

# **Proposed Establishment of an Independent Insurance Authority**

## **Consultation Paper**

**Financial Services and the Treasury Bureau**

**[www.fstb.gov.hk](http://www.fstb.gov.hk)**

**July 2010**

## FOREWORD

1. This paper is issued by the Financial Services and the Treasury Bureau (“FSTB”) to consult the public on the proposed establishment of an independent Insurance Authority.
2. FSTB welcomes written comments on or before **11 October 2010** through any of the following means:

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## CONTENTS

		<i>Page</i>
<b>Glossary</b>		iii
<b>Executive Summary</b>		1
<b>Chapter 1</b>	<b>Introduction</b>	6
<b>Chapter 2</b>	<b>Guiding Principles for the Establishment of an Independent Insurance Authority</b>	8
<b>Chapter 3</b>	<b>Functions of the Independent Insurance Authority</b>	11
<b>Chapter 4</b>	<b>Regulation of Insurers</b>	14
<b>Chapter 5</b>	<b>Regulation of Insurance Intermediaries</b>	17
<b>Chapter 6</b>	<b>Organization Framework of the Independent Insurance Authority</b>	22
<b>Chapter 7</b>	<b>Governance and Related Matters</b>	25
<b>Chapter 8</b>	<b>Funding Mechanism</b>	29
<b>Annex</b>	<b>Proposed Organization Structure of the Independent Insurance Authority</b>	32

## GLOSSARY

AML	Anti-money Laundering
CFR	Council of Financial Regulators
CIB	Hong Kong Confederation of Insurance Brokers
FSC	Financial Stability Committee
FSTB	Financial Services and the Treasury Bureau
HKFI	Hong Kong Federation of Insurers
HKMA	Hong Kong Monetary Authority
IA	Insurance Authority
IARB	Insurance Agents Registration Board
IAIS	International Association of Insurance Supervisors
ICO	Insurance Companies Ordinance, Cap 41
Insurers	Companies carrying on insurance business as authorized under the ICO
Insurance intermediaries	Insurance agents and insurance brokers as defined under the ICO
LegCo	Legislative Council
OCI	Office of the Commissioner of Insurance
PIBA	Professional Insurance Brokers Association

SFO Securities and Futures Ordinance, Cap 571

SROs Self-regulatory Organizations

## EXECUTIVE SUMMARY

1. The Government endeavours to enhance our financial regulatory regime to ensure that it evolves with market developments to maintain market stability and protect investors. For the insurance sector, the current set-up of the Office of the Commissioner of Insurance as a Government department, headed by the Insurance Authority (“IA”), is not in line with the international practice for financial regulators to be financially and operationally independent of Government.
2. To align with international practices, we **propose** the establishment of an independent IA to maintain the stability of the insurance industry and protect the interests of existing and potential policyholders. The independent IA shall also seek to strike a reasonable balance between regulation and market development, and enhance the competitiveness of the insurance industry. It shall perform its regulatory functions on a par with international standards and having regard to local circumstances, without stifling market innovation necessary for promoting market efficiency and diversity.
3. A review of the insurance regulatory arrangements following the financial tsunami indicates that improvements need to be made in order to meet new challenges of the ever-changing financial market, match the higher public expectation of enhanced protection for insurance policyholders and bring them on a par with the latest international standards. These improvements include –
  - (a) **for the better regulation of insurers:** we would need to update the Insurance Companies Ordinance (“ICO”), Cap 41 to provide the IA with a full range of supervisory powers that are necessary for maintaining market stability and are commonly available to other financial regulators; and
  - (b) **for the better regulation of insurance intermediaries:** we would need to address a number of key concerns inherent in the existing self-regulatory regime like –

- (i) perceived and real conflict of interests;
- (ii) inconsistency in the complaints handling mechanism, investigatory procedures and disciplinary regimes among the three self-regulatory organizations (“SROs”), namely the Insurance Agents Registration Board, the Hong Kong Confederation of Insurance Brokers and the Professional Insurance Brokers Association;
- (iii) limited investigatory and sanctioning powers of these SROs; and
- (iv) deviation from other international financial centres whereby intermediaries are directly regulated by an independent regulator.

4. We **propose** that the independent IA should exercise direct supervision over the conduct of insurance intermediaries through the introduction of a licensing regime. The three SROs would continue to perform the functions of a trade body including, for example, industry promotion, organization of training courses, and setting best practices, etc. This proposal would enable the independent IA to adopt a more pro-active approach in following up complaints by policyholders and misconduct of individual intermediaries. The detailed transitional arrangements for the smooth migration of existing insurance intermediaries to the new regime would have to be worked out in consultation with the industry.
5. We have considered the alternative option of a strengthened SRO system with enhanced supervision by the independent IA. However, this option may give rise to duplication of regulatory efforts by the independent IA and the SROs, as well as regulatory gaps between the two. We do not consider it a sustainable option since it is inconsistent with international practices and fails to address the above-mentioned key concerns.

6. It is important to take into account the sale environment for different insurance policyholders in considering the adoption of suitable regulatory requirements to protect policyholders. At present, over 30% of insurance products sold in Hong Kong are distributed through banks. Noting that the client profile of a bank and its sale environment are different from that of an insurance intermediary outside a bank, we consider that there are merits for the Hong Kong Monetary Authority (“HKMA”) to be given powers similar to those of the independent IA for regulating the sale of insurance products by bank employees. This would allow HKMA to impose additional conduct requirements, on top of what the independent IA may stipulate, on bank employees. All relevant bank employees should first be licensed by the independent IA.
  
