IFPHK's Response to the Consultation Paper on the Proposed Establishment of a Policyholders' Protection Fund

June 2011

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IFPHK Profile

<u>Background</u>

The Institute of Financial Planners of Hong Kong ("IFPHK") was established in June 2000 as a non-profit organisation in response to the rapid expansion of the personal insurance industry. It aims to be recognised as the region's premier professional body, representing those financial planners who uphold the highest professional standards for the benefit of the general public.

The Institute is the sole licensing body in Hong Kong authorised by Financial Planning Standards Board Limited[1] to grant the much-coveted and internationally-recognized CFP[2] certification to qualified financial planning professionals in Hong Kong and Macau.

It represents more than 14,000 financial planning practitioners in Hong Kong from diverse professional backgrounds including banking, insurance, independent financial advisory, stockbroking, accounting, and legal services.

Currently there over 133,000 CFP professionals in 24 countries/regions; the majority of these professionals are in the U.S., Canada, Australia and Japan, with more than 4,300 CFP professionals in Hong Kong.

<u>IFPHK's interest in this consultation</u>

Insurance is considered the cornerstone of financial planning. Effective and proper use of insurance products help spread risk, which can minimise its impact on families should events take a downturn. Insurance is therefore an important part of IFPHK's financial planning education and certification programme. Having knowledgeable insurance practitioners, proper consumer understanding of what insurance policies do, effective products, and financially sound underwriters is essential for those who seek financial planning. As the leading professional institute representing the interests of the financial planning industry, IFPHK has a duty to respond to any consultation paper that may impact its members and their clients. As such, IFPHK has taken a strong interest in the Consultation Paper and wishes to express its views on the proposed changes.

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[1] FPSB was established in October 2004 by 17 non-profit associations that together certify over 45,000 individuals outside the U.S. to use CFP^{CM}, CERTIFIED FINANCIAL PLANNER^{CM} and CFP^{CM} marks and that have joined FPSB as members. FPSB will protect financial planning consumers and foster professionalism in financial planning through the ongoing development and enforcement of relevant international competency and ethics standards. FPSB will also promote greater global recognition of CFP certification and its related marks as the international hallmarks of financial planning professionals.CFP^{CM}, CERTIFIED FINANCIAL PLANNER^{CM} and CFP^{CM} are certification marks owned outside the U.S. by Financial Planning Standards Board Ltd. (FPSB). The Institute of Financial Planners of Hong Kong is the marks licensing authority for the CFP marks in Hong Kong and Macau, through agreement with FPSB.

[2] CFP^{CM}, CERTIFIED FINANCIAL PLANNER^{CM} and CFP^{CM} are certification marks owned outside the U.S. by Financial Planning Standards Board Ltd. The Institute of Financial Planners of Hong Kong is the marks licensing authority for the CFP marks in Hong Kong and Macau, through agreement with FPSB.

IFPHK's representation

IFPHK has 30 founding members who contributed to its inception and foundation. These members believe in raising the standard of financial planners and increasing awareness around the need for sound financial planning. Of these 30 founding members, 8 are insurance companies. They are:

- American International Assurance Company (Bermuda) Limited
- AXA China Region Insurance Company Limited
- Ageas Insurance Company (Asia) Limited (Formerly Fortis Insurance Company (Asia) Limited)
- Manulife (International) Limited
- New York Life Insurance Worldwide Limited
- Sun Life Hong Kong Limited
- The Prudential Assurance Company Limited
- Zurich Life Insurance Company Limited

We currently have 64 corporate members, including 32 insurance companies and brokerage firms. These corporate members employ over 33,000 insurance practitioners. Therefore IFPHK is well positioned to understand the needs, concerns and aspirations of the long term insurance market practitioners. When formulating its response to the consultation, IFPHK has sought the views of its corporate members who are active in the market.

Executive Summary

The Financial Services and the Treasury Bureau ("FSTB") issued the Consultation Paper on Proposed Establishment of a Policyholders' Protection Fund (the "Consultation Paper") in March 2011. It then invited comments from market participants and the public on the relevant proposals set out in the Consultation Paper.

The Consultation Paper explains FSTB's proposals to establish a Policyholders; Protection Fund ("PPF") as a safety net to better protect policyholders' interests, to maintain market stability in the event of insurer insolvency, and increase public confidence and competition in the insurance industry. To this end, the Consultation Paper provides for various proposals on the objectives of the PPF, its coverage, the level of compensation and application, a funding mechanism, and governance arrangement.

In considering the proposed changes outlined in the Consultation Paper, IFPHK feels the following principles should be strictly adhered to;

- The PPF should deliver measurable benefits to the insurance industry in the medium and long term, and enable a healthy and sustainable business environment for the industry to thrive in by maintaining the stability of the market.
- The PPF should support the delivery of better insurance products and services to benefit and protect members of the public.
- The PPF should not operate at a cost that exceeds the benefits delivered to the industry and the investing public.

Due to differences within the industry, Hong Kong lags behind in the development of a comprehensive protection scheme for policyholders. In the wake of the financial crisis there is an urgent need to enhance consumer protection and restore public confidence by establishing a PPF. However, it is inevitable that costs will be incurred in setting up and administering such a compensation fund. The IFPHK believes the challenge will be to ensure that the limited resources available are used to help maintain high levels of consumer confidence in the insurance industry, and to compensate policyholders in the event of an insurer's insolvency.

In conclusion, IFPHK supports most of the proposed changes set out in the Consultation Paper including:

- A PPF should be established by statute with the objective of providing **last resort to policyholders**. The PPF should be complementary to the regulatory standards and requirements laid down by the Insurance Authority under the Insurance Companies Ordinance.
- The PPF should **comprise two separate schemes** for life and non-life insurance products. The PPF should **cover all individuals and SMEs,** but should exclude professional policyholders on the basis that they have more resources to perform due diligence on insurers and insurance products.
- The activating conditions of the PPF should be clearly stated in the legislation, and **compensation limits** should be applied to the PPF in order to mitigate the risk of moral hazard.

