

**Establishing a Policy Holders' Protection Scheme**  
**CONSULTATION PAPER**

**Financial Services and the Treasury Bureau**

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## FOREWORD

1. This paper is issued by the Financial Services and the Treasury Bureau (“FSTB”) to consult the public on the proposed establishment of a Policy Holders’ Protection Scheme.
2. FSTB welcomes written comments on or before 31 March 2023 through any of the following means –

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# CHAPTER 1

## INTRODUCTION

- 1.1 This consultation document sets out key features of the proposal to establish a Policy Holders' Protection Scheme ("PPS") which will strengthen safeguards for the interest of policy holders by providing compensation or securing the continuity of insurance contracts in case an insurer becomes insolvent.

### **Background**

- 1.2 Insurance plays a distinctive and significant role in our financial markets, as it helps shield individuals and businesses from unexpected perils. Effective management and mitigation of risks improve lifestyle planning, provide backing against uncertainties and encourage investments, conferring benefits to society and economic development.
- 1.3 The insurance industry is instrumental to consolidating Hong Kong's status as an international financial centre. In 2020, the value added of the insurance industry accounted for 4.4% of Gross Domestic Products in Hong Kong. Total gross premiums of the Hong Kong insurance industry amounted to \$581.7 billion in 2021, with an average growth rate of 9.7% over the past decade.
- 1.4 Hong Kong is among the world's most vibrant risk management centres. There are currently 164 authorized insurers in Hong Kong, offering a variety of products for consumers to manage risks by securing financial protection against adversities, maintaining savings, diversifying investments, etc. In 2021, the insurance penetration of Hong Kong insurance market was about 19.6%, which ranked second globally.

### *Regulatory regime and developments*

- 1.5 The Insurance Ordinance ("IO") (Cap. 41) provides for the regulation of the insurance industry, including functions and powers of the Insurance Authority ("IA") to supervise insurers for the protection of policy holders. To this end, any insurer who intends

to carry on business in or from Hong Kong must be authorized under the IO which stipulates statutory capital and other requirements as well as prudential supervision by the IA<sup>1</sup>. Apart from prudential supervision of insurers, the IO and the Companies (Winding Up and Miscellaneous Provisions) Ordinance (“CWUMPO”) (Cap. 32) have further prescribed protective arrangements for policy holders in case of insurer insolvency.

- 1.6 Since the late 1990s, there have been three insurer insolvencies in Hong Kong, all of them involving small-to-medium insurers in the general sector. There have not been any insolvency involving of long-term insurers or large general insurers.
- 1.7 In many economies, comprehensive compensation schemes are in place to provide a safety net in addition to the regulatory regime for the insurance industry. In Hong Kong, compensation schemes are in place to cover two types of general insurance, viz. motor vehicle third party claims (“motor vehicle policies”) and employees’ work-related injuries (“employees’ compensation policies”). There are however no compensation scheme for long term insurance and other types of general insurance.
- 1.8 The 2008 international financial crisis during which a number of large financial institutions faced financial difficulties highlighted the need for a more comprehensive compensation scheme in Hong Kong for the protection of policy holders, with a view to strengthening public confidence in the insurance market.
- 1.9 In 2010, the then Office of the Commissioner of Insurance commissioned (“OCI”) an actuarial study to assess the optimal levy rate, target fund size and other arrangements for a PPS. We subsequently carried out a three-month public consultation exercise in 2011 to solicit views on the proposal for establishing the PPS, including the coverage, level of compensation, funding mechanism and governance arrangements. While the public and industry generally supported the establishment of a PPS and most of the proposed key features, there were diverse views on the coverage and level of compensation.

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<sup>1</sup> Subject to the enactment of relevant legislation and formulation of implementation details, we plan to introduce a risk-based capital regime for the insurance industry of Hong Kong in 2024 to replace the existing rule-based capital adequacy regime. The RBC regime will make capital requirements more sensitive to the level of risk borne by insurers, thereby further strengthening the financial soundness of insurers and reducing the chance of insurer insolvency.

## **Recent Developments**

- 1.10 Between 2010 and 2015, we completed public consultation and legislative work for the establishment of an independent regulator for the insurance industry (i.e. the IA). Following the IA's take-over of the statutory functions from the then OCI in 2017, and based on the conclusions of the public consultation released in 2012, we have worked with the IA and industry stakeholders to fine-tune the proposal to establish a PPS.
- 1.11 In March 2018, we briefed the Panel on Financial Affairs ("FA Panel") of the Legislative Council ("LegCo") on the key legislative proposals for establishing a PPS. While Panel Members generally welcomed the establishment of a PPS, some expressed concern that the proposed design might not provide sufficient protection for policy holders. At the same time, there was concern about covering small and medium enterprises ("SMEs") under the PPS.
- 1.12 In 2019, we engaged the IA to commission a consultancy study to update the relevant parameters and review implications of the prevailing business environment on the design of the PPS, including the target fund size, lead time for accumulation and level of compensation.
- 1.13 The current proposal to establish a PPS has taken into account findings of the latest consultancy study. It maintains the objectives, guiding principles and most of the key features last presented for discussion at the FA Panel in March 2018.
- 1.14 Members of the public are invited to offer views on the key features of the proposed PPS as set out the following Chapters. We will take into account the comments received in finalizing the proposal to establish a PPS.

## **CHAPTER 2**

### **Protection against insurer insolvency in Hong Kong and international developments**

#### **Existing compensation schemes in Hong Kong**

- 2.1 At present, Hong Kong has compensation schemes in place for two types of general insurance policies mandated by statute, viz. motor insurance policies and employees' compensation policies, but not for long term insurance and other types of general insurance.
- 2.2 Where an insurer underwriting motor vehicle policies or employees' compensation policies becomes insolvent, compensation may be paid to policy holders or third party claimants under the existing schemes administered respectively by the Motor Insurers' Bureau of Hong Kong ("MIB") and Employees Compensation Insurer Insolvency Bureau ("ECIIB"), both being limited liability companies established by the insurance industry.
- 2.3 MIB was established in 1980 and its membership includes all insurers authorised to carry on motor vehicle insurance business in Hong Kong. Under the Insolvency Fund Scheme, compensation may be provided for liabilities which must be insured under the Motor Vehicles Insurance (Third Part Risks) Ordinance (Cap. 272), where a claim is not paid in full by the relevant insurer by reason of insolvency. The Insolvency Fund is accumulated through a levy collected from MIB member insurers, currently at a rate of 2% on gross premiums of motor insurance policies.
- 2.4 ECIIB was established in 2003 and its membership includes all insurers authorised to carry on employees' compensation insurance business in Hong Kong. Under the Employees Compensation Insurer Insolvency Scheme, compensation may be provided for liabilities which must be insured under the Employees' Compensation Ordinance (Cap. 282), where a claim is not paid in full by the relevant insurer by reason of insolvency. The Insolvency Fund is accumulated through a levy collected from ECIIB member insurers, currently at a rate of 2% on gross premiums of employees' compensation policies.