7. On governance arrangements, we **propose** that the following arrangements be put in place to provide adequate checks and balances for proper exercise of powers by the independent IA –
  - (a) a Governing Board comprising predominately independent non-executive directors to be appointed by the Government to provide leadership and direction, and to guide the independent IA in the development of a corporate strategy to achieve its objectives and perform its functions effectively;
  - (b) its annual report to be tabled before the Legislative Council (“LegCo”);
  - (c) its annual budget and corporate plan to be subject to the approval of the Financial Secretary;
  - (d) a statutory appeals tribunal to be established to handle appeals from insurers and insurance intermediaries against relevant decisions made by the independent IA; and
  - (e) an independent Process Review Panel to be established by the Chief Executive to review internal operating procedures of the independent IA.

8. We recognize the importance of effective interface between the independent IA and other regulators. There should be robust communication and collaboration arrangements between the independent IA and other regulators in order to bridge any regulatory gaps and minimize duplication of efforts.
  
9. We recognize the insurance supervisory principle that the regulator should be financially independent. We have to identify stable sources of revenue to enable the independent IA to recover fully its cost from the market over time. To formulate an equitable funding mechanism, we **propose** a new fee structure comprising –
  - (a) a fixed licence fee payable by all insurers and intermediaries;
  - (b) a variable licence fee payable by insurers only and calculated on the basis of their individual liabilities;
  - (c) user fees for specific services such as application for transfer of business, change of shareholding structure or change in key personnel; and
  - (d) a levy of 0.1% on insurance premiums for all insurance policies.
  
10. To reduce the impact on the insurance industry and policyholders, we **propose** to pursue the following mitigating measures in the initial five years after the establishment of the independent IA –
  - (a) the licence fee for insurance intermediaries be waived (if they are to be licensed directly by the independent IA as proposed); and
  - (b) an incremental approach be adopted in achieving the target levels of variable licence fee on insurers and levy on insurance policies.
  
11. Before achieving full cost recovery in the sixth year of the independent IA's operation, we **propose** that the Government should

provide a lump sum of \$500 million to the independent IA on its inception –

- (a) to help meet part of its expenses in the initial five years before the target levels of variable licence fee and levy are achieved; and
- (b) as contingency reserve in the event of poor market conditions which would lead to low levy income.

12. Apart from the above, we **propose** that the independent IA should take on an active role in educating existing and potential policyholders on the features and risks of insurance products, and in conducting thematic researches and studies into the latest market development trends, regulatory concerns, issues of policyholders' interests, etc.

13. We will take into account the public views received on the above proposals in preparing legislation for the establishment of an independent IA. We aim to introduce a bill into LegCo in 2011.

## **CHAPTER 1 – INTRODUCTION**

### **Purpose**

- 1.1 This consultation document sets out proposals on the functions and powers, organization framework, governance structure and funding mechanism of an independent IA, which shall replace the Office of the Commissioner of Insurance (“OCI”) in performing regulatory oversight over the insurance industry.

### **Background**

- 1.2 The existing set-up of the IA (supported by the OCI which is a government department) is not consistent with the international practice for financial regulators to be independent, both financially and operationally, of the Government. From a practical angle, an independent IA will have more flexibility in operations and staff recruitment, and better prepare Hong Kong to meet rapid changes in the international financial market and developments in international regulatory requirements.
- 1.3 To ensure that Hong Kong has a modern infrastructure for the regulation of the insurance industry, the Administration initiated a consultancy study in 2007<sup>1</sup> to look into the organization framework, governance structure and funding mechanism of an independent IA. In the light of the financial tsunami and the ensuing international discussions on the adequacy of regulatory practices, we have commissioned an extended study in 2009 to review the existing insurance regulatory arrangements and to identify areas for improvement. Whilst compared to other economies, the insurance sector in Hong Kong remains stable and operates smoothly in the midst of the crisis, we consider it important to take account of international developments following the financial tsunami in formulating proposals for the establishment of an independent IA. To ensure that relevant considerations in the local context are also taken into account, we have invited the Consultant to seek the views

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<sup>1</sup> PricewaterhouseCoopers was appointed by OCI in November 2007 to carry out the consultancy study, followed by an extended study in 2009.

of key stakeholder groups in the course of the study.

- 1.4 The Consultant has recently finalized his findings and recommendations on the extended study. Having regard to the study findings, the Administration has drawn up proposals for the establishment of an independent IA. These are set out in the ensuing chapters.

### **Consultation and Next Step**

- 1.5 We shall arrange consultative sessions in July - October 2010 to hear views direct from different stakeholder groups, including members of the insurance industry and general consumers. Members of the public as well as insurance practitioners are invited to offer their views on the proposals in writing to us **on or before 11 October 2010**.
- 1.6 We shall take into account the views and comments received in finalizing the proposals and preparing legislation to provide for the establishment of the independent IA. We aim to introduce the legislation into LegCo in 2011.

## **CHAPTER 2 – GUIDING PRINCIPLES FOR THE ESTABLISHMENT OF AN INDEPENDENT INSURANCE AUTHORITY**

### **Background**

- 2.1 At present, the IA is a public officer (viz. the Commissioner of Insurance) who is supported by the OCI established under the Financial Services and the Treasury Bureau. Both the IA and staff at the OCI are civil servants<sup>2</sup>. The IA discharges his/her functions in accordance with the ICO which was first enacted in 1983.
- 2.2 The ICO has provisions governing the regulation of insurers and insurance intermediaries in Hong Kong. An insurer must be authorized by the IA before carrying on insurance business in or from Hong Kong. The IA maintains close supervision of authorized insurers for the purpose of prudential regulation of the insurance industry. The ICO provides for the operation of a self-regulatory regime under which insurance agents<sup>3</sup> and brokers<sup>4</sup> (collectively to be referred to as “insurance intermediaries” in this consultation document), both at the corporate and individual levels, are registered with and supervised by designated industry bodies.
- 2.3 The Insurance Agents Registration Board (“IARB”) established under the Hong Kong Federation of Insurers (“HKFI”) <sup>5</sup> is responsible for registering insurance agents as appointed by insurers<sup>6</sup> after satisfying that they are fit and proper persons and meet other requirements specified in the Code of Practice issued by HKFI with the approval of the IA. These insurance agents include responsible officers and technical representatives of insurance

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<sup>2</sup> Other than those on contract terms.

