Proposed Establishment of a Policyholders' Protection Fund

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 Policyholders' Protection Fund.

2. FSTB welcomes written comments on or before **24 June 2011** through any of the following means:

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GLOSSARY

Account value	Under some life insurance policies, part of the premium is invested. The account value is the value of the investment at a particular point in time.
Accumulated benefits	Benefits, such as dividends / bonuses, that have been credited to a policy and to which a policyholder is entitled under a life insurance policy.
Annuity policy	A policy that pays benefit regularly (e.g. monthly) to the policyholder for an agreed term, in return for premium payment made at an earlier stage of the policy.
Asset recovery rate	The percentage of assets which are recoverable from the estate of the insolvent insurer after liquidation.
Captive insurer	An insurer which is formed to insure the insurance risks of its parent companies or member companies of its group.
Cash value	The amount of money a policyholder is entitled to receive from an insurer upon surrendering certain types of life insurance policy (e.g. endowment policy, whole life policy). This amount would normally increase over time.
Claim	Request by an insured for payment by an insurer upon the occurrence of an insured event.
Dividends / Bonuses	Extra benefits (in addition to the cash value of the policy or the contractual benefits under the policy) declared according to the profits made by the insurer.
Endowment policy	A life insurance policy where the sum insured of the policy is payable after a fixed period of years (at maturity) or on earlier death.

General business	Insurance business of non-life nature as set out in Part 3 of the First Schedule to the Insurance Companies Ordinance ("ICO"). Examples include accident and health insurance, home insurance, fire insurance, travel insurance and building owners' corporation third party liability insurance.
Gross insurance premiums	The amount of premium paid by policyholders before deduction of any charges such as commissions and administrative expenses.
Guaranteed renewability	Feature of an insurance policy by which the policy is renewable at the option of the insured for a specified number of years or to a stated age. The insurer cannot refuse to renew the policy and cannot change any of its provisions except the premium rate.
In-force policy	A policy that is effective.
Investment-linked policy	A life insurance policy that combines investment and protection. Part of the premium will be used to procure life insurance coverage and part will be invested in specific investment funds of the policyholder's choice. The risk of the latter investment is borne by the policyholder.
Long term business	Insurance business of a long term nature as set out in Part 2 of the First Schedule to the ICO. Examples include whole life, term life, endowment, annuities, investment-linked assurance schemes and permanent disability insurance.
Office premiums	Sum of premiums attributable to the new businesses and renewal premiums attributable to the existing businesses for a financial year.
Reinsurer	An insurer which assumes all or part of an insurance policy written by a primary insurer.

Reserving requirements	Requirements imposed by the Insurance Authority on an insurer to make adequate reserves for its insurance liabilities under the ICO.
Rider	An additional contract with separate coverage which is attached to the basic contract of a long term policy.
Scale back	Reduction of policy benefits during a policy transfer to another insurer.
Single premium policy	A policy for which only one premium payment is made and no further premium is required.
Statutory capital requirements	Minimum capital requirements as set out in section 8(3)(b) of the ICO.
Sum insured	The maximum amount payable upon the occurrence of a claim event as defined in an insurance contract.
Surrender	Action by the holder of an insurance policy to terminate it for its cash value.
Term life policy	A life insurance policy where the benefit is payable only if the life insured dies during the period specified.
Universal life policy	A life insurance policy which is subject to a flexible premium, has an adjustable benefit and a cash value.
Whole life policy	A life insurance policy where the benefit is payable on death and a cash value is payable on surrender, whichever occurs, at a premium rate which will not increase as the insured ages.

EXECUTIVE SUMMARY

1. The Insurance Companies Ordinance ("ICO"), administered by the Insurance Authority ("IA"), provides a regulatory regime for the prudential supervision of insurers. To better protect policyholders' interest, maintain market stability in the event of insurer insolvency and enhance public confidence in and competitiveness of the insurance industry, we intend to establish a Policyholders' Protection Fund ("PPF") as a safety net for policyholders.

2. We are guided by the following principles in developing the proposal for the PPF:

   (a) the proposed PPF should strike a reasonable balance in enhancing protection for policyholders and minimising additional burden to the insurance industry;

   (b) the proposed PPF should enhance market stability while minimizing the risk of moral hazard;

   (c) the proposed PPF should provide certainty on the level of compensation payment to policyholders when an insurer becomes insolvent, and a reliable system should be put in place to facilitate the collection, custody, investment and administration of levy contributions to the PPF; and

   (d) the establishment of the PPF should not in any way compromise the regulatory standards and requirements laid down by the IA under the ICO.

3. With the support of an actuarial consultancy study and input from the insurance industry, we *recommend* the establishment of a PPF with the following key features:

   Coverage

   (a) The PPF should comprise two separate and independent schemes, namely the Life Scheme and the Non-Life Scheme, to cover life and non-life insurance policies[1] respectively.

(b) The PPF should focus on individual policyholders.

(c) Subject to public views, the PPF could also cover small and medium enterprises.

Level of Compensation and the Application

(d) There should be a limit on the compensation to be paid by the PPF, proposed to be set at 100% for the first HKD100,000 plus 80% of the balance of the claim, up to a total of HKD1 million. It should be applied on a per-policy basis for life insurance policies and a per-claim basis for non-life insurance policies.

(e) For life insurance policies, the PPF should seek to facilitate the transfer of policies of an insolvent insurer to another insurer. The PPF should be allowed to pay up to HKD1 million per policy to facilitate such a transfer. In the unlikely event where a transfer cannot be arranged, the policy would either continue until expiry or be terminated. In case of continuation until expiry, the PPF should settle any claims arising subject to a compensation limit; whereas in the case of termination of policy, the PPF should pay the policyholder the cash / account value of the policy plus declared dividends / bonuses, and it may also pay an "ex-gratia" payment having regard to the losses due to premature termination of the policy. The total payment should be subject to the compensation limit of HKD1 million per policy.

(f) For non-life insurance policies, which generally have a much shorter term and will normally expire before completion of the liquidation process for the insolvent insurer, the PPF should provide for continuity of coverage until expiry of the policies and meet claims up to the compensation limit of HKD1 million per claim.

[1] Other than employees' compensation and motor vehicle claims which are covered by other existing schemes.

(g) For accident and health policies with guaranteed renewability, the PPF should be allowed to pay up to HKD1 million per policy to facilitate transfer of the policies to another insurer. If a transfer cannot be arranged, the PPF may pay the affected policyholders an “ex-gratia” payment.

Funding Mechanism

(h) A progressive funding model should be adopted, under which an initial target fund will first be built up through a moderate levy rate, with the option to impose a “stepped-up” levy rate as necessary upon occurrence of an insurer insolvency. To ensure that the PPF can make timely compensation payment to affected policyholders, the PPF should be allowed to borrow from a third party to bridge any liquidity gap.

