Consultation on a Risk-based Capital
Framework for the Insurance Industry of Hong Kong

Consultation Conclusions

Background

1. The Insurance Authority ("IA") conducted a three-month consultation exercise from 16 September to 15 December 2014 to solicit views on the proposed Risk-based Capital ("RBC") framework for Hong Kong.

2. This consultation focuses on the objectives, overarching principles and proposed framework for the RBC regime for Hong Kong's insurance industry. It is proposed that the new RBC framework should adopt a multi-faceted modular approach comprising quantitative aspects (including assessment of capital adequacy and valuation), qualitative aspects (including enterprise risk management ("ERM") and governance) and disclosure.

3. The RBC regime would be developed in four phases ("the Project"):

- Phase I involves development of the framework and key approaches.

- Phase II will involve development of detailed rules. Quantitative impact study ("QIS") should be conducted for different types of insurers to ensure that the new regime is viable and practicable, and that it should not bring about instability to the insurance industry. Phase II would begin in 2015, to be followed by another consultation exercise.

- Phase III will involve amendment of legislation. At least two to three years will be needed to complete all the preparatory tasks including public consultations.

- Phase IV will be the implementation phase. The new RBC regime should be rolled out in phases with a sufficiently long run-in period, so that insurers will have adequate time to understand the requirements thoroughly, and be able to achieve full compliance incrementally.

4. We have engaged stakeholders extensively in arriving at the consultation conclusions. In addition to making the consultation document available to the public and stakeholders, we have organized briefing sessions for and meetings with insurance companies and professional bodies during the consultation period.

Outcome of Consultation

5. We have received 51 written submissions from insurers/ organizations. The list of respondents is at **Annex A**.

6. There is general support from the insurance industry for the move towards a risk-sensitive capital framework and the enhancement of risk management. While there is general agreement on the high level principles of the conceptual framework, there are mixed views on some of the technical aspects. The following paragraphs highlight the major comments received and our responses. Detailed comments on the proposals and our responses are at **Annex B**.

Major Comments Received and Our Responses

Pillar 1 – Quantitative Aspects

Capital adequacy

7. We proposed in the consultation document that a total balance sheet approach should be adopted and that two explicit solvency control levels, namely, the prescribed capital requirement ("PCR") and the minimum capital requirement ("MCR") be used. We further proposed that PCR should be set at a confidence level calculated using 99.5% value-at-risk ("VaR") over a one-year period.

8. There is general agreement with the total balance sheet approach for the measurement of risks, as well as the establishment of the two explicit solvency control levels.

9. In respect of the determination of PCR, there are mixed views on the inclusion of one year's forecast of new business in the calibration of PCR, with concerns over the subjectivity and practicalities involved in calculations and thus comparability across insurers. However, it should be noted that ICP[1] 17.6.3 stipulates that potential growth in an insurer's portfolio should be considered in establishing the regulatory capital level to provide an acceptable level of solvency. Noting the concerns, we will review if one year's forecast of new business should be included under the Pillar 1 capital framework and whether there are viable and effective alternatives. We consider that even if the one year's forecast of new business is to be assessed under Pillar 2, there would still be implications on capital adequacy as a result of the triggering of capital add-ons, particularly if the one year's forecast of new business does have significant impact on the insurer's portfolio.

Internal models

10. We proposed that the regulatory capital requirements should be determined using a standardized approach with the flexibility that internal models might be used, subject to the approval by the IA.

11. There is overall support for the adoption of a standardized approach as a starting point of the development of the RBC regime. A majority of the respondents support that flexibility should be retained to permit the use of internal models subject to the approval by the IA. A few respondents who object to the use of internal models highlight the need to ensure a level playing field. In response to such concern, we would like to emphasize that the use of an internal model has to be approved by the IA upon application and consideration would be given if the internal model covers the risks adopted for the standardized approach and the risks are assessed holistically in a comparable manner. Also, as part of the approval process, the insurer is required to demonstrate to the IA's satisfaction that the

[1] Insurance Core Principles ("ICPs") issued by the International Association of Insurance Supervisors, the global standard-setter for the insurance industry.

internal model is appropriate in respect of its Hong Kong business. We recognize that the standardized approach will enable a smooth and balanced transition to an RBC regime for the industry as a whole, while the use of internal models has the advantage of reflecting the specific risk profiles of insurers more accurately. We will work out the detailed requirements and approval process of internal models after the development of the standardized approach in Phase II of the Project.

Approach for risk assessment

12. We proposed to adopt a stress-test based approach[2] for (i) underwriting and market risks for insurers carrying on long-term business and (ii) market risk for insurers carrying on general business. For other risks, we proposed that a risk-factor based approach[3] be adopted.

13. Respondents generally agree with our proposal. Yet, some respondents comment that there should be allowance for risk diversification benefits, and an alternative approach might need to be considered for specific risks like catastrophe exposure. We will examine the dependencies and interrelationship between risks and the possibility of adopting alternative approaches during Phase II of the Project.

14. As regards operational risk, we proposed to adopt a simple approach initially, for example, by reference to premiums, new business and claims. Some respondents feel that volume-based methodology may not be appropriate for measuring the level of operational risk an insurer faces and may not incentivize good operational risk management. They suggest either not including operational risk under Pillar 1, or adopting alternative approaches (e.g. introduction of an operational risk management grading and scaling the operational risk capital requirement based on the grading). It is necessary to manage operational risk through ERM and Own Risk and Solvency Assessment ("ORSA") under Pillar 2. However, we consider that relying solely on Pillar 2 may not be adequate and one possible alternative is to apply capital add-ons where the IA considers that an insurer does not have an adequate risk management system. We will assess the feasibility of

[2] By specifying a set of stresses and modeling the impact on assets and liabilities
[3] By specifying a set of capital charges to be applied to key risk drivers

different approaches and consider after the QIS whether to apply capital add-ons or adopt other methodologies to quantify operational risk.

Capital resources

15. We proposed that the determination of capital resources be based on a tiering approach which categorized capital resources into different classes or tiers.

16. There is in-principle agreement with the tiering approach for determining the capital resources based on quality. Definition of the quality of capital for each tier will be developed during Phase II of the Project.

Valuation

17. Respondents generally agree to our proposal that the valuation of assets and liabilities should be undertaken on an internally consistent basis and that the determination of capital should be derived from the adjustments to the general purpose financial statements based on Hong Kong Financial Reporting Standards ("HKFRS") or International Financial Reporting Standards ("IFRS"). In this regard, we will closely monitor the development of IFRS 4 Insurance Contracts.

18. We proposed that the use of economic valuation should apply to all classes of business except Class G of long-term business, the valuation of which should remain the same as required under the existing Guidance Note on the Reserve Provision for Class G of Long Term Business ("GN 7"). However, a few respondents do not agree with our proposal and opine that the valuation basis and requirements for Class G business should align with those for other classes of business. We will further examine the approach to determining the capital requirements when calibrating Class G business during Phase II of the Project.

19. There are split views between the two proposed options of allowing either market consistent valuation approach for all classes of business, or a combination of both market consistent and amortized cost valuation bases depending on the class of business. Respondents supporting the market consistent valuation approach consider that such an approach can

reflect the current solvency position more accurately, while respondents in favour of a combination of market consistent and amortized cost approaches feel that a pure market consistent approach would lead to volatility. We consider that further analysis based on the QIS results is essential before drawing up a conclusion. In conjunction with the valuation approach, we will look into the discount rate to be adopted and the approach to be used for determining the margin over current estimate ("MOCE").

20. The IAIS launched a public consultation on Risk-based Global Insurance Capital Standard ("ICS")[4] in December 2014. It covers areas of valuation, qualifying capital resources, standard method for determining the ICS capital requirements as well as the possible approaches to measuring risks. Amongst all, it is noted that the IAIS has decided that an economic valuation approach would not be adopted because of the difficulty in gaining comparability. Instead, a market-adjusted valuation approach would be the initial basis for developing the ICS. The final ICS is targeted for agreement by the end of 2016. We will keep in view the development of the ICS.

