Proposed Establishment of a Policyholders' Protection Fund

Frequently Asked Questions

Q1 Why do we need a Policyholders' Protection Fund ("PPF") and what benefits will it bring to Hong Kong?

A1 Any insurer who intends to carry on business in or from Hong Kong must be authorized under the Insurance Companies Ordinance (Cap 41) which stipulates the capital requirements and reserving requirements, as well as prudential supervision by the Insurance Authority ("IA"). This prudential regulatory regime seeks to ensure the financial stability of the insurance market and minimize insolvency risk of insurers. However, no matter how effective the regulation of the insurance industry is, the possibility of insurer insolvency in future cannot be totally avoided.

In many advanced economies, apart from prudential regulation, a policyholder compensation fund is in place to provide a safety net against insurer insolvency. The international financial crisis in 2008 and 2009, during which a number of large financial institutions faced financial difficulties, has highlighted the need for a compensation fund for policyholders.

Against this background, the Administration seeks to establish a PPF with a view to –

(a) better protecting policyholders' interest;
(b) maintaining market stability in the event of insurer insolvency; and
(c) enhancing public confidence in, and competitiveness of, the insurance industry.

To ensure a high level of certainty and transparency, we propose to establish the PPF by statute.

Q2 What is the coverage of the proposed PPF?

A2 Given the different nature of life and non-life policies, we recommend that two separate schemes, namely the Life Scheme and the Non-Life Scheme, should be set up under the PPF.

The Life Scheme will cover all direct life policies, such as term life policies, whole life policies, endowment policies, annuities, investment-linked policies and permanent disabilities 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 schemes administered by the Motor Insurance Bureau and the Employees Compensation Insurer Insolvency Bureau. The more common types include accident and health policies, home insurance policies, fire insurance policies, travel insurance policies and third party risks liability insurance policies of owners' corporations.

All authorized direct life and non-life insurers should be mandated by statute to participate in the PPF.

We recommend that the PPF would focus on individual policyholders. As it is mandatory for building owners' corporations ("OCs") to procure third party risks insurance, we also recommend to include OC policies in the coverage of the PPF.

We welcome views on whether the coverage of the PPF should be extended to cover small to medium enterprise[1] policyholders.

Q3 What level of protection will the proposed PPF offer to policyholders?

A3 Having regard to moral hazard issue, we recommend that a compensation limit for the PPF should be put in place, which is proposed to be set at 100% for the first HKD100,000 of any claim,

[1] A small to medium enterprise is defined in the context of the PPF as a manufacturing business which employs fewer than 100 persons in Hong Kong, or a non-manufacturing business which employs fewer than 50 persons in Hong Kong.

plus 80% of the balance, up to a total compensation limit of HKD1 million[2].

The compensation limit would be applied on a per-policy basis for life insurance and on a per-claim basis for non-life policies.

Based on industry data as at end 2009, the proposed compensation limit would be able to meet 90%-100% of the claims arising from some 90% of life policies. It would also be able to fully meet claims of some 96% of non-life policies.

Q4 **What is the funding mechanism of the proposed PPF?**

A4 Having studied three possible funding models i.e. the pre-funding model, post-funding model and progressive funding model, on balance, we recommend to adopt a progressive funding approach. This model will ensure the availability of an upfront reserve to meet at least part of future liabilities through an affordable level of levy which would avoid putting pressure on the premium levels or affecting the sustainability of the industry. At the same time, it will maintain the flexibility to increase the levy rate to meet actual needs.

The pre-funding model requires a high level of reserves to be built up as soon as possible in anticipation of all possible future liabilities. While this model offers the greatest certainty, it has the major drawback of locking up a huge amount of levies which in turn will put pressure on the premium levels.

The post-funding model seeks to collect levies after an insurer insolvency has occurred. Whilst it avoids the need to build up a reserve in advance or to administer a fund, it may require a very deep levy which could undermine the financial position of insurers, especially if the insolvency occurs during an economic downturn.

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[2] For example, a claim for HKD1.225 million would hit the compensation limit of HKD1 million, computed as: HKD100,000 × 100% + HKD(1,225,000-100,000) × 80% = HKD1,000,000.

