced compensation, or no compensation.

1.16 Based on our research and interviews, we present several different PPF options for public consultation. These take into account that PPFs in other jurisdictions are very different from each other, and the mixed views of stakeholders.

1.17 The "broader" PPF options cover a wider range of insurance products, have higher compensation payment limits, and as a result, incur greater financial costs to implement compared with the "limited" PPF options.

1.18 Summary charts of the broader and limited PPF options, for life and non-life insurance, are included in Appendices A and B respectively.

1.19 Under both the broader and limited PPF options for life insurance policies, the PPF can help the insolvency administrator[1] to arrange for another (solvent) insurer to take over and continue the policies of the insolvent insurer by making an incentive payment to the other (solvent) insurer. This would only be done if the amount of the incentive payment is less expensive for the PPF than paying out compensation directly to the policyholders that have suffered financial loss.

1.20 The Insurance Authority invites comments from all interested persons on the matters set out in this Consultation Paper. It would be helpful if comments could cover your views on both whether a PPF should be introduced in Hong Kong, <u>and</u> what type of PPF it should be, assuming a PPF was introduced.

The following sections (2 through 8) explain the matters set out above in more detail.

2. INTRODUCTION AND BACKGROUND

What is the purpose of this Consultation Paper?

2.1 The Insurance Authority's missions are to "protect the interests of policyholders, to maintain the general stability of the insurance industry, and to instil public confidence in Hong Kong's insurance market."

2.2 As Hong Kong's insurance market has grown and matured over the years, the Insurance Authority has taken a number of steps to enhance Hong Kong's insurance regulations.

2.3 The Insurance Authority has noted that no matter how stringently the insurance industry is regulated, the possibility of insurer insolvencies cannot be totally avoided. As a result, Hong Kong policyholders may suffer financial losses in insurer insolvencies and the spillover effect may impinge upon public confidence in the insurance industry. PPFs aim to provide a safety net for such contingencies.

2.4 Hong Kong's existing insurance compensation scheme arrangements are less extensive than those in many other advanced economies.

2.5 For the above reasons, the Government engaged PwC in November 2002 to conduct a consultancy study on PPFs. The nature and extent of PwC's work was agreed with the Government. PwC's work included research into PPFs in a sample of overseas jurisdictions, and interviews with a range of parties in Hong Kong who have an interest in PPFs.

[1] An insolvency administrator of an insolvent insurer includes a provisional liquidator, liquidator or insolvency scheme administrator appointed by the Court.

2.6 As part of the consultancy study, PwC has prepared this Consultation Paper for release by the Insurance Authority. It invites comments from the public on whether PPFs should be introduced in Hong Kong, and if so, which PPF options should be preferred.

2.7 This Consultation Paper forms part of the information gathering process to assist the Government in coming to a view on the feasibility of establishing PPFs in Hong Kong. It is not intended to include all of our findings and comments received on PPFs to date.

2.8 There are numerous variations on each of the PPF options presented in this Consultation Paper, and on which public comment is invited. If, following the public consultation exercise, the Government decides to take forward the PPF proposal, the specific details of the proposed PPF scheme would need to be further developed, in light of the comments received during the consultation process.

What are policyholders' protection funds?

2.9 PPFs are a final safety net for protecting policyholders. They can pay compensation to policyholders if an insurer runs into financial difficulties and is unable to make payments under its insurance policies.

2.10 There are many ways in which policyholders can be protected, and there are many different kinds of PPFs seen in other jurisdictions.

2.11 PPFs usually apply only when an insurer is insolvent, i.e., when it does not have enough assets to pay its liabilities to policyholders and other creditors.

2.12 Under a PPF scheme, compensation can be paid to certain types of policyholders and third party claimants. The amount of compensation paid is usually subject to limits and restrictions.

2.13 In some jurisdictions, PPFs act only as a compensation fund. In other jurisdictions, PPFs can also provide financial support to an insurer so that insurance policies can be continued.

What types of insurance policies can be covered by a PPF?

2.14 PPFs can potentially cover many different types of insurance policies.

2.15 In this Consultation Paper, when we refer to life insurance, we mean classes of long term business as set out in the First Schedule to the Insurance Companies Ordinance in Hong Kong (or when we refer to other jurisdictions: equivalent classes of insurance). Life insurance includes savings and protection products, such as whole life insurance policies, endowments, term life policies and policy riders, such as medical, critical illness and disability protection. When we refer to protection products, we mean life insurance policies where an insurer undertakes to make payment if an adverse insured event occurs, such as death, sickness or disability. Savings products are those under which a policyholder expects to receive payment from the insurer on the date of maturity or surrender of a life insurance policy (even if no claim occurs). Many life insurance policies include a combination of both protection and savings elements.

2.16 When we refer to non-life insurance, we mean classes of general business as set out in the First Schedule to the Insurance Companies Ordinance. Examples of non-life insurance products are travel insurance, medical, personal accident, motor, fire, household, marine, goods-in-transit, employees compensation and general liability insurance policies.

3. CURRENT PROTECTION ARRANGEMENTS ON INSURER INSOLVENCY

How are policyholders currently protected if an insurer is insolvent?

3.1 Hong Kong already has compensation schemes in place for non-life insurance policies covering third party motor vehicle accident victims ("motor vehicle" policies) and employees' work-related injuries ("employees compensation" or "EC" policies). These types of insurance policies are compulsory under law. If the insurer of these compulsory policies becomes insolvent, compensation is paid to policyholders or third party claimants in respect of claims under the policy.

3.2 Insolvency protection for motor vehicle policies is provided by the Insolvency Fund Scheme administered by the Motor Insurers' Bureau of Hong Kong ("MIB"). The MIB is a limited liability company established by the insurance industry. All insurers authorised by the Insurance Authority to carry on motor vehicle insurance business in Hong Kong are required as a condition of authorisation to become members of the MIB. The MIB Insolvency Fund levies are currently 2% of premiums on motor vehicle policies.

3.3 The compensation scheme covering compulsory EC insurance is the Employees Compensation Assistance Scheme ("ECAS"). In recent years, the ECAS fund itself has run into financial difficulties and legislation passed in 2002 included provisions to remove coverage of insurer insolvency from ECAS. In early 2003, a new insolvency compensation scheme for compulsory EC policies was established. The structure of the new scheme, the Employees Compensation Insurer Insolvency Scheme ("ECIIS"), is similar to that operated by the MIB. The ECIIS is administered by a limited liability company, the Employees Compensation Insurer Insolvency Bureau ("ECIIB"), established by the insurance industry. From April 2003, insurers contribute to the Insolvency Fund of the ECIIB at a rate of 2% of EC premiums (in addition to certain other levies applicable to EC policies), with coverage commencing in April 2004 (which is intended to allow sufficient time for funds to accumulate). Like the MIB's Insolvency Fund scheme, the ECIIS specifically provides for a "queuing system", under which, if claims against the scheme exceed the amount of funds available at that date, these are paid when funds become available, in the order in which they were presented to the scheme.

3.4 There are no compensation schemes or PPFs for other types of insurance policies, that is, all types of life insurance and all other types of non-life insurance policies.

3.5 For these types of insurance policies, no compensation is paid to policyholders if the insurer becomes insolvent. However, the Companies Ordinance and Insurance Companies Ordinance contain specific provisions for dealing with an insurer insolvency.

3.6 One of the first steps in the liquidation of an insolvent insurer under the Companies Ordinance is for the Court to appoint a provisional liquidator. The provisional liquidator is responsible for taking control of the assets of the insurer for the purposes of preserving and protecting these assets, but cannot normally pay out any of the assets to policyholders or other creditors.

3.7 Following the appointment of the provisional liquidator, the Court can appoint a liquidator or an insolvency scheme administrator, who is responsible for sharing the assets of the insurer amongst its creditors according to the preference provisions of the Companies Ordinance (or according to the provisions of a scheme of arrangement).

3.8 For insolvent non-life insurers, under the Companies Ordinance, policyholders have a preferential claim[2] against the remaining assets of the insurer (direct insurance claims have a higher level of preference than reinsurance claims). These preferences apply to claims, but do not apply to premium refunds.

3.9 For insolvent life insurers, under the Insurance Companies Ordinance, the Court can approve a reduction of the amount of policyholder benefits. Under such circumstances, the policyholders would have no choice but to accept the arrangements sanctioned by the Court. The Court can also approve a transfer of life insurance policies to another insurer.