Cash value floor

21. We proposed to require a cash value floor in the valuation of technical provisions. Many respondents express concern about the proposal. They feel that a cash value floor may not tally with the concurrent principle of economic valuation and assuming surrender of all policies would be overly conservative. Some respondents suggest alternative approaches, such as using stress tests for mass lapse in determining capital requirements. In proposing a cash value floor, we have taken into account practices in other jurisdictions. We consider that a certain level of cash value floor is desirable to address possible risk of mass lapse arising from adverse economic situations or confidence crisis. The suggested alternative approaches will also be examined during Phase II of the Project. Detailed assessment and comparison of the approaches will be conducted before drawing a conclusion.

[4] Once adopted, the ICS will apply to internationally active insurance groups ("IAIGs") as part of the IAIS' common framework for the supervision of IAIGs.

Pillar 2 – Qualitative Aspects

22. With the objective of fostering better risk management across the industry, there is overall support to our proposal for enhancing Pillar 2 requirements relating to ERM and ORSA. Some respondents are concerned that the requirements relating to investment might add restrictions to their investment management strategies and decisions. Our intention is to set out principle-based requirements, which will allow flexibility for individual companies to make their own investment decisions. Further guidance will be developed at the next phase.

23. Respondents generally agree with the early introduction of Pillar 2 requirements ahead of implementation of Pillar 1. A few respondents point out that Pillar 1 capital requirements would be necessary for the quantitative analysis within an ORSA report. We propose to introduce Pillar 2 requirements by phases where ORSA requirements may be introduced later than corporate governance and ERM requirements. Insurers will be given sufficient time to understand the Pillar 2 requirements before implementation.

24. In view of the diverse nature of the insurance industry in Hong Kong, we proposed the adoption of the principle of proportionality such that the new requirements under Pillar 2 are appropriate to the nature, scale and complexity of an insurer’s business. Most of the respondents agree with our proposal. We will examine the extent to which the principle of proportionality should apply with a view to developing a regime that provides adequate policyholder protection.

25. We also proposed that the IA should have the power to apply capital add-ons, in the event of inadequate corporate governance or ERM, to be commensurate with the scale and complexity of the insurer. Most of the respondents agree with our proposal. However, many of them state that it would be necessary to have a clear definition and transparent rules for the power to be invoked. Conceptually, the process of applying capital add-ons is a dynamic process between the IA and the insurer concerned, involving series of dialogues and assessments. The level of capital add-ons is expected to vary on a case-by-case basis. Details of the capital add-ons,

including the criteria, basis and the process of application will be developed during Phase II of the Project.

Pillar 3 – Disclosure

26. We proposed that, in addition to the statutory reporting requirement to the IA, insurers should disclose to the public information about their risk assessments, capital resources and capital requirements in their published accounts. Respondents generally agree with the disclosure requirements, but some of them comment that the extent and amount of information to be disclosed should be meaningful for policyholders. It is also important to ensure alignment with other disclosure requirements.

Group-wide supervision

On-shore and off-shore funds

27. We proposed that insurers should maintain separate funds for their on-shore and off-shore general and long-term insurance businesses.

28. There are mixed views on the proposal. Some respondents agree with segregating on-shore policyholders and the related assets from other businesses, while some other respondents feel that separate funds are not necessary and this would increase administrative and compliance burden. A few respondents consider that policyholders of on-shore and off-shore businesses should be given the same level of protection. We consider that, with the introduction of on-shore and off-shore funds, the IA would have more information on the insurer's assets and liabilities representing their insurance business through branch operations outside Hong Kong. This is essential for the prudential regulatory work of the IA. We will further examine the details and the comments received during Phase II of the Project.

Group-wide supervisory approach

29. We proposed that the IA should supervise insurers operating in Hong Kong on both a solo entity and group entity basis.

30. Respondents generally support the introduction of group-wide supervision. Some respondents comment that there should be no regulatory overlaps with other supervisors. We agree that regulatory overlaps should be avoided and it is necessary to develop an effective group-wide supervisory regime underpinned by effective coordination among supervisors.

31. Many respondents request further elaboration on the definition of "insurance subgroup". Similarly, some respondents are concerned about the duplication of regulatory requirements when a subgroup is part of a larger group which is subject to the supervision of a home supervisor. The objective of supervising subgroups is to allow the IA to be satisfied that their Hong Kong business is adequately protected from the impact of any adverse development in other sectors of the group. Where an insurance subgroup is part of the supervisory regime of a home supervisor, the IA would generally rely on the capital requirements imposed by the home supervisor on the subgroup, but the capital requirements imposed by the IA on each local entity of the subgroup would still prevail. As the subgroup's Hong Kong business may be substantial in the Hong Kong market, the IA would need to exercise supervisory measures on the subgroup under Pillars 2 and 3.

32. Respondents express concern about the complexity and practicality of the proposed three-tier group-wide supervisory approach. We understand that the concerns are mainly about Tier 2 requirements. Further details will be worked out during Phase II of the Project, with a view to striking a balance between the need for group-wide supervision and compliance burden.

Group-wide supervisory requirements

33. We proposed that the group-wide capital requirement should be based on a group level focus approach[5] and adopt the consolidation method[6]. More than half of the respondents agree with our proposal, while a few respondents prefer adopting the legal entity focus approach[7] or aggregation

[5] A separate assessment is made for the group as a whole on a consistent basis.
[6] The insurance group's consolidated accounts will be used as a basis for capital assessment with adjustments on intra-group holdings.
[7] Capital adequacy of the parent and each of the insurance legal entities in the insurance group are assessed individually, taking into account the risks arising from relationships within the group.

method[8]. Adopting the consolidation method has the benefit of ensuring consistent valuation for determining the capital requirement across the group. We also note the concern of individual respondents and have proposed a flexible approach where an insurance group may apply to the IA for deconsolidating particular subsidiaries and using aggregate method for those subsidiaries for the purpose of group-wide capital requirement.

34. In respect of Pillar 2 requirements on a group, some respondents comment that two sets of ORSA should be avoided. We will further examine if it is appropriate to use a group ORSA for a local entity operating in Hong Kong.

35. There is general acceptance of the proposed requirement on prior notification of material intra-group transactions as well as material events or transactions of the group. Some respondents suggest that the threshold should be predefined and set high enough to avoid massive reporting. Prior notification facilitates the IA to monitor possible group risks, interconnectedness of group entities and their potential impact on solvency, liquidity and profitability. We agree that the materiality level and scope should be carefully set to achieve the objective while at the same time reduce compliance burden. We will take these views into account when formulating the details.

Next Step

36. Since the industry accepts in principle the proposed conceptual framework, save some technical aspects, we will proceed to the next phase which involves developing the detailed rules and carrying out the QIS. After that, another consultation exercise will be conducted. We will continue to engage the industry during the process with a view to developing a practical and viable RBC regime which is most appropriate for the insurance industry of Hong Kong.

Office of the Commissioner of Insurance
30 September 2015

[8] Summation of surpluses or deficits for each insurance legal entity in the group with relevant adjustments for intra-group holdings is required.

Annex A

List of Respondents

1. ACE Insurance Limited
2. Actuarial Society of Hong Kong
3. Allianz Global Corporate & Specialty SE Hong Kong Branch
4. AIA Group Limited
5. AIG Insurance Hong Kong Limited
6. Asia Capital Reinsurance Group Pte. Ltd.
7. Atradius Credit Insurance N.V.
8. AXA
9. BEA Life Limited
10. BlackRock, Inc
11. Blue Cross (Asia-Pacific) Insurance Limited
12. BOC Group Life Assurance Company Limited
13. C.F. Yam
14. Chevalier Insurance Company Limited
15. China Ping An Insurance (Hong Kong) Company Limited
16. China Taiping Insurance (HK) Company Limited
17. China Taiping Insurance Holdings Company Limited
18. Compagnie Française d'Assurance pour le Commerce Extérieur Hong Kong Branch
19. Deloitte Consulting (Hong Kong) Limited
20. Ernst & Young Advisory Services Limited
21. Guy Carpenter & Co Private Limited
22. Hang Seng Insurance Company Limited
23. The Hong Kong Association of Banks
24. The Hong Kong Federation of Insurers
25. The Hong Kong Mortgage Corporation Limited
26. HSBC Insurance (Asia) Limited
27. Liberty Mutual Insurance Europe Limited

28. Lloyd’s
29. Manulife (International) Limited
30. MetLife Limited
31. Min Xin Insurance Company Limited
32. Minan Property And Casualty Insurance Company Limited
33. Munich Reinsurance Company
34. Peak Reinsurance Company Limited
35. Phoenix Life Limited
36. Prudential Hong Kong Limited
37. SCOR Reinsurance Company (Asia) Limited
38. Sun Life Hong Kong Limited
39. Swiss Reinsurance Company Ltd
40. Taiping Reinsurance Company Limited.
41. Towers Watson Hong Kong Limited
42. Transamerica Life (Bermuda) Ltd.
43. The West of England Ship Owners Mutual Insurance Association (Luxembourg)
44. Zurich Insurance (Hong Kong)
45.
46.
47.
48. * Seven respondents asked not to be identified.
49.
50.
51.