(i) The PPF should be empowered to collect the levy from insurers. Based on the actuarial consultancy study, the initial target fund size should be HKD1.2 billion for the Life Scheme and HKD75 million for the Non-Life Scheme. On this basis, the initial levy rates for both Schemes should be set at 0.07% of the applicable premiums.

(j) Any claims that have been compensated by the PPF should be subrogated to the PPF for recovery from the assets of the insolvent insurer.

Governance Arrangements

(k) The PPF should be established by statute and administered by a governing body to be appointed by the Financial Secretary. Its operation should be subject to a high level of transparency and accountability. An Appeal Board should be established to handle appeals against relevant decisions made by the PPF.

4. We welcome views from the public on the proposals. Members of the public are invited to write to us on or before 24 June 2011. We will take into account the views received in finalizing the proposals which will form the basis for preparing legislation for the establishment of the PPF. We aim to announce the finalized proposals within 2011.

CHAPTER 1 – INTRODUCTION

Purpose

1.1 This consultation document sets out the key features of the proposed Policyholders' Protection Fund ("PPF"), including the coverage and level of compensation, funding mechanism and governance arrangements.

Background

1.2 The Hong Kong insurance market has grown significantly in recent years. Many consumers buy insurance products not only for financial protection against adversities, but also for saving and investment purposes. The gross insurance premiums received in 2010 amounted to HKD207.2 billion[2], representing a 33% increase compared with the HKD156 billion in 2006.

1.3 The Insurance Companies Ordinance ("ICO") (Cap 41), administered by the Insurance Authority ("IA"), provides a regulatory regime for the prudential supervision of insurers. The regulatory regime seeks to promote the general stability of the insurance industry and protect policyholders. To this end, any insurer who intends to carry on business in or from Hong Kong must be authorized under the ICO which stipulates the statutory capital requirements and reserving requirements, as well as prudential supervision by the IA. This prudential regulatory regime, which has been enhanced from time to time in line with international developments in the past decade, seeks to ensure the financial stability of the insurance market and minimize insolvency risk of insurers. The Companies Ordinance ("CO") (Cap 32) and the ICO have further prescribed protective arrangements for policyholders in case of insurer insolvency (see Chapter 2).

[2] Provisional Statistics for Long Term Business and General Business for the period ended 31 December 2010.

1.4 In the past two decades, there were only a handful of insurer insolvencies in Hong Kong, all of them involving small insurers in the non-life sector. There have not been any insolvencies involving life insurers or large non-life insurers in Hong Kong.

1.5 This notwithstanding, no matter how effective the regulation of the insurance industry is, the possibility of insurer insolvencies cannot be totally avoided.

1.6 In many advanced economies, a policyholder compensation fund is in place to provide a safety net in addition to prudential regulation. Examples of jurisdictions with such compensation funds include the UK, Singapore, Japan and Canada. In Hong Kong, compensation funds are in place to cover employees' compensation and motor vehicle third party claims. These are discussed in Chapter 2. There is however no compensation fund for life insurance and other types of non-life insurance.

1.7 In 2002, the IA commissioned a consultancy study on the feasibility of establishing PPF(s) in Hong Kong. A public consultation exercise was carried out between December 2003 and April 2004, during which mixed feedback was received. Some respondents expressed support for a compensation fund for policyholders to boost consumer confidence while others, particularly members of the insurance industry, were concerned about possible moral hazard and impact on premiums.

Recent Developments

1.8 The international financial crisis in 2008 and 2009, during which a number of large financial institutions faced financial difficulties, has highlighted the need for a compensation fund for policyholders with a view to strengthening their confidence in the insurance market.

1.9 In 2008, the Hong Kong Federation of Insurers ("HKFI"), a trade association representing insurers in Hong Kong, indicated in-principle agreement to explore a contingency plan to protect policyholders in case of insurer insolvency. The Administration and HKFI have since worked in partnership in developing a conceptual framework for the PPF, which received support from the Panel on Financial Affairs of the Legislative Council in July 2009.

1.10 In 2010, the IA commissioned an actuarial consultancy study to assess the optimal levy rate, target fund size and other detailed arrangements for the proposed PPF. The Consultant has recently finalized its findings and proposals. A Steering Committee with representation from both the Administration and HKFI has been established to oversee the study and make recommendations on the following key issues:

(a) coverage and level of compensation (Chapter 3);

(b) funding mechanism (Chapter 4); and

(c) governance arrangement (Chapter 5).

Consultation and Next Step

1.11 Members of the public are invited to offer their views on the proposals by writing to us on or before 24 June 2011.

1.12 We will take into account the views and comments received in finalizing the proposals which will form the basis for preparing legislation for the establishment of the PPF. We aim to announce the finalized proposals within 2011.

CHAPTER 2 – CURRENT PROTECTION AGAINST INSURER INSOLVENCY IN HONG KONG AND OVERSEAS JURISDICTIONS

Existing Schemes in Hong Kong

2.1 Hong Kong already has compensation schemes in place for non-life insurance policies covering motor vehicle third party claims ("motor vehicle policies") and employees' work-related injuries ("employees' compensation ("EC") policies"). These types of insurance policies are mandated by statute. If an insurer of these compulsory policies becomes insolvent, compensation is paid to policyholders or third party claimants in respect of claims under the policies.

2.2 Insolvency protection for motor vehicle policies is provided by the Insolvency Fund Scheme administered by the Motor Insurers' Bureau of Hong Kong ("MIB"). The MIB is a limited liability company established by the insurance industry. All insurers authorized by the IA to carry on motor vehicle insurance business in Hong Kong are required to become members of the MIB. When the MIB Insolvency Fund was first established in 1985, the initial levy was 2.5% of the premium[3]. The levy rate has since been revised several times. It was revised to 2% in 1995, 1% in 2005 and 0%[4] in 2008.

2.3 Insolvency protection for EC policies is provided by the Employees Compensation Insurer Insolvency Scheme which was established in 2003 and is administered by the Employees Compensation Insurer Insolvency Bureau ("ECIIB"). The ECIIB is a limited liability company established by the insurance industry. The levy is 2% of EC premium.

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[3] Together with the First Fund Scheme, which provides compensation to victims of traffic accidents involving uninsured vehicles, the gross MIB levy on the premium of motor vehicle policies has, except from 2001 to 2003, been 3%.

[4] Levy for the Insolvency Fund Scheme has been suspended since 1 January 2008 as the fund accumulated was considered adequate.

2.4 Both the MIB's Insolvency Fund Scheme and the EC Insurer Insolvency Scheme specifically provide for a "queuing system" to cater for situations where funds available in the schemes are inadequate to meet the liabilities of insolvent insurer(s). Under this system, if claims exceed the amount of funds available, they will be paid in the order in which they are presented to the scheme as and when funds become available.