- The primary objective for the Life Scheme should be to facilitate a transfer of insurance policies in case of insurer's insolvency. On the other hand, the primary objective for the Non-life Scheme is to pay out compensation to claimants. Therefore, the **operation procedure** of the PPF should clearly align with the above objectives, and it should be clearly defined in the legislation.
- The PPF should apply the **progressive funding model** to accumulate fund size gradually. In case of shortfall, the PPF is empowered to borrow money from third party with the approval of the legislative council. This approach strikes a balance between the need for visibility of sufficient funds to protect policyholders, and the demand of insurers for keeping costs low.
- The PPF should apply the simplest method of calculating contributions by setting **a levy rate on the premium**.
- The PPF should be **administered by a small independent body with low overheads**. The independent body should have the flexibility to engage additional staff or experts in cases of insolvency.

While IFPHK agrees with the principles and rationale of setting up a PPF, IFPHK shares the industry's concerns regarding the possibility of high cost incurred in the operation and administration of the fund. IFPHK believes it is important to build a scheme that is simple and cost-effective. As such, IFPHK proposes the following suggestions:

- The Government should provide a **defined list of insurance classes, eligible persons and eligible claimants** to the industry and the public in order to avoid any confusion or misunderstanding that may arise.
- The Government should consider **fully guaranteeing the third party risk insurance by owner's corporation** in order to align it with other compulsory schemes such as the Motor Insurer's Bureau of Hong Kong, and the Employees Compensation Insurer Insolvency Bureau.
- A **detailed payout procedure** which will be administered by a small operation should be established, and it should be constantly tested and reviewed in order to maintain and enhance its readiness and effectiveness in paying claims to eligible claimants.
- The Government should establish and obtain consensus from the industry on the **mechanism of charging a stepped-up levy** in order to ensure that it will not add onerous cost to the industry
- The administration of the PPF Board shall be kept to a minimum by **sharing resources** with the Insurance Authority and integrating it with the operation of the two existing schemes.

The statements given in IFPHK's response to the Consultation Paper are based on an objective and independent analysis of the market and consumer needs. To ensure that IFPHK understands the concerns and practicality of the issue, it sought comments from active industry practitioners who deal with this issue on a regular basis. It should also be noted that the views and recommendations outlined herein represents the collective views of both IFPHK management team and selected industry representatives.

The Consultation

The Financial Services and the Treasury Bureau ("FSTB") issued the Consultation Document on the proposed establishment of a Policyholders' Protection Fund (the "Consultation Paper") on 25 March 2011. It then invited comments from market participants and the public on the relevant proposals set out in the Consultation Paper.

The Consultation Paper sets out the key features of the proposed Policyholders' Protection Fund ("PPF"), including its principles, coverage and level of compensation to policyholders or claimants, its funding mechanism and governance arrangement.

The PPF is intended to (a) better protect policyholders' interest; (b) maintain market stability and (c) enhance public confidence in and the competitiveness of the insurance industry.

The PPF will be comprised of two separate and independent schemes, namely the Life Scheme and the Non-Life Scheme. Both schemes are focused on individual policyholders, but may extend to small and medium enterprises ("SME") based on the results of this Consultation Paper. The limit of the compensation is proposed to be set at 100% for the first HKD100k, plus 80% of the remaining balance, up to a total of HKD1m. The compensation will be paid on a per-policy basis for life insurance and a per-claim basis for non-life insurance.

The PPF will adopt a progressive funding model under which an initial target fund will be built up with the option to impose a "stepped-up" levy rate in the event of an insurer's insolvency. To ensure that the PPF can make timely compensation payments and discharge its function, it should be allowed to borrow from a third party to bridge any liquidity gap.

In relation to governance and administration arrangements of the PPF, a governing body appointed by the Financial Secretary will be established by statue to administer the PPF and to handle appeals against relevant decisions made by the PPF.

The Consultation Paper contains five chapters relating to the following areas for the industry or public to provide comments:-

- Guiding Principles of the PPF;
- Coverage of the PPF;
- Level of Compensation and the Application;
- Funding Mechanism of the PPF; and
- Governance Arrangements of the PPF.

IFPHK Response Methodology

IFPHK is a professional body that seeks to promote higher professional standards in the financial planning industry. It feels that it is important to respond to consultation and policy papers that significantly impact the financial planning sector. When formulating its response to such papers, it takes a systematic approach that includes:

1. An independent and objective study of the proposals and their overall impact, both positive and negative, on the industry and consumers, based on theoretical and practical analysis.
2. Study of international practices in markets that are either more developed or similar to Hong Kong to understand how similar proposals may have succeeded or failed, and the reasons why that may have happened.
3. Collection of comments and opinions from industry participants, including legal and compliance professionals whose business practices may be impacted by the proposals in the Consultation Paper.

After collecting and consolidating the views of the industry, IFPHK analysed the information together with its own research in markets deemed relevant to the situation in Hong Kong, including Japan, European Union, the United Kingdom and Singapore, Canada and United States. The result enabled IFPHK to formulate responses to the various questions raised in the Consultation Paper, as well as make recommendations on the practical application and effectiveness of the relevant proposals and their likely impact on the industry.

The views expressed in this submission paper are not necessarily summaries of views from the industry, but the result of independent critical analysis and consideration by IFPHK as a professional body. As a result, not all the views collected by IFPHK are recorded in this submission paper and neither have all the views expressed in this submission paper been directly endorsed by the industry representatives or members who were consulted.