3.10 A transfer of policies, even with a reduction in policy benefits, may be better for life insurance policyholders than liquidation, which may cause greater disruption and financial loss. For example, it may be too expensive or difficult for some policyholders to replace their old policies, and these policyholders may prefer that a new insurer simply took over their existing policies, even if the benefits on their existing policies were reduced.

What are the limitations of the current protection on insolvency?

3.11 While the preferential ranking or treatment provided to non-life policyholders under the Companies Ordinance may increase their share of an insolvent insurer's assets, the amount paid to policyholders depends on the amount of assets available for distribution to creditors. There is therefore no certainty that enough assets will be recovered and paid to policyholders to meet the value of their claims, or to make a meaningful contribution towards their claims.

3.12 Insolvencies can be very complex and costly to administer, especially if the insolvent insurer holds assets outside of Hong Kong. The administration costs of the insolvency process will further reduce the assets of the insurer.

[2] Under the Companies Ordinance, certain employee-related debts and debts due to the Government have a higher level of preference than insurance claims.

3.13 It may be many years before policyholders receive any payments from a formal insolvency process. Both the agreement of claims and the recovery of related reinsurance assets can be very time-consuming, depending on the types of insurance policies issued by the insurer.

3.14 For life insurance, depending on the circumstances, it may be difficult to find another insurer willing to take over the policies of the insolvent insurer, unless policy benefits are significantly reduced.

Have there been many insurer insolvencies in Hong Kong in the past?

3.15 There have not been many large insurer insolvencies over the last twenty years in Hong Kong, in particular there has not been a large insurer insolvency affecting many private individuals and households in Hong Kong.

3.16 The largest recent insurer insolvencies in Hong Kong were of companies in the HIH Insurance group in 2001. The main HIH companies in Hong Kong have entered into an insolvent scheme of arrangement, under which the value of claims is being finalised and small claims are being paid in full at an early stage, in an effort to reduce the costs of administering the estate. However, certain creditors will still receive dividends that are significantly less than the full amount of their insurance claims.

3.17 Some of HIH's Hong Kong policyholders are entitled to receive compensation from the MIB scheme (for certain motor insurance claims) or the ECAS scheme (for certain EC insurance claims). HIH's other Hong Kong policyholders (with other types of insurance claims) will not receive any compensation.

What would happen if a large insurer failed in future?

3.18 The Hong Kong insurance market has grown significantly in recent years. Many consumers buy insurance products and invest their savings in life insurance products. Net insurance liabilities for individual life products, which provide some indication of the potential value of accumulated savings, totalled HK$102.7 billion for 2001[3] (reflecting accumulated growth in net insurance liabilities of 70% over the amount reported in 1998, some three years previously), and representing approximately HK$15,000 per capita, or HK$50,000 per household[4].

3.19 A Thematic Household Survey arranged by the Insurance Authority in the first quarter of 2002 found that about half of the adults surveyed had taken out life insurance products, with most of these being savings products. Average policy premiums per household were approximately HK$18,000 per year. Most people bought life insurance products from just one insurer.

---

[3] Extracted from the 2002 annual report of the Office of the Commissioner of Insurance.

[4] Based on a population of 6.7 million and 2.1 million households for 2001, as reported by the Government Census and Statistics Department.

3.20 The survey also found that, in the previous 12 months, 29% of households had taken out non-life products, such as travel insurance, household insurance, fire, motor and medical policies.

3.21 Although it is impossible to predict future insurer insolvencies, and how these will affect consumers in Hong Kong, the above statistics indicate that a large insurer insolvency could result in significant financial losses for consumers.

4. INTERNATIONAL COMPARISON OF PPFs

Which overseas PPFs were considered?

4.1 PPFs are common in many advanced economies; however, the protection offered by PPFs is very different in each jurisdiction.

4.2 The consultancy study considered PPF arrangements in a sample of jurisdictions with well-developed insurance markets, including the US, Canada, the UK, France, Ireland, the Netherlands, the Isle of Man, Singapore, Japan, South Korea and Australia. Each of these jurisdictions has established PPFs for life insurance, or non-life insurance, or both.

4.3 For the US, because PPFs are different in each US state, our research covered a sample of five states: New York, California, Delaware, Pennsylvania and Connecticut. These were selected on the basis that many US insurers carrying on insurance business in Hong Kong are domiciled in these states.

4.4 In many of the jurisdictions we looked at, PPFs have been introduced but had seldom been activated, especially for life insurers.

What do the overseas PPFs have in common?

4.5 In most jurisdictions included in our research sample:

a) Separate funds are kept for life and non-life insurance;
b) Insurers conducting insurance business protected by the PPF scheme are required to become members of the PPF scheme;
c) Insurers are required to pay levies to the PPF scheme;
d) Life PPFs can often provide financial support for the transfer of a group of insurance policies from an insolvent insurer to another solvent insurer;
e) Compulsory non-life insurance policies are usually compensated in full for claims made under the policy;
f) For other types of insurance policies, some form of compensation limits are in place; and
g) Certain types of insurance policies issued to large commercial buyers are usually excluded from PPF coverage (e.g., aviation risks, reinsurance policies).

What are the major differences between overseas PPFs?

4.6 Overseas PPFs included in our research sample often differed in the following respects:

a) Coverage of different types of insurance policies;
b) Compensation limits;
c) Coverage of unexpired non-life premiums;
d) Coverage of non-life corporate policyholders; and
e) Whether levies are made and funds are built up on the basis of pre-event funding (before an insolvency event occurs) or post-event funding (after an insolvency event occurs).

In the rest of this section, we focus on the areas of difference, for life and non-life PPFs separately.

What protection is provided by PPFs for life insurance policies?

4.7 Most jurisdictions in the research sample have established PPFs that pay compensation to life insurance policyholders. Compensation is limited in all of these, but in different ways.

4.8 In some jurisdictions, compensation payments are limited to a percentage of the claim or policy value (e.g., 90% in the UK[5] and Singapore), with no overall limit of the amount of compensation paid. In other jurisdictions, compensation payments are made at 100% up to fixed dollar/money limits (e.g., Canada and most of the US states we looked at). PPF compensation limits for life insurance in various jurisdictions are shown in Appendix C.

4.9 In the jurisdictions with fixed dollar limits, different limits usually apply to different types of life insurance products and claims. For example, higher compensation payments are made for death claims, as compared to the cash value of savings policies.

4.10 If an insurer becomes insolvent before a life insurance policy expires, the value of the policy will need to be estimated. In some cases, the value on which a compensation payment is based will be less than what the policyholder thinks their policy is worth. Also, under some schemes, if an actuary engaged by the PPF considers that policy benefits are excessive, compensation payments can be further reduced.

4.11 PPFs in several jurisdictions can protect policyholders in other ways as well as making compensation payments to policyholders. For example, the PPF can make payments to other insurers to take over and continue the policy.

[5] The UK's PPF scheme pays compensation at a rate of 100% on the first GBP2,000, and 90% of amounts in excess of GBP2,000.

What protection is provided by PPFs for non-life insurance policies?

4.12 In some jurisdictions in our research sample, PPFs cover only those non-life products that are compulsory under law, such as employees' work injuries or third party motor vehicle accident victims. This is the case in Hong Kong and Singapore.[6]

4.13 In Australia, many non-life policyholders suffered significant financial losses due to the HIH insolvency in 2001. As these were not covered by any existing compensation schemes, the Australian government set up special funds to pay compensation to certain families and small business policyholders of HIH.

4.14 As we noted for the life PPFs, the non-life PPFs in our research sample also have different limits on compensation. In some jurisdictions, compensation is limited to 90% of the claim, with no overall limit on the amount of compensation paid (e.g., the UK). In others, compensation is paid at 100% of the claim up to fixed dollar limits (e.g., the US). PPF compensation limits for non-life insurance in various jurisdictions are shown in Appendix D.

4.15 Non-life PPFs also generally restrict which types of policyholders can claim compensation, and for which types of non-life policy.

4.16 Certain PPFs only allow private individuals to claim compensation, but not companies. Other PPFs also allow small companies to receive compensation. The definition of a "small company" is different in different jurisdictions.

4.17 Some jurisdictions allow all policyholders to claim compensation, whether these are individuals, small or large companies. However, certain jurisdictions limit compensation to specific types of non-life policies only. For example, compensation is limited mainly to types of policies taken out by private individuals.