2.5 There is currently no compensation scheme for life insurance and other types of non-life insurance.

Protection Under the CO and the ICO

2.6 The CO and the ICO contain provisions for dealing with insurer insolvency.

2.7 Upon an insurer insolvency, the first step would normally be the appointment of a manager by the IA, who would subsequently be replaced by the provisional liquidator appointed by the Court. The manager / provisional liquidator is responsible for taking control of the assets of the insurer. Thereafter, the Court may appoint a liquidator, who would be responsible for distributing the assets of the insurer, after payment of expenses and fees, to its creditors according to the provisions of the CO. Alternatively, application may be made for sanction from the Court in respect of a scheme of arrangement under section 166 of the CO. Once sanctioned by the Court, the scheme is binding on all creditors of the insurer.

2.8 For insolvent non-life insurers, under the CO, 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, have a preferential claim[5] against the assets of the insurer. For insolvent life insurers, the ICO has stipulated how

5 Under the CO, certain employee-related debts and debts due to the Government have a higher level of preference than insurance claims.

the assets under their long term business fund are to be dealt with[6], and has also provided for the continuation of the life business in liquidation by the liquidator. The Court may approve a transfer of the life insurance policies to another insurer. The Court may also reduce the liability of the insurance contracts of the insurer concerned on terms and conditions as it thinks fit.

Overseas Experience

2.9 Many overseas economies have compensation funds in place as a safety net, in addition to prudential regulation, for insurer insolvency. Examples include the UK, Singapore, Japan, and Canada.

2.10 These overseas schemes differ in their scale or mode, but many of them share the following characteristics:

(a) operating either on a post-funding or progressive funding mode;

(b) operating on the basis of a levy collected from insurers;

(c) excluding large commercial entities and focusing on protecting private individuals and in some cases small and medium enterprises ("SMEs") as well;

(d) putting a limit on the compensation to mitigate moral hazard;

(e) maintaining separate compensation funds for life and non-life insurance businesses;

(f) providing for continuation and transfer of life policies and offering financial support to facilitate the transfer of the insolvent insurer's business to another insurer; and

6 Under section 23 of the ICO, the assets representing a fund maintained by an insurer in respect of its long term business shall be applicable only for the purposes of that part of that business to which the fund relates.

(g) not requiring a huge amount of reserve to cater for all possible liabilities arising from insurer insolvency, but requiring a reasonable amount to meet the shortfall and liquidity gap only as the estate of the insolvent insurer should normally be adequate to meet all or most of the claims arising from its insurance contracts.

CHAPTER 3 – OBJECTIVES, COVERAGE AND LEVEL OF COMPENSATION

Objectives

3.1 The Administration seeks to set up the PPF with a view to:

(a) better protecting policyholders' interest;

(b) maintaining market stability in the event of insurer insolvency; and

(c) enhancing public confidence in, and competitiveness of, the insurance industry.

Guiding Principles

3.2 In developing the proposals for the PPF, we are guided by the following principles:

(a) the proposed PPF should strike a reasonable balance in enhancing protection for policyholders and minimizing additional burden to the insurance industry;

(b) the proposed PPF should enhance market stability while minimizing the risk of moral hazard;

(c) the proposed PPF should provide certainty on the level of compensation payment to policyholders when an insurer becomes insolvent, and a reliable system should be put in place to facilitate the collection, custody, investment and administration of levy contributions to the PPF; and

(d) the establishment of the PPF should not in any way compromise the regulatory standards and requirements laid down by the IA under the ICO.

Coverage

Individual and SME policyholders

3.3 The majority of compensation funds in overseas jurisdictions cover only natural persons, and corporates are normally excluded. We believe this is mainly because large corporate insurance buyers are able to protect their interests in buying policies and manage their risks. We *recommend* to focus the PPF on individual policyholders.

3.4 SMEs[7] are generally less sophisticated than large corporates and may benefit from the protection of a compensation fund. However, some SMEs may not see the need of relying on the PPF in enhancing their risk management. We *welcome views*, particularly from SMEs, on whether the coverage of the PPF should be extended to SME policyholders.

3.5 The statutory requirement for building owners' corporations ("OC") to procure third party risks insurance has taken effect since 1 January 2011. On account of the mandatory nature of the insurance requirements, we *recommend* to include OC policyholders in the coverage of the PPF.

Life and Non-Life Schemes

3.6 On the basis of paragraphs 3.3 to 3.5, we *recommend* that all authorized direct life and non-life insurers should be mandated by statute to participate in the PPF. Reinsurers, wholesale retirement schemes and captive insurers whose clients are normally large corporates would not be included.

3.7 Given the different nature of life and non-life policies in respect of, for example, their duration, payout and risk profile, we *recommend*

[7] An SME is defined in the context of the proposed PPF as a manufacturing business which employs fewer than 100 persons in Hong Kong, or a non-manufacturing business which employs fewer than 50 persons in Hong Kong.

to set up two separate schemes under the PPF – the Life Scheme and the Non-life Scheme. The Life Scheme will cover all direct life policies written in Hong Kong. Life policies refer to insurance policies that pay benefits related to the life status of the policyholders, such as term life policies, whole life policies, endowment policies, annuities, investment-linked policies and permanent disability policies. The Non-Life Scheme will cover all direct non-life insurance policies written in Hong Kong, except those that are already covered by the schemes administered by the MIB and the ECIIB. The more common types include accident and health policies, home insurance policies, fire insurance policies, travel insurance policies, and third party risks liability insurance policies of OCs. Examples illustrating deployment of the PPF for some of these policies are in **Annex B**.

3.8 There will be no cross-subsidy between the two Schemes. The respective levy rates for the two Schemes will be calculated separately, and the levies collected will be maintained in separate accounts. To ensure independence, inter-Scheme lending will not be permitted.

Policies that Pre-dated the PPF

3.9 We *recommend* that all in-force policies as at the date of the introduction of the PPF as well as new policies issued thereafter will be covered by the two Schemes.

Conditions for Activating the PPF

3.10 As a general principle, the circumstances that would trigger the activation of the PPF should be clearly stipulated in the interest of transparency and certainty. Moreover, it should cover all scenarios where the insurer concerned is not able to settle the insurance claims underwritten by it. Drawing reference from other insurer insolvency compensation regimes, we have drawn up a list of conditions for activating the PPF in **Annex C**.

Eligible Claims

3.11 In summary, the proposed PPF will accept claims in respect of in-force life and non-life policies, apart from those specifically excluded in paragraphs 3.6 and 3.7 above. Compensation will be made to those who are entitled to payment of a claim and such claim has not been settled, subject to the compensation limit recommended in paragraph 3.14 below.

3.12 To ensure better protection for policyholders, we further *recommend* that for both the Life and Non-Life Schemes, there should not be any cut-off date for the submission of claims. All claims submitted before or after the insolvency but within the time limit specified in the insurance policy (if any) will go through the normal claims verification and assessment process and be met by the PPF up to the compensation limit.

Compensation Limit

3.13 The PPF, as the safety net for insurer insolvency, seeks to provide a certain level of relief for a policyholder. To strike a reasonable balance between the cost and benefit of the PPF and taking into account the moral hazard concern, we *recommend* that there should be a compensation limit. In this regard, the most common model adopted by overseas jurisdictions is to set both percentage and dollar caps on the level of compensation.