IFPHK Submission

This submission is the result of IFPHK's own independent internal analysis after seeking the views of its Members.

1. Guiding Principles of the PPF

The proposed PPF aims to better protect policyholders' interests, maintain market stability, and enhance public confidence. In order to achieve these objectives, the PPF should be established and designed based on the following four guiding principles:

- To strike a reasonable balance in enhancing protection for policyholders and minimising any additional burden to the insurance industry
- To enhance market stability while minimising the risk of moral hazard
- To provide certainty on the level of compensation payment to policyholders
- To align and complement the regulatory standards and requirements laid down by the Insurance Authority ("IA") under the Insurance Companies Ordinance ("ICO")

The ultimate purpose of the PPF is to provide a safety net in addition to the existing prudential regulation.

<u>IFPHK Response</u>

Insurance is a risk management business. Insurance products are essentially making a promise to deliver money in the future. For life insurance, policies have a long term horizon. Hence the soundness of an insurer is one of the key factors an individual considers when choosng an insurance policy. Although policyholders are the creditors of an insurance company and can recover claims through the insolvency procedure, the winding up and insolvency proceedings are often complex and time-consuming. Even if they can recover money from the insolvency procedure, the cancellation of insurance contracts can result in a loss of risk transfer as policyholders may find it difficult to take on a similar policy due to reasons such as a change in personal circumstances. In light of the above, it is not practical and sufficient to rely solely on the insolvency procedure to protect the interests of policyholders.

Failure of an insurer, especially a large one, can have a far reaching impact. If an insurance company goes bankrupt and its policyholders suffer losses, the general public may lose confidence in the soundness of other insurers and may be discouraged from seeking insurance, which would result in broader negative implications across the industry and society as a whole. In consideration of this domino effect, it is pertinent to establish a safety net to protect the interests of policyholders in addition to the prudential regulation which governs the financial soundness of insurers.

Over the past decade industry views have been mixed on the launching of a PPF in Hong Kong. A consultancy study conducted in 2003 on the feasibility of establishing a PPF indicated that several insurers and insurance intermediary associations did not believe a PPF should be implemented as they were concerned that 'moral hazard risk' would encourage some consumers and insurers to take greater risk. They were also concerned about the additional cost of a PPF scheme[3]. Some argued that a PPF was not a cure for insolvency, and Hong Kong has sound regulator to maintain

[3] PricewaterhouseCoopers, Feasibility of Establishing Policyholders' Protection Funds in Hong Kong, December 2003.

the soundness and stability of the insurance industry. Because of these diverse views, Hong Kong has been sluggish in the development of a PPF, despite a compensation scheme having been established for compulsory class of insurances[4].

The global financial market and the international regulatory environment have changed significantly since the last consultation in 2004. It is evident that insurance companies are not immune from financial crisis. Insurance and reinsurance companies are major investors in capital markets, and their investment portfolios include exposure to sub-prime residential mortgaged-backed and related securities. The credit rating outlook for the US life insurance sector was revised to "negative" from "stable" during Q3 2008 by at least one of the three major rating agencies[5]. The impact of the "nationalization" of American Insurance Group ("AIG") spilled over to other countries. In Hong Kong the insurance regulator ring-fenced the assets of the local subsidiary of AIG in order to protect local policyholders[6]. According to the annual report of Office of the Commissioner of Insurance ("OCI"), consumer confidence plummeted to an all time low in Q1 of 2009 and office premiums for new individual life business fell, mostly due to substantial decreases in investment-linked business. The number of complaints also skyrocketed[7]. In 2009 the industry witnessed the fall of a general insurer. Anglo-Starlite made the local headlines owing to allegations of fraud contributing to the insolvency. Anglo-Starlite insured a large share of the taxi market. Fortunately many policyholders were protected under the MIB. In the aftermath of the financial crisis there was general recognition that in spite of supervisory measures, it is inevitable that some insurance companies will encounter serious financial difficulties which could seriously harm the confidence of policyholders. As such, there is urgency to developing a policyholder compensation scheme similar to the deposit protection[8] and the securities investors' compensation arrangements[9] already established in Hong Kong, in order to regain consumer confidence. Some industry participants have already urged the Government to accelerate the process of establishing a PPF.

Indeed, Insurance policyholder protection schemes are becoming more widespread in financial system around the world and are fairly common among advanced economies. For example, at least 21 OECD countries are reported to have in place or are implementing schemes for life and general insurance products[10]. Though many focus on protecting claimants under compulsory classes of insurance, 9 of the 21 schemes extend beyond compulsory classes. These include Canada, France, Ireland, Japan, Korea, Norway, Poland, the United Kingdom and the United States.[11]

The financial crisis has awakened the industry and the public to the importance of having some kind of protection scheme for insurance policies. The benefits of a PPF to the economy include;

- Helps to maintain public confidence in, and foster development of, the insurance industry.

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[4] Hong Kong already has compensation schemes in place for non-life insurance policies covering third party motor vehicle accident victims and employees' work related injuries. These types of insurance policies are compulsory under law. Motor third-party liability insurance and employee's compensation insurance are covered by the Insolvency Fund are administered by the Motor Insurers' Bureau of Hong Kong respectively

[5] Sebastian Schich, Insurance Companies and the Financial Crisis, OECD Journal 2009/2

[6] IMF, People's Republic of China – Hong Kong Special Administrative Region: 2008 Article IV Consultation Discussion – Staff Report; Staff Statement; and Public Information Notice on the Executive Board Discussion, December 2008.

[7] OCI annual report 2009

[8] Following bank runs in Hong Kong after the failure of BCCI, the Hong Kong Deposit Protection Scheme (DPS) was established in 2004. It will pay compensation up to HK$100,000 per depositor if a bank is insolvent.