Who pays for the PPFs and how much do they cost?

4.18 Our international research showed that insurers usually have to pay for the costs of the compensation schemes. In some cases, government support is also provided.

4.19 The costs of a PPF vary, and are difficult to predict in advance.

4.20 Many of the PPFs in our research sample are "post-funded", which means that levies are made on insurers only if an insurer insolvency occurs. If there are no insolvencies, no PPF levies are made, or only a small levy is collected to cover the administration costs of the PPF.

[6] This was also the case in Australia prior to the HIH failure. However in April 2003, the judge overseeing the HIH Royal Commission recommended that a formal PPF scheme be introduced to pay compensation to policyholders if insurer failures occur in future.

4.21 In post-funded schemes, levies on insurers are usually capped at around 1% or 2% of premiums per annum. In the UK, which has a relatively comprehensive scheme, levies are limited to 0.8% of net premiums on protected policies. Actual levies paid by insurers are usually lower than this.

4.22 Some of the PPFs in our research sample are "pre-funded" or have a combination of pre- and post-funding. Under pre-funded schemes, funds are built up in preparation for an insolvency.

4.23 Levies for pre-funded PPFs in our international research sample were lower than the levy caps for the post-funded schemes.

4.24 Our research found that in overseas schemes separate PPF accounts are kept for life and non-life insurance.

4.25 Post-funded life PPF schemes in our research sample include the UK, Singapore, the Isle of Man and the US. Examples of pre-funded life PPF schemes are seen in Japan and South Korea. For non-life PPF schemes, the UK and all US states in our sample, except New York, are post-funded. The New York non-life scheme, Japan and South Korea are pre-funded. Both the Canadian life and non-life schemes employ a combination of pre- and post-funding, however the pre-funded element is smaller.

5. OTHER TYPES OF PROTECTION FUNDS IN HONG KONG

Are compensation funds in place in Hong Kong for other types of financial products?

5.1 In Hong Kong, a compensation fund is already in place for securities investors. This pays compensation of up to HK$150,000 per investor if there is loss caused by a default by a broker dealing in securities and futures products traded in Hong Kong Exchanges and Clearing Limited.

5.2 Legislation has been drafted for a compensation fund for bank deposits. This fund will pay compensation of up to HK$100,000 per depositor if a bank is insolvent.

5.3 A compensation fund is also in place for members of MPF schemes. This compensation fund can pay compensation if there has been "misfeasance or illegal conduct" by the MPF trustees or administrators of the scheme and such conduct has caused losses to members' accrued benefits.

6. STAKEHOLDER VIEWS ON INTRODUCING PPFs

Who has been consulted so far?

6.1 In light of the technical and complex nature of PPFs and the wide range of overseas practices, the consultancy study included a series of initial, informal interviews with a range of interested parties.

6.2 These interviews helped us to identify the pros and cons of PPFs in Hong Kong, and to consider which of the many types of overseas PPF models may be more suitable for Hong Kong.

6.3 Interviews and discussions were held by PwC with approximately 60 individuals from over 20 insurers, 4 industry organisations for brokers and agents, and 15 other organisations such as government departments, consumer protection bodies, academics and professional bodies.

6.4 In this Consultation Paper, we refer to these interested parties as "stakeholders".

Do these stakeholder interviews form part of the public consultation process?

6.5 The stakeholder interviews provided valuable information that has assisted us in preparing this Consultation Paper. However, these interviews are separate and distinct from the formal public consultation exercise that is being conducted by the Government, and which will open this subject for comment from the public as a whole.

Is there support for a PPF in Hong Kong, and what are the main pros and cons?

6.6 It is too early to conclude whether there is support for a PPF in Hong Kong. This will be considered after the public consultation exercise.

6.7 Views received during the stakeholder interviews on whether to establish PPFs in Hong Kong were mixed, and several insurers and insurance intermediary associations in particular did not believe that a PPF should be implemented.

6.8 These insurers and insurance intermediary associations were concerned that establishing a PPF might encourage some consumers and some insurers to take greater risks. In their view, a PPF might lead to "moral hazard" risk.

6.9 Many stakeholders thought that if a PPF guaranteed all insurance policies in full, some consumers might ignore the financial strength and business reputation of the relevant insurers when selecting insurance policies. If an insurer with relatively weaker financial strength or business reputation becomes insolvent, its policyholders would be compensated by the PPF. These compensation costs would then be paid for by the relatively stronger and better-run insurers, who might pass on the costs to their policyholders. This might not be fair to the stronger and better-run insurers and their policyholders, and might be bad for the insurance industry as a whole.

6.10 Some large insurers and brokers felt that buying an insurance policy is an investment decision that insurance consumers must consider very carefully. They felt that prudent buyers and their insurers should not have to pay for the bad decisions of others. Some people thought that introducing a PPF went against free market principles.

6.11 Some consumer representatives had experienced losses from the HIH insolvency in Hong Kong. They thought that PPFs were a good idea because the insurance industry is very complex and policyholders cannot know for certain whether their insurer will continue to be financially healthy in the future.

6.12 Some insurers felt that it was a good idea to give more protection to policyholders so that Hong Kong's consumer protection arrangements could catch up with other advanced economies. However, they felt that a PPF should be carefully designed to keep extra costs to a minimum.

6.13 Many insurers, insurance agents and brokers were also concerned about additional costs of a PPF scheme. They felt that the extra costs would eventually be passed on to policyholders, or even to their insurance agents.

6.14 Stakeholders were asked how much consumers might be willing to pay for extra protection from insurer insolvency. Many thought that an extra one or two per cent of insurance premiums may be affordable for most insurance products. Some stakeholders felt that the costs should be lower for investment-linked products: maybe between 0.25% and 0.5% of premiums.

7. STAKEHOLDER VIEWS ON DESIGN FEATURES OF PPFs

Who has commented on the potential design features of a Hong Kong PPF?

7.1 All stakeholders interviewed were asked what the design features of a PPF should be, if a PPF were to be introduced in Hong Kong. Although some representatives from insurers and associations of insurance intermediaries did not believe a PPF should be implemented in Hong Kong, most were prepared to give their views on the design features on a PPF, if it were to be implemented.

Which design features did stakeholders agree on?

7.2 If a PPF had to be introduced in Hong Kong, most stakeholders thought that:

a) Separate funds should be maintained for life and non-life insurance;
b) The PPF should be funded by insurers;
c) Membership by insurers should generally be compulsory;
d) In principle, the scheme could exempt certain overseas-incorporated insurers if their home country provided PPF protection to Hong Kong policyholders at least equal to a Hong Kong PPF;
e) There should be some form of insurance industry involvement in the running of the scheme;
f) There is no strong need for a PPF to cover policies issued offshore by Hong Kong insurers; and
g) There should be some form of compensation limits.

For which design features did stakeholders give mixed views?

7.3 Stakeholders generally gave mixed or different views on the following design aspects of a PPF:

a) Whether all types of insurance policies should be covered, or only some types of policies;
b) Whether life insurance savings products, in particular, should be covered;
c) Whether a non-life PPF should also protect corporate policyholders;
d) What types of compensation limits should be applied, and in particular, what the dollar limits should be;
e) Whether the PPF should be pre- or post-event funded;
f) Whether financially stronger insurers should pay less than financially weaker insurers to fund the scheme.

Further details of stakeholder views on the above aspects, for life and non-life separately, is included as Appendix E.

8. PPF OPTIONS

Should PPFs be introduced in Hong Kong?

8.1 If a large insurer became insolvent in Hong Kong, it could be complicated and difficult for everyone involved. Problems will be even greater if it is a large life insurer, or an insurer with overseas policyholders or overseas assets. Policyholders will not know for sure whether their policies will be continued, or paid out, or whether they will receive anything back. It may be many months, even years, before local and overseas governments, courts, different groups of policyholders and other people agree what should be done with the insolvent insurer.

8.2 The main arguments for a PPF are that many jurisdictions with well-developed insurance markets have introduced PPFs, or are thinking of doing so, and that a PPF would protect unfortunate policyholders with only small additional costs to insurance consumers overall (due to the benefits of risk pooling).

8.3 The main arguments against a PPF are that it may encourage insurers and consumers to be less prudent, weaken the insurance industry, and unfairly increase costs for other policyholders.