Annex B

<u>Summary of feedback on the consultation questions and responses from OCI</u>

Question 1

Do you agree that a total balance sheet approach should be adopted in the assessment of solvency, valuation of assets and liabilities and determination of capital resources? If not, why?

- Number of responses to the question: 34

- Comments received:
  - There is general agreement with the total balance sheet approach.
  - 3 respondents state that further elaboration would be needed on, say, valuation of assets and liabilities.

- Response from OCI:
  - We note that respondents generally agree with the total balance sheet approach.
  - The total balance sheet approach is a broad concept. Detailed proposals will be developed in Phase II of the Project.

Question 2

Do you agree that we should impose two different solvency control levels (PCR and MCR) explicitly? If not, why?

- Number of responses to the question: 37

- Comments received:
  - 33 respondents agree with the two different solvency control levels.
  - 5 respondents ask for more information on the supervisory actions for each of the two solvency control levels.
  - 3 respondents are concerned about the possibility of additional trigger points other than the MCR and PCR and consider that having more than two solvency control levels would be too complicated.
  - 3 respondents say they expect that there would be no supervisory actions above the PCR.

- Response from OCI:
  - Interventions would be triggered only if an insurer's solvency falls below the prescribed control levels.
  - Both the PCR and the MCR would be prescribed in the legislation, and the related regulatory measures will also be set out clearly.

Question 3

(i) Do you agree that PCR should be determined on a going-concern basis and allow for one year's forecast of new business?

- Number of responses to the question: 34

- Comments received:
  - 25 respondents agree with the determination of PCR on a going-concern basis.
  - 29 respondents have commented on the proposed allowance for one year's forecast of new business. Their views are mixed.
    - 11 out of the 14 respondents who have commented on short-term business agree with allowing for one year's new business for short-term business.
    - For long-term business, 14 respondents have expressed concern over the use of one year's forecast of new business to assess solvency, due to issues of subjectivity and practicalities in calculations, both of which may affect comparability across insurers.
    - 11 respondents have suggested alternative options, such as inclusion of one year's new business under Pillar 2 rather than Pillar 1.

- Response from OCI:
  - PCR will be determined on a going-concern basis.
  - We note the concerns and counter-suggestions regarding one year's forecast of new business.
  - However, ICP 17.6.3 stipulates that the potential growth in an insurer's portfolio should be considered in establishing the regulatory capital level to provide an acceptable level of solvency.
  - We will examine if one year's forecast of new business should be included in the Pillar 1 capital framework, and whether there can be viable and effective alternatives.
  - In any event, even if the forecast of one year's new business is to be

assessed under Pillar 2, there would still be implications for capital adequacy, as inadequate risk management under Pillar 2 may trigger capital add-ons, particularly if the one year's new business does have significant impact on the insurer's portfolio.

(ii) Do you agree with aligning PCR with a minimum investment grade based on VaR calculated at a 99.5% confidence level over a one-year time horizon?

- Number of responses to the question: 27

- Comments received:
  - 22 out of the 27 respondents express general agreement to the need to ensure consistency with international practice and the proposal to define target criteria over a one-year timeframe.
  - 3 respondents feel that the RBC system should focus on Asian needs and characteristics.
  - However, 14 respondents opine that the confidence level should be concluded only after the QIS has been completed to ensure reasonableness.
  - 2 respondents consider that other confidence levels or measures (for example, TVaR) should be allowed in calibration.
  - 4 respondents are concerned about the challenge of having insufficient data to calibrate 99.5% VaR.

- Response from OCI:
  - It should be noted that 99.5% VaR is commonly adopted in other jurisdictions, and is thus an appropriate basis in setting the target criteria.
  - The proposed target criteria of 99.5% VaR will need to go through the calibration and the QIS exercise to ensure that it is workable.
  - Stresses and factors specific to each line of business would be included in the calibration of the 99.5% VaR.

- o In practice, the calibration of 99.5% VaR would take the form of a set of parameters comprising common stresses and key factors for insurers to follow. These parameters will be tested during the QIS in Phase II of the Project and further discussion will focus on the parameters.

(iii) Do you agree that the same target criteria should be applied to all classes of business?

- Number of responses to the question: 25

- Comments received:
  - o 20 of the 25 respondents agree with the application of the same target criteria to all classes of business.
  - o In addition, 21 respondents consider that the target criteria should be consistently applied to all insurers.
  - o However, 3 respondents feel that different target criteria should be considered for different classes of business due to different nature of risks.
  - o 3 respondents suggest that the target criteria of 99.5% VaR should be calibrated on an entity level. Diversification benefits should then be taken into account if the target criteria are applied separately to each class of business within the entity.
  - o 3 respondents request further clarification of the calibration of Class G business, since we proposed to adopt the prevailing GN 7 (Guidance Note on the Reserve Provision for Class G of Long Term Business) requirements.

- Response from OCI:
  - o Different risks will be taken into account and calibrated during the QIS in determining PCR and the proposed set of parameters.
  - o We agree that policyholders of different classes of business should have the same level of protection. As a start, we will apply the same target criteria to all classes of business for the QIS testing.

- We will further examine in Phase II of the Project whether dependencies and interrelationship between risks can be allowed.
- Question 14 provides further details on Class G business.

Question 4

Do you agree that MCR should be designed as a simpler calculation than PCR? Do you agree that the level for MCR should be determined after the industry QIS has been carried out? If not, why?

Number of responses to the question: 35

- Comments received:
  - There is general agreement by 32 respondents that MCR should be simpler than PCR and the level of MCR should be determined after the QIS has been completed.
  - Respondents have diverse views on the approaches to determining the level of MCR:
    - 6 respondents consider that there should be consistency in the calculation for PCR and MCR and that MCR should be calibrated at a lower confidence level.
    - 5 respondents suggest that MCR should be determined at a certain percentage of PCR.
    - 5 respondents suggest a minimum monetary amount or a combination of minimum monetary amount and percentage of PCR.
    - 1 respondent propose a concept of “corridor” with a floor and a ceiling.
    - 2 respondents suggest that the gap between PCR and MCR should be sufficiently large.

- Response from OCI:
  - We will examine the various approaches regarding the determination of MCR and the appropriate level of MCR as part of the QIS.

Question 5

Do you agree with adopting a standardized approach as a starting point to reflect the nature and materiality of risks and calibration of PCR and MCR for all insurers while retaining the flexibility to allow internal models? If not, why?

- Number of responses to the question: 39

- Comments received:
  - There is general support to adopting a standardized approach for the calibration of PCR and MCR as a starting point.
  - 25 respondents have commented on the issue of whether flexibility should be retained to allow internal models.
  - 22 out of the 25 respondents support allowing internal models, and 4 respondents feel that internal models developed by the parent companies should be allowed at the initial stage after implementation of the new RBC system.
  - 3 respondents hold opposite views. They highlight the need to ensure a level playing field as well as the substantial resources involved in the approval process. Some suggest that internal models should not be allowed except for unusual and specific risks.
  - 5 respondents also comment that internal models should not be introduced at the initial stage but could be explored in the future.
  - 3 respondents express that there should be detailed transitional arrangements to migrate from a standardized approach to internal models approach.
  - 10 respondents consider that more information would be needed, especially in relation to the criteria for approving internal models.

- Response from OCI:
  - We note the overall support for a standardized approach.
  - In response to the concern of a level playing field, we would like to emphasize that the use of internal models has to be approved by the

IA upon application, and consideration would be given if the internal models cover the risks adopted for the standardized approach and the risks are assessed holistically in a comparable manner.

- In addition, these internal models being or having been approved by the lead supervisors would have been designed with the group's requirements. As such, rather than directly replicating the internal model used by the group, it is required to demonstrate to the IA's satisfaction that the internal model is appropriate in respect of its Hong Kong business as part of the approval process. Data, assumptions and calculations of the internal model, which may be maintained at group level, need to be maintained and accessible at the local entity level.