<sup>3</sup> An insurance agent is defined under ICO as a person who holds himself out to advise on or arrange contracts of insurance in or from Hong Kong as an agent or sub-agent of one or more insurers.

<sup>4</sup> An insurance broker is defined under ICO as a person who carries on the business of negotiating or arranging contracts of insurance in or from Hong Kong as the agent of the policyholder or potential policyholder or advising on matters related to insurance.

<sup>5</sup> The HKFI is the industry association of insurers authorized to operate in Hong Kong.

<sup>6</sup> An appointed insurance agent shall not represent more than four insurers, of whom no more than two shall be long term business insurers.

agency companies. Insurers are responsible for the administration of their appointed agents in accordance with the aforementioned Code. As for insurance brokers, they must be authorized by the IA or admitted as members of broker bodies approved by the IA. At present, all insurance brokers, including chief executives and technical representatives of broker companies, are members of either one of the two broker bodies approved by the IA, viz. the Hong Kong Confederation of Insurance Brokers (“CIB”) and the Professional Insurance Brokers Association (“PIBA”). All insurance brokers must be fit and proper persons and satisfy the minimum requirements for capital and net assets, qualifications and experience, etc. specified by the IA. The IA does not exercise direct supervision over the conduct of insurance agents or brokers.

- 2.4 In view of the fast-changing market landscape and evolving international regulatory standards, the existing set-up of the IA and OCI, and the current legislative framework, are not conducive to the effective regulation of the insurance industry in the long run. They may not be able to meet the increasing public expectation of enhanced protection for insurance policyholders. This in turn would undermine our competitiveness as an international financial centre.

## **Proposals**

- 2.5 It is important to ensure that the independent IA is able to rise to challenges regarding both prudential regulation of insurers and conduct regulation of insurance intermediaries and evolve with market developments, so as to maintain the stability of the insurance industry and protect the interests of policyholders.
- 2.6 With these objectives in mind, in drawing up the detailed legislative proposals for the establishment of an independent IA, we will be guided by the principles that –
- (a) the independent IA should be given regulatory, operational and financial independence subject to reasonable safeguards;

- (b) the independent IA should be given the necessary powers to discharge its statutory functions effectively;
- (c) the exercise of powers by the independent IA should be subject to adequate checks and balances, including an independent appeal mechanism against its major decisions;
- (d) apart from prudential of insurers and conduct regulation of insurance intermediaries for the purpose of maintaining general stability of the insurance industry and protecting policyholders, the independent IA should also play a role in facilitating compliance and promoting healthy market development, with a view to enhancing the competitiveness of Hong Kong as an international financial centre;
- (e) the organization structure of the independent IA should enable it to respond effectively to changing market needs and new regulatory requirements; and
- (f) the independent IA should eventually operate on a full-cost recovery basis.

***Consultation Questions***

1. *Do you agree that an independent IA should be established along the principles set out in paragraph 2.6?*
2. *Do you think that there are other important principles in addition to those set out in paragraph 2.6 that the Administration should adopt in working out the detailed legislative proposals for the establishment of the independent IA? If so, what are they?*

## **CHAPTER 3 – FUNCTIONS OF THE INDEPENDENT INSURANCE AUTHORITY**

### **Background**

3.1 As stipulated in section 4A of the ICO, the principal function of the existing IA is to regulate and supervise the insurance industry with a view to promoting the general stability of the insurance industry and protecting existing and potential policyholders. Specifically, the IA shall –

- (a) be responsible for supervising an insurer's and an insurance intermediary's compliance with the provisions of the ICO;
- (b) consider and propose reforms relating to insurance business;
- (c) promote and encourage proper standards of conduct, as well as sound and prudent business practices amongst insurers;
- (d) promote and encourage proper standards of conduct for insurance intermediaries and, where necessary, review and revise the regulatory system for the same;
- (e) promote and develop self-regulation by market and professional bodies of the insurance industry; and
- (f) cooperate with and assist financial services supervisory authorities of Hong Kong or of any place outside Hong Kong, whenever appropriate, to the extent permitted by the ICO.

3.2 The existing functions of the IA regarding prudential regulation of the insurance industry are common to all overseas regulators. Such prudential regulatory functions are essential to maintaining the overall stability of the financial sector. However, Hong Kong stands out as the only jurisdiction among major financial centres which relies on a self-regulatory regime for supervising the conduct of insurance intermediaries. Besides, the IA does not have an explicit role in educating existing and potential insurance

policyholders, or conducting thematic researches and studies on latest development trends or regulatory issues of the insurance industry. Examples include potential problems associated with particular insurance products, or issues arising from recurring complaints from policyholders. These have become increasingly important tools for insurance regulators to promote product knowledge and risk awareness among the public, as well as to identify areas of systemic concerns and facilitate healthy industry growth.

## **Proposals**

3.3 On a review of local and international practices and experience in financial market regulation, we propose that consideration be given for the independent IA to assume additional functions in the following areas, apart from carrying out the existing functions of the IA as set out in paragraph 3.1 above –

- (a) to perform a direct, and hence more effective role in supervising the conduct of insurance intermediaries, including licensing, inspection, handling complaints<sup>7</sup>, investigation into misconduct, and imposing disciplinary sanctions;
- (b) to organize public education programmes to raise literacy among potential and existing insurance policyholders regarding the features and risks of insurance products, in order to facilitate informed decision-making by policyholders; and
- (c) to conduct thematic researches and studies into the latest market development trends, regulatory concerns both at the local and international levels, issues of policyholders' interests, etc. with a view to formulating effective regulatory strategies and facilitating sustainable market development.