3.14 We *recommend* that the compensation should be 100% for the first HKD100,000 of any claim, plus 80% of the balance, up to a total compensation limit of HKD1 million[8]. For life insurance, the compensation limit would be applied on a per-policy basis. For non-life insurance, the compensation limit would be applied on a per-claim basis.

[8] For example, a claim for HKD1.225 million would hit the compensation limit of HKD1 million, computed as: HKD100,000 × 100% + HKD(1,225,000-100,000) × 80% = HKD1,000,000.

3.15 Based on industry data by end 2009, this compensation limit would be able to meet 90-100% of the claims arising from some 90% of life policies. It would also be able to fully meet claims of some 96% of non-life policies.

Arrangements in the Event of Insurer Insolvency

3.16 Upon the occurrence of an insurer insolvency, a manager[9] / provisional liquidator / liquidator will be appointed to carry on the business of the insurer concerned. He will liaise closely with the PPF Board in managing the policies and claims of the insolvent insurer. Different courses of action may be pursued under different circumstances in handling different policies (see paragraphs 3.17 to 3.24 below).

Life Scheme

3.17 Premature encashment or surrender of life policies could lead to a substantial loss to policyholders. Owing to the long-term nature of life insurance products, it will be in the interest of policyholders if their policies could continue to be in force. Therefore, as a first priority, the liquidator will seek to achieve a transfer of life policies to another insurer. Experiences in other jurisdictions confirm that such is feasible and is welcomed by affected policyholders.

3.18 Hence, we *recommend* that the Life Scheme should facilitate the transfer of policies to a replacement insurer wherever possible, and be given the flexibility to make a payment to facilitate the transfer, if such payment is needed, up to HKD1 million per policy[10]. Policyholders can however choose to terminate the policies if they so wish. In such cases, they will be entitled to the cash / account

[9] The person appointed pursuant to section 35(2)(b) of the ICO.

[10] Experiences in overseas jurisdictions show that in most cases, the sum insured of the transferred policies would remain at the original level. However, in some very exceptional cases where the cost of transfer is higher than the sum of the facilitation payment from the PPF and the assets allocated by the liquidator from the insolvent estate to the policies, the sum insured may need to be scaled back accordingly.

value or accumulated benefits, up to the compensation limit, but without the "ex-gratia" payment (see paragraph 3.19 below).

3.19 In the unlikely event where life policies cannot be transferred, the policies would be treated under one of the following two possible scenarios: (a) continuation of policies until expiry; and (b) termination of policies. In the case of (a), we *recommend* that the Life Scheme should settle any claims arising, subject to the compensation limit set out in paragraph 3.14. As for (b), we *recommend* that the Life Scheme should pay the affected policyholders the cash / account value of the policy plus declared dividends / bonuses, and it may also pay an "ex-gratia" payment having regard to the losses arising from the premature termination of the policy[11]. The total payment should be subject to the compensation limit of HKD1 million per policy.

Non-Life Scheme

3.20 As non-life insurance contracts are usually in force for one year or a shorter period, they should have expired before the liquidation process is completed. Transfer of non-life policies would not be cost-effective. We therefore *recommend* that the Non-Life Scheme should provide for continuity of coverage until the expiry of all policies.

3.21 The Non-Life Scheme will meet the claims arising from all covered policies subject to a limit of HKD1 million per claim, whether the insured incident occurs before or after the insolvency, and whether the claim is submitted before or after the insolvency, subject to the time limit specified in the insurance policy (if any).

Accident and Health ("A & H") Policies with Guaranteed Renewability

3.22 A & H policies may take the form of a standalone non-life policy or a rider to a life policy. Some of them may provide for guaranteed

[11] The PPF Board (or a committee established by the PPF Board as provided by law) would decide the amount of "ex-gratia" payment on a case-by-case basis, taking into account the circumstances of individual policies and policyholders, the availability of alternative coverage in the market and actuarial assessment of the loss to the policyholders etc.

renewability. For those policies with such a guarantee, policyholders affected by insurer insolvency may suffer a disadvantage in procuring alternative coverage, partly due to ageing or changing health conditions, and partly because the cost of guaranteed renewability has normally been reflected in the premium of the original policy. To provide relief to these policyholders, the PPF will seek to transfer such policies to another insurer, whether it is a standalone non-life policy or a rider to a life policy. Similar to the arrangements for life policies, we *recommend* to allow the PPF to make a payment to facilitate the transfer, up to the proposed limit of HKD1 million per policy.

3.23 In the unlikely event where a transfer of such policies cannot be arranged, we *recommend* that the PPF may pay to the affected policyholders an "ex-gratia" payment having regard to the premium differential if the policyholder is to procure a similar policy from another insurance company, subject to a limit of HKD1 million per policy[12].

3.24 As regards A & H policies without guaranteed renewability, they will continue until expiry, i.e. to be treated in the same manner as other non-life policies in case of insurer insolvency.

Illustrative Examples

3.25 The deployment of the PPF in relation to different types of insurance contracts under various scenarios are illustrated in the examples in **Annex B**.

[12] Similarly, the "ex-gratia" payment would have to be decided by the PPF Board (or a committee established by the PPF Board as provided by law) on a case-by-case basis, taking into account the circumstances of individual policies and policyholders, the availability of alternative coverage in the market and actuarial assessment of the loss to the policyholder etc.

CHAPTER 4 – FUNDING MECHANISM

Funding Model

4.1 We have studied three possible funding models i.e. the pre-funding model, post-funding model and progressive funding model. The pre-funding model seeks to build up a fund in anticipation of future liabilities. The post-funding model seeks to collect contributions after an insurer insolvency has occurred. The progressive funding model is a combination of both, usually with an initial moderate levy rate complemented by a "stepped-up" levy rate upon occurrence of insolvency.

4.2 We consider that the progressive funding model is a more pragmatic approach, as compared with the pre-funding and post-funding models. The pre-funding model requires a high level of reserves to be built up as soon as possible in anticipation of all possible future liabilities. While this model offers the greatest certainty, it has the major drawback of locking up a huge amount of levies which in turn will put pressure on the premium levels. As for the post-funding model which seeks to collect levies after an insurer insolvency has occurred, it avoids the need to build up a reserve in advance or to administer a fund. However, it may require a very deep levy which could undermine the financial position of insurers, especially if the insolvency occurs during an economic downturn.

4.3 On balance, we *recommend* to adopt a progressive funding approach. This model will ensure the availability of an upfront reserve to meet at least part of future liabilities through an affordable level of levy which will unlikely put pressure on the premium levels nor affect the sustainability of the industry. At the same time, it will maintain the flexibility to increase the levy rate to meet actual needs.

4.4 We *recommend* an initial levy till the PPF has reached its target size. In the case of an insurer insolvency, funds available from the PPF would be deployed to meet the liabilities of the insurer concerned.