## **Prevailing protection under the CWUMPO and the IO**

- 2.5 The CWUMPO and the IO contain provisions for dealing with insurer insolvency.
- 2.6 Upon an insurer insolvency, the first step would normally be the appointment of a manager by the IA, who would be subsequently replaced by a provisional liquidator appointed by the Court. The manager or provisional liquidator is responsible for taking control of the insurer's assets. Thereafter, the Court may appoint a liquidator, who would be responsible for distributing assets of the insurer, after payment of expenses and fees, to its creditors according to the provisions of the CWUMPO.
- 2.7 For an insolvent long term insurer, the IO has stipulated how the assets under its long term business fund are to be dealt with<sup>2</sup>. The IO has also provided for the continuation of long term business in liquidation. For instance, the liquidator appointed by the Court must carry on an insolvent insurer's long term business with a view to its being transferred as a going concern to another insurer. The Court may approve a transfer of the insolvent insurer's long term business to another insurer on the application of the liquidator. The Court may also reduce the liability of long term insurance contracts of the insolvent insurer on terms and conditions as it thinks fit, instead of making a winding-up order.
- 2.8 For an insolvent general insurer, under the CWUMPO, any sum payable to a person in respect of any claim (other than a claim for a refund of premium) made under or in accordance with a contract of insurance effected by the insolvent insurer as part of its general business, subject to conditions, has a preferential claim against the assets of the insurer (save for certain employee-related debts due to the Government which have a higher level of preference than insurance claims).

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<sup>2</sup> Under the IO, the assets representing a fund maintained by an insolvent insurer in respect of its long term business shall be available only for meeting the liabilities of the concerned insurer attributable to that part of that business to which the fund relates.

## International developments

- 2.9 Despite the effective insurance regulatory regime which minimises the likelihood of insurer insolvency, the rare instance of winding up an insurance company may lead to substantial financial losses and disruption of insurance protection for policy holders. In this regard, the International Association of Insurance Supervisors (“IAIS”)<sup>3</sup> has promulgated guidelines recognising the use of a policy holders’ protection scheme to protect policyholders and beneficiaries in the case of insolvency of an insurer. According to the IAIS’ guidelines, these protection schemes should provide certainty on the level of compensation payment, and are usually seen as last-resort mechanisms in offering protection to policy holders in case of an insurer insolvency.
- 2.10 Many economies have compensation schemes in place to provide a safety net in addition to prudential regulation. Examples include the US, the UK, Singapore, Australia and Canada. While these schemes vary in scale and mode, many share the following characteristics –
- (a) operating on a post-funding or progressive funding mode;
  - (b) operating based on a levy collected from insurers;
  - (c) excluding large commercial entities and focusing on private individuals and, in some cases, SMEs as well;
  - (d) maintaining separate funds for long term and general insurance business;
  - (e) putting a limit on the compensation amount;
  - (f) providing for continuation and transfer of long term policies and offering financial support to facilitate the transfer of an insolvent insurer’s long term business to another insurer; and

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<sup>3</sup> The IAIS was established in 1994, with a membership of insurance regulators and supervisors from more than 200 jurisdictions. Its mission is to promote effective and globally consistent supervision of the insurance industry, in order to develop stable insurance markets for the benefit of policyholders.

- (g) maintaining a reasonable fund size to meet the shortfall and liquidity gap only, instead of catering for all possible liabilities, given that the assets of an insolvent insurer should normally be adequate to meet the bulk of the claims arising from its insurance contracts.

2.11 Following its visit to Hong Kong in September 2019 under the Financial Sector Assessment Programme, the International Monetary Fund mentioned in the “Technical Note – Insurance Sector Regulation and Supervision” issued in June 2021 that the planned introduction of a PPS in Hong Kong would provide a welcome enhancement of policy holder protection.

2.12 We see a need to establish a PPS in Hong Kong to provide an additional safety net for protection of policy holders in case of insurer insolvency, so as to benchmark with international standards and best practices.

Questions relating to Chapter 2

- 2(a) Do you agree that there is a need to establish a PPS in Hong Kong to provide an additional safety for protection of policy holders in case of insurer insolvency?

## CHAPTER 3

### Objectives, guiding principles and coverage of the PPS

#### Objectives

- 3.1 We seek to set up a PPS with a view to –
- (a) better protecting the interest of policy holders;
  - (b) maintaining market stability in the event of insurer insolvency; and
  - (c) enhancing public confidence in, and competitiveness of, the insurance industry of Hong Kong.

#### Guiding Principles

- 3.2 In formulating the proposal for establishing the PPS, we are guided by the following principles –
- (a) the PPS should strike a reasonable balance between enhancing protection for policy holders and minimising additional burden on insurers;
  - (b) the PPS should enhance market stability while minimising the risk of moral hazard on insurers and policy holders<sup>4</sup>;
  - (c) the PPS should provide certainty on the level of compensation payment to policy holders when an insurer becomes insolvent, and a robust system should be put in place to facilitate the collection, custody, investment and administration of levy contributions to the PPS; and

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<sup>4</sup> In the public consultation in 2011, some respondents were concerned about the potential moral hazard of providing an additional PPS safety net, in that –

- (a) insurers might become more aggressive in their pricing and investment strategies, thus increasing risk for insurers to become insolvent; and
- (b) policy holders may give less weight to the financial standing or rating of insurers, being inclined to choose products with the lowest premium.

- (d) the establishment of the PPS should not compromise the regulatory standards and requirements laid down by the IA under the IO.

## Coverage

### *Eligible policy holders*

- 3.3 The majority of compensation funds in other jurisdictions cover natural persons, and large corporations are normally excluded. We believe that this is mainly because large corporations are generally able to manage their risks and protect their interests in procuring insurance. We **recommend** that the PPS should focus on individual policy holders.
- 3.4 In the public consultation in 2011, we invited views on whether the PPS should cover SMEs which are generally less sophisticated than large corporates and may benefit from the protection of a compensation fund. We noted that there was considerable support, including those from the Consumer Council and the Small and Medium Enterprises Committee, for the PPS to cover SMEs primarily on the ground that SMEs would have less resources to assess the financial ability of insurers and are generally less capable to protect their interests. On the other hand, some respondents from the insurance industry considered that the PPS should focus on individuals and raised questions on the definition of SMEs as well as the practicability and cost implications arising from the need for insurers to verify the SME status of policy holders.
- 3.5 In the consultation conclusions in 2012, we proposed that the PPS should cover SMEs, and defined an SME as a manufacturing enterprise which employs fewer than 100 persons or a non-manufacturing enterprise which employs fewer than 50 persons in Hong Kong. We also proposed to adopt user-friendly verification procedures such as self-declaration of status by SME policy holders<sup>5</sup> to minimize the administrative cost and impact on insurers.