3.4 Overall speaking, we propose that the independent IA should endeavor to maintain the stability of the insurance industry and

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<sup>7</sup> All complaints against insurance intermediaries are currently being dealt with by the self-regulatory organizations. Details are set out in Chapter 5.

protect interests of existing and potential policyholders by effective prudential and conduct regulation of insurers and insurance intermediaries. The independent IA shall also seek to strike a reasonable balance between regulation and market development and enhance the competitiveness of the insurance industry. It shall perform its regulatory functions on a par with international standards and having regard to local circumstances, without stifling market innovation necessary for promoting market efficiency and diversity.

***Consultation Questions***

3. *Do you agree that the independent IA should have an expanded role beyond the existing functions of the IA as set out in paragraph 3.1? If so, do you agree that the independent IA should assume the additional functions as proposed in paragraphs 3.3 and 3.4?*
4. *Do you agree the independent IA should also have a duty to enhance the competitiveness of the insurance industry, which will help to reinforce Hong Kong's status as an international financial centre?*

## CHAPTER 4 – REGULATION OF INSURERS

### Background

#### I. Existing regime

- 4.1 At present, there are 170 authorized insurers in Hong Kong, of which 46 are long-term insurers, 103 are general insurers, 19 carrying out both long-term and general businesses and two are captive insurers.
- 4.2 The IA regulates insurers operating in Hong Kong in accordance with the ICO. He/she sets requirements in respect of capital adequacy, solvency margin, handling of assets and liabilities, submission of financial reports, as well as fitness and properness of directors and controllers, etc. for insurers to follow.
- 4.3 Apart from the above, the IA is empowered under Part V of the ICO to take interventionary actions for protecting the interests of existing and potential policyholders where causes for concern are identified in respect of an insurer. Possible interventionary actions include requirements for production of documents and conduct of actuarial investigations, requirements on the types of investments that can be held, cap on scale of operation, requirements for bank deposits to be held in the name of the IA, placing of assets in the IA's custody, assumption of control by a manager appointed by the IA or petitioning for winding-up of the insurer. The IA also has the power to require an insurer to take such actions in respect of its affairs, business or property as he/she considers appropriate.
- 4.4 The ICO provides for criminal sanctions for breaches of the aforesaid requirements.

#### II. Other local and overseas regimes

- 4.5 Having reviewed relevant local and overseas experiences, the Consultant has identified a range of supervisory powers that are commonly available to comparable local and overseas regulators to

facilitate their discharge of regulatory functions, but such powers have not been provided for the IA under the existing ICO. Examples of these include explicit powers to enter into premises for inspection and investigation; powers to impose supervisory sanctions including reprimands, fines and partial / full suspension or revocation of authorization; and power to prosecute summary offences.

## **Proposals**

4.6 Whilst the existing regime has withstood major financial shocks in the past such as that arising from the financial tsunami, given the fast-changing financial landscape and our open economy, it is important to equip the IA with the necessary toolbox available to other financial regulators such that the IA will have the capability to deal with situations that may compromise policyholders' interests or undermine financial stability. Such enhancements could help maintain our international competitiveness as an international financial centre.

4.7 In drawing up proposals for new powers for the independent IA, the Consultant has taken into account the range of powers and disciplinary tools under the proposed regulatory framework for the anti-money laundering ("AML") regime which are to be enforced by financial regulators in Hong Kong, including the IA<sup>8</sup>. The proposed AML regime is modelled on relevant provisions in the Securities and Futures Ordinance ("SFO") which provides the most up-to-date reference for effective enforcement of breaches of financial market regulatory requirements. The Consultant accordingly recommends that the additional powers of the independent IA could be aligned with those to be provided under the AML regime. They include powers to –

- (a) enter into premises of the regulated entities to conduct inspections;

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<sup>8</sup> Under the proposed AML regime, IA will be given a broad range of supervisory powers to enforce the statutory AML requirements against insurers. Similar powers should also be made applicable to the independent IA to ensure effective prudential regulation of insurers outside the AML requirements.

- (b) initiate and pursue investigations ;
- (c) make enquiries;
- (d) have access to records and documents;
- (e) apply to the Court of First Instance for court orders to compel compliance with the reasonable requirements imposed by the independent IA in the course of inspection and investigation;
- (f) impose supervisory sanctions such as public reprimands and fines; and
- (g) prosecute offences summarily.

4.8 The exercise of these powers should be subject to reasonable checks and balances, including an independent appeal mechanism for insurers. This is discussed in Chapter 7.

***Consultation Questions***

5. *Do you agree that the independent IA should be vested with additional powers as proposed in paragraph 4.7 to enable it to regulate insurers more effectively?*

## CHAPTER 5 – REGULATION OF INSURANCE INTERMEDIARIES

### Background

#### I. Existing regime

- 5.1 Insurance intermediaries are subject to the self-regulatory framework stipulated under Part X of the ICO, which defines the distinct roles of an insurance agent and an insurance broker, and requires them to be appointed or authorized in accordance with the relevant statutory provisions.
- 5.2 Under the self-regulatory framework, the three SROs, namely the IARB established under HKFI, and CIB and PIBA which are broker bodies authorized by the IA under the ICO, perform the supervisory role in accordance with requirements stipulated in non-statutory codes approved by the IA.
- 5.3 The IARB is responsible for the registration of qualified insurance agents and their administration through a non-statutory Code of Practice approved by the IA. The CIB and PIBA are responsible for ensuring that their members are fit and proper persons to be brokers and that they comply with the minimum requirements specified by the IA<sup>9</sup>. They are also responsible to incorporate such requirements in their respective non-statutory Regulations / Codes issued to members. The SROs are responsible for handling all complaints against their registrants / members, i.e. insurance intermediaries, and they carry out investigation and take disciplinary actions on substantiated cases. The IA maintains general oversight over the SROs.
- 5.4 As at 30 April 2010, there are 68,569 insurance intermediaries in Hong Kong, of whom 31,997 are individual agents, 2,352 are agency companies, 25,955 are responsible officers / technical

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<sup>9</sup> The ICO requires IA to stipulate minimum requirements for brokers in areas including qualifications and experience, capital and net assets, professional indemnity insurance, keeping of separate client accounts and keeping of proper books and accounts.

representatives of agency companies, 569 are authorized broker firms and 7,696 are chief executives / technical representatives of these broker firms. They are members of one of the three aforementioned SROs.