- We recognize that a standardized approach will enable a smooth and balanced transition to an RBC regime for the industry as a whole, while the use of internal models has the advantage of reflecting more accurately the specific risk profiles of insurers. Retaining the power of the IA to approve the use of internal models of individual insurers under the new RBC regime will help the IA and the industry get prepared when the industry becomes more sophisticated and is ready to move on to adopting internal models.

- It is inevitable that the detailed requirements and approval process of internal models will be worked out only after the development of the standardized approach. Since internal models could better integrate the processes of risk and capital management within an insurer, we highly encourage insurers to include internal models within their ERM and ORSA under Pillar 2, so as to help progression towards using internal models for capital assessment in the future, and foster the culture of risk assessment.

Question 6

Do you agree with the broad categories of risk that we have initially identified as driving capital requirements, namely, underwriting risk, market risk, credit risk and operational risk? Do you agree that other risks should be better dealt with through enhanced ERM? If not, why?

- Number of responses to the question: 36

- Comments received:
  - o 34 respondents generally agree that there is a general agreement that underwriting risk, market risk and credit risk should be the broad risk categories for the capital requirements under Pillar 1.
  - o 5 respondents request more details about each of the broad risk categories which would be studied in Phase II of the Project. Some suggest the incorporation of sub-risk categories when further details are available.
  - o 28 respondents agree that operational risk is a relevant and material risk faced by insurers, and that this risk should be assessed under Pillar 1.
  - o 6 respondents disagree with the inclusion of operational risk under Pillar 1. They consider that operational risk arises from the failure of internal control system, personnel, management, etc. Any proxy based on size or volume may not be able to reflect the actual operational risk borne by the insurers and hence, such risk should be addressed in the context of ERM and ORSA under Pillar 2.
  - o Some opine that risk diversification benefits should be allowed.

- Response from OCI:
  - o We have only stated the broad categories of risk for capital requirements. Individual sub-risk categories will be identified and calibrated during the QIS. In-depth information on approaches, methodologies and calculations will be developed in Phase II of the Project.

- We will examine the dependencies and interrelationship between risks, as well as the effect of risk diversification during the QIS.
- We note the industry's concern about the inclusion of operational risk under Pillar 1. Question 7 provides further details on operational risk.

Question 7

Do you agree that we should adopt a simple approach in defining capital requirements for operational risks based on premiums, new business and claims and be considered in the QIS? If not, why?

- Number of responses to the question: 35

- Comments received:
  - o 28 respondents agree with the inclusion of operational risk under Pillar 1. 16 of them agree with adopting a simple approach in defining operational risk capital requirements. 6 respondents object to including operational risk under Pillar 1.
  - o Regardless of their position on Pillar 1, 13 respondents feel that volume-based methodology may not be appropriate for measuring the level of operational risk, and may not incentivize good operational risk management.
  - o Alternative approaches put forward include:
    - ➢ 3 respondents suggest introduction of an operational risk management grading and scaling operational risk capital requirements based on the grading.
    - ➢ 3 respondents propose developing a series of simple factors to be applied to represent low, medium and high operational risk capital requirements.
    - ➢ 5 respondents suggest that measurement can be based on policy liabilities, change in number of policies, complexity of the business model, loss distribution approaches, etc.

- Response from OCI:
  - o Comments and counter-proposals noted.
  - o Operational risks arise from various factors such as procedures, systems, personnel and external events. Managing such risks through ERM and ORSA is a must.
  - o While sophisticated data may not be available to measure operational risks, relying solely on Pillar 2 requirements may not be adequate. One possible alternative is to apply capital add-ons where the IA

considers that an insurer does not have an adequate risk management system.

- We will assess the feasibility of different approaches and consider, after the QIS, whether to apply capital add-ons or adopt other methodologies to quantify operational risks.

Question 8

Do you agree that legal risk, liquidity risk, strategic risk and reputational risk should be addressed through risk management processes rather than by holding additional capital? If not, why?

- Number of responses to the question: 34

- Comments received:
  - There is general agreement with the proposal.

- Response from OCI:
  - Noted.

Question 9

Do you agree that liquidity risk should be dealt with through enhanced supervisory oversight of ALM rather than by prescribing minimum liquidity risk standards? If not, why?

- Number of responses to the question: 34

- Comments received:
  - There is general agreement with the proposal.

- Response from OCI:
  - Noted.

Question 10

Do you agree that a stress-test based approach should be adopted for underwriting and market risks for insurers carrying on long-term business and market risk for insurers carrying on general business? Do you agree that a risk-factor based approach should be adopted for other risks? If not, why?

- Number of responses to the question: 33

- Comments received:

  Long-term business (20 respondents)

  - 19 respondents agree that a stress-test based approach should be adopted for underwriting and market risks for long-term business.
  - 7 respondents consider that a stress-test based approach would be more appropriate for certain types of credit risk, for example, credit spread risk, credit risk on corporate bonds, etc.
  - 5 respondents request further information on how the loss absorbing capacity of certain products (e.g. participating policies) would be allowed during stresses.

  General business (23 respondents)

  - 20 respondents agree that a stress-test based approach should be adopted for market risk for general business.
  - 7 respondents feel that while they do not object to the proposed risk-factor based approach for underwriting risk of general business, they believe that a stress-test based approach or other approaches may be more suitable for such risk, and 3 of them have quoted catastrophe exposures as an example. They therefore suggest that a decision on whether a risk-factor based approach or a stress-test based approach should be adopted should only be made after the QIS exercise.

- Response from OCI:

  Long-term business

  - We will proceed to Phase II of the Project using the proposed approach.
  - Individual sub-risk categories will be identified and calibrated during the QIS. Treatment of credit risk and loss absorbing capacity of participating policies will be considered at that stage.

  General business

  - We will proceed with the proposed stress-test based approach for market risk.
  - We recognize the challenge of adopting a stress-test based approach for underwriting risk for some general insurers, and consider that a risk-factor based approach may be easier to understand and implement.
  - We propose to commence the QIS with the risk-factor based approach for underwriting risk. In respect of specific risks or classes of business, for example, catastrophe risk or monoline business, we may consider the possibility of adopting alternative approaches, subject to the QIS results.

Question 11

Do you agree to tier capital resources based on quality? What other approaches should we consider to quantitatively assess quality and suitability of capital?

- Number of responses to the question: 33

- Comments received:
  - 30 respondents agree with adopting a tiering approach for capital resources based on quality.
  - 3 respondents opine that two tiers of capital would be sufficient, with Tier 1 capital available on both going-concern basis and wind-up basis and Tier 2 capital available on wind-up basis.
  - 3 respondents comment that a clear definition of quality of capital needs to be given.
  - 4 respondents suggest that any new forms of capital instruments should be permitted should they be qualified for the definition.

- Response from OCI:
  - We will proceed with the tiering approach for capital resources based on quality.
  - Definition of quality of capital for each tier will be developed in Phase II of the Project, with due attention to the ability of the capital to absorb losses on going-concern basis as well as wind-up basis. The qualifying criteria of capital resources, instead of a list of capital instruments, is to be prescribed.
  - It is important to ensure that a capital instrument is able to meet all the qualifying criteria, which will be further examined during Phase II of the Project, before admitting it as capital resources. We have proposed that the IA will have the discretion to permit certain instruments to be counted wholly or partially as capital resources on a case-by-case basis.
  - We note the suggestion of several respondents for a two-tier system for classifying capital resources. Yet, it must also be pointed out

that having sub-tiers under Tier 1 capital is not an uncommon practice. The detailed composition and structure of tiered capital will be further examined during the QIS.

Question 12

Do you agree that recognition of insurance contracts should align with general purpose financial statements under HKFRS or IFRS? If not, why?

- Number of responses to the question: 32

- Comments received:
  - o Most (30 respondents) agree with the proposal to align recognition of insurance contracts with the general purpose financial statements under HKFRS or IFRS.
  - o 6 respondents have expressed views on the measurement of policy liabilities. Where the definition of contract boundary would be used to determine the cashflows to be included for the calculation of technical provisions, the definition might not be able to reflect the economic substance of the contracts, including the expectation of policy renewals for certain types of products and the ability of the insurers to re-price at renewal.
  - o 2 respondents ask for clarification regarding treatment of the combination of insurance contracts.
  - o 7 respondents note that the definition of contract boundary is still being examined by IASB.