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<sup>5</sup> Self-declaration may be made at the time an SME policy holder procures the relevant insurance policy that it satisfy the definition of “SME”. The eligibility status of SME policy holder may remain during the policy term, and further proof may be requested for determining entitlement to protection if PPS is triggered in the event of relevant insurer insolvency.

- 3.6 In subsequent engagement with the insurance industry, stakeholders continued to express concerns about the proposed SME definition and verification procedures. Specifically, they suggested defining SME based on business turnover instead of staff headcount. They also underlined the practical difficulty for insurers and intermediaries to verify the SME status as self-declared by policyholders and the added burden in maintaining relevant records. At the FA Panel meeting in March 2018 during which the legislative proposals on the PPS were discussed, the Panel noted the industry's view that the PPS should not cover SMEs because while some SMEs had few employees, their capital size was huge.
- 3.7 At present, small corporates are covered under similar protection schemes in the UK, Australia, Singapore and Canada, although their definition of small corporations or protection afforded to eligible corporations vary<sup>6</sup>. On the other hand, while the definition of SME based on headcount has been generally adopted by the Government for identifying targets for support, there are various eligibility criteria to fit specific objectives of the respective support measures in Hong Kong. In light of the forgoing, while appreciating the need to cover SMEs under the PPS, we consider it prudent to further discuss with stakeholders on the definition of SME and related operational arrangements. On balance, we **recommend** that the PPS should focus on individual policy holders at the initial stage of implementation, and be expanded to cover SMEs as and when conditions are ripe.

#### *Protected policies*

- 3.8 To ensure comprehensive protection for policy holders, and on the basis that SME policy holders will eventually be covered under the PPS, we **recommend** that the PPS should cover all insurance policies in force as at the date of the establishment of PPS as well as new policies issued thereafter, except the policies of the following types of business –

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<sup>6</sup> For instance, only small businesses with annual turnover of less than £1 million are covered under similar protection scheme in the UK. For Australia, while all businesses are covered under its protection scheme if the claim amount is less than A\$5,000, only Australian-based small businesses are covered if the claim amount is A\$5,000 or above. In the case of Singapore, while all corporations are covered under its scheme, only compulsory insurance policies taken out by corporations are protected.

- (a) Reinsurance business;
- (b) Long term business of managing contributions under a retirement scheme<sup>7</sup>; and
- (c) General business which is (i) subject to alternative protection under existing arrangements, or (ii) focused on specialty risks, or lines of business which are unusual for individuals or SMEs<sup>8</sup>.

3.9 We **recommend** that all insurers authorized to carry on business in Hong Kong should be required to participate as members of the PPS, except –

- (a) captive insurers, reinsurers, special purpose insurers and other insurers not authorised to carry on business of any policies protected under the PPS; and
- (b) foreign-incorporated insurers exempted on the grounds of equivalent protection afforded by a similar scheme in other jurisdictions<sup>9</sup> on a case-by-case basis.

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<sup>7</sup> Within the meaning of IO Schedule 1 Part 2, the long term business proposed to be excluded are those of Class G (Retirement scheme management category I) and Class H (Retirement scheme management category I), which include such schemes as the Occupational Retirement Schemes and Mandatory Provident Funds Schemes. We propose to exclude these policies from the PPS given that such schemes are held in trust arrangements that would protect assets in the event of the insurer concerned becoming insolvent.

<sup>8</sup> Within the meaning of IO Schedule 1 Part 3, the general business proposed to be excluded are as follows –

- (i) Motor vehicle policies (Classes 3 and 10) which will be covered by MIB;
- (ii) Employees compensation policies (part of Class 13 General liability) which will be covered by ECIB;
- (iii) Aviation insurance (Classes 5 and 11) which is unusual for individuals/SMEs;
- (iv) Marine insurance (Classes 6 and 12), which is unusual for individuals/SMEs;
- (v) Credit insurance (Class 14) which can be insured through the Hong Kong Export Credit Insurance Corporation, a statutory body guaranteed by the Government;
- (vi) Risk of war and strike, riots and civil commotion in goods in transit insurance (part of Class 7); and
- (vii) Offshore risks of policies other than travel, accident, sickness and goods in transit insurance.

<sup>9</sup> In the earlier consultation, we noted views that some insurers may already be covered by similar policy holders' protections schemes in other jurisdictions, and there should be no need to charge double levies on policies protected under other schemes. We consider it may be reasonable to allow case-by-case exemption on application by such insurers able to demonstrate that they offer equivalent protection to policy holders via an alternative scheme of similar nature.

3.10 Given the different nature of long term and general policies, for example, in respect of their duration, payout and risk profile, we **recommend** that two separate funds should be established under the PPS, namely –

- (a) the Long Term Fund to cover policies that pay benefits related to the life status of the policy holder, including term life policies, endowment policies, annuities, investment-linked policies, permanent disability policies; and
- (b) the General Fund to cover non-life policies, including accident and health policies, home insurance policies, fire insurance policies, travel insurance policies, third party risk liability insurance policies of building owners' corporations<sup>10</sup>.

Questions relating to Chapter 3

- 3(a) Do you support the objectives and guiding principles for developing the PPS?
- 3(b) Do you agree with the proposed scope of eligible policy holders under the PPS?
  - Views are welcome, in particular, on the inclusion of SMEs as well as the definition of SME and the verification procedures to be adopted.
- 3(c) Do you agree with the proposed compulsory membership of insurers under the PPS?
- 3(d) Do you agree with the proposed scope of protected long term and general policies under the PPS?

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<sup>10</sup> In line with earlier proposal which received general support, building owners' corporations are included in the scope of eligible policy holders under the PPS as building owners are usually individuals and it is a mandatory requirement for such corporations to procure third party risk insurance under the Building Management (Third Party Risks Insurance) Regulation (Cap. 344B).

## CHAPTER 4

### Arrangements in the Event of Insurer Insolvency

#### Conditions for Activating the PPS

- 4.1 With reference to the insurer insolvency compensation regimes in other jurisdictions, we **recommend** that the use of the Fund(s) under the PPS will be triggered upon occurrence of a “specified event” which is defined as –
- (a) winding up proceedings of an insurer who is a member of the PPS have commenced; and
  - (b) the IA has assessed the situation and served a written notice that the Long Term Fund or General Fund, or both as the case may be, should be used.
- 4.2 Once activated, compensation will be made from the respective Long Term Fund, General Fund, or both as the case may be, to claims lodged by holders of protected policies written by the insolvent insurer.

#### Compensation limit

- 4.3 In the public consultation in 2011, we proposed setting a compensation limit to strike a balance between cost and benefit of the PPS and minimize the risk of moral hazard. We also proposed that the compensation should be the first \$100,000 of any claim, plus 80% of the balance, up to a total compensation limit of \$1 million<sup>11</sup>. While some respondents suggested raising the limit, we maintained the proposed limit of \$1 million in the consultation consultations having regard to findings of the actuarial study conducted in 2010 on the impact of increase in compensation limit on protection level and levy rate.