8.4 It is important to appreciate the limitations of a PPF scheme. For example, even if a relatively comprehensive PPF were introduced in Hong Kong, there may be uncertainty and delay in agreeing and paying claims as a result of the insolvency administration process, and certain policyholders may receive reduced compensation, or no compensation.

8.5 We are interested in knowing whether you think PPFs should be introduced in Hong Kong for life and/or non-life insurance.

What do we mean by "PPF options"?

8.6 We present several different options for compensation schemes for public comment. These take into account the results of our research conducted to date in connection with the consultancy study.

8.7 For practical reasons we have limited the number of options to two PPF options for life, and two PPF options for non-life insurance.

8.8 If you think PPFs should cover many types of policies and have more generous compensation payments, we present "broader" PPF options, for both life and non-life, for you to consider.

8.9 If you think PPFs should cover fewer types of policies and pay less generous compensation, we present "limited" PPF options (again, for both life and non-life) for you to consider.

8.10 Under each of the PPF options, we present further choice on the finer details of the option. We call these choices "sub-options". These have also been developed from the different stakeholder views and international practices.

8.11 Besides commenting on the Key Questions in this consultation exercise (see section 9 below), you can also suggest any combination or variation of the PPF options, or propose a completely different PPF model.

How could the potential pitfalls of PPFs be mitigated?

8.12 In highlighting each of the PPF options, we have considered ways in which certain potential PPF pitfalls could be mitigated. The table below sets out examples of these.

Potential PPF pitfalls	Examples of ways to mitigate potential PPF pitfalls
Moral hazard risk	Under the "broader" options: Applying percentage limits on compensation, so that policyholders bear a portion of the loss on insurer insolvency. Under the "limited" options: Restricting coverage to certain types of policy only, and apply dollar limits.
Increased cost	Minimising ongoing PPF scheme costs in the event that no insolvencies occur, e.g., by keeping the PPF scheme and the levy framework relatively simple, potentially integrating the non-life PPF with the existing compensation schemes for compulsory insurance (MIB and ECIIB). Minimising claims handling costs in the event of an insolvency, e.g., by involving the insurance industry in claims handling, allowing the PPF to co-operate with the insolvency administrator if this is in the commercial best interests of the PPF, and requiring the life PPF to provide financial support for a policy transfer if this is more cost-effective than paying compensation directly to policyholders.

Potential PPF pitfalls	Examples of ways to mitigate potential PPF pitfalls
Distortion of free market competition	Requiring all insurers issuing PPF-covered policies in Hong Kong to become members of the PPF. Under the non-life PPF options: Excluding certain types of business dealt mainly by large multinational consumers (who are able to choose between Hong Kong and overseas insurers).
Weakening of the insurance industry (as a result of moral hazard risk and because when an insolvency occurs, the resulting PPF levies will reduce the capital of the surviving insurers)	See moral hazard risk above. Ensuring that the PPF does not alter the existing responsibilities of the insurance supervisor and other prudential protection mechanisms. Building up a fund (i.e., with pre-event levies) over time to provide a "cushion" for absorbing the financial cost of insolvencies (i.e., the fund will reduce/prevent the need to impose a post-event levy on the surviving insurers).

8.13 To encourage consumers to choose their insurers carefully (i.e., to limit moral hazard risk), and to limit the cost of a PPF scheme, none of the PPF options presented in this Consultation Paper compensate all policyholders in full. Rather, they seek to provide a reasonable level of protection for the majority of relevant policyholders.

8.14 For the PPF option for non-life insurance, it may be cost-effective for the day-to-day management and supervision of the PPF to be integrated with the existing MIB and ECIIB schemes. This would require industry support. If it is considered desirable to prevent cross-subsidization between levies on compulsory and non-compulsory insurance (e.g., to the extent that the relevant PPFs are funded by different groups of insurers and insurance consumers), separate accounts (i.e., within the new integrated PPF) could be kept for the funds transferred from the existing insolvency compensation schemes.

What do the PPFs do under each of the PPF options?

8.15 The PPF options only cover policies issued in Hong Kong by insurers authorised by the Insurance Authority.

8.16 The PPF becomes involved as soon as the Hong Kong Court appoints an insolvency administrator (e.g., a provisional liquidator, liquidator, insolvency scheme administrator) for an insolvent insurer.

8.17 In general, the PPF is only required to pay out compensation to a policyholder when the insurer defaults on a payment under a valid policy, or when the insolvency administrator of the insurer determines the value of the policy in a liquidation of the insurer. Events of insurer default will include failing to pay relevant claims and may also include failure to make payments on maturity or early surrender of the policy, depending on the type of PPF scheme selected.

8.18 As an alternative to paying compensation to policyholders, the PPF for life insurance (under both the broader and limited scheme options) may under certain circumstances be able to help the insolvency administrator to arrange for another insurer to take over and continue the policies. The PPF could do this by making an incentive payment to the other insurer, but only if the amount of the incentive payment is less expensive for the PPF than paying out compensation directly to policyholders. The arrangement will need to be agreed with the insolvency administrator and approved by the Courts, and policy benefits may be reduced (as is currently allowed under the Insurance Companies Ordinance).

8.19 Introduction of these PPF options does not change any of the roles and responsibilities given to a provisional liquidator, liquidator, the Insurance Authority or the Courts, under existing Hong Kong laws (for example, the introduction of a PPF would not prevent "schemes of arrangement" under the Companies Ordinance from being established if this was the best way of dealing with an insurer insolvency). The operation of the PPF does not change the amount of benefits or claims under an insurance policy (as noted previously, under the Insurance Companies Ordinance, these can only be modified with the Court's approval), and it cannot take over the business of an insurer.

8.20 Summary charts of the broader and limited PPF options, for life and non-life insurance, are included in Appendices A and B respectively.

What is the "broader" PPF option for life insurance?

8.21 The broader PPF option for life insurance pays compensation based on 90% of the value of the policy. Compensation would be paid out on protection policies as well as on the savings value of policies, with the same percentage limit being applied for all types of policies.

8.22 If there has been a death, disability or other type of claim, the value of the policy will be based on the insured amount stated in the policy.

8.23 If the policy has not yet matured and no claims or benefits have fallen due under the policy, the value of the policy would be based on its value in the insolvency process.

8.24 The valuation of the policy in the insolvency process would be determined by the insolvency administrator according to insolvency laws (or the relevant insolvent scheme of arrangement). It is therefore difficult to know in advance how the value of a life policy in a particular circumstance will be measured. This is further complicated by the following: (i) the terms of each life insurance policy are different, (ii) Hong Kong does not have any detailed rules on how to value life insurance policies in a liquidation, and (iii) there have been no significant life insurer insolvencies in Hong Kong over the last 20 years. The calculation will probably be based on the benefits that may become due in the future, and should take into account the time value of money. However, for savings products, the value of the policy calculated by the insolvency administrator may be less than the value that the policyholder believes the policy is worth.

8.25 To prevent abuse of the scheme, the PPF can further reduce the amount of compensation. This will only occur if an independent professional actuary finds that policy benefits were excessive compared to others in the market.

8.26 Some policies may have no value if there have not been any claims, and the policy does not provide for a cash value. It is possible that pure term-life insurance policies may not have a compensation value, even if the policyholder cannot find another insurer to insure them.

8.27 Compensation payments may also be limited to an overall dollar amount (as well as the 90% limit), in order to contain the cost of the PPF (and potentially also further mitigate moral hazard risk).

8.28 The sub-options under the broader PPF option for life insurance are to either:

(i) Cover all types of life policies up to the same limit;

or

(ii) Cover all types of life policies, except that investment-linked insurance policies should either not be covered, or be covered up to a lower limit: possibly HK$150,000 per policy.

8.29 Sub-option (ii) is suggested because PPFs in some jurisdictions do not cover policies where investment risk is borne by the policyholder, and because some stakeholders considered that policyholders of investment-linked products usually should know that they bear a certain level of investment risk. Other reasons given by stakeholders were that: (a) insurers' profit margins on investment-linked products are often narrower than on other types of products; and (b) it may be difficult for insurers to compete with unit trust providers because unit trusts do not have to pay PPF levies. Unlike many other types of life insurance savings products, it may also be relatively easier to "ring fence" investment-linked products from other types of life insurance savings products. Because investment-linked products have to be approved by the Securities and Futures Commission ("SFC"), there is also some consistency with the HK$150,000 limit under the SFC's investor compensation scheme (however people should note that the SFC's investor compensation does not cover all types of securities that an insurer might place under an investment-linked fund. For example, it does not cover overseas-listed shares or unit trusts).