[9] The Investor Compensation Fund was established under the Securities and Futures Ordinance (Cap. 571). It 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 Stock Exchange.

[10] Gillian Garcia and Henriette Prast, Depositor and investor protection in the EU and the Netherlands: a brief history

[11] Takahiro Yasui, Policyholder Protection Funds: Rationale and Structure, 2001 OECD

- Makes it possible to handle bankruptcy cases without exposing policyholders to risk of severe loss.

Hong Kong is behind the curve with respect to developing a PPF. In 2003 the IMF noted Hong Kong's lack of a compensation mechanism in the context of insurance, albeit protection schemes for compulsory insurance already in place. Hence, IFPHK supports the proposal of establishing a PPF by statue, with the primary objective of protecting the interests of policyholders. However, costs should be kept low for both insurers and policyholders.

2. Coverage of the PPF

Considering that the majority of compensation funds in other jurisdictions cover only natural persons and corporates are normally excluded because of their ability to protect their interests and manage their risks when buying policies, the FSTB proposes to focus on individual policyholders. However, the coverage may be extended to small and medium enterprise ("SME") depending on the result of the Consultation Paper. As PPFs normally cover all compulsory classes of insurance, the proposed PPF will include building owners' ("OC") as policyholders as defined under the mandatory requirement in place since 1 January 2011.

In light of the different nature of life and non-life policies, the PPF will consist of two separate schemes – the Life Scheme and the Non-life Scheme. The Life Scheme will cover all **direct** life policies written in Hong Kong. The Non-Life Scheme will cover all **direct** non-life insurance policies written in Hong Kong, except those that are already covered by the MIB and the ECIIB.

There will be no cross subsidiaries for the two Schemes, and the levies collected are to be kept in separate accounts. The coverage will be based on a per policy basis. All in-force polices as at the date of the introduction of the PPF as well as new policies issued thereafter will be covered by the two Schemes.

The proposed definitions of life policies and non-life insurance policies are provided in the Consultation Paper, in which;

- Life policies: insurance policies that pay benefits related to the life status of the policyholders, such as term life polices, whole life policies, endowment policies, annuities, investment-linked policies and permanent disability policies.
- Non-life policies: direct non-life insurance policies written in Hong Kong, except those that are already covered by existing schemes, common types including accident and health policies, home insurance policies, fire insurance policies, travel insurance policies, and third party risk liability insurance policies held by owner's corporations.

<u>IFPHK Response</u>

Covering all types of insurance, and natural and legal persons, might be excessively costly and increase the risk of moral hazard. In order to reduce the cost and risk, eligibility should be restricted to insurance business and persons who satisfy certain criteria. IFPHK's views on the proposed restrictions as stipulated in the Consultation Paper are as follows:

Scheme structure of the PPF

IFPHK acknowledges that life insurance and non-life insurance are of totally different nature and structure. The former is usually long-term while the latter is generally short-term. Thus it would be sensible to separate the PPF into two Schemes. Despite general agreement on the scope of life and non-life insurance, there should be a defined list of insurance business covered under the two schemes. The list should use terms that align with those stipulated in Part 2 and Part 3 of Schedule 1 of the Insurance Companies Ordinance ("ICO"), which uses terms likes "classes of long term business" and "general business".

Insurance classes covered by the PPF

Most existing non-life schemes in other jurisdictions are not general scheme and do not cover all products. Professional business class is normally excluded because these products are designed particularly for corporations. In the UK the PPF does not cover policies written by Lloyd's as the insurer has its own enactment[12]. IFPHK noted that general business classes stated on Part 3 of Schedule 1 of the ICO include professional insurance business such as aircraft, credit, etc. Although the policyholders of these professional insurance classes are usually large corporations which are excluded from the proposed PPF, a defined list of insurance business covered by the PPF is still desirable to gain widespread understanding and to avoid confusion.

Eligible persons covered by the PPF

There is general consensus that professional policyholders (e.g. large corporations) shall be excluded from the PPF as these policyholders have the financial resources and internal expertise to assess the risks of an insurer and an insurance product. However, opinion is split on whether the PPF should cover small and medium enterprises policyholders. Depending on the agreed definition of small and medium enterprises ("SME"), IFPHK considers it fair to extend PPF coverage to SMEs. The insolvency of Anglo Starlite Insurance indicated that SMEs can also be vulnerable to loss resulting from the failure of insurance companies[13]. To qualify as an SME, the Government proposes to use the definition in the SME[14] Loan Guarantee Scheme. While IFPHK agrees the simplest method to classify a SME is by the number of employees, such a method might pose administrative difficulties to the insurers, especially if they are obliged to ascertain the eligibility of a client upon each policy renewal. As such, the Government should engage active dialogue with the insurers and the professional bodies to come up with an agreeable definition of SME. Agreement should be reached before finalizing the PPF proposals. IPFHK suggests the following items be included in the discussion with insurers and professional bodies:

- The time reference of qualifying a policyholder as SME (e.g. at the start date of the policy)
- The obligations of the insurers on ascertaining and confirming whether a client fulfills the requirement to be a SME
- The evidential requirements of proving a policyholder's eligibility of being a SME (e.g. self declaration)
- The definition of number of persons and whether they include full-time, part-time and contract staff.

[12] G V Rao, Policyholders' Protection Fund – Rationale for is Creation

[13] Anglo-Starlite insured a large share of the taxi market and policyholders were protected under the MIB

[14] In accordance to the eligibility criteria of the SME Loan Guarantee Scheme, the definition of SME is as follows:

- A manufacturing business[14] which employs fewer than 100 persons in Hong Kong;
- Non-manufacturing business which employs fewer than 50 persons in Hong Kong.