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<sup>11</sup> For example, a claim for \$1.225 million would hit the compensation limit of \$1 million (calculated as:  $\$100,000 \times 100\% + \$ (1,225,000 - 100,000) \times 80\% = \$1,000,000$ ), whereas a claim of \$0.5 million would be compensated at \$0.42 million (calculated as:  $\$100,000 \times 100\% + \$ (500,000 - 100,000) \times 80\% = \$420,000$ ). Any claim for more than \$1.225 million would be compensated at the cap of \$1 million.

- 4.4 According to the findings of the consultancy study based on industry data in 2019, due to the growth of the insurance market over the years, the number and value of insurance policies in Hong Kong have seen an increase. Based on this study, policies with claim amount of not more than \$1.225 million (their compensation would fall within the previously proposed limit of \$1 million) account for 99.1% and 99.9% of the respective number of long term policies and general policies. Such proportion is comparable to that based on the 2010 study (i.e. 99.8% and 99.9% of the respective number of long term policies and general policies then). However, in terms of claim amount, policies with claim amount of not more than \$1.225 million only account for 62.5% of the long term market, much lower than the proportion of 82.3% based on the 2010 study due to an increased sale of large-sized long term policies in the past decade; whereas the proportion of general policies is now 62.3%, broadly comparable to that (59.8%) based on the 2010 study.
- 4.5 It is also noted from the recent consultancy study that increasing the compensation limit under the PPS would enhance the level of protection in terms of claim amount. Based on industry data in 2019 and without affecting the rate of levy for fund accumulation (detailed at paragraph 5.10 below), a comparison of three options on compensation limit and their protection level are set out in the following table. We welcome views on which option to be adopted under the PPS.

	Compensation limit	Policies within the cap on clam amount <sup>12</sup>	
		% by count	% by claim amount
<p><b><u>Option 1</u></b></p> <p><b>\$1 million</b></p> <p>(previous proposal)</p>	<p>Maximum of <b>\$1 million</b> – 100% of the first \$100,000 + 80% of the remaining amount</p> <p>(i.e. claim amount capped at \$1,225,000)</p>	<p>LT: 99.1% G: 99.9%</p>	<p>LT: 62.5% G: 62.3%</p>
<p><b><u>Option 2</u></b></p> <p><b>\$2 million</b></p>	<p>Maximum of <b>\$2 million</b> – 100% of the first \$200,000 + 80% of the remaining amount</p> <p>(i.e. claim amount capped at \$2,450,000)</p>	<p>LT: 99.6% G: 99.9%</p>	<p>LT: 72.5% G: 69.0%</p>
<p><b><u>Option 3</u></b></p> <p><b>\$4 million</b></p> <p>(Under this option, the level of protection in terms of claim amount for long term policies is comparable to the level at the 2010 study.)</p>	<p>Maximum of <b>\$4 million</b> – 100% of the first \$400,000 + 80% of the remaining amount</p> <p>(i.e. claim amount capped at \$4,900,000)</p>	<p>LT: 99.9% G: 100 %</p>	<p>LT: 81.6% G: 77.5%</p>

<sup>12</sup> Under Option 1, a policy within the cap on claim amount refers to one with claim amount within \$1.225 million; whereas under Option 2 and Option 3, this refers to policies with claim amount under \$2.45 million and \$4.9 million respectively.

Take long term policies in the above Option 1 for instance, 99.1% of policies are estimated to have claim amounts within the limit of \$1.225 million, and these policies take up 62.5% of claim amount in the market; whereas the 0.9% policies with claims amount above the limit of \$1.225 million account for about 37.5% of claim amount in the market.

## **Relief for policy holders in the event of insurer insolvency**

4.6 Upon the occurrence of insurer insolvency, a manager, provisional liquidator or liquidator, as the case may be, will be appointed under the prevailing insurance regulatory and insolvency regimes to carry on the business of the insurance company concerned. Such person will be closely involved in managing the policies and claims where PPS is activated to cover protected policies written by the insolvent insurer. Different courses of action may be pursued under different circumstances in handling different policies, as proposed in paragraphs 4.7 to 4.14 below.

### *Long Term Fund*

4.7 Premature encashment or surrender of long term policies could lead to a substantial loss for policy holders. Owing to the life protection nature of these products, it will be in the best interest of policy holders if such policies could continue to be in force. In this regard, the IO currently provides that the liquidator must carry on an insolvent insurer's long term business with a view to its being transferred as a going concern to another insurer. It also allows the Court, if it thinks just, to reduce the amount of insurance contracts of an insurer which is unable to pay its debt, instead of making a winding-up order.

4.8 We **recommend** that the PPS should facilitate transfer of long term policies to a replacement insurer wherever possible, and be able to (i) make a payment to facilitate such transfer and (ii) settle claims and pay benefits for protected policies pending such transfer. We also **recommend** that the PPS may set up a dedicated insurance company for running off the business of an insolvent insurer (i.e. provide coverage for protected policies until expiry, without effecting any new contracts), if transfer of policies to another commercial insurer cannot be arranged.

4.9 We **recommend** that for any termination of policies (whether by the liquidator or by the policy holders), the PPS may refund unexpired premiums, and settle claims and pay benefits for protected policies before termination. We further **recommend** that where the Court has ordered reduction of amount of contracts, or where the liquidator has to terminate the policies (when neither the transfer of policies to another commercial insurer nor the setting up of a dedicated

company for running off purposes can be arranged), the PPS may make “ex-gratia” payment to assist the policy holders to procure replacement policies.

### *General Fund*

- 4.10 As general insurance contracts are usually in force for a shorter period (normally one year), these policies are likely to have expired before the liquidation process is complete. Having considered the practice of other jurisdictions and that alternative coverage is generally available in the market, we **recommend** that the PPS should provide insurance coverage for protected general policies up to 60 days following the specified event, or until expiry / termination, whichever is earlier. Any unexpired premiums will be refunded.

### *Accident and health (“A&H”) policies with guaranteed renewability*

- 4.11 A&H policies may take the form of a standalone general insurance policy<sup>13</sup>, or a rider to a long term policy. For those A&H policies which provide for guaranteed renewability, policy holders may suffer disadvantage if they have to procure alternative coverage in the event of insurer insolvency. This is because their conditions (e.g. health status) may have changed and the cost of guaranteed renewability is normally reflected in the premiums paid.
- 4.12 To better protect policy holders, we **recommend** providing relief for A&H policies with guaranteed renewability along similar arrangement as long term policies, prioritising transfer to another insurer for continuity. On the other hand, A&H policies without guaranteed renewability, including those which are riders to a long term policy, will be treated in the same manner as other general policies.