We further *recommend* that if the funds are not sufficient to meet all such liabilities especially when the PPF is still in its formative years, there should be an effective mechanism to bridge the liquidity gap in order to protect the interest of policyholders (see paragraphs 4.15 to 4.17 below). Thereafter, a "stepped-up" levy may be collected, the size of which will have to be assessed after the occurrence of an insolvency, taking into account the size of the fund then, the amount of liabilities as well as the likelihood of recovery of assets from the insolvent estate. At the same time, the "stepped-up" levy should not be set at a prohibitively high level that would cause undue burden to the participating insurers, which in turn would be detrimental to the insurance industry and policyholders.

4.5 If there is no insurer insolvency by the time the target fund size is achieved, the need for any adjustment to the levy rate will have to be assessed at that juncture, taking into account the market situation, the risk profile of the industry, and public views on the matter.

Collection of Levy

4.6 As the PPF seeks to maintain market stability, promote industry competitiveness and address issues arising from insurer insolvency, we *recommend* that the PPF collect the levies from insurers. International experience also strongly favours levy contribution from insurers.

4.7 There is the possibility of individual insurers attempting to pass the cost of the levy to the policyholders. However, given the keen competition amongst insurers in Hong Kong and that the proposed levy is to be set at an affordable level (see paragraph 4.11 below), we believe the impact on the premium levels would be minimal.

4.8 We *recommend* to use premiums as the basis for levy calculation, applicable to the office premiums (for life insurers) and the gross written premiums (for non-life insurers) reported in their audited returns. This would facilitate administration of the fund.

Initial Target Fund Size and Levy Rate

Initial target fund size

4.9 In determining the initial target fund size, we have taken into account the general aspiration of the public for full compensation in all eventualities of an insurer insolvency, as well as the cost implications to insurers which may in turn put pressure on premiums, apart from the moral hazard issue. On the basis of extensive actuarial modelling using the current data[13] and risk profile of the insurance business in Hong Kong, plus relevant assumptions[14] regarding, among other things, economic conditions and interest rates, we *recommend* that:

(a) for the Life Scheme, the initial target fund size should be HKD1.2 billion; and

(b) for the Non-life Scheme, the initial target fund size should be HKD75 million.

4.10 We aim to build up the initial target fund in 15 years, noting that various factors such as the inflation rate and changes in the investment environment may affect the speed of the build-up of the fund. In addition, as the underlying assumptions for determining the target fund size, such as growth of the insurance industry and

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13 Based on industry data as at end of 2009.

14 With the industry data, the Consultant ran the actuarial model based on a large number of simulations (50,000) and the following major modeling assumptions in formulating the proposal:
- (a) a confidence level of 99%, i.e. having a 99% probability of meeting compensation payments of all protected liabilities (subject to the compensation limit set out in paragraph 3.14) in any one year;
- (b) asset recovery rate of 50-90% for life insurers and 40-80% for non-life insurers;
- (c) default rate of insurers based on the credit rating assigned to them by major rating agencies;
- (d) investment of the fund in low-risk vehicles, i.e. investment return of 2% per annum;
- (e) low to medium growth rate in the insurance sector (i.e. 5-10% growth rate), trending to 2.5-5% growth rate in 10 years;
- (f) inflation of 2% per annum;
- (g) running cost amounting to 0.2% of the initial target fund size; and
- (h) lending rate of 3% in case third-party lending is needed to fill a funding gap.

risk profile, may change over time, we intend to review the target fund size on a regular basis.

Levy rate

4.11 On the basis of the above parameters and assumptions, we *recommend* that the initial levy rates for both the Life Scheme and the Non-Life Scheme should be set at 0.07% of the applicable premium. The levy rate will also be reviewed as part of the regular review of the target fund size.

Asset recovery mechanism

4.12 An issue relevant to the source of funding of the PPF is the extent to which it can make a claim against the estate of the insolvent insurer, thereby enabling the recovery of part or all of the compensation. As we understand, all compensation schemes in overseas jurisdictions, as well as the MIB and the ECIIB, can claim against the estate of the insolvent insurer.

4.13 In the event of insurer insolvency, we *recommend* that when claimants are compensated by the PPF, the protected element of their claims (i.e. the part met by the PPF) should be subrogated to the PPF. In other words, the PPF will take over the protected element of the claims and seek recovery from the estate of the insolvent insurer.

4.14 The PPF will then be involved in the winding up process. We further *recommend* that the PPF should have equal ranking with the two classes of creditors specified in section 265 of the CO, i.e. the Employee Compensation Assistance Fund and all other direct insurance claims not met by the PPF.

Financing Arrangement to Bridge Liquidity Gap

4.15 As mentioned in paragraph 4.4 above, there should be a mechanism to bridge any liquidity gap under a progressive funding model. This should enable the PPF to start making compensation payment before receiving distribution from the insurer’s estate in case of insurer insolvency.

4.16 Accordingly, we *recommend* to allow PPF to borrow from a third party to bridge any liquidity gap, e.g. from commercial lenders for which the Government may act as the guarantor, or from the Government direct. In either case, approval of the Legislative Council would be required. We envisage that with the legislative backing to recoup through a levy from insurers, the PPF should be able to obtain financing on competitive terms.

4.17 In the event that a liquidity gap does occur, the Administration will work closely with the PPF Board to facilitate the making of the most suitable arrangement for ensuring timely compensation payments and a sustainable scheme.

CHAPTER 5 – GOVERNANCE ARRANGEMENTS AND RELATED MATTERS

Legal and Organizational Structure

5.1 The PPF affects a broad spectrum of the population in Hong Kong. We *recommend* that the PPF should be established by legislation and be administered by a statutory body. This will better ensure a high level of certainty, transparency and accountability in its design and implementation.

5.2 We further *recommend* that the PPF should operate under the oversight of an independent governing body (viz. the PPF Board) appointed by the Financial Secretary ("FS"). Having regard to the functions of the PPF Board (see paragraph 5.4 below), we *recommend* that the PPF Board should comprise professionals experienced in insurance, finance, accounting, law and consumer affairs etc, and ex-officio representatives from the Government.

5.3 Given the highly technical and complicated nature of insurance business and operations, it is important that the PPF Board has access to advice from people with up-to-date knowledge of the industry. Accordingly, we *recommend* that the PPF Board should establish two industry committees, one for the Life Scheme and one for the Non-Life Scheme. They will offer advice to the PPF Board on industry-related issues, such as the collection of levies and management of claims in the event of insurer insolvency.

Functions and Powers of the PPF Board

5.4 We *recommend* that the functions and powers of the PPF Board should be stipulated in the statute, and should cover, but not be limited to, the following:

(a) to manage and administer the PPF;

(b) to assess and collect contributions from insurers;

(c) to liaise with the manager / provisional liquidator / liquidator, decide the level of claims / compensation payments and make payments;

(d) to recover from the assets of the insolvent insurer the compensation paid to policyholders / claimants;

(e) to invest the money of the PPF;

(f) to borrow money to fill any funding gap; and

(g) to make statutory rules, after consultation with the FS, relating to the procedures for making compensations.