Apart from the definition of SME, some industry players would like to seek greater clarification on the distinction between policyholder, claimant and beneficiary. Some consumers would use an investment company or trustee as the policyholder. Since eligibility of the PPF is based upon the status of the policyholder and not the claimant or beneficiary, if the investment company or trustee is not qualified to be a SME, these consumers are not entitled to the protection of the PPF under the existing proposal. Since insurance intermediaries have the responsibility of disclosing to clients a loss of protection, the Government should provide clear guidance and training to the industry in order to avoid unnecessary disputes.

In summary, defining and designing eligible coverage of the PPF would require special attention, and the Government should hold more rounds of discussions with the industry. To eliminate doubt and confusion, IFPHK suggests any legislation should clearly define and set out the following:

- Eligible persons (e.g. natural persons, SME)
- Eligible claimants
- Type of insurance covered under the Life Scheme of the PPF
- Type of insurance covered under the Non-Life Scheme of the PPF
- Exclusions of the PPF

3. Level of Compensation and the Application

To ensure transparency and certainty, the Consultation Paper provides a list of conditions for activating the PPF. These conditions include a winding up order in Hong Kong, or when insurers are unable to pay their debts or relevant claims, or similar events concerning the insurer have occurred in any jurisdiction outside Hong Kong.

To curb any moral hazard the PPF applies a percentage limit as well as a dollar cap on compensation amounts. The compensation limit proposed in the Consultation Paper is 100% for the first HKD100k of any claim, plus 80% of the balance up to a total compensation limit of HKD1m. For life insurance the compensation limit would be applied on a per-policy basis. For non-life insurance the compensation limit would be applied on a per-claim basis. FTSB suggests that there should not be any cut-off date for the submission of claims.

In the event of insolvency of an insurer, a manager/provisional liquidator/liquidator (collectively referred as the “liquidator”) will be appointed to carry on the business of the insurer concerned. The liquidator will liaise closely with the proposed PPF Board in managing the policies and claims of the insolvent insurer. Different courses of action for different types of policies have been suggested in the Consultation Paper.

a. Life Scheme

Owing to the long term nature of life insurance products, the first priority of the liquidator will be to seek to transfer life policies from the insolvent to solvent insurer. The Life Scheme would facilitate the transfer of policies to a replacement insurer, and be given the flexibility to make a payment to facilitate the transfer up to the compensation limit. Policyholders will have a choice to terminate their policy(ies) and be entitled to the cash, account value, or accumulated benefits, up to the compensation limit, but without the “ex-gratia” payment. In case of transfer not being available, the policies will either continue until expiry and the Life Scheme will settle any claims arising subject to the compensation limit, or policies will be terminated and the Life Scheme would pay the affected policyholders the cash or account value of the policy, plus a dividend or bonus and ex-gratia payment, subject to the compensation limit.

b. Non-life Scheme
   As non-life insurance contracts are of a shorter period, the Non-Life Scheme would provide for continuity of coverage until the expiry of all policies. The Non-Life Scheme will meet the claims arising from all covered policies, subject to the compensation limit. Certain accident and health policies (A&H) provide for guaranteed renewability. The PPF will seek to transfer such policies to another insurer and allow the PPF to make a payment to facilitate the transfer, up to the compensation limit. If transfer is not possible, the PPF may pay to the affected policyholders an "ex-gratia" payment having regard to the premium differential if the policy holder wants to procure a similar policy from another insurance company subject to the compensation limit.

<u>IFPHK Response</u>

Since the compensation amounts and the actual application of the PPF have direct impact on the effectiveness of the PPF to enhance public confidence, it should be properly designed to ensure the visibility of a safety net, but not so prominent to stimulate risky behavior by consumers and insurers. IFPHK's views on the compensation level and the proposed application process of the PPF are as follows:

Activating conditions
Sometimes policyholders in Hong Kong are affected by the failure of insurers in other jurisdictions, as was seen with the collapse of HIH, Australia's second largest insurer. In 2001 the main HIH companies in Hong Kong entered into an insolvent scheme of arrangement where some policyholders were entitled to receive compensation from the MIB and the EC insurance claims. However, other policyholders were not eligible to receive compensation. In view of the HIH insolvency and the recent "nationalisation" of AIG as mentioned in (1), IFPHK believes it pragmatic and reasonable to include insolvency events outside Hong Kong that have an impact on policyholders in Hong Kong into the activating conditions of the PPF.

Compensation limits
Where there is a safety net consumers may be less inclined to perform due diligence when selecting an insurer, and seek out the cheapest products regardless of the risk. The lack of risk adverse behavior among consumers is likely to give incentives to insurance companies for increased risk-taking. A PPF might subsidise mismanagement by one insurance company at the expense of another that runs its business in a prudent manner. It is unfair for prudently managed insurers to have to contend with reckless competitors that adopt aggressive management and pricing strategies. This situation could seriously undermine sound and fair competition in the industry. To curb the potential for moral hazard risk arising from the PPF, most jurisdictions do not compensate consumers for the full amount, except for compulsory insurance. The PPF will be used for bridging the timing gap between the failure of an insurer to pay a claim and the claimants finally obtaining money from the insolvency procedure, and is not intended to compensate policyholders' for risk taking behavior. Ultimately, it is the policyholder's responsibility to select an insurer and insurance policy in a prudent manner. As such, IFPHK considers it appropriate to establish compensation limits on the claims to the PPF in order to contain cost, and to mitigate against moral hazard risk.