### *Application of the compensation limit*

- 4.13 In line with the proposals presented to the FA Panel in March 2018, we **recommend** that the compensation limit should apply to long term insurance on a per-policy basis and to general insurance on a per-claim basis, except in the case of –

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<sup>13</sup> Schedule 1 of the IO provides at Part 4 that the group of “accident and health” business encompasses general business classes 1 (accident) and 2 (sickness).

- (a) group long term policies where the compensation limit should apply on a per-life basis<sup>14</sup>;
- (b) A&H riders to long term policies (irrespective of whether they provide for guarantee renewability) where the compensation limit will apply on a per-claim basis; and
- (c) multiple general insurance claims arising from one insured event where the compensation limit should apply on a per-event basis.

4.14 We further **recommend** that the aggregated amount of (i) any payment to facilitate a transfer of long term policies to another insurer, to settle insurance claims and benefits or to refund unexpired premiums and (ii) any ex-gratia payment should not exceed the compensation limit.

### **Illustrative examples**

4.15 The deployment of PPS in relation to different types of protected policies under various scenarios are illustrated in some examples provided at **Annex**.

#### Questions relating to Chapter 4

- 4(a) What would be the appropriate level of protection offered under PPS? Do you prefer Option 1 (\$1 million), Option 2 (\$2 million) or Option 3 (\$4 million) on the compensation limit?
- 4(b) Do you agree with the relief to be provided under PPS?
  - (i) Do you agree with the arrangement of prioritising transfer of long term policies?
  - (ii) Do you agree with the arrangement of transitional continuity for general policies?

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<sup>14</sup> The proposal would protect the beneficiary of every insured individual, and prevent scenario where a relatively small amount of compensation would be divided to each claimant in case of multiple deaths. The financial impact of such proposal would be insignificant given the small number of group long term policies covered under PPS.

## CHAPTER 5

### Funding Mechanism

#### Source of funding

- 5.1 As the PPS would benefit the insurance industry by maintaining market stability and promoting industry competitiveness, we **recommend** that the PPS be funded by levies to be collected from insurers who are required to participate as scheme members.
- 5.2 We note that the following three possible funding models are adopted for similar schemes in other jurisdictions –
- (a) Pre-funding model, which seeks to build up a reserve by early collection of levies in anticipation of future liabilities. While offering certainty with a high level of reserve, this has the drawback of locking up a huge amount of levies which in turn puts pressure on the premiums charged on policy holders;
  - (b) Post-funding model, which seeks to collect levy contributions after an insurer insolvency has occurred. This avoids the need to build up and maintain reserve funds, but may require very steep rate of levies in the event of insurer insolvency, undermining the financial position of insurers especially if coinciding with economic downturn; and
  - (c) Progressive funding model, which is a combination of the above, usually with an initial moderate levy rate complemented by an additional levy upon occurrence of insolvency. This would ensure the availability of an upfront reserve through an affordable level of levy which will not put excessive pressure on nor affect sustainability of the insurance industry, meeting any arising liabilities while allowing flexibility to increase the levy rate to meet actual needs;

On balance, we **recommend** adopting a progressive funding model which is a more balanced and pragmatic approach.

- 5.3 To accumulate the upfront reserve, we **recommend** imposing an initial levy (to be prescribed in subsidiary legislation) until the PPS

Funds have reached a target size. In case of an insurer insolvency, the available funds under the PPS would be deployed to meet relevant liabilities.

- 5.4 In the event that the PPS Funds are not sufficient to meet all the liabilities of an insurer insolvency, we **recommend** that the PPS be allowed to borrow from a third party (e.g. a commercial lender for which the Government may act as the guarantor, or from the Government direct) subject the approval of LegCo, so as to bridge the liquidity gap. This should facilitate the PPS to make timely payment before receiving distribution from the insolvent insurer's estate. We further **recommend** that an additional levy (to be prescribed in subsidiary legislation) may be collected to restore the fund size back to the target level.
- 5.5 If there is no insurer insolvency by the time the target fund size is achieved, we **recommend** that suspension or reduction of levy rate may be considered when the accumulated amount exceeds the target size and two years' operating expenses for the PPS.

### **Recovery of assets**

- 5.6 An issue relevant to the funding of PPS is whether the PPS can recover part or all of the compensation paid by making a claim against the estate of the insolvent insurer. In line with the practice of similar compensation schemes in other jurisdictions as well as the existing schemes administered by MIB and ECIIB in Hong Kong, we **recommend** that where claimants are compensated by the PPS in case of an insurer insolvency, the protected element of the claim (i.e. the part met by PPS) should be subrogated to the PPS. In other words, i.e. the PPS will take over the claimants' rights and seek recovery from the state of the insolvent insurer.
- 5.7 We also **welcome views** on whether the PPS should have equal ranking with two classes of creditors (i.e. the Employee Compensation Assistance Fund and all other direct insurance claims not met with the PPS) specified in section 265 of the CWUMPO during the winding up process, as proposed during the earlier public consultation in 2011. Under this proposed ranking, the PPS will enjoy preferential status over ordinary creditors, thereby facilitating the recovery of funds for payment made in relation to an insurer

insolvency. However, some respondents during earlier consultation were concerned that this might be disadvantageous to MIB and ECIIB when claiming from the estate of the same insolvent insurer because their compensation schemes are ranked as ordinary creditors.

## **Target fund size and levy rate**

5.8 At the FA Panel meeting in March 2018, some members were concerned that the proposed target fund size of \$1.2 billion and \$75 million for the Long Term Fund and the General Fund respectively was too low in providing adequate protection for policy holders. In view the lapse of time and change in market conditions, the IA collected industry data in 2019 to re-evaluate the relevant parameters of the PPS (including target fund size and lead time for accumulation) during the recent consultancy study.

### *Initial levy rate*

5.9 In line with the proposal which received general support from previous public consultation in 2011 and subsequently presented to the FA Panel in March 2018, we **recommend** that the initial levy rate for both the Long Term and General Fund be set at 0.07% of the applicable premium income, with a minimum annual levy payment of \$10,000 for each insurer<sup>15</sup>. Levies from long term and general policies will contribute respectively to the Long Term and General Fund, and there will no cross-subsidy between the two funds.

### *Initial target fund size*

5.10 In determining the initial target fund size, it is necessary to strike a reasonable balance between the need to secure adequate compensation for policy holders in case of insurer insolvency and to minimize the cost implications on insurers. For ease of comparison, the initial fund size and lead-time for accumulation assuming an initial levy rate of 0.07% under the three options on compensation limit set out in paragraph 4.5 above are illustrated below –

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<sup>15</sup> The amount of levy payable by a participating insurer is calculated based on the gross premium income of the protected policies issued by such insurer in a financial year.