- Response from OCI:
  - o We only proposed the approach to the recognition of insurance contracts rather than the means to determine the cashflows to be included in calculating the policy liabilities. We will align our recognition of insurance contracts with the general purpose financial statements.
  - o We have elaborated the contract boundary in the consultation paper based on the IASB's revised exposure draft on IFRS 4. We note the concern that products are priced and managed with the expectation that the contracts will remain in-force for years. Question 13 provides further details on the valuation of assets and liabilities.

- IFRS 4 is still under development. We will further consider this issue during the QIS.

Question 13

Do you agree to undertake valuation of assets and liabilities on an internally consistent basis and that the valuation of assets and liabilities to support the determination of capital should be derived from adjustments to the general purpose financial statements based on HKFRS or IFRS? Do you foresee any difficulties with this approach?

- Number of responses to the question: 34

- Comments received:
  - o 30 respondents agree in principle with the proposed approach.
  - o 5 respondents consider that the valuation basis should be consistent for all insurers. 4 respondents consider that valuation options allowed under HKFRS or IFRS and different accounting policies adopted by different insurers might not be consistent.
  - o 7 respondents suggest treatment for certain items, such as intangible assets and contractual service margin.
  - o 6 respondents consider that the valuation basis under HKFRS or IFRS might not be appropriate for solvency purpose, while another 2 respondents feel that adjustments to the general purpose financial statements should be minimized to avoid additional compliance burden.

- Response from OCI:
  - o We note the comments and suggestions, which will be examined during Phase II of the Project.
  - o While using the HKFRS or IFRS valuation basis as a starting point and making necessary adjustment for solvency purpose may be a pragmatic approach, we are mindful that the end result should be a capital requirement which is suitable and practicable for the local industry. Since IFRS 4 has yet to be finalized, it is uncertain at this juncture the form and extent of adjustments that have to be made.
  - o We will closely monitor the development of IFRS 4.

Question 14

Do you agree to use economic valuation for all classes of business except Class G of long-term business? Are there other classes of business which should adopt an alternative approach? Why?

- Number of responses to the question: 30

- Comments received:
  - 22 respondents agree to use economic valuation for all classes of business.
  - 8 respondents ask for further details on economic valuation.
  - Views are diverse on the exclusion of Class G business. While 2 respondents consider that the current valuation approach for Class G business should continue, 6 respondents opine that the valuation basis and requirements for Class G business should align with those for other classes of business.
  - 2 respondents have expressed concern over PCR for Class G business and whether additional capital is required to protect policyholders of Class G business. They expect that the reserve plus PCR calculated under the proposed framework would be the same as the existing Class G reserve calculation.

- Response from OCI:
  - The 99^{th} percentile required under GN 7 covering most of the adverse situations at all times is likely to be more stringent than the proposed 99.5% VaR over 12 months for PCR. We will further examine the approach to determining the capital requirements when calibrating Class G business in Phase II of the Project.
  - Question 15 provides details on the valuation approach and latest IAIS developments in relation to economic valuation.

Question 15

Do you agree that a market consistent approach should be used for all classes of business (option (a)) or that a combination of market consistent and amortized cost approaches should be used depending on the class of business (option (b))? Why? If you prefer option (b), which classes of business should market consistent or amortized cost approach be applied to?

- Number of responses to the question: 33

- Comments received:
  - Views are split on this issue.
  - 15 respondents support option (a), contending that this would be more in line with the latest IFRS 4 development and could reflect the current solvency position more accurately. Volatility could be reduced through better asset-liability matching. A combination of market consistent and amortized cost approaches would lead to inconsistency and incomparability in solvency assessment among insurers.
  - 5 respondents suggest that liabilities should be discounted with allowance for spread to reflect the nature of long-term insurance business.
  - 14 respondents are in favour of option (b) i.e. combination of market consistent and amortized cost approaches. They feel that a pure market consistent approach would lead to volatility and would not reflect the management intention to hold investment vehicles.
  - 6 respondents express concern about the lack of liquid long-dated bonds in the Hong Kong Dollar market.
  - 2 respondents suggest adopting a market consistent approach for Class C business.
  - 4 respondents suggest adopting the amortized cost approach for business with discretionary benefits dependent on long-term asset returns, like participating business.
  - 2 respondents consider that fair value should be adopted for invested assets and amortized cost for other assets.

- 4 respondents have not stated their preference but mentioned consistency with IFRS and global insurance capital standards.

- Response from OCI:
  - The IAIS launched a public consultation on Risk-based Global Insurance Capital Standard ("ICS") in December 2014.
  - The IAIS has decided that an economic valuation approach would not be adopted because of the difficulty in gaining comparability. Instead, a market-adjusted valuation approach would be the initial basis for developing the ICS since it increases comparability and risk sensitivity. Data will also be collected with a view to developing a Generally Accepted Accounting Principles ("GAAP") with adjustments valuation approach.
  - The final ICS is targeted for agreement by the end of 2016.
  - We note that the industry has split views between the two options. We consider that further analysis based on the QIS results is essential before drawing up a conclusion. The basic principle is that a consistent approach should be adopted across the industry and the valuation methodology should be clearly defined for different classes of business.
  - We will keep in view the developments of the ICS.

Question 16

Do you agree with the two techniques set out in our proposal? Are there other techniques that we should consider?

- Number of responses to the question: 29

- Comments received:
  - 21 respondents agree with the need to avoid undue pro-cyclicality.
  - 8 respondents comment that the discount rate to be adopted should be market risk free rate plus adjustments (e.g. illiquidity premium), rather than making reference to historical yields.
  - 2 respondents consider that the proposed use of market-referenced rate might lead to inconsistency between asset and liability valuation.
  - 4 respondents suggest adopting an ultimate forward rate when the market is not deep and liquid.
  - 3 respondents consider it necessary to receive further clarifications on "anomalous market conditions".

- Response from OCI:
  - This proposal focuses more on supervisory actions on discount rates under anomalous market conditions, rather than the discount rate to be adopted.
  - In the revised IFRS 4 Exposure Draft, it is stated that discount rates that reflect the characteristics of cash flow should be consistent with observable current market prices for instruments with cash flows whose characteristics are consistent with those of the insurance contracts in terms of, for example, timing, currency and liquidity. It is further described that when observable market variables are not available, an entity should use estimation techniques to determine the appropriate discount rate, taking into account other available observable inputs. It is necessary to determine the discount rates to be applied to cash flows beyond the period for which observable market data is available using the current, observable market yield

curve available. In such a case, the IA should be able to apply alternative valuation techniques.

- As stated in the ICS consultation paper, IAIS is developing a more stable long term discount rate by either setting a long term rate based on average market conditions over a period of time or by using a macroeconomic approach alongside a convergence approach from the last point based on observed data.
- We will develop the details regarding the alternative valuation techniques and anomalous market conditions during Phase II of the Project, taking into account the development of IFRS 4 and also ICS. The proposed ultimate forward rate will also be considered.

Question 17

Do you agree that technical provisions should include a risk margin and allow for the time value of money? What aspects of the valuation of technical provisions should Phase II focus on? What other approaches should be considered? Why?

- Number of responses to the question: 34

- Comments received:
  - 24 respondents agree with the allowance for the time value of money for technical provisions.
  - 2 respondents consider that it would be necessary to differentiate short-tailed and long-tailed businesses, and time value of money should only be applied to long-tailed business.
  - There are diverse views on the inclusion of MOCE:
    - 4 respondents request further clarification on how MOCE is determined.
    - 1 respondent feels that MOCE should be included as part of the required capital rather than part of the technical provisions.
    - 8 respondents consider it important to ensure that there is no double counting of capital requirements and MOCE.
    - 4 respondents comment that the approaches and methodologies to be used for determining MOCE should be consistent across the industry for greater comparability.

- Response from OCI:
  - We will proceed with the proposal of allowance for time value of money in Phase II of the Project.
  - The discount rate should reflect the economics of the insurance obligations and the extent to which insurance benefits are dependent on underlying assets. We will look into the discount rate, in conjunction with the valuation approaches, during Phase II of the Project.
  - We note the diverse views on MOCE. The treatment of MOCE as well as the determination approach would need to be further

considered in Phase II of the Project. We will also continue to monitor the development of the ICS, where the treatment of MOCE is still being examined.