Consistent approach towards compulsory insurance
As mentioned in (1), compulsory insurance is generally fully guaranteed because compulsory insurance is intended to provide a secure fund of compensation for the victims of accidents. If government demands that people buy certain insurance, they also have a special responsibility to

ensure the soundness of these insurers. At present, there are two compensation schemes on compulsory insurance running in Hong Kong:

1. Insolvency protection for motor vehicle policies is provided by the Insolvency Fund Scheme ("IFS") administered by the Motor Insurers' Bureau ("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. The IFS is to satisfy any claim where the policy of insurance is ineffective due to the inability of an insurer to pay its debts by reasons of its insolvency.
2. The Employees Compensation Insurer Insolvency Scheme ("ECIIS") is administered by a limited liability company the Employees Compensation Insurer Insolvency Bureau which is established by the insurance industry. Insurers contribute ECIIS at a rate of 2% of EC premiums. The ECIIS is responsible for protecting EC policyholders from insurer insolvency.

Presumably the establishment of PPF in Hong Kong would not warrant any change to existing compensation schemes. The mandatory requirement for owners' corporation ("OC") to procure third party risk insurance took effect on 1 January 2011. IFPHK noted it was proposed that OC be included in the PPF, and thereby claims from this insurance are subject to the compensation limits of the PPF. To be consistent with the existing schemes for compulsory insurance, compensation for all building owner's corporation should be fully guaranteed. It might therefore be viable and economical to consolidate the operations of the three compulsory insurances. The governance arrangement of the PPF will be further discussed in (5).

Application of the PPF

Even if policyholders are able to recover part of their savings from the judicial procedure, they may not succeed in finding similar coverage because of changes in personal circumstances. Owing to the long-term nature of life products, policyholders are often considered better off by continuing with their contracts rather than having contracts immediately terminated and receiving cash compensation. In contrast, non-life insurance is generally short-term. Therefore, the continuation of contracts is considered less important than the efficient handling of the insolvency case and settlement of the outstanding claims. Therefore the proposed course of action is pertinent to the objectives of the PPF.

Payout procedure of the PPF

The fundamental objective of PPF is to compensate losses to policyholders in the event of insolvency of an insurer before they can recover their money from the judicial process. The basic operation of the PPF is to efficiently compensate eligible claimants. The PPF then recovers payments from the judicial insolvency procedure. In order to minimize claims handling costs and to ensure the smooth running of the payout process, a detailed payout procedure should be drafted, and a small dedicated team within the proposed PPF Board shall be established to familiarise with the payout procedure. The PPF can also adopt the queuing system used by MIB and ECIIB in handling outstanding claims, if claims against the scheme exceed the amount of funds available at a given date and claims are paid out in the order in which they were presented to the scheme. IFPHK also suggests the government adopt the practice of the Deposit Protection Board ("DBP") by having a small operation department to conduct regular payout rehearsals and simulation tests in order to maintain and enhance the readiness of its payout infrastructure, and effectiveness of the PPF's payout procedure.

4. Funding Mechanism of the PPF

Having considered three possible funding models, FTSB considers the progressive funding model a more pragmatic approach as it ensures the availability of an upfront reserve and maintains the flexibility to increase the levy rate to meet actual needs. FTSB proposes an initial levy of 0.07% of the office premium and the gross written premium until the PPF has reached its target size. The target fund size for Life Scheme and Non Life Scheme are HKD1.2b and HKD75m respectively. FSTB anticipates building up the initial target fund in 15 years. The target fund size and the levy rate will be reviewed on a regular basis.

If the funds are not sufficient to meet all such liabilities, a "stepped-up" levy may be collected to bridge the liquidity gap. The PPF is also allowed to borrow from a third party to bridge any liquidity gap. The approval of the Legislative Council would be required.

The Consultation Paper also contains an asset recovery mechanism in order to enable the PPF to make claims against the estate of the insolvent insurer. The PPF should have equal ranking with the two classes of creditors specified in section 265 of the Company Ordinance i.e. the Employee Compensation Assistance Fund, and all other direct insurance claims not met by the PPF.

IFPHK Response

The funding model of PPF varies across different jurisdictions and each is unique. Despite the differences most people would recognize that the funding mechanism is crucial for building an effective PPF. The funding mechanism not only determines the level of protection, but can have important implications on the cost to the industry. It should be mindful that the levies imposed on insurers might translate into costs for policyholders.

Funding mechanism
Lessons learned from international experience show that the final cost of a given failure can be difficult to predict, and can vary widely in each case. The value may not materialise until after the failure of the insurer. This makes determining the level of potential exposure of a failure problematic, and therefore there is no perfect funding model where one size fits all. Each funding mechanism has advantages and shortfalls. Pre-funding allows for better predictability for member companies concerning future financial burdens, but bear higher setup and operational costs than post-funding. Post-funding has the advantage in that it requires virtually no administration cost until insolvency, but may hinder prompt pay-out to policyholders, and may increase pro-cyclical effect as insurers are more likely to fail in economic difficulties[15]. One of the objectives of the PPF is to provide a safety net that should enhance public confidence. To this end, the existence of a sufficient amount of funds for policyholder protection ensures the visibility of a safety net and thus contributes to the maintenance of public confidence in the industry[16]. IFPHK prefers to adopt the progressive funding approach to balance the need to ensure visibility of sufficient funding and to avoid adding onerous costs to insurers. When a larger company fails, a large amount of funds needs to be used to protect the interests of policyholders. In order to deal with the case swiftly, IFPHK concurs with the

[15] European Commission, White paper on Insurance Guarantee Schemes, COM(2010)370.
[16] Hato Schmeiser & Joel Wagner, The impact of introducing insurance guaranty schemes on pricing and capital structures

proposal of equipping the PPF with the power to borrow from credit institutions given that the approval procedures are properly stated in the legislation. However, IFPHK would like to seek more clarification on the option of charging "stepped-up" levy. IFPHK and the industry player who IFPHK interviewed worries that empowering the PPF with a "stepped-up" levy option without laying down a detailed calculation mechanism, a detailed approval and collection process and a cap on the stepped-up levy would be onerous to the industry and is also unfair to other policyholders. As such, the Government should establish a detailed mechanism on the "stepped-up" levy, and such mechanism should be agreed by the industry prior to finalizing the proposal.