<b>Compensation limit</b>	<b>Initial levy rate</b>	<b>Target fund size</b>	<b>Lead time</b>
<u>Option 1</u> \$1 million	0.07%	LT: \$1.48 billion G: \$78 million	LT: 6 years G: 9 years
<u>Option 2</u> \$2 million		LT: \$2.08 billion G: \$95 million	LT: 9 years G: 11 years
<u>Option 3</u> \$4 million		LT: \$2.88 billion G: \$112 million	LT: 13 years G: 14 years

*Cap on additional levy*

5.11 In earlier consultation, industry stakeholders suggested that there should be a cap on the additional levy to be collected from participating insurers in the event that the PPS Fund(s) were insufficient to meet all liabilities of an insurer insolvency, so as to minimize the uncertainty of the magnitude of future increase of the levy rate. They also suggested imposing the additional levy incrementally, i.e. adjusting the rate of additional levy according to a pre-fixed progressive scale such that it would reach the cap of 1% in ten years.

5.12 Having considered the practices of other jurisdictions and the need to provide more certainty to insurers in their financial planning, we **recommend** that the rate of any additional levy be capped at 1%. However, as the actual rate of an additional levy to be collected would depend on circumstances prevailing at the time (e.g. the amount of remaining funds, likelihood of recovering assets from the insolvent estate and affordability of the insurers participating in the PPS), we do not consider it appropriate to adopt a pre-fixed progressive scale in reaching the cap.

Questions relating to Chapter 5

- 5(a) Do you support a progressive funding model with levies collected from participating insurers for the operation of PPS?
- 5(b) Do you support the borrowing mechanism for the PPS to meet any liquidity gap?
- 5(c) What are your views on the proposed priority ranking of PPS with the two classes of creditors (i.e. the Employee Compensation Assistance Fund and all other direct insurance claims not met with the PPS) specified in section 265 of the CWUMPO during the winding up process?
- 5(d) Do you agree with the proposed levy rate and levy cap? Do you have any views on the arrangement for levy review and adjustment?

## CHAPTER 6

### Governance, administration and related matters

#### Legal and organizational structure

6.1 We **recommend** that the PPS should be established by statute and should operate under the oversight of a statutory body named the Policy Holders' Protection Scheme Board ("PPS Board"). This will better ensure a high level of certainty, transparency and accountability in the design and implementation of PPS. We further **recommend** that the IA<sup>16</sup> should serve as the administrative arm of the PPS Board for cost-effectiveness and operational efficiency.

#### The PPS Board

##### *Functions and powers*

- 6.2 We **recommend** that functions and powers of the PPS Board to be stipulated in legislation should cover, but not be limited to, the following –
- (a) to manage and administer the PPS, including usage of the Long Term Fund or General Fund;
  - (b) to assess and collect payment, including levy contributions, from scheme members;
  - (c) to liaise with the liquidator, provisional liquidator or other relevant persons for making arrangements including to settle insurance claims and pay compensation;
  - (d) to facilitate transfer of business, including making necessary payments and establishing dedicated insurance company for the specific purpose of running-off business of an insolvent scheme member;

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<sup>16</sup> The IA is an independent regulator established under the IO to regulate and supervise the insurance industry for the promotion of the general stability of the insurance industry and for the protection of existing and potential policy holders.

- (e) to recover compensation paid out of the PPS from assets of the insolvent scheme members;
- (f) to maintain financial position of the PPS by investing funds, or borrowing money to meet any liquidity gap; and
- (g) to issue guidelines and make regulations for managing the PPS.

### *Membership*

- 6.3 Considering the functions and powers of the PPS Board, we **recommend** that its membership should comprise representatives from the Government and the IA, as well as professionals with relevant expertise (e.g. insurance, actuarial science, finance, accounting, law, consumer affairs). Members of the PPS Board should be appointed by the Chief Executive.

### *Governance arrangements*

- 6.4 To ensure accountability and transparency of the operation of the PPS Board, we **recommend** that the PPS Board must submit the annual budget of the PPS for approval by the Financial Secretary (“FS”), maintain proper accounts, and prepare annual reports and audited financial statements to be tabled before LegCo. We further **recommend** that FS may appoint the Director of Audit to or an external auditor to perform audit reviews on the PPS.

### *Investment guidance*

- 6.5 We **recommend** that the PPS Board should exercise a high level of prudence in investing the money of the PPS. In performing its investment functions, the PPS Board should make reference to the practices of other compensation funds (e.g. the Deposit Protection Scheme).

### *Confidentiality*

- 6.6 Given their access to sensitive commercial information on scheme members, we **recommend** that PPS Board members and any other persons engaged in the operation of the PPS should be required to keep confidential any information obtained in the course of carrying

out relevant functions. Disclosure of information would be subject to conditions prescribed in law.

### *Appeal Mechanism*

- 6.7 A person aggrieved by a relevant decision made under the PPS should be able to apply for a review of the decision. We **recommend** setting up an independent Policy Holders' Protection Appeals Tribunal to deal with appeals against relevant decisions of the PPS Board. The relevant decisions subject to review include a decision on whether a policy holder is an eligible person, a decision on the amount of payments to relevant policy holders, a decision to exempt an insurer from PPS membership, a decision on the level of levy payable by scheme members, etc.

#### Questions relating to Chapter 6

- 6(a) Do you agree with the proposed establishment of the PPS Board and composition, and that the IA should be its administrative arm?
- 6(b) Do you agree with the proposed powers and functions of the PPS Board?
- 6(c) Do you have other suggestions on the proposed governance arrangements?

**Illustrative examples of  
the Policy Holders' Protection Scheme ("PPS") in practice**

<b>No.</b>	<b>Scenario</b>
1	How long term policies and A&H policies with guaranteed renewability are protected
2	How general policies are protected
3	How time of claim submission (before or after an insurer's insolvency) affects compensation
4	How time of the occurrence of the insurable event (before or after an insurer's insolvency) affects compensation
5	How does a policy holder's decision to surrender his policy affect compensation
6	How is a policy holder's right to continue his long term policy protected
7	How are Building Owners' Corporation third party liability insurance policies protected

## 1. How long term policies and A&H policies with guaranteed renewability are protected

All protected long term policies or a rider with guaranteed renewability held by eligible policy holders are covered by the Long term Fund of the PPS, meaning that when their insurer fails the PPS may make payment to policy holders up to a compensation limit (amount subject to the final PPS design). The PPS seeks to facilitate the transfer of long term policies to a replacement insurer or to set up a dedicated insurance company for running off the business of an insolvent insurer. In the event that this cannot be arranged and the policy has to be terminated, the PPS may make an ex-gratia payment to facilitate the policy holders to procure a replacement policy if the policy holders so wish.

Mr A has a 10-year regular premium endowment policy. The sum insured is HK\$1,400,000, and the beneficiary is his son, Boy A. A regular premium endowment policy is a saving-type product, in which Mr A pays a premium of HK\$100,000 each year and is entitled to a guaranteed cash value if he surrenders the policy during the term of the policy. If he dies before the end of year 10, Boy A will be entitled to the insured sum of HK\$ 1,400,000. When the policy matures in year 10, Mr A will also be entitled to the insured amount of HK\$1,400,000.