Governance Arrangements

5.5 To ensure accountability and transparency of the operation of the PPF Board, we *recommend* that the annual budget of the PPF should be subject to approval by the FS. The PPF Board should also prepare and publish an annual report (including the audited statement of accounts) for both the Life Scheme and the Non-Life Scheme. They will be laid before the Legislative Council. Moreover, we *recommend* that the FS should have the power to appoint the Director of Audit or an external auditor to perform audit reviews on the PPF.

Guidance on Investment

5.6 The PPF Board should exercise a high level of prudence in investing the money of the PPF. We *recommend* that the money which is not immediately required be invested in low-risk vehicles, such as deposits with banks, Exchange Fund Bills and sovereign bonds with good credit rating.

Daily Operations

5.7 We *recommend* that the PPF Board should maintain a small team of staff for daily operations and be empowered to engage additional staff or advisers in the event of insurer insolvency when it has to work closely with the manager / provisional liquidator / liquidator, particularly in claims management and payment of compensation.

Confidentiality

5.8 As the PPF Board would have access to sensitive information about insurers, we *recommend* that the PPF Board and its staff should be required to keep confidential any information obtained in the course of carrying out its functions. Disclosure of information would be subject to clear conditions as prescribed in law.

Appeal Mechanism

5.9 Any person who is aggrieved by relevant decisions made under the PPF should be able to file an application for a review of the decision. We *recommend* that an Appeal Board be set up to deal with appeals against the decisions of the PPF Board. The Chairman and members of the Appeal Board should be appointed by the Chief Executive.

Annex A

Comparison of Overseas Compensation Plans for Policyholders

Jurisdiction	**United Kingdom**		**Canada**	
	Life Insurance Policies	**Non-life Insurance Policies**	**Life Insurance Policies**	**Non-life Insurance Policies**
Scope of coverage	● All life policies taken out by individuals and SMEs	● Non-life policies (except marine, aviation, transport business and credit insurance) taken out by individuals and SMEs ● Large businesses covered for compulsory classes	● All life policies held by Canadian citizens or residents purchased from a member company	● Most property and casualty policies
Compensation limit	● 90% of claims without limit	● 90% of the agreed claims without limit for non-compulsory insurance ● 100% of the agreed claims without limit for compulsory insurance	● At least 85% of guaranteed benefits; and ● 100% when benefits are below specified dollar values as follows: - Death benefit – CAD 200,000 - Monthly income – CAD 2,000 - Health expense – CAD 60,000 - Cash value – CAD 60,000 ● 100% of accumulated value up to CAD100,000 for deposit-type products	● Limit of CAD250,000 per insured per occurrence (CAD300,000 for personal property policies) ● 70% of unearned premiums capped at CAD700 per policy
Funding basis	Post-funding	Post-funding	Progressive funding	Progressive funding
Levy rate	● Based on estimated funding requirements, annual levy is assessed and apportioned amongst insurers based on a combination of premiums and reserves	● Based on estimated funding requirements, annual levy is assessed and apportioned amongst insurers based on a combination of premiums and reserves	● Levy is not currently being assessed as target liquidity fund size of CAD100 million has been exceeded	● Limit to 1.5% of direct written premium
Levy collection	Charged on insurers	Charged on insurers	Charged on insurers	Charged on insurers

Comparison of Overseas Compensation Plans for Policyholders (continued)

Jurisdiction	Singapore*		Japan	
	Life Insurance Policies	**Non-life Insurance Policies**	**Life Insurance Policies**	**Non-life Insurance Policies**
Scope of coverage	● All individual and group life policies ● Accident & health ("A&H") policies written in the life insurance fund	● Compulsory motor third party injury and work injury compensation insurance policies ● Individual and group A&H insurance ● Personal motor insurance, property insurance, foreign domestic maid insurance and travel insurance	● Most life policies	● All non-life policies taken out by individuals, SMEs and associations of unit owners in a building
Compensation limit	● 100% coverage for protected liabilities of all life and A&H policies ● Limit to S$500,000 for sum assured and S$100,000 for cash value, except for disability income, long-term care, medical care and group insurance policies which are not subject to any limit	● 100% coverage for covered business without limit	● 90% of policy reserves	● 90% for sickness and personal accident policies ● 100% coverage for compulsory motor liability and earthquake policies ● 100% coverage for claims of other classes of policies within three months from insolvency and 80% thereafter
Funding basis	Progressive funding	Progressive funding	Pre-funding	Pre-funding
Levy rate	● Levy rate ranges from 0.017% to 0.15% of protected liabilities	● Levy rate ranges from 0.13% to 1.15% of gross premium income of protected classes of business	● Annual levy: JPY46 billion to be apportioned among insurers based on a percentage of a combination of premiums and reserves	● Annual levy: JPY5 billion to be apportioned among insurers based on a percentage of a combination of premiums and reserves
Levy collection	Charged on insurers	Charged on insurers	Charged on insurers	Charged on insurers

* Based on Consultation Paper on Deposit Insurance and Policy Owners' Protection Schemes Bill issued by the Monetary Authority of Singapore in 2010.

Annex B

Examples on the Application of the Proposed Policyholders' Protection Fund to Different Types of Insurance Policies

Example 1 – Home Insurance Plan

Mr A has a home insurance plan that reimburses him for any property losses. It is a 1-year policy that will expire on 31 December 201X. His insurer becomes insolvent on 30 September 201X.

Suppose there are four scenarios:

(i) *Mr A submits a claim to his insurer on 30 August 201X. The insurer has adjusted the claim and has agreed on 15 September 201X that the amount payable is HKD4,000. Mr A has not yet received the payment when the insurer becomes insolvent;*

(ii) *Mr A submits a claim to the liquidator on 30 October 201X for a property loss that happened in August 201X. The claim adjustor confirms that the claim amount payable is HKD10,000;*

(iii) *Mr A submits a claim to the liquidator on 30 October 201X for a property loss that happened in October 201X. The claim adjustor confirms that the claim amount payable is HKD20,000;*

(iv) *Mr A submits a claim to the liquidator on 30 October 201X for a property loss that happened in October 201X. The claim adjustor confirms that the claim amount payable is HKD2,500,000.*

In scenario (i), Mr A will be entitled to compensation of HKD4,000 from the PPF.

In scenarios (ii) and (iii), Mr A will be entitled to compensation of HKD10,000 and HKD20,000 from the PPF respectively.

In scenario (iv), Mr A will be entitled to compensation of HKD1,000,000 from the PPF, and to claim HKD1,500,000 from the assets of the insolvent insurer.

Example 2 – Travel Insurance Plan

Miss B purchases a travel insurance policy for a holiday that she has booked from 1 March to 14 March. Before she leaves for her holiday, her insurer becomes insolvent. Whilst on holiday she loses her new camera which costs HKD2,500.