Target level
To address industry concerns regarding additional costs arising from the PPF, the government needs to introduce a target fund size to the two Schemes. Levies will be collected from member insurers until the target fund size is reached. Some industry players are concerned about whether the proposed target fund sizes, particularly the fund size of Non-life Scheme, will be adequate to meet the obligations resulting from an insurers' failure. For example, the target fund size of the Non-life Scheme is HKD75m, but the amount of outstanding claims from the failure of Anglo-Starlite amounted to HKD272m. Yet this only represents 0.5% of the general insurance market and 4.9% of the motor vehicle business in Hong Kong. IFPHK believes that compensation from PPF should only cover the payments at the initial stage to bridge the timing gap during lengthy judicial procedures. It is crucial to minimize costs to insurers so the target fund size should not be excessive. As of 31 December 2010, the retained surplus of the IFS and ECIIS were HKD921m and HKD591m respectively. Indeed, many policyholders were able to recover losses from MIB and ECIIB[17] in the case of Anglo-Starlite, and the remaining became preferential creditors.

Nonetheless, the recommendation of HKD75m as the initial target fund size for Non-life Scheme should be reconsidered with a revised actuarial modeling using more current data that includes OC since OC was only become effective as another compulsory insurance since January 2011. To alleviate the risk of funding shortfalls should a large insurer fail, IFPHK envisages that the PPF will have complementary post-funding arrangements and external credit facilities as mentioned earlier, in order to finance the shortfalls. Moreover, mechanism and procedures should be in place to constantly assess and monitor the sufficiency of PPF to meet its obligations, and the target fund size shall be adjusted accordingly.

Contributions calculation model
PPFs are typically funded by the industry. The contributions of insurance companies are normally calculated based on gross or net premiums as proposed in the Consultation Paper. The magnitudes of levies and calculation models are different across jurisdictions. Globally, there is no consensus on the adequate level of charge against the risk of insurer insolvency. The levy ranges from 0.125% (e.g. Malta) to a cap of 5% (hunters' liability insurance of Italy). For pure life business under the PPF scheme, the charge is calculated as a fraction of the net reserves of insurers e.g. Germany 0.02%, and France 0.05%[18]. Some countries apply risk-adjusted contributions in an endeavor to avoid placing an unfair burden on soundly managed companies and to give incentive to member companies to improve their financial soundness. In Korea, the assessment takes the risk factor into account. Insurance companies are categorised into three groups according to their respective financial soundness. The companies in the least risky group enjoy 5 percent discount to

[17] About 16,000 policyholders are involved, of which 15,906 being motor insurance policies and 32 employees compensation policies. Only 62 policies are not covered by any compensation scheme.
[18] Hato Schmeiser & Joel Wagner, The impact of introducing insurance guaranty schemes on pricing and capital structures

their contributions, while the contributions for those in the most risky category are increased by 5 percent[19]. Germany applies basic risk adjustment on the charges. The annual contribution of each firm is increased or decreased depending on the firm's equity capital relative to its solvency margin[20]. There are, however, arguments against the above approach, which include that it may increase insolvency cases by imposing a heavier burden on less profitable companies. IFPHK stresses that contributions from insurance companies should be mandatory, and the contribution rate must be assessed in a fair manner and collected in such a way as to avoid imposing excessive burden on the companies. As such, the levy framework and the organisation of the PPF should be relatively simple, and IFPHK concurs that the proposed calculation model based on premiums is the simplest way of collecting contributions from insurers. To further enjoy economies of scale for operation and administration of PPF, IFPHK recommends that resources should be shared among the existing agencies such as the Insurance Authority and the existing compensation scheme for compulsory insurance (i.e. MIB and ECIIB). The governance arrangement will be elaborated in (5) below.

5. Governance Arrangement of the PPF

FSTB proposed the PPF be established by legislation and administered by a statutory body. The PPF will be operated under the oversight of an independent governing body appointed by the Financial Secretary ("PPF Board"). The PPF Board will comprise professionals from different disciplines. Two industry committees, one for Life Scheme and one for the Non Life Scheme will be established. They will offer advice to the PPF Board on industry-related issues, such as the collection of levies and management of claims in the event of insurer insolvency. The functions and powers of the PPF Board will be stipulated in the statute. The annual budget of the PPF will be subject to approval by the FS. The FS would have the power to appoint the Director of Audit or an external auditor to perform audit reviews on the PPF.

The PPF Board is empowered to invest PPF funds that are not immediately required in low-risk vehicles such as deposits with banks, exchange fund bills, and sovereign bonds with good credit rating.

The PPF Board will maintain a small team of staff for daily operations and be empowered to engage additional staff or advisers in the event of insurer insolvency. The PPF Board and its staff should be required to keep confidential any information obtained in the course of carrying out their functions. Disclosure of information would be subjected to clear conditions as prescribed in law.

Similar to other statutory bodies, any person who is aggrieved by relevant decisions made under the PPF can file an application for a review of the decision with an Appeal Board. The Chairman and members of the Appeal Board will be appointed by the Chief Executive.

IFPHK Response

The PPF will be legally obliged to provide protection for policyholders in the event of insolvency of member insurers. When necessary to carry out their duties, they may enter into contracts to commission some operations, take legal actions and make concessions to recover their funds,

[19] Takahiro Yasui, Policyholder Protection Funds: Rationale and Structure, 2001 OECD

[20] Hato Schmeiser & Joel Wagner, The impact of introducing insurance guaranty schemes on pricing and capital structures

employ staff, and so on. IPFHK agrees that the PPF Board shall be established to perform the following functions:

- To manage and administer the PPF;
- To assess and collect contributions from insurers
- To recover from the assets of the insolvent insurer the compensation paid to policyholders or claimants;
- To invest the money of the PPF;
- To borrow money, after obtained approval from Legislative Council, to fill any funding gap;
- To make statutory rules, after consultation with the Financial Secretary, relation to the procedures for making compensations.