## **II. Review of performance**

- 5.5 The IA has been working closely with the SROs with a view to improving the self-regulatory regime. For instance, to enhance the credibility and transparency of their operations, the SROs are working towards increasing the number of independent members on their boards, and enhancing disclosure of information on complaints and disciplinary actions taken. The CIB and PIBA are also aligning their disciplinary guidelines to promote consistency in the sanctions imposed on insurance brokers.
- 5.6 Despite the improvements being pursued, the Consultant has identified a number of areas with the self-regulatory regime which are unsatisfactory. First, there is conflict of interests, both perceived and real, as the SROs are also trade bodies financed by its members. This is particularly the case for insurance brokers, where there are two broker SROs, and the competition for membership may lead to a perception that there is inclination towards more leniency in disciplinary matters. As for insurance agents, the IARB is set up under the auspices of HKFI, an industry association of insurers. According to the IARB's investigation protocol, investigation of complaints against agents would be conducted primarily by the insurer which is the principal of the agent concerned. Besides, the Consultant noted that the three SROs are not fully aligned in regard to their disciplinary procedures, levels of sanctions and complaints handling mechanism. The SROs also have limited sanctions over their members. The primary sanctions are written reprimands and suspension or revocation of membership. The Consultant has pointed out that a self-regulatory regime is not in line with international practices in the insurance sector. In other major international financial centres, intermediaries are regulated directly by a regulator independent of the trade.

## Proposals

5.7 The Consultant recommends that the independent IA should have more effective supervisory oversight over insurance intermediaries. It has set out the following two options –

**Option 1** – *enhanced supervision by the independent IA under a strengthened SRO system; or*

**Option 2** – *direct licensing and supervision by the independent IA*

5.8 For **Option 1**, the independent IA would be empowered to require the three SROs to harmonize their disciplinary regimes to minimize inconsistencies and ensure early complaints resolution. The independent IA should be given additional powers to sanction insurance intermediaries, in the event that reliance on SROs' self-regulatory process is considered inappropriate for reasons such as unreasonable delay in taking regulatory actions and ineffective sanctions against serious misconduct. These powers could include powers to investigate and impose supervisory sanctions such as fines, reprimands, and suspension and revocation of SRO membership.

5.9 Option 1 has the merits of minimizing changes to the existing insurance regulatory regime and hence reducing possible impact on the affected stakeholders. However, the fundamental problem over the perceived or real conflict of interests remains under a self-regulatory framework, which is not in line with international practices. Besides, enhanced supervision by the independent IA under this option may give rise to duplication of regulatory efforts by the independent IA and the SROs, as well as regulatory gaps between the two. Moreover, to allow the independent IA to maintain effective oversight over the SROs, the independent IA would, in any event, need to be equipped with the necessary regulatory toolbox as in Option 2 to be discussed below.

5.10 Under **Option 2**, the independent IA will assume all regulatory functions over insurance intermediaries. The three SROs would

continue to perform the functions of a trade body including, for example, industry promotion, organization of training courses, and setting best practices, etc. This option gives recognition to the increased public expectation of regulators, and the international trend of replacing self-regulation with independent regulation. It will also enable the independent IA to adopt a more pro-active approach in following up complaints by policyholders and misconduct of individual intermediaries, and in identifying industry-wide issues and market conducts that are central to protection of policyholders. The direct supervision of insurance intermediaries by the independent IA would help enhance public confidence in the professionalism of the practitioners, thus helping foster the further development of the industry. Under this option, detailed transitional arrangements for the smooth migration of existing insurance intermediaries to the new regime would have to be worked out in consultation with the industry.

- 5.11 The Consultant recommends that the additional powers to be given to the independent IA under Option 2 should align with those set out in paragraph 4.7 for insurers.
- 5.12 Having examined the Consultant's findings, we believe that Option 2 is the preferred option, as it would facilitate the sustainable development of the insurance industry on a par with international regulatory practices.

### ***Conduct of insurance intermediaries selling insurance products in banks***

- 5.13 Of the 68,000 insurance intermediaries, some 18,000 are bank employees who are registered with and supervised by IARB in their marketing and sale of insurance products. Although insurance products are sold through banks, currently the Hong Kong Monetary Authority ("HKMA") does not have any direct power to discipline individual bank employees in respect of their conduct of insurance business.
- 5.14 According to market statistics, over 30% of insurance products sold in Hong Kong are distributed through banks. The client profile

and sale environment in a bank are different from those of an insurance intermediary outside a bank. Taking these into account, there are merits to allow HKMA to impose additional conduct requirements, on top of what the independent IA may stipulate, on bank employees selling insurance products under Option 2 above. To enable HKMA to conduct proper conduct regulation of these bank employees, there are also merits to vest in the HKMA powers similar to those for the independent IA. These would include power to conduct inspection and investigation, as well as to impose disciplinary sanctions. The independent IA would continue to be responsible for licensing all relevant bank employees and determine whether they are fit and proper to remain licensed as an insurance intermediary having regard to any disciplinary sanctions that might have been imposed by HKMA. Under this option, detailed arrangements to ensure seamless interface between HKMA and the independent IA in the supervision of insurance intermediaries will have to be worked out. This would be a subject to be addressed when formulating the new legislative framework for the independent IA. See also paragraph 7.3 on checks and balances.