The insurer becomes insolvent on 1 January 2023, at which time Mr A's policy has been in force for 5 years, and the cash value of his policy is HK\$600,000. Suppose there are four scenarios:

- (i) Mr A dies on 15 December 2022, and the claim has yet to be processed or paid by the insolvent insurer;
- (ii) Mr A dies on 15 January 2023;
- (iii) Mr A chooses to surrender his policy;
- (iv) Mr A chooses to continue his policy.

For illustrative purposes, assume that the final design of the PPS is to cover the first HK\$400,000 and 80% of the remaining amount with the amount of total payment capping at HK\$4,000,000.

In scenarios (i) and (ii), Boy A will be entitled to compensation of HK\$1,200,000 (calculated as HK\$400,000 + 80% x HK\$ 1,000,000) from the PPS and to claim HK\$200,000 from the assets of the insolvent insurer.

In scenario (iii), Mr A will be entitled to receive HK\$560,000 (calculated as HK\$400,000 + 80% x HK\$200,000) for the policy's cash value from the PPS, and to claim the remaining HK\$40,000 from the assets of the insolvent insurer.

In scenario (iv), if the liquidator can transfer his policy to another insurer, the terms and conditions of the policy will be determined by the Court in accordance with the Insurance Ordinance (Cap. 41). Mr A will continue to pay premiums to the new insurer, and the premium will be decided by the Court. Mr A will be entitled to claim from the new insurer if he surrenders his policy or when the policy expires. Boy A will also be entitled to claim from the new insurer if Mr A dies. If the liquidator is unable to transfer his policy to another insurer, the PPS may set up a dedicated insurance company to take over the insolvent insurers' policies, including Mr A's policy, failing which (for reasons such as disproportionate cost of setting up a dedicated company) the PPS may make ex-gratia payment to facilitate Mr A in procuring a replacement policy.

## 2. How general policies are protected

All protected general policies held by eligible policy holders are covered by the General Fund of the PPS, meaning that when their insurer fails the PPS pays compensation to policy holders up to the compensation limit. Some general policies are recommended not to be covered by the PPS such as those focusing on specialty risks, or lines of business which are unusual for individuals and SMEs.

The PPS provides insurance coverage for protected general policies up to 60 days following the “specified event” (i.e. procedures triggering activation of the PPS), or until expiry / termination, whichever is earlier. The PPS provides payment of claims and benefits for an insured event occurring during the covered period. Any unexpired premiums will be refunded.

Mr A has a home insurance plan that reimburses him for any property losses to his flat in Hong Kong. It is a 1-year policy that expires on 30 June 2023. His insurer becomes insolvent on 1 January 2023. Suppose there are five scenarios:

- (i) Mr A suffers a property loss caused by a fire outbreak that happened on 15 December 2022. The insurer has agreed that the amount payable is HK\$800,000 but Mr A has not yet received the payment when the insurer becomes insolvent;
- (ii) Mr A suffers a property loss caused by a fire outbreak that happened on 15 January 2023, half a month after the insurer becomes insolvent. The liquidator’s claim adjustor confirms that the claim amount payable is HK\$800,000;
- (iii) Mr A suffers a property loss caused by a fire outbreak that happened on 1 April 2023, three months after the insurer becomes insolvent;
- (iv) Mr A’s property is in Japan instead of Hong Kong;
- (v) Mr A is the owner of a large corporation (which is not a SME corporation) and holds the policy through his company.

For illustrative purposes, assume that the final design of the PPS is to cover the first HK\$ 400,000 and 80% of the remaining amount with the amount of total payment capping at HK\$4,000,000. Assuming the specified event triggering activation of the PPS is carried out on the day of insurer insolvency, the 60-day extended coverage of Mr A’s policy under the PPS will expire on 2 March 2023.

In scenarios (i), (ii), and (iii) Mr A is entitled to refunds of any unexpired premiums.

- In scenario (i), Mr A is additionally entitled to compensation of HK\$720,000 (calculated as HK\$400,000 + 80% x HK\$ 400,000) for claims and benefits due from the PPS, and to claim the remaining HK\$80,000 from the assets of the insurer.

- In scenario (ii), Mr A is additionally entitled to compensation of HK\$ 720,000 as the coverage of his policy is extended for 60 days from the time of insurer failure. Mr A can also claim the remaining HK\$80,000 from the assets of the insurer.
- In scenario (iii), Mr A is not entitled to payments for his property loss as his policy is no longer valid after 60 days from the time of insurer failure. Mr A can claim HK\$800,000 from the assets of the insurer

In scenarios (iv) and (v), Mr A is not protected by the PPS, thus not entitled to any compensation; and Mr A or his company can claim HK\$800,000 from the assets of the insurer. For scenario (iv), the policy insures offshore risks which are recommended not to be covered by the PPS. For scenario (v), the policy is held by a large corporation which is recommended not to be an eligible policy holder under the PPS.

### **3. How time of claim submission (before or after an insurer's insolvency) affects compensation**

In general, the timing of claim submission does not affect the amount of compensation a policy holder is entitled to as long as the policy is still valid during the time when the insured event takes place.

Mr A has insured his life for HK\$2,000,000 if he dies during the term of the policy which will expire in 2030. The beneficiary is Mrs A. Suppose Mr A dies on 15 December 2022 right before the insurer becomes insolvent on 1 Jan 2023 and there are two scenarios:

- (i) A claim on Mr A's term life policy was submitted to his insurer on 20 December 2022 before the specified event. The insurer has agreed that the amount payable is HK\$2,000,000 but payment was not yet received when the insurer becomes insolvent;
- (ii) Similar to (i), but in this case a claim was submitted after the specified event to the liquidator on 10 January 2023. The liquidator's claim adjuster confirms that the claim amount payable is HK\$2,000,000.

For illustrative purposes, assume that the final design of the PPS is to cover the first HK\$400,000 and 80% of the remaining amount with the amount of total payment capping at HK\$4,000,000.

In both scenarios (i) and (ii), Mr A will be entitled to compensation of HK\$1,680,000 (calculated as HK\$400,000 + 80% x HK\$1,600,000) from the PPS for claims and benefits due, and to claim the remaining HK\$320,000 from the assets of the insurer.

#### **4. How time of the occurrence of the insurable event (before or after an insurer's insolvency) affects compensation**

For general policy, the PPS should provide insurance coverage for protected general policies up to 60 days following the specified event, or until expiry / termination, whichever is earlier.