8.30 If a lower compensation limit is applied for investment-linked policies, the PPF scheme will need to specify how this will be applied to insurance policies with a combination of investment-linked and guaranteed benefits. We are interested in your comments on this.

8.31 The selection of appropriate compensation limits under the broader scheme option should be addressed prior to implementation. At this stage, we are interested in your views as to what an appropriate range of limits would be.

What is the "limited" PPF option for life insurance?

8.32 The limited PPF option for life insurance pays compensation up to a fixed dollar limit on certain protection-type claims only.

8.33 We have not selected a dollar limit, but comments from some stakeholders suggest a limit in the range between HK$600,000 and HK$1 million.

8.34 The protection-type claims that will be covered are death, disability, personal accident, sickness and medical claims.

8.35 The sub-options under the limited PPF option for life insurance are to either:

(i) Cover certain protection products only;

or

(ii) Cover certain protection products (up to a limit in the range of HK$600,000 to HK$1 million) and provide a basic level of coverage on certain savings products (up to a lower limit).

(The lower limit for certain savings products could potentially be in the range of HK$100,000 to HK$300,000: HK$100,000 is the compensation limit under the planned Hong Kong deposit protection scheme, and HK$300,000 represents the lowest comparable PPF compensation limit seen in our overseas research sample.)

8.36 *Under sub-option (ii)*: If certain savings products are covered, the compensation limit on these would be lower than the compensation limit for protection products. The use of a lower compensation limit for savings products is seen in the US and Canadian PPF schemes. It may be possible to cover only certain types of savings products, however it might be difficult to differentiate between different types of savings products. This is because life insurance products often contain multiple benefits, some benefits will have greater importance for some consumers, and the relative importance of some benefits may change over the (often long) life of a policy. Life insurers are also continually developing new types of products. One method of limiting coverage is to only cover those savings products where the insurer has guaranteed a minimum level of payout or return: this means that most investment-linked products would not be covered.

What is the "broader" PPF option for non-life insurance?

8.37 The broader PPF option for non-life insurance is similar to the broader option for life insurance because it also pays compensation based on 90% of claims across a broad range of policies, except for the two compulsory classes of insurance (see paragraph 8.41 below).

8.38 Like the broader option for life insurance, the broader option for non-life insurance may also limit compensation payments to an overall dollar amount (as well as the 90% limit), with the same objective of limiting the cost of the scheme. The choice of compensation limit may depend on which sub-option is chosen.

8.39 Compensation would only be paid if the claim occurs before the date of insolvency, or within 30 days of insolvency. This means that policyholders would have up to 30 days to take out new insurance policies with another insurer. (As the PPF will only pay 90% compensation if there is a claim during the 30 day period, policyholders would be encouraged to arrange for a new policy as soon as possible.)

8.40 Policyholders will not be compensated for unexpired premiums (i.e., the portion of policy premiums relating to periods after the date of insolvency and/or policy cancellation). This is consistent with Hong Kong's current claims priority framework for insolvencies, and the existing MIB and ECAS schemes, which do not cover unexpired premiums.

8.41 Compensation for claims under EC and motor vehicle policies will continue to be 100% covered, as is the case under the existing MIB and ECAS schemes.

8.42 The Government is preparing a regulation that provides for details of the requirement for all building owners' corporations to take out insurance policies to protect the owners from liabilities in respect of third party bodily injury and death. The requirement would apply to all residential, commercial and industrial buildings where an owners' corporation has been formed. As this regulation (if introduced) will impact a wide range of potential policyholders in Hong Kong, it may be desirable to include PPF coverage for claims under these types of insurance policies (at 100%, on the same basis as the compensation schemes for EC and motor vehicle policies). We are interested in your views on this.

8.43 Compensation will be paid on many types of insurance claims by private individuals, including travel insurance, personal accident, motor vehicle damage, fire, household contents and medical insurance claims.

8.44 Coverage of other types of claims may depend on which sub-option is chosen.

8.45 We present three sub-options for dealing with corporate policyholders:

(i) Corporate policyholders can be excluded, meaning that only private individuals receive compensation;

or

(ii) Coverage can be extended in various ways so that small companies receive compensation as well;

or

(iii) All types of policyholders can be compensated, whether they are private individuals, small companies, or large companies.

8.46 *Under sub-option (i)*: There may not be a strong need to limit the types of insurance claims covered by the PPF scheme (from a cost limitation perspective), because only private individuals are eligible for compensation. In addition, if an overall dollar limit is introduced, it may be quite high.

8.47 *Under sub-option (ii)*: There are many ways to extend coverage to small companies. One way to decide whether a non-life insurance policy is covered by the PPF is to look at the terms of the policy. For example, policies might be covered if they have sums assured of under HK$5 million[7], or policies might be covered if they have premiums of less than HK$10,000. Another way is to define a "small company" based on its turnover, total assets, net assets or number of employees. For example, a company may be covered if it has less than 50 employees or net assets of less than HK$10 million when it takes out the insurance policy. We invite your comments on which method of targeting smaller companies is most appropriate (if this sub-option were to be selected), and the relevant dollar amounts and/or other criterion to be applied.

8.48 *Under sub-option (iii)*: If all types of policyholders are compensated, then it will be more important to set dollar limits to make the scheme affordable. Certain types of non-life policies that are used only by large sophisticated companies should be excluded, because covering them would be expensive and large companies often do not need protection as much as individuals and small companies. Examples of these types of policies are policies insuring aircraft, ships and fidelity risks.

[7] The limits presented in this paragraph for sum assured, premium amount, number of employees and net assets are for illustrative purposes only. Appropriate limits will need to be determined if this sub-option is selected.

What is the "limited" PPF option for non-life insurance?

8.49 The limited PPF option for non-life insurance pays compensation up to a fixed dollar limit, and only to certain policyholders for certain types of claims.

8.50 We have not selected a dollar limit, but comments from some stakeholders suggest a limit in the range between HK$600,000 and HK$1 million. This range is the same as that suggested under the limited option for life policies.

8.51 Only individuals would be covered, not companies.

8.52 The types of claims covered would include accidental death, personal injury, medical expenses, disability and sickness claims.

8.53 The sub-options under the limited PPF option for non-life insurance are:

(i) No other types of claim are covered;

or

(ii) Compensation is also paid if a policyholder loses their home due to fire, or if an injured person sues a policyholder for being negligent.

8.54 *Under sub-option (ii)*: Specific details and restrictions regarding the types of claims that will be covered will need to be further developed if this sub-option is selected. For example, if it is decided that the scheme should protect injured third parties and/or individual home owners, the scheme should also cover claims where the policyholder is a building owners corporation (as well as covering individual policyholders).

How much would the PPF schemes cost and who would pay for them?

8.55 It is not practical to determine the funding costs of a PPF scheme until all of its key features are addressed. However, the broader PPF options will clearly be more expensive than the limited PPF options.

8.56 To limit the cost of the chosen PPF option (whether broader or limited options), there will be a degree of trade-off between the range of products/policyholders covered and the compensation limits. For example, if a narrower range of policies are covered, higher compensation limits can be set.

8.57 The precedent from Hong Kong's MIB and ECIIB compensation schemes, and from many overseas PPF schemes is that levies are charged to insurers based on the amount of premiums on protected types of policies. However there is international precedent for using other methods, such as a proportion of technical reserves. If levies are based on premiums, the appropriate premium measure should be determined. For example, premiums could be either gross or net of reinsurance.

8.58 It would be a commercial decision of the insurers as to whether, and if so, to what extent, the costs of the levies would be passed on to their policyholders.

8.59 The PPF options have a mixture of pre-funding and post-funding. The rationale is that the pre-funding portion will pay for the day-to-day running costs of the scheme and may build up an amount of cash over a number of years. The post-funding portion will only be charged to insurers if the need arises, i.e., if there is a large insurer insolvency.

8.60 For non-life PPF schemes, the pre-funding portion might be greater than the post-funding portion, which will result in a balance of funds being accumulated to deal with a potential non-life insurer insolvency (there is some precedent in Hong Kong for pre-funding under the MIB, ECAS and ECIIB compensation schemes, and there has been some experience of non-life insurer insolvencies in Hong Kong). Non-life insurers may choose to include a specific charge for this in their policies. Based on PPF levy caps in other jurisdictions, the policy charge might be up to 1% or 2% of premiums, depending on the type of PPF scheme selected.