#### ***Consultation Questions***

6. *Do you consider that the existing self-regulatory arrangements for insurance intermediaries should be changed, and if so, do you support that Option 2 (i.e. direct supervision of insurance intermediaries by the independent IA) should be pursued? If not, why?*
7. *Do you consider that in relation to the sale of insurance products in banks, the HKMA should be vested with powers similar to those for the independent IA to allow HKMA to regulate bank employees selling insurance products given the different client profile and sale environment in banks?*

## **CHAPTER 6 – ORGANIZATION FRAMEWORK OF THE INDEPENDENT INSURANCE AUTHORITY**

### **Background**

#### **I. Current status**

6.1 The OCI now comprises three divisions, namely General Business Division, Long Term Business Division, and Policy and Development Division, each headed by an officer at the rank of Assistant Commissioner. Regulatory duties are assigned to ten professional teams under these three divisions, each led by a Senior Insurance Officer.

6.2 Currently, OCI has an establishment of 123, comprising 95 professional (accountants and actuaries) and managerial staff, as well as 28 support staff. There are services that are provided to the OCI by other Government departments, which are not reflected in the organization's current staffing numbers. For example, the Department of Justice provides legal support, the Civil Service Bureau and the Government Logistics Department provide back office support, the Office of the Government Chief Information Officer provides IT support and the Information Services Department provides media relations support, etc.

#### **II. Consultant's findings**

6.3 At present, the OCI stands out as the only financial services regulator in Hong Kong still operating within the Government machinery. This is not in keeping with international insurance supervisory principles stipulated by the International Association of Insurance Supervisors ("IAIS")<sup>10</sup> that require regulators to be given financial, operational and political autonomy. Indeed, insurance regulators in most developed markets such as the UK, Australia and Singapore are already independent entities. As a leading global

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<sup>10</sup> IAIS is an international association of insurance regulators and supervisors from some 190 jurisdictions. It sets insurance supervisory principles and regulatory standards that are widely adopted globally.

financial centre, Hong Kong should not lag behind.

- 6.4 From a practical perspective, an independent IA not subject to the intricate Government rules and procedures should have greater nimbleness and agility in coping with market dynamics. The ability to deploy flexible staff recruitment and management policies and to offer market terms to attract professionals to join as regulators is also crucial in enhancing professionalism and achieving better value for money, thereby enabling Hong Kong to meet new challenges of the ever-changing financial market. All these play an important part in protecting policyholders, upholding market stability and sustained growth of the insurance business in Hong Kong.

## **Proposals**

### **I. Structure**

- 6.5 The Consultant recommends that an independent IA be established and be organized along five main divisions as follows –
- Long-Term Business
  - General Business
  - Policy and Development
  - Market Conduct
  - Corporate Services
- 6.6 The first three Divisions are similar to OCI's current organizational set-up. The two new Divisions, viz. Market Conduct and Corporate Services Divisions, are proposed to enable the independent IA to strengthen supervision of insurance intermediaries as discussed in Chapter 5 and to assume corporate functions which are currently provided to OCI by other Government departments. The proposed organization structure is at **Annex**.
- 6.7 Under the proposed structure, the Consultant recommends that the independent IA should initially have a workforce of 237 staff, as compared to OCI's existing establishment of 123. This would

allow the independent IA to perform the existing functions of IA more effectively and to assume the additional functions as set out in paragraph 6.2 and under Option 2 in Chapter 5 (paragraph 5.10). The proposed structure equally applies to Option 1 (paragraph 5.8 and 5.9) since the independent IA needs to exercise enhanced oversight over SROs' performance, although the number of staff required for the Market Conduct Division could be reduced.

## **II. Recruitment and remuneration**

6.8 In line with the practices of other local regulators, the Consultant recommends that the independent IA should recruit its staff from the open market. To enable the independent IA to attract, retain and motivate people with the right skills, calibre and experience, the Consultant recommends a market-driven approach in setting the remuneration package. Basically, this would include a "base pay" benchmarked against similar jobs in the local market and an "incentive pay" for staff that exceed the performance requirements. The base pay should be reviewed annually, whilst the incentive pay should be given to no more than 50% of staff in a given year to create a real incentive for people who excel in performance.

### ***Consultation Questions***

8. *Do you agree that the recommendations as set out in paragraphs 6.5 to 6.8 should be pursued for the independent IA to operate as an independent entity? Any other views?*

## CHAPTER 7 – GOVERNANCE AND RELATED MATTERS

### Background

7.1 Currently, pursuant to section 4 of the ICO, the Chief Executive appoints a public officer to be the IA. The Commissioner of Insurance is appointed for such purpose and performs his / her functions through the OCI, which is a government department. Relevant IA's decisions are subject to appeals to the Financial Secretary in accordance with the provisions of the ICO.

### Checks and balances

7.2 With the establishment of an independent IA, the Consultant recommends that a Governing Board should be appointed by the Government to provide leadership and direction, and to guide the independent IA in the development of a corporate strategy to exercise its mandate. We propose that the Governing Board should comprise predominantly non-executive directors, who could be appointed from a cross-section of the community including relevant professional fields (e.g. actuarial, accounting, legal), the Consumer Council, the academia and Government. The Consultant also recommends that the Governing Board be assisted by Committees designated to oversee specific areas of the independent IA's work and make recommendations to the Board. The Committees may include Audit Committee, Finance Committee, Remuneration Committee and Management Committee. In addition, the Consultant recommends that an Advisory Committee be formed to advise the Governing Board on issues affecting the industry. We propose that the Advisory Committee should tap industry input and market views by appointing insurance practitioners, industry body representatives and user / consumer groups to sit on it. Please see the proposed organization structure of the independent IA at the **Annex**.