Mr A purchased a travel insurance policy for HK\$500 for an upcoming vacation (the policy term being the duration of his vacation). Subsequent to purchasing the policy, his insurer becomes insolvent on 1 Jan 2023. Suppose there are three scenarios:-

- (i) The insurance policy covers Mr A's vacation from 1 December to 14 December 2022 before the insurer's insolvency. During the holiday Mr A loses his Hong Kong identity card. The replacement cost for the card is HK\$370;
- (ii) Similar to (i), but in this case Mr A's vacation is from 1 February to 14 February 2023, a month after the insurer's insolvency;
- (iii) Similar to (i), but in this case Mr A's vacation is from 1 April to 14 April 2023, three months after the insurer's insolvency.

Assuming the specified event triggering activation of the PPS is carried out on the day of insurer insolvency, the 60-day extended coverage of Mr A's policy under the PPS will expire on 2 March 2023.

In both scenarios (i) and (ii), Mr A will be entitled to compensation of HK\$370. It is because the PPS provides extended coverage for eligible general policies for 60 days. Also, in scenario (ii), as Mr A receives coverage from PPS for the whole policy term, there is no refund of unexpired premiums.

In scenario (iii), Mr A will receive HK\$500 from the PPS for a refund of the unexpired premiums but not compensation for his loss of identity card. It is because the travel policy is terminated 60 days after the insurer's insolvency.

For long term policy, the time when an insured event takes place may not have any impact on the amount of compensation because the PPS's priority is to facilitate the transfer of such policies as soon as possible. Therefore, a policy holder can submit a claim to the replacement insurer after the specified event if their policies are transferred to a new insurer.

Mr A has a regular premium disability income policy that pays him a disability income of HK\$400,000 per annum up to age 65 if he becomes disabled. Also, Mr A is not required to pay premiums in the time he has become disabled. His insurer becomes insolvent on 1 January 2023. Suppose Mr A becomes disabled as he suffers serious injuries in a crash on 1 February 2023.

For illustrative purposes, assume that the final design of the PPS is to cover the first HK\$400,000 and 80% of the remaining amount with the amount of total payment capping at HK\$4,000,000.

During the liquidation process, Mr A will be entitled to receive disability income of HK\$400,000 for the first year, and then HK\$320,000 (calculated as HK\$400,000 x 80%) afterwards until the PPS payment reaches HK\$4,000,000, or Mr A recovers from the disability, reaches age 65 or dies, whichever is earlier. Mr A will also be entitled to claim from the assets of the insolvent insurer for disability income not covered by the payment from the PPS.

If the liquidator of the insolvent insurer can transfer his policy to another insurer, then the terms and conditions of the policy will be determined by the Court. Mr A will receive the disability income (as determined by the Court) from the new insurer until he recovers or dies. If the Court orders a reduction of the contract amount before a transfer, Mr A may receive an ex-gratia payment from the PPS, the amount of which is capped by the compensation limit.

## 5. How does a policy holder's decision to surrender his policy affect compensation

For long term policies, subject to the terms of each specific policy, a policy holder can usually choose to surrender a policy and receive the surrender value of that policy. If a policy holder wishes to surrender a policy after an insurer's insolvency, the policy holder is entitled to the cash value of that policy from the PPS.

Mr A has purchased a whole life policy which pays death benefits to the beneficiary. At any point during the term of the policy, Mr A can surrender the policy and receive the cash value and dividends. As the insurer becomes insolvent on 1 January 2023 when the cash value and dividends are worth HK\$3,000,000, Mr A chooses to submit a request to the liquidator to surrender his policy later on 15 January 2023 to receive the said cash value and dividends.

For illustrative purposes, assume that the final design of the PPS is to cover the first HK\$400,000 and 80% of the remaining amount with the amount of total payment capping at HK\$4,000,000.

In this case, Mr A is entitled to receive HK\$2,480,000 from the PPS (calculated as  $\text{HK\$}400,000 + 80\% \times \text{HK\$}2,600,000$ ), and to claim the remaining HK\$520,000 from the assets of the insolvent insurer.

## 6. How is a policy holder's right to continue his long term policy protected

For long term policies, subject to the terms of each policy, a policy holder can usually choose to continue the policy at the end of the policy term by continuing to pay premiums. If the policy holder wishes to continue his long term policy after the insurer's insolvency, he may continue his policy with a new insurer arranged by the PPS.

Mr A purchased an annuity policy on 1 December 2022. Mr A will start to receive an annuity payment 10 years after the time of purchase, i.e. starting from 1 January 2032, the policy pays him HK\$100,000 per annum with certainty. A cash value is payable if he surrenders the policy. Suppose Mr A chooses to continue the policy when the insurer becomes insolvent on 1 January 2023, and there are three different scenarios:

- (i) The PPS takes priority to facilitate the transfer of the long term policies to a replacement insurer, and makes a payment for such transfer from the Long term Fund. If such a transfer is made, Mr A continues the policy with the replacement insurer;
- (ii) The PPS may not be able to transfer the policy to a new insurer and instead may set up a dedicated insurance company for running off the business of an insolvent insurer (i.e. provide coverage for protected policies until expiry without effecting any new contracts). In this case, Mr A continues the policy with this insurance company in run-off;
- (iii) The Court orders a reduction of the contract amount before a transfer. In this case, Mr A may receive an ex-gratia payment from the PPS, the amount of which is capped by the compensation limit.

## **7. How are Building Owners' Corporation third party liability insurance policies protected**

It is recommended that third party insurance policies held by the building owners' corporations are protected by the PPS.

The Owners' Corporation of a building holds a third party liability policy that covers legal liability for damages in respect of injuries or death of third parties as a result of the negligent acts of the Owner's Corporation. For the 1-year policy, the insured amount is HK\$10,000,000 per event, and the expiry date is 30 June 2023. The policy's insurer becomes insolvent on 1 January 2023. Suppose there are two scenarios:

- (i) An accident happened on 15 December 2022, injuring Mr B. The insurer has agreed that the amount payable is HK\$1,000,000 but Mr B has not yet received the payment when the insurer becomes insolvent;
- (ii) An accident happened on 1 May 2023, four months after the insurer becomes insolvent, injuring Mr B.

For illustrative purposes, assume that the final design of the PPS is to cover the first HK\$ 400,000 and 80% of the remaining amount with the amount of total payment capping at HK\$4,000,000. Assuming the specified event triggering activation of the PPS is carried out on the day of insurer insolvency, the 60-day extended coverage of the Owners' Corporation policy under the PPS will expire on 2 March 2023.

In scenarios (i), and (ii), the Owner's Corporation is entitled to refunds of any unexpired premiums.

- In scenario (i), Mr B is entitled to compensation of HK\$880,000 (calculated as HK\$400,000 + 80% x HK\$600,000) for claims and benefits due from the PPS, and to claim the remaining HK\$120,000 from the assets of the insolvent insurer.
- In scenario (ii), Mr B is not entitled to payments from the PPS as the third party liability policy is no longer valid after 60 days from the time of insurer failure.

-END-