8.61 A smaller pre-funding element may be appropriate for life PPF schemes, because there has been little experience of life insurer insolvency in Hong Kong, and because most overseas life PPFs in our research sample are post-funded. If a post-funding basis is applied and if no insolvencies occur, the costs of a PPF may be very small (in the past, life insurer insolvencies have tended to be less frequent than non-life insurer insolvencies, both in Hong Kong and elsewhere). If insolvencies do occur, insurers may need to pay a levy of up to 1% or 2% of premiums (based on levy caps seen in other jurisdictions), depending on the maximum levy limit. Levies might be lower for investment-linked policies, if they are covered by the compensation scheme. Details of maximum levies will need to be decided before a scheme is introduced.

8.62 It will be a commercial decision for life insurers as to whether to include the cost of a PPF levy as a specific charge in their policies. However this may be difficult to do for policies that are issued before the compensation scheme is introduced. The way in which PPF levies are charged to these policies may depend on the contract wording.

8.63 The exact PPF contribution levy rates, for life and non-life separately, will need to be determined after the choice of options, and will require further data from the insurance industry regarding insurance policies eligible for protection under the relevant option/sub-option. Based on Hong Kong's insurer insolvency experience over the last 20 years, and the PPF arrangements in other jurisdictions studied, the cost is likely to be less than 1% or 2% of premiums.

8.64 The levies could be structured in various ways (for example, they may include an annual operating expense levy which is separate from the insolvency cost component).

Should all insurers pay the same levy rate?

8.65 Several stakeholders thought that financially stronger insurers have a lower risk of failing, and should therefore receive a discount on their PPF levies. We did not find much precedent for this practice in overseas PPFs, but risk-based levies are being adopted under Hong Kong's planned deposit protection scheme, and internationally, insurance regulation is becoming more risk-based.

8.66 If a risk-based levy system is introduced for a Hong Kong PPF, it will need to be clear and impartial. One potential method is for insurers to be given a discount, in the range of between 10% and 20%, on the normal contribution levy, if they meet one of the following criteria:

a) The insurer obtains a suitably high external credit rating;

or

b) For insurers without credit ratings, the insurer maintains a certain target level of surplus over the minimum prescribed solvency margin under the Insurance Companies Ordinance.

It is possible that a risk-based framework might only be applied to certain elements of the levies (for example, life, non-life, pre- or post-event levies). The exact criteria (and relevant determination dates) will need to be considered before a PPF scheme is implemented.

What happens if the compensation scheme runs out of money?

8.67 It is always possible that a very large insurer fails and the PPF does not have enough money to pay compensation to all policyholders. The PPF may also run out of money if more than one insurer fails.

8.68 If this happens, the PPF may decide that some policyholders have higher priority, while other policyholders have to wait for compensation. For example, under Hong Kong's recently-established compensation scheme for work-related injuries (the ECIIB, which takes over coverage from ECAS in April 2004), compensation claims made by employees have a higher priority than claims made by employers. Detailed guidelines on determining higher priority claims (including levels of discretion, if any, and appropriate safeguards) would need to be determined prior to implementation.

9. KEY QUESTIONS FOR PUBLIC COMMENT

We welcome comments in any form on the areas discussed above. We would however be grateful for your comments on at least the questions listed below.

The following questions address whether PPFs should be introduced in Hong Kong:

9.1 Do you support the introduction of a PPF in Hong Kong for:

a) Life insurance?

b) Non-life insurance?

9.2 Do you have any other comments on Hong Kong's overall policyholder protection framework on insurer insolvency?

The following questions address the design features of PPFs, if they are introduced in Hong Kong:

9.3 Which of the following PPF options is most suitable for life insurance products?
a) Limited scheme: Life
b) Broader scheme: Life
c) Another type of PPF scheme for life products (Please provide details.)

9.4 Which of the following PPF options is most suitable for non-life insurance products?
a) Limited scheme: Non-life
b) Broader scheme: Non-life
c) Another type of PPF scheme for non-life products (Please provide details.)

9.5 Under a limited PPF scheme for life products, do you think that certain savings products should be considered "higher priority" for payment of compensation? If so, which types of products and what is the maximum level of compensation that should be paid? Can you suggest specific criteria for determining "higher priority" savings products?

9.6 Under a broader PPF scheme for life insurance, how should investment-linked products be treated:
a) Subject to the same coverage and compensation limits as other types of savings products?
b) Subject to a lower compensation limit? (And if so, what should the limit be?)
c) Not covered at all?

9.7 Under a limited PPF scheme for non-life insurance, do you think that individuals' third party liability and homeowners fire policies should be considered "higher priority" for payment of compensation?

9.8 Under a broader PPF scheme for non-life insurance, do you think that companies should be covered? If so, which types of companies, and how should these be defined or targeted?

9.9 What compensation limits (dollar and/or percentage) should be introduced under the PPF options? [8]
a) Limited scheme: Life
b) Broader scheme: Life
c) Limited scheme: Non-life
d) Broader scheme: Non-life

[8] In section 8 of this Consultation Paper, we indicate potential ranges of dollar limits and percentage limits under each PPF option, taking into account cost and moral hazard considerations, international research and comments made by stakeholders. In summary, these potential compensation limits are:
a) Limited scheme, Life: HK$600,000 to HK$1 million for certain protection products (see paragraph 8.33), and as a sub-option: HK$100,000 to HK$300,000 for certain savings products (see paragraph 8.35)
b) Broader scheme, Life: 90%, potentially with dollar limits, and potentially varied by type of product, such as a HK$150,000 limit for investment-linked insurance policies (see paragraphs 8.27, 8.28 and 8.29)
c) Limited scheme, Non-life: HK$600,000 to HK$1 million (see paragraph 8.50)
d) Broader scheme, Non-life: 90%, potentially with dollar limits (see paragraph 8.38).
You may wish to suggest compensation limits other than as summarised above.

9.10 Do you have any further comments on the proposed design features of the four PPF options presented?
- a) Limited scheme: Life
- b) Broader scheme: Life
- c) Limited scheme: Non-life
- d) Broader scheme: Non-life

9.11 Who should be responsible for managing the PPF scheme and what administration framework should be introduced? For example, should the PPF scheme be administered by industry representatives, consumer representatives, an independent body or a government-related body, or some combination of these?
- a) For a life PPF?
- b) For a non-life PPF?

9.12 Should PPFs be funded on a pre- or post- event basis, or a combination thereof?
- a) Limited scheme: Life
- b) Broader scheme: Life
- c) Limited scheme: Non-life
- d) Broader scheme: Non-life

9.13 How should the PPF levy framework and levy caps be structured? For example: (i) Should the levy be divided into an administration cost component and an insolvency cost component? (ii) Should levies be based on premiums, technical reserves or some other measure?

9.14 Should PPF levies on insurers take into account their relative financial strength?
- a) For pre-funding levies?
- b) For post-funding levies?
- c) For a life PPF?
- d) For a non-life PPF?

9.15 If PPF levies take into account the financial strength of insurers, should this be applied:
- a) Using a simple formula discount method (e.g., a standard 20% discount for insurers with a recognised credit rating or solvency level above minimum levels) or a sliding scale method?
- b) Using objective, publicly available information regarding the insurer (e.g., published credit rating or balance sheet solvency amount) <u>or</u> subjective, private information regarding the insurer (e.g., based on the supervisor's assessment of the financial strength and management of the insurer)?

9.16 If PPF levies are based on insurance premiums, what will you regard as an acceptable ceiling for the relevant premium levy rate (e.g., 1%, 2%, etc.)?

9.17 Do you have comments on any other aspects of PPFs?

10. REQUEST FOR COMMENTS

10.1 The Insurance Authority invites comments from all interested persons.

10.2 Comments could cover both whether a PPF should be introduced, and what type of PPF it should be, assuming a PPF was introduced. It would be helpful if comments could be made on the list of questions in section 9 of this Consultation Paper.