The ultimate objective of the PPFs is to provide a final safety net to policyholders and should only be complementary to prudential and regulatory supervisions. Therefore the PPF Board needs to be operated in close co-ordination with other relevant supervisory authorities. As the IFPHK repeatedly advocates in its submissions to Consultation Paper, the government should avoid duplicating and accumulating supervisory functions at a cost to taxpayers. The challenge to the government is to ensure that limited resources are used to help maintain high levels of consumer confidence in the insurance industry, and to compensate policyholders efficiently in the event of an insurer's insolvency. To this end, IFPHK recommends the PPF Board to share part of the resources with the proposed independent Insurance Authority. Similar arrangements exist between the deposit protection board ("DPB") and the Hong Kong Monetary Authority ("HKMA"). Pursuant to section 6 of the DPS Ordinance, the DPB shall perform its function through the HKMA unless indicated otherwise by the Financial Secretary. This means the HKMA assigns staff to assist the DPB in discharging its functions. An Executive Director of the HKMA is designated as the CEO of the DPB. The HKMA also supports the DPB on aspects such as accounting, administration, human resources, dealing and settlement of the DPB fund and information technology while the DPB has a full-time operation department to ensure the smooth running of the payout procedure. Such arrangement is different from the structure of the two existing compensation schemes. Both MIB and ECIIB were established by the insurance industry as non-profit making companies limited by guarantee. Both pledge to perform their functions as prescribed in the agreement they entered into with the Government. It should be mindful that running several offices for different compensation schemes can be costly, the operating expenses of IFS and ECIIS are HKD18m and HKD2m respectively for the year ended 31 December 2010. The Consultancy study in December 2003 suggested that it may be cost-effective to combine the supervision of non-life schemes with the existing MIB and ECIIB schemes[21]. To optimise resource allocation and minimise administration costs, IFPHK recommends the Government revisit the proposals with the industry and the relevant professional bodies to explore the feasibility of combining the operation of existing schemes into the proposed PPF Board.

Regarding the composition of the PPF Board, a typical PPF based on international experience is usually administered by a board of directors or governors. The boards usually consist of directors who represent member insurance companies. Many boards include independent directors who are expected to represent public or consumer interests. In some cases, the insurance commissioner or his representative sits on the board. IFPHK recommends the PPF Board apply the board composition of the DPB. The DPB currently comprises nine members who come from different professions, including two ex-officio members representing the HKMA and the Secretary for Financial Services and the Treasury. Similar to the practice of the DPB, members of the PPF Board

[21] PricewaterhouseCoopers, Feasibility of Establishing Policyholders' Protection Funds in Hong Kong, December 2003.

and its Committees should be subjected to a Code of Conduct which governs the confidentiality and conflicts of interest obligations of the board and committee members.

Two industry committees for the PPF Board will be established, one for the Life Scheme and one for the Non-life scheme. Since the PPF Board will be given power to invest the funds of the PPF, IFPHK agrees that the PPF Board should exercise a high level of prudence when investing with a prime objective of capital preservation, IFPHK thinks it is important to establish an investment policy which clearly list out the type of investment vehicles to be used for the PPF. IFPHK also recommends an investment committee with members having investment background be established to make recommendations on the investment policy of the PPF, to monitor the investment performance, and to establish proper controls on PPF's investment activities. The committee should be given appropriate power to exercise investment decisions that maximize investment returns provided they are in compliance with the investment policy.

IFPHK agrees with the establishment of an appeal board. The type of decision by the PPB Board that can be the subject of an appeal should be clearly defined in the legislation.

Conclusion

In principle, IFPHK welcomes the establishment of a policyholder protection fund. Most industry participants who IFPHK interviewed also see it as a positive development in enhancing the standard of the insurance industry.

Hong Kong is characterised by a large number of international insurers that compete with each other to offer a large variety of products giving consumers a lot more choice. In 2009, Hong Kong had 87 locally incorporated insurers. This is more than the UK (12), US (13) and Bermuda (14). The total gross insurance premium amounted to HKD189b in 2008, but slightly down to HKD186b in 2009 due to the financial crisis[22]. Whilst IFPHK believes the Government should provide a regulatory system and framework that allows the insurance industry to thrive in size and number of insurers, it is equally critical to establish a PPF that provides last-resort protection to safeguard the interests of consumers.

To this end, IFPHK recommends the protections system to be

- Clearly laid out in law and regulation
- Compulsory requirements for authorization
- Offer limited coverage so that professional investors can exercise market discipline and mitigate against moral hazard risk
- Maintain low setup and on-going administration costs
- Understood by member insurers and the public

The aim of having the proposals in the Consultation Paper is to provide more protection to policyholders and to enhance the stability of the insurance industry. The establishment of PPF will not replace any prudential and supervisory regulations. With the PPF, the insurance authority may feel less pressure for strict supervision to avoid any possibility of insolvency. IFPHK stresses that effective risk management and comprehensive governance structures are cornerstones of the insurance system. It should work in tandem with the PPF to create a level playing field between insurance companies and to ensure stability of the insurance market.

Finally, the economy and market is still recovering from the financial crisis. Therefore it is a good time for industry, regulators and professional bodies to work together to improve the regulatory regime and infrastructure. This will provide for better corporate governance, strengthening consumer confidence, and enhancing the quality and standard of the insurance market.

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[22] OCI, OECD-Asia Regional Seminar: Enhancing Transparency and Monitoring of Insurance Markets, Regional Experience: Hong Kong, September 2010.