Miss B will be entitled to compensation of HKD2,500 from the PPF.

Example 3 – Term Life Policy

Mr C has insured his life for HKD900,000 payable if he dies during the term of the policy which will expire in 2025. The beneficiary is Mrs C. The policy is guaranteed renewable every year, and Mr C pays premium each year to keep the policy in force. The insurer becomes insolvent on 28 February 201X.

Suppose there are four scenarios:

(i) Mr C dies on 20 February 201X;

(ii) Mr C dies on 20 March 201X;

(iii) Mr C chooses to surrender his policy on 31 March 201X;

(iv) Mr C chooses to continue his policy.

In scenarios (i) and (ii), Mrs C will be entitled to compensation of HKD740,000 [HKD100,000 + 80% x HKD800,000][1] from the PPF and to claim HKD160,000 from the assets of the insolvent insurer.

In scenario (iii), as term life policy does not have a cash value and the insured event (death of Mr C) has not occurred, there is no eligible claim and hence no entitlement to any payment / compensation.

In scenario (iv), if the liquidator is able to transfer his policy to another insurer, the terms and conditions of the policy will be determined by the Court[2]. Mr C will continue to pay premium to the new insurer, and the premium level will be determined by the Court. Under this scenario, if Mr C dies before the policy expires in 2025, Mrs C will be entitled to claim from the new insurer. However, if the liquidator is unable to transfer his policy to another insurer, then the policy will be terminated. Mr C may be entitled to an ex-gratia payment from the PPF[3].

1 See paragraph 3.14.

2 PPF will pay the latter insurer up to HKD1,000,000 to facilitate the transfer (see paragraph 3.18).

3 The amount of the ex-gratia payment will be decided by the PPF to enable Mr C to procure a similar policy with similar benefits from another insurer, and will be capped at HKD1,000,000 (see paragraph 3.19).

Example 4 – Endowment Policy

Mrs D has a 10 year regular premium endowment policy. The sum insured is HKD1,400,000. The beneficiary is Little D. Regular premium endowment policy is a saving-type product, in which Mrs D pays a premium of HKD100,000 each year and is entitled to a guaranteed cash value if she surrenders the policy during the term of the policy. If she dies before the end of year 10, Little D will be entitled to the insured sum of HKD1,400,000. When the policy matures in year 10, Mrs D will also be entitled to the insured amount of HKD1,400,000 .

The insurer becomes insolvent on 28 February 201X, at which time Mrs D's policy has been in force for 5 years, and the cash value of her policy is HKD600,000.

Suppose there are four scenarios:

(i) Mrs D dies on 20 February 201X;

(ii) Mrs D dies on 20 March 201X;

(iii) Mrs D chooses to surrender her policy;

(iv) Mrs D chooses to continue her policy.

In scenarios (i) and (ii), Little D will be entitled to compensation of HKD1,000,000 from the PPF and to claim HKD400,000 from the assets of the insolvent insurer.

In scenario (iii), Mrs D will be entitled to receive HKD500,000 (HKD100,000 + 80% x $500,000)[4] *from the PPF and to claim HKD100,000 from the assets of the insolvent insurer.*

In scenario (iv), if the liquidator is able to transfer her policy to another insurer, the terms and conditions of the policy will be determined by the Court[5]*. Mrs D will continue to pay premium to the new insurer, and the premium will be decided by the Court. Mrs D will be entitled to claim from the new insurer if she surrenders her policy or when the policy expires. Little D will also be entitled to claim from the new insurer if Mrs D dies. If the liquidator is unable to transfer her policy to another insurer, the policy will be terminated. Mrs D will be entitled to the cash value and dividends of her policy, and she may be entitled to an ex-gratia payment from the PPF*[6]*.*

[4] See paragraph 3.14.

[5] PPF will pay the latter insurer up to HKD1,000,000 to facilitate the transfer (see paragraph 3.18).

[6] The amount of the ex-gratia payment will be decided by the PPF to enable Mrs D to procure a replacement policy with similar benefits from another insurer. The total payment from the PPF (cash value, dividends and ex-gratia payment) will be capped at HKD1,000,000 (see paragraph 3.19).

Example 5 – Annuity Policy

Mr E has purchased a single premium annuity policy on 28 February 2010. The deferral period is 10 years, meaning that Mr E will start to receive an annuity payment on 28 February 2020. The policy will pay him HKD100,000 per annum for 10 years with certainty (i.e. from 28 February 2020 to 27 February 2030), and HKD100,000 per annum for life thereafter (i.e. from 28 February 2030 onwards). From 28 February 2010 to 27 February 2020, the policy will have a cash value if he surrenders the policy or if he dies. From 28 February 2020 to 27 February 2030, a cash value is payable only if he surrenders the policy. From 28 February 2030 onwards, no cash value is payable even if he dies or if he surrenders the policy. Mrs E is the beneficiary if Mr E dies.

Suppose there are seven scenarios:

(i) The insurer becomes insolvent on 28 February 2015:
- *(a) Mr E chooses to surrender his policy on 31 March 2015. The policy's cash value is HKD900,000;*
- *(b) Mr E dies on 20 February 2015. The policy's cash value is HKD900,000;*
- *(c) Mr E dies on 20 March 2015. The policy's cash value is HKD900,000;*
- *(d) Mr E chooses to continue his policy;*

(ii) The insurer becomes insolvent on 28 February 2025:
- *(a) Mr E chooses to surrender his policy on 31 March 2025. The policy's cash value is HKD700,000;*
- *(b) Mr E chooses to continue his policy;*

(iii) The insurer becomes insolvent on 28 February 2035. The policy has no cash value. Mr E chooses to continue his policy.

In scenarios (i)(a), (b) and (c), Mr E or Mrs E (as the case may be) will be entitled to receive HKD740,000 (HKD100,000 + 80% x HKD800,000)[7] *from the PPF and to claim HKD160,000 from the assets of the insolvent insurer.*

In scenario (i)(d), if the liquidator of the insolvent insurer is able to transfer his policy to another insurer, then the terms and conditions of the policy will be determined by the Court. Mr E will be entitled to annuity payments as decided by the Court from the new insurer from 28 February 2020 onwards. If the liquidator is unable to transfer his policy to another insurer, then the policy will be terminated. Mr E will be entitled to the cash value and he may be entitled to an ex-gratia payment from the PPF[8]*.*

In scenario (ii)(a), Mr E will be entitled to receive HKD580,000 (HKD100,000 + 80% x HKD600,000)[7] *from the PPF and to claim HKD120,000 from the assets of the insolvent insurer.*

[7] See paragraph 3.14.

[8] The amount of the ex-gratia payment will be decided by the PPF to enable Mr E to procure a replacement policy with similar benefits from another insurer. The total payment from the PPF (cash value, dividends and ex-gratia payment) will be capped at HKD1,000,000 (see paragraph 3.19).