Question 18

Do you agree to require explicit allowance for options and guarantees? If not, what alternative approaches would be appropriate to reflect the value of options and guarantees?

- Number of responses to the question: 25

- Comments received:
  - 23 of the respondents support explicit allowance for options and guarantees.
  - 3 respondents request further guidance on the methodologies in valuing options and guarantees to be developed.
  - 3 respondents are concerned that methodologies adopted to value the options and guarantees might vary between companies, thus leading to subjectivity and incomparability.
  - 1 respondent is concerned that sophisticated methodologies might pose challenges to smaller companies.
  - 2 respondents suggest that options and guarantees should be reflected under stress-testing scenarios. Another respondent suggests that a stress-testing approach should be used in determining simple or immaterial options and guarantees.
  - 1 respondent comments that the Appointed Actuary should be allowed to decide the assumptions and methodologies adopted in determining the allowance for options and guarantees.
  - 2 respondents consider that the assumption on management actions has to be elaborated.

- Response from OCI:
  - We will proceed with the proposal and examine the comments received in Phase II of the Project.
  - Methodologies for valuing options and guarantees would be further explored in terms of nature, scale, complexity, feasibility and resources.

Question 19

Do you agree to require a cash value floor in the valuation of technical provisions? At what level should the floor be set? Are there alternative means of providing the same level of protection which you consider more appropriate?

- Number of responses to the question: 30

- Comments received:
  - 22 respondents are concerned about the proposed cash value floor in the valuation of technical provisions. 13 of them feel that a cash value floor may not tally with the concurrent principle of economic valuation and 3 of them think that assuming surrender of all policies would be overly conservative. 3 respondents also comment that the inclusion of a cash value floor might have unintended consequences, which might not be favourable to policyholders.
  - 14 respondents suggest using stress tests for mass lapse in determining capital requirements.
  - 3 respondents suggest other alternatives of applying the cash value floor at the aggregate of technical provisions plus the required capital, with the excess amount held as additional required capital; or introducing different tiers of capital resources arising from the shortfall of technical provisions against cash value floor.
  - Should the cash value floor be considered necessary, 4 respondents comment that it should be applied at the portfolio level or the local entity level.

- Response from OCI:
  - The proposal is applicable to long-term business only.
  - In proposing a cash value floor, we have taken into account practice in other jurisdictions. We consider that a certain level of cash value floor is desirable to address possible risk of mass lapse arising from adverse economic situations or confidence crisis.

- We note the comments received. The suggested alternative approaches will be examined in the QIS. Detailed assessment and comparison of approaches will be carried out.

Question 20

Do you agree that asset allocation should follow principle-based requirements rather than rule-based requirements? If not, why?

- Number of responses to the question: 34

- Comments received:
  - o 31 respondents agree that principle-based requirements would be more appropriate.
  - o 4 respondents consider that discretion should be allowed for insurers to make their own investment decisions without additional restrictions so that they are able to invest in accordance with their own risk appetite and liabilities.

- Response from OCI:
  - o We will adopt principle-based asset allocation requirements, which will allow flexibility for individual companies to make their own investment decisions.
  - o We understand that as the asset profiles of insurers in Hong Kong vary, the asset allocation requirements would serve as risk management guidance rather than a restriction on the investment strategies. Further guidance will be developed at a later stage.

Question 21

Do you agree with the introduction of a prudent-person principle approach for investments? If not, why?

- Number of responses to the question: 34

- Comments received:
  - 26 of the respondents agree with the prudent-person principle approach for investments.
  - 11 respondents are uncertain about the interpretation of this principle, and feel that more information and examples would be needed.
  - 4 respondents point out that the adoption of the principle should not restrict investment management strategies, and should not create uncertainty of what would be acceptable practice.

- Response from OCI:
  - Prudent-person principle is a high-level principle where a prudent man would be expected to act with discretion and intelligence to seek reasonable income and preserve capital.
  - We intend to set out broad principles which could be translated into a series of best practices on investment, for example, investment policy, asset-liability matching, risk diversification, liquidity management, documentation, etc. We will develop more guidance and best practices at Phase II of the Project.

Question 22

Should enhancements to the existing regulations around asset allocation and management be made by amending GN 13 (which could be achieved ahead of the proposed implementation of the RBC framework)?

- Number of responses to the question: 32

- Comments received:
  - o 26 of the respondents agree that effecting enhancements to asset allocation and management through updating the existing guidance note would be appropriate.
  - o 24 of them support the early introduction of enhanced requirements on asset allocation and management so as to encourage positive risk management behavior on asset-liability matching, risk diversification, and liquidity management.
  - o 5 respondents are concerned about additional restrictions on investment. They opine that any enhancements would need to be feasible, practical, and not overly expensive.
  - o 4 respondents raise queries on the feasibility of early introduction of enhanced requirements on asset allocation and management due to the inherent interaction between asset allocation and Pillar 1 capital requirements.

- Response from OCI:
  - o Further details will be worked out during Phase II of the Project. The industry will be consulted on any proposed amendments to GN13.
  - o Given that GN 13 was promulgated in 2004, we consider that it is time to update it in response to international developments, especially the ICPs.
  - o We will continue to explore the possibility of amending GN 13 ahead of the implementation of the RBC framework. We recognize that there are interactions between asset allocation and Pillar 1 capital requirements. As we proposed in the consultation document,

Pillar 1 capital requirements will be prescribed in the legislation. The legislative exercise usually takes longer time than amendments to GN13. We believe that insurers will have more understanding of the capital requirements during Phase II of the Project, which may in turn help improve their ERM and also their solvency position before the RBC framework is implemented.

Question 23

Do you agree that all insurers should be required to do their ORSA having regard to their own business strategy and environment in addition to the PCR set by the IA? If not, why?

- Number of responses to the question: 33

- Comments received:
  - o 29 respondents agree with the need for ORSA.
  - o 4 respondents consider it necessary to have detailed guidance on ORSA requirements and the requirements should be commensurate with the size, nature and complexity of the business. 3 other respondents express concerns about constraints for smaller insurers and suggest adopting the principle of proportionality.
  - o 5 respondents ask if insurers operating as a branch or subsidiary of a larger group could submit the group ORSA.
  - o 2 respondents feel that ORSA requirements should not be overly prescriptive.

- Response from OCI:
  - o We note the overall support for ORSA requirements which are stipulated in the ICPs.
  - o Taking into account the comments received, we will further develop the detailed requirements of ORSA at Phase II of the Project.
  - o The appropriateness of using the group ORSA for an insurer operating as a branch or subsidiary in Hong Kong will be assessed. Considerations include whether the group ORSA meets the local ORSA requirements; how the local entity's financial resources and capital requirements are accommodated in the overall group ORSA; and whether risks to Hong Kong policyholders are adequately addressed etc.
  - o Question 25 provides further details on the principles of proportionality to Pillar 2 requirements.

Question 24

Do you agree to enhance ERM and corporate governance standards by introducing an ORSA requirement, including stress and scenario testing and continuity analysis? Should these standards be introduced ahead of new Pillar 1 requirements?

- Number of responses to the question: 34

- Comments received:
  - o Respondents generally agree with the proposed enhancement of ERM and corporate governance standards by introducing ORSA requirement, which is consistent with the responses to Question 22 and Question 23.
  - o 16 respondents agree that enhancement of ERM and corporate governance before the implementation of Pillar 1 capital requirements would encourage the industry to better prepare for the RBC regime.
  - o 5 respondents comment that Pillar 1 capital requirements would be necessary for the quantitative analysis within an ORSA report.
  - o 5 respondents are concerned about the resource implications and 3 respondents suggest that, similar to the QIS, testing of the readiness of the industry to comply with ORSA requirements should be conducted.

- Response from OCI:
  - o We will develop the detailed requirements of ORSA during Phase II of the Project.
  - o We propose to introduce Pillar 2 requirements by phases where ORSA requirements may be introduced slightly later than ERM and corporate governance requirements. Insurers will be given sufficient time to understand the Pillar 2 requirements before implementation.
  - o The industry will be further consulted on the ORSA requirements.

Question 25

Do you agree to apply the principles of proportionality to the Pillar 2 requirements of the RBC regime? If not, why?