10.3 Comments can be sent in either English or Chinese, preferably by 31 March 2004, in the following ways.

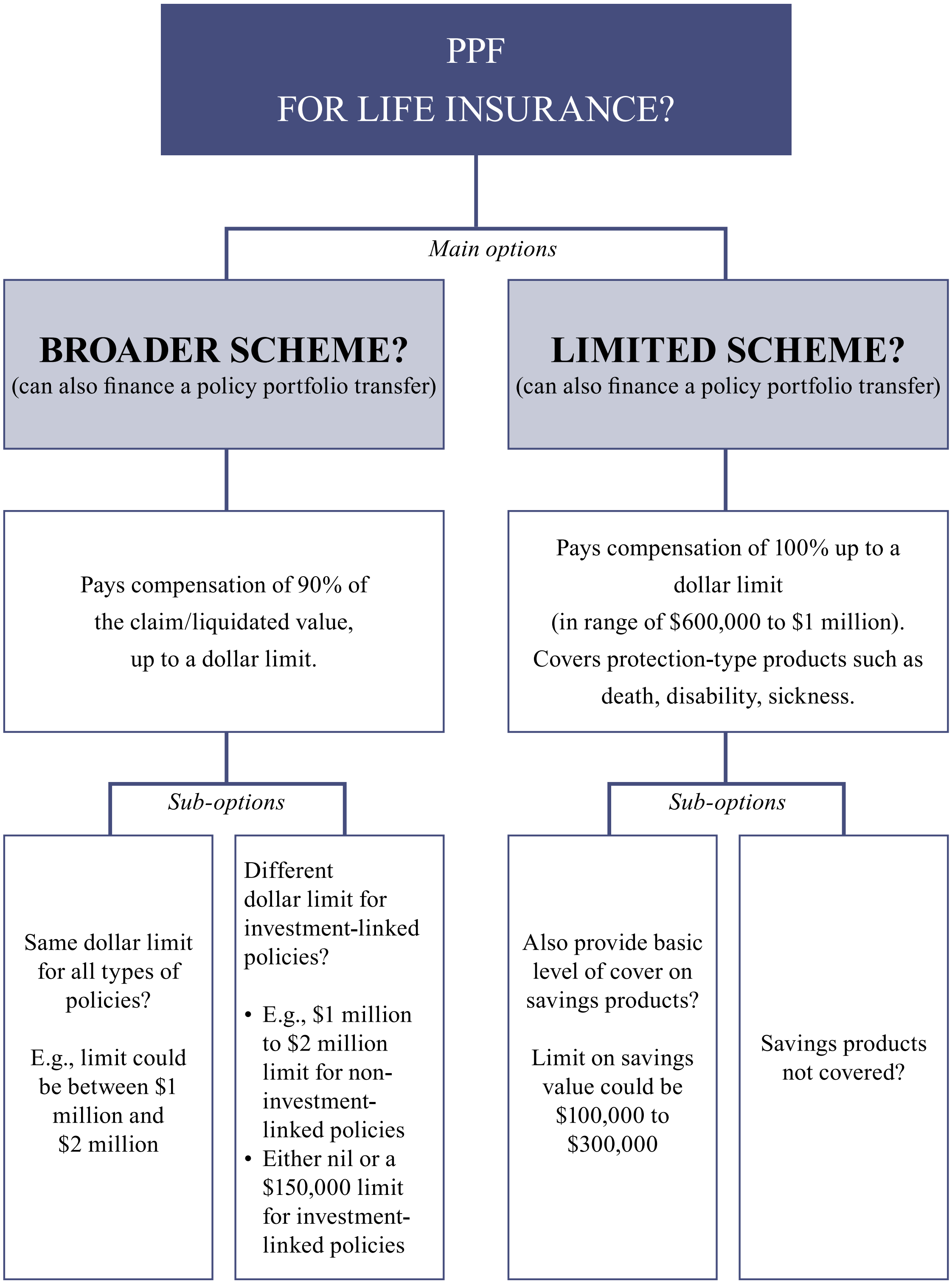
By mail to:	Office of the Commissioner of Insurance 21/F Queensway Government Offices 66 Queensway Hong Kong [Consultation Paper on the "Feasibility of Establishing Policyholders' Protection Funds in Hong Kong"]
By fax to:	2869 0252
By e-mail to:	ppf@oci.gov.hk

It is intended that all responses to the Consultation Paper will be made available for public inspection, unless respondents request otherwise.

