



Supplemental Response to the Consultation Paper “Proposed Establishment of an Independent Insurance Authority”

This Supplemental Response is supplemental to the Law Society’s Response dated 26 October 2010 on the Consultation Paper and follows further consideration of the Consultation Paper by the Law Society. The following comments supplement the answers given to the 11 questions raised by the FSTB in the Consultation Paper:

1. QUESTION 1

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

Paragraph 2.6 sets out six principles by which the FSTB will be guided in drawing the detailed legislative proposals. However, the principles are based on certain assumptions:-

- (a) the independent IA should be given financial independence. However, we understand that not all insurance regulators in other jurisdictions enjoy financial independence and independence from Government funding is not necessarily the most important element in determining whether an insurance regulator is likely to operate in an independent fashion;
- (b) it is self-evident that the independent IA should be given the necessary powers to discharge her statutory functions effectively but it is not clear to what extent the existing powers of the IA are inadequate in this regard. It is not necessarily the case that the independent IA should have the same powers, for example, as the SFC which some may say are more than necessary;
- (c) again it is appropriate that the exercise of the powers of the independent IA should be subject to adequate checks and balances, including an independent appeal mechanism against major decisions. However, there is an assumption that the existing checks and balances are inadequate and that the major decisions of the IA cannot be appealed but it is considered that there is no market sentiment that the existing IA has abused her powers and that where she has done so (if she has done so) there is inadequate redress through the courts and political process in Hong Kong;
- (d) it is arguable that the independent IA should be responsible for carrying out the prudential regulation of insurance brokers as well as of insurers, since

insurance brokers hold client money (albeit required to be segregated in a client account). It is also questionable whether the independent IA should have a view to enhancing the competitiveness of Hong Kong; market competitiveness is not inherently a function of the insurance regulator. The independent IA should regulate as effectively as is necessary to achieve its regulatory objectives but no more, leaving the market itself to operate competitively. It is essential (within Hong Kong's traditional economic framework) that the market be permitted to operate competitively and without partiality, undue interference or cost provided that certain minimum protections are given to the Hong Kong public;

- (e) it is unclear in what regard the existing structure of the IA makes it unable to respond effectively to changing market needs and new regulatory requirements, or how the proposed structure of the independent IA will enable it to do so;
- (f) it is political objective rather than a regulatory truism that the independent IA should operate on a full-cost recovery basis. As mentioned above, it is understood that not all insurance regulators enjoy financial independence but that does not necessarily make them less effectual or independent as regulators.

These comments suggest that further consultation with greater consideration of the detail of these principles would be appropriate. The Consultation Paper is very general or "high level" and it is difficult to comment substantively when the material is thin and the detail and analysis shallow. It may be appropriate for a more detailed consultation paper to be issued on which careful analysis can be made and consideration given. (For example, the statement is made (in paragraph 1.2 of the Consultation Paper) that "an independent IA will have more flexibility in operations" without stating (a) why such flexibility is needed and (b) in what respects the existing IA is not sufficiently flexible; and (in paragraph 1.3) that it is important to take account of international developments following the financial tsunami in formulating these proposals without explaining why, when "the insurance sector in Hong Kong remains stable and operates smoothly in the midst of the crisis").

In addition, in the second paragraph of our original Response on this question, we note the gap in practice in the regulation of insurance intermediaries (and insurers) selling ILAS, which we state is caused by the SFC view that the sale of ILAS does not constitute the regulated activity of dealing in securities. Though it is arguable that the predominant purpose of the acquisition of an ILAS is investment in the underlying securities and not insurance, any gap is also caused because insurance intermediaries will, when advising on ILAS, also advise on the underlying securities and may advise on the purchase of those underlying securities direct from the market instead of within the ILAS. Such advice on, and in some cases dealing in, securities is a regulated activity for which the SFC refuses to grant the necessary licence.

We also note in our response to Question 1 of the Consultation Paper that it is difficult to identify a policy rationale for establishing different regulatory regimes depending on the specific legal form of the product and the seller. However, though we acknowledge and reconfirm this difficulty, we do recognise that the specific legal

form of the product (for example, rights under a contract with an insurer are different from an entitlement under a trust) and the identity of the seller (an insurer is subject to capital requirements and prudential regulation while an unit trust or mutual fund relies not on its own capital but on the law relating to trusts or a custodian to provide the equivalent protection) should not be ignored as both are substantively different in legal design and effect and can in principle provide a policy rationale for different regulatory regimes.

The establishment of a consistent regulatory regime applying to all intermediaries advising on and selling investment products, whatever their nature, and providing a level playing field and standardised requirements would be appropriate and beneficial.

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?