- Number of responses to the question: 34

- Comments received:
  - 31 respondents agree with the principle of proportionality.
  - 2 respondents, however, do not agree with the proposal because they feel that the concept of proportionality has already been built into the Pillar 2 requirements and thus positive actions in favour of small and medium sized insurers are unnecessary.
  - 3 respondents opine that all policyholders should be subject to the same level of protection regardless of the size of insurers.
  - 1 respondent comments that there should be consistency and comparability between insurers. 2 respondents feel that there should be a level playing field amongst insurers, while one of them supports the proposal.
  - 9 respondents consider it necessary to have further details on how to apply the principle of proportionality.

- Response from OCI:
  - The principle of proportionality assesses the nature, scale and complexity of the risks to which an insurance entity is exposed to and justifies simpler and less burdensome requirements for low risk profile. In other words, the principle of proportionality would be more akin to the assessment of overall risks rather than the size of individual insurers.
  - We will examine the extent to which the principle of proportionality should apply given the profile of Hong Kong's insurance industry, with a view to developing a regime that provides adequate policyholder protection.

Question 26

Do you consider that the IA should have the power to apply capital add-ons in the event of inadequate corporate governance and/or ERM commensurate with the scale and complexity of the insurer?

- Number of responses to the question: 34

- Comments received:
  - 25 respondents agree with the proposed power of the IA to apply capital add-ons. Nevertheless, 21 respondents state that it would be necessary to have a clear definition and transparent rules for this power to be invoked.
  - 4 respondents disagree with the proposal as they feel that the IA should discuss with the subject insurers action plans to improve corporate governance and ERM instead of applying capital add-ons.
  - 4 respondents suggest the granting of a grace period to enable the insurers concerned to take remedial actions before applying capital add-ons.
  - 3 respondents suggest that appeal mechanisms should be in place.
  - 2 respondents are concerned about the public disclosure of capital add-ons required by the IA.

- Response from OCI:
  - Details on the capital add-ons, including the criteria, basis and the process of application will be developed during Phase II of the Project when the components of PCR, MCR and capital resources are established.
  - The process of applying capital add-ons is a dynamic process between the IA and the insurer concerned, involving a series of dialogues and assessments. The suggested grace period for the insurer to take remedial actions can also be part of the process.

- To be consistent with the principle of an economic balance sheet[9], capital add-ons would normally be included in the PCR as an adjusted component in addition to the risk charges calculated under the standardized approach or internal model. The level of capital add-ons is expected to vary on a case-by-case basis and is subject to further examination, especially on the methodology to determinate the amount of capital add-ons.

[9] For an economic balance sheet, all assets and liabilities are based on market-consistent valuation basis. This approach would apply to off-balance sheet items.

Question 27

Do you agree that insurers should, in addition to the statutory reporting to the IA, disclose to the public information about their risk assessments, capital resources and capital requirements in their published accounts and that enhanced disclosure requirements are addressed once proposals in respect of Pillar 1 and Pillar 2 are further evolved? If not, why?

- Number of responses to the question: 32

- Comments received:
    - 27 respondents agree with the disclosure requirements.
    - 9 respondents comment that the extent and amount of information to be disclosed should be meaningful for policyholders.
    - 8 respondents agree that further discussion on disclosure requirements should be made.
    - 5 respondents feel that public education would be necessary to avoid misinterpretation which might lead to loss of confidence.
    - 7 respondents comment that it is important to ensure alignment with other disclosure requirements. Examples mentioned include those under accounting standards, Listing Rules and other laws and regulations.
    - 4 respondents suggest that the disclosure should only be submitted to the IA at the initial stage.
    - 3 respondents indicate preference for disclosing qualitative information publicly and keep quantitative information confidential.
    - 1 respondent does not agree that the information should be disclosed in annual financial statements. Another respondent does not agree that the information should be subject to audit.

- Response from OCI:
    - We note that there is general acceptance of more transparency and public disclosure of information related to an insurer's risk and capital. This is in fact a global trend to provide greater

transparency to policyholders and the general public on the risks to which the company is exposed and the manner in which those risks are managed.

- ICP 20 requires disclosure of both qualitative and quantitative information. We agree that there should be a balance regarding the quantity and quality of information disclosed to avoid overloading. Phased implementation has been proposed so that both insurers and policyholders can better understand and interpret the information.
- The disclosure requirements of other regimes will also be taken into account to avoid confusion to the public.

Question 28

Do you agree to introduce requirements to set up on-shore and off-shore funds? If not, why?

- Number of responses to the question: 36

- Comments received:
  - o There are mixed views on the proposal to set up on-shore and off-shore funds. 17 respondents agree with the proposal and 13 disagree.
  - o 6 respondents request more details on the requirements.
  - o 4 respondents consider that policyholders of on-shore and off-shore businesses should be given the same level of protection, which could be achieved by non-segregation.
  - o 8 respondents feel that having separate funds is not necessary and would increase the administrative and compliance burden.
  - o 6 respondents do not support having different capital requirements for on-shore and off-shore businesses, given that such risk characteristics should be reflected in the relevant risk charges. It may also undermine the principle of consistent capital requirements at the local entity level.
  - o 3 respondents have commented on the potential impact on the competitiveness of multinational insurers.

- Response from OCI:
  - o On-shore business generally refers to the business of Hong Kong operations while off-shore business refers to business of overseas operations through branches.
  - o With the introduction of on-shore and off-shore funds, the IA would have more information on the insurers' assets and liabilities representing their insurance businesses through branch operations outside Hong Kong. This is essential for the prudential regulatory work of the IA.

- We note that similar requirements are in place in other jurisdictions.
- We will further examine the details and the comments received during Phase II of the Project.

Question 29

Do you agree that group-wide supervision should be applied to each of the Pillars? If not, why?

- Number of responses to the question: 33

- Comments received:
  - 24 respondents support group-wide supervision.
  - 9 respondents comment that there should be no regulatory overlaps with other supervisors. Given that some insurers are part of insurance groups who are already under group-wide supervision in other regimes, they feel that the IA should collaborate and coordinate with home supervisors and work through supervisory colleges on group supervision.
  - 2 respondents suggest that group-wide supervision should only be applied to those insurers based in Hong Kong.
  - 3 respondents suggest that it might not be necessary to apply group-wide supervision to all Pillars, and that applying group-wide supervision only to Pillars 2 and 3 would be adequate.

- Response from OCI:
  - The new ICPs stipulate the need for group-wide supervision. This is also a key recommendation for the insurance sector in the Detailed Assessment Report of Financial Sector Assessment Program carried out by the International Monetary Fund on Hong Kong in 2014.
  - We agree that duplication of regulation should be avoided and it would be necessary to develop effective group-wide supervisory regimes and coordinate with other supervisors whenever appropriate.
  - Key considerations that will be taken into account include the scope of the home supervisory regime (i.e. whether the group-wide supervisory regulations in home jurisdictions would cover at least what the Hong Kong regime requires), the materiality (i.e. whether the group-wide supervisory regulations in the home jurisdictions would sufficiently cover Hong Kong business e.g. whether ORSA

clearly takes into account risks for Hong Kong business) and capital fungibility within the group. There may be cases where the Hong Kong business of a branch or subsidiary could be substantial in Hong Kong but only constitute a small portion of the group portfolio, and the home supervisory regime may not sufficiently cover the risks of the Hong Kong entity(ies) or subgroup. In such cases, we may need to be more proactive and hence, the proposed tiering approach to group-wide supervision.

Question 30

Do you agree with the definitions of insurance groups and subgroups? Do you consider that they can be applied with sufficient clarity?

- Number of responses to the question: 34

- Comments received:
    - o 17 respondents request further elaboration on insurance subgroups.
    - o 3 respondents agree that group-wide supervision could be exercised where the insurer is not subject to any group-wide supervision or is part of a conglomerate.
    - o 6 respondents are concerned about the duplication of regulatory requirements when a subgroup is part of a larger group which is also subject to the supervision of a home supervisor.
    - o 4 respondents suggest that the IA may give equivalence status to Pillar 1 measures taken by those other jurisdictions.
    - o 4 respondents suggest that the IA may give equivalence status to Pillar 2 measures taken by those other jurisdictions.