7.3 In view of the proposed powers to be vested in the independent IA, the Consultant recommends that a system be put in place to provide adequate checks and balances for proper exercise of those powers. Having reviewed the arrangements for other financial regulators, we propose that –

- (a) the Chief Executive Officer of the independent IA, as well as the non-executive Chairman and all members of its Governing Board (including executive directors and non-executive directors) be appointed by the Chief Executive;
- (b) its annual report be tabled before LegCo;
- (c) its annual budget and corporate plan be subject to the approval of the Financial Secretary;
- (d) a statutory appeals tribunal be established to handle appeals from insurers and intermediaries against relevant decisions made by the independent IA; and
- (e) an independent Process Review Panel be established by the Chief Executive to review internal operating procedures, including those for ensuring consistency and fairness.

To ensure consistency and equity in the regulation of insurance intermediaries, we believe that proposals in items (d) and (e) above should also apply to the HKMA in respect of its performance of supervisory functions over bank employees selling insurance products. See paragraphs 5.13 and 5.14.

7.4 Apart from the above, the decisions of the independent IA shall be subject to judicial review. Complaints against the independent IA may be lodged with the Office of the Ombudsman. The Director of Audit and the Independent Commission Against Corruption should also be empowered to oversee the practices and procedures of the independent IA.

## **Related matters**

- 7.5 At present, the IA has entered into Memoranda of Understanding with other local regulators viz. the Securities and Futures Commission, the HKMA and the Mandatory Provident Fund Schemes Authority. These Memoranda set out the framework for mutual assistance, exchange of information and holding of bilateral meetings to facilitate the effective discharge of their regulatory duties. The independent IA should enter into similar cooperation agreements with these regulators upon its establishment which would take into account its expanded regulatory responsibilities and the need for close collaboration to address potential cross-sector issues.
- 7.6 Same as the incumbent IA, the independent IA would be a member of the Council of Financial Regulators (“CFR”) chaired by the Financial Secretary and the Financial Stability Committee (“FSC”) chaired by the Secretary for Financial Services and the Treasury. The CFR and FSC seek to provide regular inter-regulator forums to, amongst others, deliberate regulatory and supervisory issues carrying a cross-sectoral impact, minimize regulatory duplication or gaps, monitor the functioning of the financial system of Hong Kong and deliberate on issues and developments with possible cross market and systemic implications.
- 7.7 With an expanded regulatory remit, we expect the independent IA will have more interface with other regulators in intermediary regulation. The independent IA and other regulators shall further strengthen their communication and collaboration arrangements to minimize duplication of efforts and enhance protection for policyholders. For instance, a formal inter-regulator communication platform could be established to promote regular exchanges on product trends and associated risks for insurance policyholders. This would facilitate the timely development of appropriate conduct requirements for different sectors taking into account their specific circumstances.

***Consultation Questions***

9. *Do you agree with the proposed checks and balances and governance arrangements for the independent IA as set out in this Chapter?*

## CHAPTER 8 – FUNDING MECHANISM

### Background

8.1 Currently, OCI incurs an annual operating cost of around \$110 million and recovers some 37% of it from annual licence fees paid by insurers at a fixed rate of \$227,300 per insurer and \$22,600 for captive insurer. The remaining some 60% of the regulatory cost is subsidized by the public coffers.

### Proposals

8.2 Based on the proposed staffing level mentioned in Chapter 6, the Consultant estimates that the independent IA's annual operating cost would initially be around \$240 million. In line with the insurance supervisory principle that the regulator should be financially independent, the Consultant recommends that stable sources of revenue should be identified to enable the independent IA to recover the full cost from the market. Having made references to other comparators<sup>11</sup> and the Consultant's recommendations, we propose a new fee structure comprising –

- (a) a fixed licence fee payable by all insurers and insurance intermediaries<sup>12</sup>;
- (b) a variable licence fee payable by insurers only and calculated on the basis of their individual liabilities;
- (c) user fees for specific services such as application for transfer of business, change of shareholding structure or change in key personnel; and
- (d) a levy of 0.1% on insurance premiums for all insurance policies.

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<sup>11</sup> For instance, SFC's expenditure is funded by a combination of market levy, fees and charges and investment income at the ratio of 8:1:1 based on its 2010-11 Budget.

<sup>12</sup> The fixed licence fee for intermediaries is only applicable if Option 2 discussed in Chapter 5 on direct licensing of intermediaries by the independent IA is adopted.

- 8.3 The fixed licence fee is intended to recover the basic regulatory costs from the insurers. We expect the actual levels should be similar to the pre-existing ones, i.e. in the range of \$250,000 - \$300,000. The variable licence fee reflects the increased supervisory efforts associated with the size and complexity of the operations of an insurer. The proposed market levy at 0.1% of insurance premiums would provide the independent IA with a stable source of revenue.
- 8.4 To reduce the impact on the industry and policyholders, we propose to pursue the following mitigating measures in the first five years after the establishment of the independent IA –
- (a) the licence fee for insurance intermediaries be waived<sup>13</sup>; and
  - (b) an incremental approach be adopted in achieving the target levels of variable licence fee on insurers and levy on insurance policies<sup>14</sup>.
- 8.5 Before achieving full cost recovery in the sixth year of the independent IA's operation, we propose that the Government should provide a lump sum of \$500 million to the independent IA on its inception, partly to help meet part of its expenses in the initial five years before the target levels of variable licence fee and levy are achieved, and partly as contingency reserve in the event of poor market conditions which would lead to low levy income.