The comments above set out a range of additional principles to be considered when deciding how to progress with and, if appropriate, working out the detailed legislative proposals.

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?

Chapter 3 of the Consultation Paper implies that the existing statutorily-required SRO structure in Hong Kong is flawed and failing. However, though it may no longer be the preferred international model and has the potential for conflicts of interest, there is little evidence to show that the structure is actually failing to address the insurance regulatory requirements of Hong Kong, that conflicts of interest are adversely affecting the supervision and regulation of the Hong Kong insurance market and that the existing regulatory regime needs to be changed to an independently regulated structure. The suggested additional functions of the independent IA also imply that the existing SRO's are insufficiently effective in supervising the conduct of intermediaries and no explanation is given for the need for the insurance regulator (as distinct from the insurance industry) to raise literacy amongst policy holders in order to facilitate informed decision-making.

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?

Though enhancing the competitiveness of the insurance industry to reinforce Hong Kong's status as an international financial centre would appear to be self-evidently beneficial to Hong Kong, it is arguable whether this should be an express duty of the independent IA. Further, the increased cost implications of the proposals in the Consultation Paper detract from this proposed duty. Further consultation on this proposed duty is required.

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?

(c) Excessive Powers

Though there may be a need to grant the new independent IA similar powers to the SFC to regulate insurers in connection with AML, there is no evidence that the current IA's powers are inadequate or the proposed powers are required for the purpose of insurance regulation as such and in the context of insurance activities and regulation, many of the proposed powers appear unnecessary and excessive. The power to revoke the authorisation of an insurer who has existing or continuing obligations under its insurance portfolio has not traditionally been granted as the exercise of this power can result in policy holders having insurance contracts with an unregulated insurer.

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?

Though in theory under Option 2 a single independent IA would ensure consistent regulation of insurance intermediaries, we consider that consistency of regulation between SRO's is not the principal issue of concern in Hong Kong. More problematic issues are the minimum standards of education and understanding of insurance products, the mis-selling of insurance products and compliance with existing laws and regulations by all intermediaries and other persons involved in advising on, arranging and administering insurance products, from insurance company managers to third parties falling outside the scope of existing regulations. In consequence, though it may be preferable to improve or change the existing self-regulatory arrangements for insurance intermediaries and Option 2 may be the best solution, it is not necessarily

the right solution as it will not inherently address the current issues being faced in Hong Kong. A better solution may be to strengthen the existing SRO's and to enhance the supervision of those SRO's by the independent IA.

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?

No further comment to our original Response.

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?

It has long been an insurance industry concern that the insurance regulator has only been able to recruit staff within broad established Government parameters. Therefore the proposal for the independent IA to be able to recruit staff from the open market with the right skills, calibre and experience seems appropriate. However, it is not possible to comment validly on the proposed staff numbers or remuneration packages without more detail.

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?

No further comment to our original Response except to add to paragraph (c) that an avenue to the Office of the Ombudsman or other informal and straightforward process for review or appeal might be valuable (at least to insurance intermediaries) if the statutory appeals tribunal and the right of judicial review process are considered to be unduly onerous and unwieldy.

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?

If the insurance industry and policy holders are to be required to bear the cost of an independent IA, it would seem reasonable that that cost should not be borne in full

from the outset and that that cost should in part be borne by the provision of a start-up lump sum. No comment is made on whether the costs of the independent IA should be recovered in full from the insurance industry and policy holders or the period over which that recovery should take place, though it is understood that insurance regulators in some other jurisdictions are not self-funded and their independence is not apparently challenged or compromised (and indeed the decisions of the current IA are not questioned by reference to the source of her funding).

11. QUESTION 11

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

As suggested in the answer to Question 4 above, the proposed fee structure may render Hong Kong's insurance industry less, rather than more, competitive. There is also a concern that a levy on insurance premiums is an insurance premium tax by another name, which may adversely affect Hong Kong's reputation as a low tax and minimal tax jurisdiction. Further, the fee calculated on that element of the premium attributable to investment (if any) would constitute a form of investment or savings tax, which does not apply to other investments and savings in Hong Kong. In addition, premiums (and thus the amount of the levy) will increase proportionately with the value of the sums insured whilst the costs of the independent IA may not increase correspondingly.

With regard to the variable licence fee payable by insurers based on their liabilities, it would seem that the larger insurers would be required to pay more than the smaller insurers, yet the larger insurers may be better capitalised and may have charged higher premiums to reflect their perception of higher risk, while the less-conservative insurers may book lower liabilities and charge lower premiums but constitute higher regulatory risk. It may be appropriate for higher fees to be paid by insurers bearing higher regulatory risk, rather than those with large assets and liabilities. This moral hazard element of the proposed variable licence fee is not addressed.

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