- Response from OCI:
    - o The IA always supports and participates in group-wide supervision and works closely with other supervisors. The objective of supervising subgroups is to allow the IA to ensure that the Hong Kong business is adequately protected from the impact of any adverse developments in the other parts of the group. We also note that some other jurisdictions have introduced similar mechanisms in their group-wide supervision regimes.
    - o Given that each insurer has its unique corporate structure, we have only proposed a high level definition for insurance subgroups.
    - o Where an insurance subgroup is part of the supervisory regime of a home supervisor, the IA would generally rely on the capital requirements imposed by the home supervisor on the subgroup (the IA's capital requirements on each local entity of the subgroup still prevail) so as to avoid regulatory overlaps. However, as the

subgroup’s Hong Kong business may be substantial in the Hong Kong market, the IA would need to exercise supervisory measures on the subgroup under Pillars 2 and 3.

Question 31

Do you agree that whether supervision of subgroups should be based on size, specifically whether premiums or assets exceed a benchmark? If not, why?

- Number of responses to the question: 34

- Comments received:
  - 18 respondents agree that it would be appropriate to identify subgroups based on size. 5 respondents reiterate the concern on regulatory overlaps. 2 other respondents disagree with the supervision of subgroups based on size.
  - 7 respondents suggest other factors that may be considered including the proportion of a subgroup's Hong Kong business, vis-à-vis the group's total business, level of control, etc.

- Response from OCI:
  - We have proposed to define subgroups based on size with benchmark either in absolute amount or relative to the group or the Hong Kong insurance market. We may explore alternative approaches in this regard.

Question 32

Do you agree that PCR and MCR at a group level should be established as the triggering points for different degree of supervisory intervention? If not, why?

- Number of responses to the question: 32

- Comments received:
  - 25 respondents agree with the proposal.
  - 5 respondents suggest that the group PCR or MCR should be applied to Hong Kong based insurance groups only.
  - 5 respondents ask for details on how supervisory intervention by the IA in respect of a breach of the group PCR or MCR would be effected and how this would interact with other supervisors.

- Response from OCI:
  - We will develop further proposals on group PCR and MCR as part of the QIS.
  - For avoidance of doubt, the group capital requirements are proposed to apply only to Hong Kong based insurance groups and insurance subgroups which are not subject to any group-wide capital requirements.

Question 33

Do you agree that the group-wide capital requirement should be based on a group level focus approach (i.e. considered as a single integrated entity, rather than a set of interdependent legal entities) and use the consolidation method rather than the aggregation method? If not, why?

- Number of responses to the question: 33

- Comments received:
  - 22 respondents agree with the proposal.
  - 2 respondents prefer adopting a legal entity focus approach and 4 respondents propose using aggregation method i.e. the group-wide capital requirements would be the aggregate of each of the local capital requirements of the entities within the group, and request the IA to accept capital regimes of other jurisdictions to be equivalent to the Hong Kong RBC regime based on certain objective criteria.
  - 5 respondents express concern on the capital fungibility across members of a group especially at time of volatility.

- Response from OCI:
  - ICP 17.1.13 stipulates that additional considerations arising from using the aggregation method should be given to the consistency of valuation and capital adequacy requirements.
  - Given that there are different regulatory and capital requirement calculations among jurisdictions, a simple aggregation approach may not be adequate.
  - Adopting the consolidation method has the benefit of ensuring consistent valuation for the determination of capital requirements across the group.
  - We note the concern of individual respondents. We have proposed a flexible approach where an insurance group may apply to the IA for deconsolidating particular subsidiaries and using the aggregate method for those subsidiaries for the purpose of group-wide capital requirements. Whether deconsolidation can be allowed will depend

on the impact on the capital, level of policyholder protection, capital fungibility, etc on a case-by-case basis.

Question 34

Do you think that the IA should require the group to carry out its ORSA at a group level and apply consistent policies for assessing their individual insurance entities?

- Number of responses to the question: 33

- Comments received:
  - 21 respondents generally agree with the proposal.
  - 7 respondents comment that where the group ORSA complies with an advanced regime, two sets of ORSA should be avoided.
  - On the contrary, 3 respondents comment that group ORSA may not be proper for individual members of the group due to different jurisdictions and local ORSA requirements in place.
  - 3 respondents suggest allowing the group ORSA to make reference to the ORSA of individual members.

- Response from OCI:
  - We will examine further if it is appropriate to use a group ORSA for a local entity operating in Hong Kong.
  - As for locally based insurance groups, a group ORSA is necessary to ensure that the group addresses the risks arising from all entities within the group.

Question 35

Do you agree that all authorized insurers should be required to submit to the IA (i) prior notification of material intra-group transactions as well as material events or transactions of the group, and (ii) regular reporting of risk exposures within the group?

- Number of responses to the question: 33

- Comments received:
  - General agreement by 18 of the respondents.
  - 9 respondents are concerned about the materiality threshold, and suggest that the threshold should be predefined and set at a level high enough to avoid massive reporting.
  - 3 respondents feel that the Listing Rules should be taken into account when the disclosure requirements are formulated to avoid unnecessary overlaps and ensure that sensitive information is handled properly.
  - 4 respondents enquire whether the former prior notification is an approval process.

- Response from OCI:
  - The level of intra-group interconnectedness directly affects the extent of contagion risk for entities within a group. Intra-group transactions may have adverse impact on the solvency, liquidity and profitability of individual entities of the group.
  - Transactions which need approval from the IA are prescribed in the legislation. While prior notification is not an approval process, it facilitates the IA to monitor possible group risks, interconnectedness of group entities and their potential impact on solvency, liquidity and profitability.
  - We agree that the materiality level and scope should be carefully set to achieve the objective and at the same time reduce compliance burden. We will take these views into account when formulating

the threshold and basis for group events and intra-group transactions notification and reporting requirements.

Question 36

Do you agree with the minimum list of transactions or events requiring disclosure? If not, why?

- Number of responses to the question: 34

- Comments received:
  - 8 respondents highlight possible issues related to prior notification, particularly on practicality, confidentiality, as well as cross-border and cross-sector issues.
  - 3 respondents point out that they may not be able to identify material intra-group transactions in other parts of the group not connected with the insurer.
  - 7 respondents request further clarification on whether the scope of reporting is restricted to those transactions that affect the insurers operating in Hong Kong.
  - 7 respondents have commented on individual transactions set out in the list such as "purchases or sales of assets" and "arrangements for provision of management or other services". There are suggestions to include "derivatives" and "dividends".

- Response from OCI:
  - It should be clarified that the scope of reporting should be confined to those transactions involving insurers or insurance groups under the IA's supervision.
  - When it comes to group events or transactions, it is proposed to be applied to the holding company level, or at group member level if the group member can exercise significant influence on the insurer.
  - We will refine the list of reportable transactions and events, taking into account the comments received and requirements of other regimes.

Question 37

Do you agree with the proposed approach to group-wide supervision? Are the three tiers sufficiently clearly defined and do they in practice merit different approaches?

- Number of responses to the question: 34

- Comments received:
  - 19 respondents agree in principle with the tiering approach to group-wide supervision.
  - 7 respondents express concern about the complexity and the practicality of the proposed three-tier group-wide supervisory approach.
  - 8 respondents are concerned about the potential regulatory overlaps.
  - 3 respondents have concerns about the legitimacy for the IA to impose Pillar 2 requirements on entities incorporated outside Hong Kong.
  - 11 respondents request more information.

- Response from OCI:
  - We note the concerns raised, which are mainly on the Tier 2 requirements for insurance subgroups. Further details will be worked out during Phase II of the Project, including the benchmark for identifying subgroups and the ORSA requirements, with a view to striking a balance between the need for group-wide supervision and the compliance burden on insurers.

ABBREVIATIONS

ALM	Asset-liability management
ERM	Enterprise risk management
HKFRS	Hong Kong Financial Reporting Standard
IA	Insurance Authority
IAIS	International Association of Insurance Supervisors
IASB	The International Accounting Standards Board
ICP	Insurance Core Principles
ICS	Insurance Capital Standard
IFRS	International Financial Reporting Standards
MCR	Minimum Capital Requirement
MOCE	Margin over the Current Estimate
OCI	Office of the Commissioner of Insurance
ORSA	Own Risk and Solvency Assessment
PCR	Prescribed Capital Requirement
QIS	Quantitative impact study
RBC	Risk-based capital
TVaR	Tail value-at-risk
VaR	Value-at-risk