APPENDICES

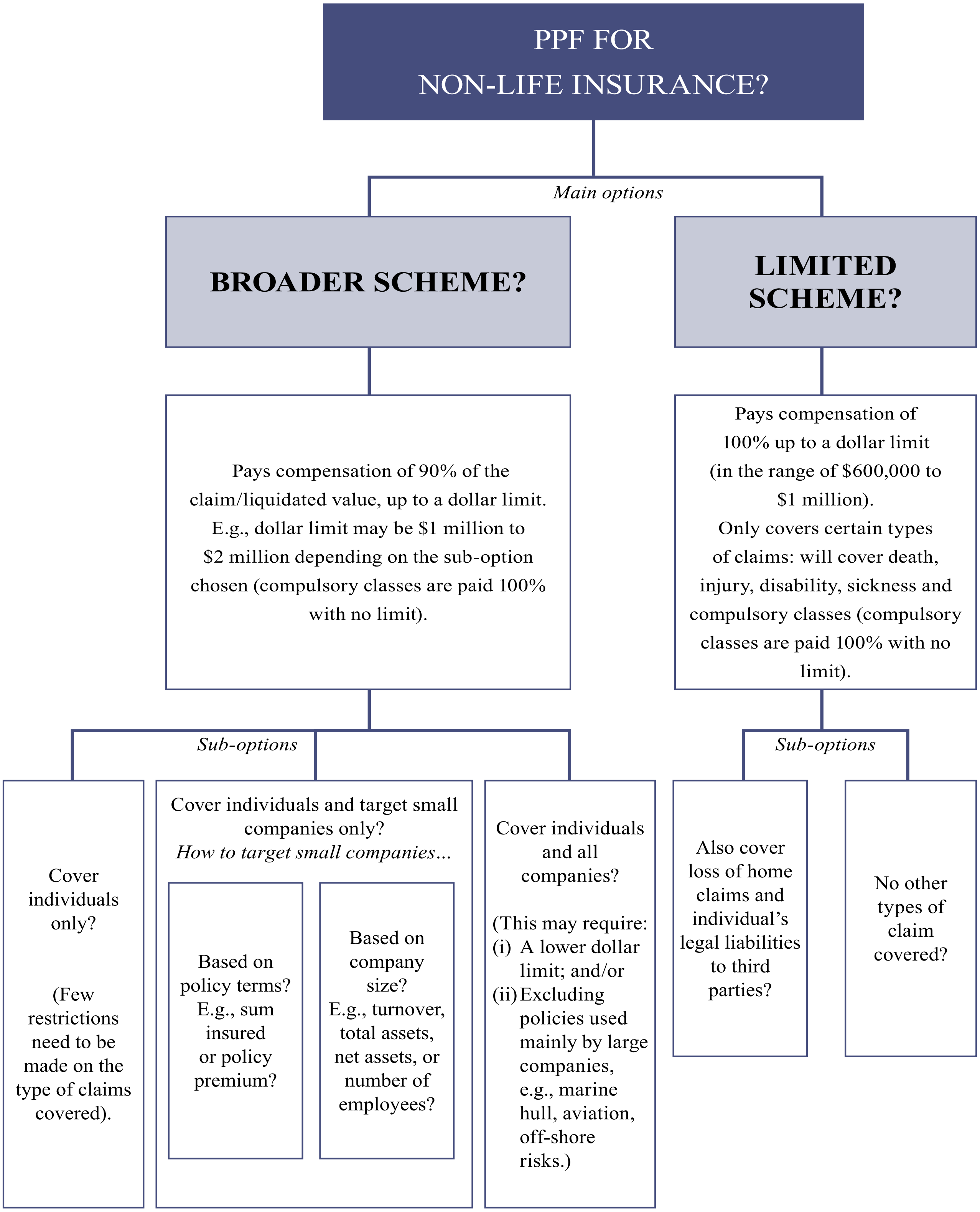
Appendix A

Summary chart of PPF options – life insurance



Appendix B

Summary chart of PPF options – non-life insurance



Appendix C

Compensation limits for other PPF schemes – life insurance

Life insurance PPF scheme	Summary of compensation limits for life insurance
United Kingdom	100% for first GBP2,000 (HK$26,000), thereafter 90%
Singapore	90%
Isle of Man	90%
Japan	90%
South Korea	Up to 50 million Won (HK$325,000)
France	Between Euro 70,000 and Euro 90,000 (HK$827,000) per person
Canada	Death benefits: C$200,000 (HK$1.1 million) Cash value and accumulated value: C$60,000 (HK$342,000) Health expense: C$60,000 (HK$342,000) Monthly income: C$2,000 (HK$11,000)
United States – New York	Individual life policies: US$500,000 (HK$3.9 million) Group annuity policies and funding agreement under an employee benefit plan: US$1 million (HK$7.8 million)
United States – California	1) Shall not exceed the lesser of the following: a) 80% of the contractual obligation b) Death benefits: US$250,000 (HK$2 million) c) Cash value or annuity benefits: US$100,000 (HK$780,000) Aggregate limit in respect of one life: US$250,000 (HK$2 million) 2) Health care benefits: US$200,000 (HK$1.6 million) Aggregate limit in respect of multiple policies: US$5 million (HK$39 million)
United States – Delaware	Death and disability benefits: US$300,000 (HK$2.3 million) Cash value or annuity benefits: US$100,000 (HK$780,000) Aggregate limit in respect of one life: US$300,000 (HK$2.3 million) Basic hospital, medical and surgical plan: US$500,000 (HK$3.9 million) Governmental retirement plan: US$100,000 (HK$780,000) Owner of non-group policies regardless of individual, firm or corporation: US$1 million (HK$7.8 million) Unallocated annuity contract: US$1 million (HK$7.8 million)
United States – Connecticut	Death benefits: US$300,000 (HK$2.3 million) Cash value or annuity benefits: US$100,000 (HK$780,000) Health insurance: US$500,000 (HK$3.9 million) Aggregate limit in respect of one life: US$500,000 (HK$3.9 million) Government retirement plan: US$100,000 (HK$780,000) Aggregate limit in respect of multiple policies: US$5 million (HK$39 million) Unallocated annuity contracts: US$5 million (HK$39 million)
United States – Pennsylvania	Death benefits: US$300,000 (HK$2.3 million) Cash value: US$100,000 (HK$780,000) Annuity benefits: US$300,000 (HK$2.3 million) Health insurance: US$100,000 (HK$780,000) Aggregate limit in respect of one life: US$300,000 (HK$2.3 million) Government retirement plan: US$300,000 (HK$2.3 million) Corporate retirement plan: US$5 million (HK$39 million) Unallocated annuity contracts: US$5 million (HK$39 million)

Appendix D

Compensation limits for other PPF schemes – non-life insurance

Non-life insurance PPF scheme	Summary of compensation limits for non-life insurance (other than compulsory insurance classes)
United Kingdom	100% for first GBP2,000 (HK$26,000), thereafter 90%
Japan	90% compensated for specified classes, including: 1) Voluntary motor insurance 2) Fire insurance for individuals, small sized enterprises and certain buildings with sectional ownership 3) Personal accident insurance 4) Medical expenses insurance 5) Nursing care expenses insurance
Australia: HIH compensation scheme	100% compensated for: 1) Salary continuance and disability insurance; 2) Personal injury; 3) Total loss of primary residence; 4) Not-for-profit organisations. 90% compensated: 1) if family taxable income is less than A$77,234 (increased by A$3,139 per additional child) 2) if family taxable income is greater than A$77,234 (increased by A$3,139 per additional child) and claim is greater than 10% of family taxable income 3) if a small business with less than 50 employees
Ireland	65%, up to 650,000 Irish pounds/Euro 825,330 (HK$7.6 million)
Canada	C$250,000 (HK$1.4 million)
South Korea	Up to 50 million Won (HK$325,000)
United States – New York	US$1 million per claim (HK$7.8 million) For risks outside of the state, limited to US$5 million per policy (HK$39 million)
United States – California	US$500,000 (HK$3.9 million), with US$100 deductible (HK$780)
United States – Delaware	US$300,000 (HK$2.3 million)
United States – Connecticut	US$300,000 (HK$2.3 million), with US$100 deductible (HK$780)
United States – Pennsylvania	US$300,000 (HK$2.3 million)

In Appendices C and D: Hong Kong Dollar equivalent amounts are based on approximate exchange rates as at 31 May 2003. Rounding is generally to the nearest HK$1,000 (for amounts below HK$1 million), or to the nearest HK$0.1 million (for amounts in excess of HK$1 million). Information presented is based on PPF scheme provisions reported to be in effect during the period that research was performed in early 2003.

Appendix E

Stakeholder views on design features of PPFs

Some of the views expressed by stakeholders on the potential scope of PPF coverage are as follows:

What protection should a PPF provide for life insurance policies?

1) If a compensation fund were to be introduced for life insurance, most stakeholders thought that (as a minimum) it should pay compensation for protection-type policy claims such as death claims, disability claims and critical illness claims that had occurred before the insolvency and which the insurer had not yet paid out to policyholders or their families.

2) Some stakeholders thought that policyholders that had been paying premiums on non-investment life insurance policies for many years should also be protected, even if no claim had occurred. This is because they may have taken out their policies when they were younger and healthier, when premiums were affordable. If they are old or sick when their insurer becomes insolvent, a new insurer would charge them much more for the same protection. It could be too expensive or impossible for these policyholders to replace their old policies. These types of policyholders may prefer that a new insurer simply took over their existing policies.

3) Stakeholders had mixed views on whether compensation should be paid on the savings value of life insurance policies.

4) People were also asked what the compensation limits should be for life insurance policies. Their answers usually fell into two groups:
   a) The first group thought that compensation should be paid on all types of policies, based on a percentage of the value of the policy. Many of these favoured the 90% compensation limit seen in the UK. However many recognised that there should also be an overall dollar limit on top of this, possibly HK$2 million or HK$3 million, to limit the costs of the scheme.
   b) The second group thought that a lower level of compensation should be paid, up to a fixed dollar limit. This could cover protection-type policies, and possibly savings policies. Some thought savings policies should receive less compensation than protection products (as seen in the US and Canada).

5) When stakeholders were asked whether only certain types of savings policies might be covered, many thought that this might be difficult to apply. This is because many types of savings policies sold in Hong Kong have a mixture of different types of benefits. It may not be easy to classify them into clear, separate "higher" and "lower" priority groups to decide whether compensation is paid on various types of policies.

Appendix E

Stakeholder views on design features of PPFs

What protection should a PPF provide for non-life insurance policies?

6) Stakeholders usually found it easier to classify non-life insurance claims into higher and lower priority groups (as compared to life insurance savings products) to decide whether compensation should be paid on various types of insurance policies.

7) If a PPF were to be introduced for non-life insurance, most stakeholders thought that (as a minimum) it should cover death, personal accident and disability claims that occur before an insurer becomes insolvent.

8) Many people also thought that compensation should be paid if policyholders lose their family home or have claimed a large amount of medical expenses under their insurance policies.

9) Many stakeholders also thought that compensation should be paid to policyholders who were being sued by third parties for being negligent, as these types of claims can be very large and are costly to defend in the courts.

10) Many interviewees did not consider that a non-life PPF should cover policies issued to companies. Some of these thought that if consumers were sophisticated enough to set up a company, they should take responsibility for their own financial decisions, and should not receive compensation if they chose a weaker insurer.

11) Other stakeholders thought that small companies are important to Hong Kong's economy and many of these are family businesses that should receive protection.

12) A number of stakeholders suggested that compensation payments could be limited to between HK$500,000 and HK$1 million.

13) Several stakeholders thought that if a PPF was introduced, it should be kept simple and fair by covering all types of policies and all types of policyholders, whether they are large companies, small companies or private individuals. Some of these stakeholders suggested that, if dollar compensation limits were kept low, then the scheme might not be too expensive to implement.

REQUEST FOR COMMENTS

The Insurance Authority invites comments from all interested persons.

Comments could cover both whether a PPF should be introduced, and what type of PPF it should be, assuming a PPF was introduced. It would be helpful if comments could be made on the list of questions in section 9 of this Consultation Paper.

Comments can be sent in either English or Chinese, preferably by 31 March 2004, in the following ways.

By mail to:	Office of the Commissioner of Insurance 21/F Queensway Government Offices 66 Queensway Hong Kong [Consultation Paper on the "Feasibility of Establishing Policyholders' Protection Funds in Hong Kong"]
By fax to:	2869 0252
By e-mail to:	ppf@oci.gov.hk

It is intended that all responses to the Consultation Paper will be made available for public inspection, unless respondents request otherwise.