<sup>13</sup> The waiver is relevant if the insurance intermediaries are to be licensed directly by the independent IA as proposed under Option 2 in Chapter 5. In the case of Option 1, the full cost of independent IA's operation will be recovered from the market through appropriate means.

<sup>14</sup>

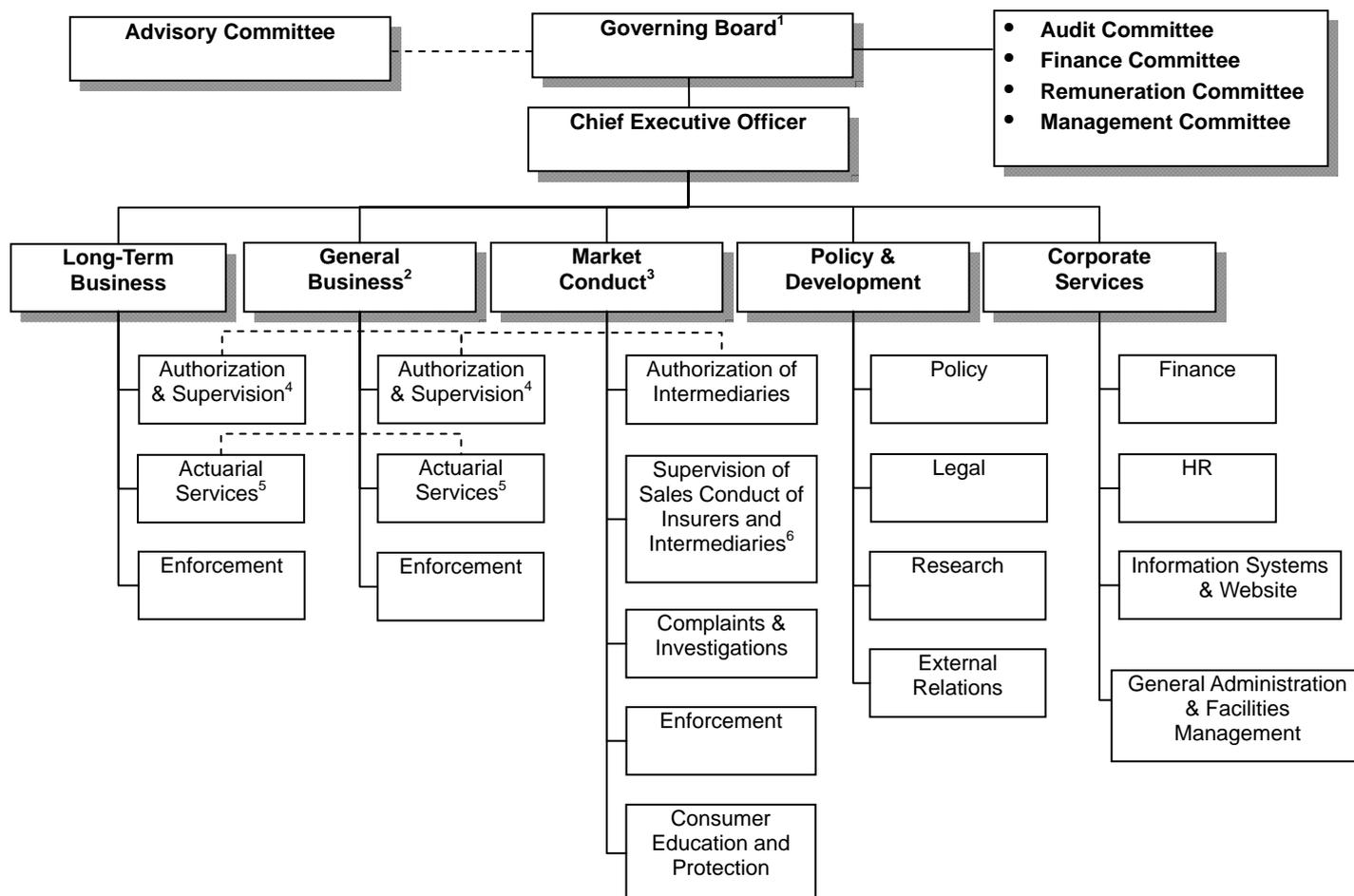
	Proposed Rate					
	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Variable fee (as a percentage on insurance liabilities)	0.0001%	0.0005%	0.0013%	0.0026%	0.0031%	0.0039%
Market levy (as a percentage on insurance premiums)	0.04%	0.05%	0.06%	0.07%	0.085%	0.1%

- 8.6 Our intention is to have 70% of the expenditure of the independent IA met by the levy and the remaining 30% by the various licence and users fees in the long run.

***Consultation Questions***

10. *Do you agree that the Government should provide a lump sum to support the independent IA in its initial years of operation and the independent IA should seek to reach full cost recovery in six years?*
11. *Do you agree with the proposed fee structure as set out in paragraphs 8.2 and 8.6?*

## Proposed Organization Structure of the Independent Insurance Authority



### Notes

- (1) Governing Board comprises predominantly non-executive directors selected from a cross-section of the community including relevant professional fields, the Consumer Council, the academia and Government; a Chairman appointed from amongst them and the Chief Executive Officer of the independent IA.
- (2) Might include the operation of the current Government Terrorism Facility in relation to employees' compensation insurance.
- (3) Supervision of market conduct of insurers (Long-Term Business and General Business) and insurance intermediaries.
- (4) The dotted-line denotes that one of the team leaders will take on an additional role of overseeing the continuous professional development needs of the Authorization & Supervision staff across the independent IA.
- (5) The dotted-line denotes that one of the team leaders will take on an additional role of overseeing the continuous professional development needs of the Actuarial Services staff across the independent IA.
- (6) Includes the implementation of the Insurance Intermediaries Quality Assurance Scheme.