



## Law Society's Response to the Consultation Paper "Proposed Establishment of an Independent Insurance Authority"

The Financial Services and Treasury Bureau (FSTB) published its Consultation Paper "*Proposed Establishment of an Independent Insurance Authority*" (Consultation Paper) on 12 July 2010 with a proposal to align Hong Kong's regulatory regime with international practices. Currently, the insurance industry is regulated by the Office of the Commissioner of Insurance which is a Government Department, headed by the "Insurance Authority" (IA).

The aim is to have the IA to be both financially and operationally independent of Government and the proposals seek to achieve a balance between "*regulation and market development, as well as enhance the competitiveness of the insurance industry*". The Consultation Paper sets out a high level proposal. Naturally, if there is consensus to proceed with the proposal, the Law Society will review any draft legislation and prepare detailed submissions.

The Law Society's Insurance Law Committee and Securities Law committee have reviewed the proposals outlined in the Consultation Paper and have prepared the following response to the 11 questions raised by the FSTB:

### 1. QUESTION 1

*Do you agree that an independent IA should be established along the lines set out in paragraph 2.6?*

Whilst regulatory independence would align the IA more closely with current international practices, it is unclear why the current regulatory framework is not generally conducive to the effective regulation of the insurance industry or is unable to meet public expectations for enhanced protection of insurance policy holders.

In respect of long-term insurance, at present, there is a gap in practice in the regulation of insurance intermediaries selling investment-linked assurance schemes ("ILAS"). This is because the Securities and Futures Commission ("SFC") has taken the view that the sale of ILAS does not constitute the regulated activity of dealing in securities under the Securities and Futures Ordinance ("SFO") because, amongst other things, ILAS are first and foremost insurance policies providing the policyholder with life cover but which have an additional investment element and life cover, as distinct from investment, would appear to be the dominant factor motivating a policyholder to acquire an ILAS product.

Whether the SFC's view is theoretically correct or not, it should be recognized that the sale of ILAS is fundamentally the sale of an investment product and the regulatory framework applicable to the sale of ILAS and the sale of investment products, whether ILAS, unit trusts or mutual funds and whether by banks or non-banks, should be consistent. Therefore, in our view, the sale

of ILAS by insurance intermediaries should both in theory as well as in practice fall within the purview of the SFC. It is difficult to identify a policy rationale for establishing different regulatory regimes each establishing different selling practices depending not on the substance of the product and the position of the buyer but on the specific legal form of the product and the seller.

**The absence of any obvious mischief weighs against the cost of establishing an independent IA.**

## **2. QUESTION 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?*

No.

## **3. QUESTION 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?*

Subject to our comments in response to Question 1, yes. In particular, it is undesirable for insurance intermediaries to fall outside a statutory scheme and for an independent IA to focus solely or principally on the prudential regulation of insurance companies. Instead, the independent IA should assume the responsibility of supervising insurance intermediaries both prudentially and in relation to the conduct of their business.

## **4. QUESTION 4**

*Do you agree that 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?*

Yes.

## **5. QUESTION 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?*

Subject to our comments in response to Question 1, broadly, yes. However, the enforcement model under the SFO places substantial powers in the hands of the regulator, a level of power which, based on experience to date, we argue is appropriate only under strict conditions:

### **(a) Certainty in Regulatory Standards**

A fundamental concern is to ensure that regulatory standards are clear. Where regulations are drafted in subjective terms which are open to interpretation, there is every risk that a regulator may in hindsight seek to interpret the regulations in a manner which establishes standards higher than those understood by those regulated. There is a substantial margin of difference in many cases at any time between minimum regulatory standards and best practices. It is highly undesirable for regulated persons to discover

regulatory standards by enforcement action.

**(b) Independence in Enforcement**

There is a perception of bias where a single regulator conducts an investigation, prosecutes and disciplines regulated persons.

**As a separate point, we note the ongoing trend in over-riding the privilege of self-incrimination in financial regulatory matters and substituting in its lieu a privilege not to have self-incriminating evidence used in criminal proceedings against a defendant. We note that, under the SFO, this latter privilege neither extends to derivative evidence nor to regulatory disciplinary proceedings. We further note the fundamental basis for the privilege of self-incrimination.**

**6. QUESTION 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?*

Subject to our comments in response to Question 1, yes. Option 2 would harmonize regulation between insurance intermediaries and ensure consistent and smooth regulation between insurers and insurance intermediaries.

**7. QUESTION 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?*

Subject to our comments in response to Question 1, no. It is undesirable for regulatory standards and enforcement practices relating to the sale of insurance products within banks to differ from those of other regulated practices.

Malpractices within banks related to the sale of Lehman Mini Bonds highlight the need for consistent content and enforcement of sales regulations. At the time (as now), the HKMA was responsible for regulating banks in accordance with SFC standards. It is perceived by many commentators that whilst the HKMA adopted SFC standards, it did not enforce those standards in the same way as the SFC.

In any event, it is inherently difficult for 2 different regulators to enforce in the same way even if they adopt same standards.

**8. QUESTION 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?*

Subject to our comments in response to Question 1, yes.

## 9. QUESTION 9

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

Yes. However:

### (a) **Failure to Decide**

The statutory tribunal should expressly have jurisdiction to act where the independent IA fails to decide or alternatively, statutory time limitations should apply to decisions of the independent IA. Based on experience under the SFO, a regulator may at times delay making a decision at all, requesting, for example, further information endlessly. It is unclear whether in these circumstances in the absence of clear statutory language the statutory tribunal would have the jurisdiction to intervene.

### (b) **Independent Enforcement**

As set out in our response to Question 5, we prefer to see independent determination of enforcement actions. Based on experience under the SFO, a statutory appeals tribunal is likely to be deferential to the independent IA and thus, could not address perceptions of bias. At the same time, particularly in political climates hostile to a regulator, a regulator may have a self-interest in successful enforcement action. It is undesirable for a regulator to have any self-interest in enforcement action.

### (c) **Ombudsman**

In light of the statutory appeals tribunal and the right of judicial review, it is unclear whether there is any need for an avenue to the Office of the Ombudsman.

## 10. QUESTION 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?*

Yes.

## 11. QUESTION 11

*Do you agree with the proposed fee structure as set out in paragraphs 8.2 and 8.6?*

It is unclear whether the levy would be in practice enforceable to the extent that contracts of insurance may be booked offshore.

**The Law Society of Hong Kong**

**Insurance Law Committee and Securities Law Committee**

**26 October 2010**

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