Q5 **What is the target fund size of the proposed PPF, who will pay and what will be the levy rate?**

A5 We recommend that the initial target fund size should be HKD 1.2 billion for the Life Scheme and HKD75 million for the Non-Life Scheme. The plan is to build up the initial target fund in 15 years. The initial levy rates for both the PPF Life Scheme and PPF Non-Life Scheme should be set at 0.07% of the applicable premium.

As the PPF seeks to maintain market stability, promote industry competitiveness and address issues arising from insurer insolvency, we recommend that the PPF should collect the levies from insurers. International experience also strongly favours levy contribution by insurers.

Given the keen competition amongst insurers in Hong Kong and that the proposed levy is to be set at an affordable level, we believe the impact on the premium levels would be minimal.

Q6 **How PPF is going to compensate the policyholders in the event of insurer insolvency?**

A6 <u>Life Scheme</u>

Owing to the long-term nature of life insurance products, it will be in the interest of policyholders if their life policies could continue to be in force. The liquidator will therefore seek to transfer the policies to another insurer as a first priority. We recommend to allow the Life Scheme to make a payment to facilitate such a transfer, up to HKD1 million per policy.

In the unlikely event where policies cannot be transferred, the affected policies would be treated under one of the following two possible scenarios: (a) continuation of policies until expiry; and (b) termination of policies. For (a), we recommend that the Life Scheme should settle any claims arising, subject to the compensation limit set out in A3 above. As for (b), we recommend that the Life Scheme should pay the affected policyholders the cash / account value plus declared dividends / bonuses, and it may also pay an “ex-gratia” payment having regard to the losses arising from the premature termination of the policies. The total payment should be subject to a limit of HKD1 million per policy.

Non-life Scheme

Non-life insurance policies would normally have expired before the liquidation process is completed as they are usually in force for one year or a shorter period. We therefore recommend that the Non-Life Scheme should meet the claims arising from all covered policies subject to the compensation limit set out in A3 above, whether the insured incident occurs before or after the insolvency, and irrespective of whether the claim is submitted before or after the insolvency, subject to the time limit specified in the insurance policy (if any).

It is noted that in the case of an insurer insolvency, the policyholders of Accident & Health policies (either as standalone non-life policies or riders to life policies) with guaranteed renewability may suffer from a disadvantage in procuring alternative coverage. We therefore also recommend to allow the PPF to make a payment to facilitate the transfer of such policies to another insurer, up to the limit of HKD1 million per policy. In the unlikely event whereby such a transfer cannot be arranged, we recommend that the PPF may pay the affected policyholders, subject to a limit of HKD1 million per policy, an “ex-gratia” payment having regard to the premium differential if they are to procure similar policies from another insurance company.

Q7 **What measures will be taken to bridge any funding gap when the proposed PPF is still in its formative years?**

A7 We recommend to allow the PPF to borrow from a third party to bridge any liquidity gap, e.g. from commercial lenders for which the Government may act as the guarantor, or from the Government direct. In either case, approval of the Legislative Council would be required.

In the event that a liquidity gap does occur, the Administration will work closely with the PPF Board to facilitate the making of the most suitable arrangement for ensuring timely compensation payments and a sustainable scheme.

Q8 **Who will administer the PPF?**

A8 We recommend that a PPF Board appointed by the Financial Secretary should be established by legislation. The PPF Board should comprise professionals experienced in insurance, finance, accounting, law and consumer affairs etc, and ex-officio representatives from the Government. The PPF Board should maintain a small team of staff and be empowered to engage additional manpower or advisers in the event of insurer insolvency.

Q9 **When will the proposed PPF be established?**

A9 We have commenced a three-month public consultation on the proposals for a PPF on 25 March 2011. We will take into account the views and comments received from stakeholders and the public in finalizing the proposals which will form the basis for preparing legislation for the establishment of the PPF. We aim to announce the finalized proposals within 2011.

Q10 How and when to submit views?

A10 We welcome written comments on or before **24 June 2011** through any of the following means:

Mail: Special Duties Division, Financial Services Branch
Financial Services and the Treasury Bureau
18/F, Tower I
Admiralty Centre
18, Harcourt Road
Hong Kong
Fax : (852) 2527 0292
Email: ppf_consultation@fstb.gov.hk

Financial Services and the Treasury Bureau
Office of the Commissioner of Insurance
25 March 2011