In scenarios (ii)(b) and (iii), Mr E will receive an income of HKD100,000 per annum from the PPF, until the PPF payment has reached HKD1,000,000, or Mr E dies, whichever is the earlier. Similar to scenario (i)(d), if the liquidator is able to transfer his policy to another insurer, then the terms and conditions of the policy will be determined by the Court. Mr E will be entitled to annuity payments as decided by the Court from the new insurer. However, if the liquidator is unable to transfer his policy to another insurer, then the policy will be terminated. In scenario (ii)(b), he will be entitled to the cash value, and may be entitled to an ex-gratia payment from the PPF[8]*. In scenario (iii), he may be entitled to an ex-gratia payment from the PPF*[9]*.*

9 The amount of the ex-gratia payment will be decided by the PPF to enable Mr E to procure a replacement policy with similar benefits from another insurer and will be capped at HKD1,000,000 (see paragraph 3.19).

Example 6 – Investment-Linked Policy

Mr F has a 10-year regular premium investment-linked policy, under which he pays HKD30,000 each year to purchase units in a mutual fund of his choice. If he dies during the 10-year term of the policy, Mrs F will receive the greater of the current value of his purchased units in the mutual fund at the date of death or 101% of the premium that he has paid. At any point during the term of the policy, he can cash in the policy and receive the current value of the units at the date of encashment.

The insurer becomes insolvent on 1 March 201X. At that juncture, the policy has been in force for 5 years i.e. Mr F has paid a total premium of HKD150,000.

Suppose there are four scenarios:

(i) Mr F dies on 20 February 201X, and on that day, the units are worth HKD101,975;

(ii) Mr F dies on 20 March 201X, and on that day, the units are worth HKD90,871;

(iii) Mr F chooses to surrender his policy on 31 March 201X, and on that day, the units are worth HKD91,271;

(iv) Mr F chooses to continue his policy.

In scenarios (i) and (ii), the unit value is lower than the total premium paid. Mrs F's total claim is HKD151,500 (HKD150,000 x 101%). Mrs F will be entitled to receive HKD141,200 (HKD100,000 + 80% x HKD51,500)[10] from the PPF and to claim HKD10,300 from the assets of the insolvent insurer.

In scenario (iii), Mr F will be entitled to receive HKD91,271 from the PPF.

In scenario (iv), if the liquidator is able to transfer his policy to another insurer, then the terms and conditions of the policy will be determined by the Court. Mr F will continue to pay premium to the new insurer, and the premium level will be determined by the Court. If Mr F surrenders his policy, he will be entitled to claim from the new insurer. If he dies, then Mrs F will be entitled to claim from the new insurer. If the liquidator is unable to transfer his policy to another insurer, then the policy will be terminated. Mr F will be entitled to the current value of the units as at the date of termination, and he may be entitled to an ex-gratia payment from the PPF[11].

[10] See paragraph 3.14.

[11] The amount of the ex-gratia payment will be decided by the PPF. The total payment from the PPF (current unit value and ex-gratia payment) will be capped at HKD1,000,000 (see paragraph 3.19).

Example 7 – Accident and Health Policies / Riders[12]

Ms G has a 1-year medical expenses policy that reimburses her for hospital expenses. The policy will expire on 31 March 201X. According to the terms of the policy, any claims must be submitted within three months from the insured event. Her insurer becomes insolvent on 1 February 201X.

Suppose there are six scenarios:

(i) Ms G is injured on 1 March 201X and has incurred hospital/medical bills of HKD800,000:
(a) She submits the claim to the liquidator on 30 March 201X;
(b) She submits the claim to the liquidator on 30 May 201X;

(ii) Ms G is injured on 3 January 201X and incurs hospital/medical bills of HKD800,000:
(a) She submits the claim to the liquidator on 30 March 201X;
(b) She submits the claim to the liquidator on 2 April 201X;

(iii) Ms G is injured on 1 July 201X and incurs hospital/medical bills of HKD800,000;

(iv) Ms G's policy has a clause that guarantees renewal upon expiry at the same premium rate.

In scenarios (i)(a), (i)(b), (ii)(a) and (ii)(b), Ms G is entitled to compensation of HKD660,000 (HKD100,000 + 80% x HKD700,000)[13]*from the PPF, and to claim HKD140,000 from the assets of the insolvent insurer.*

In scenario (iii), Ms G will not be entitled to any compensation as her policy has expired before the insured event (i.e. her injury) occurs.

In scenario (iv), if the liquidator is able to transfer her policy to another insurer, then the terms and conditions of the policy will be determined by the Court. If Ms G wishes to renew the policy, she can do so with the new insurer based on the terms determined by the Court. If she is injured and has incurred hospital expenses after she has renewed the policy with the new insurer, then she will be entitled to claim from the new insurer. If the liquidator is unable to transfer her policy, then the policy will not be renewed upon its expiry on 31 March 201X. Ms G may be entitled to an ex-gratia payment from the PPF[14]*.*

12 The scenarios below will apply whether the policy is a standalone policy or a rider to a life policy.

13 See paragraph 3.14.

14 The amount of the ex-gratia payment will be decided by the PPF to enable Ms G to procure a replacement policy with similar benefits from another insurer. The total payment from the PPF (claim amount and ex-gratia payment) will be capped at HKD1,000,000 (see paragraph 3.23).

Example 8 – Permanent Disability Policy

Mr H has a regular premium disability income policy that pays him a disability income of HKD200,000 per annum up to age 65 if he becomes disabled. No premium payment is required when he becomes disabled. No cash value is payable if Mr H surrenders the policy.

Mr H becomes disabled on 20 February 20X0, and has been collecting disability income of HKD200,000 per annum from the insolvent insurer for the past five years. The insurer becomes insolvent on 1 March 20X5, at which time Mr H is aged 45. He chooses to continue his policy.

During the liquidation process, Mr H will be entitled to receive disability income of HKD200,000 per annum from the PPF until the PPF payment reaches HKD1,000,000, or Mr H recovers from the disability or dies, whichever is the earlier. Mr H will also be entitled to claim from the assets of the insolvent insurer for disability income not covered by the HKD1,000,000 payment from the PPF.

If the liquidator of the insolvent insurer is able to transfer his policy to another insurer, then the terms and conditions of the policy will be determined by the Court. Mr H will receive the disability income from the new insurer until he recovers or dies. If the liquidator is unable to transfer his policy to another insurer, then the policy will be terminated. If the PPF payment has not reached HKD1,000,000, then Mr H may be eligible for an ex-gratia payment from the PPF[15]*.*

[15] The total payment from the PPF (disability income payment and ex-gratia payment) will be capped at HKD1,000,000 (see paragraph 3.19).

Example 9 – Whole-life policy / Universal Life Policy

Mr I has purchased a whole life policy. The beneficiary is Mrs I. If Mr I dies during the term of the policy, Mrs I receives HKD1,100,000 or the sum of the cash value and declared dividends[16], whichever is the higher. At any point during the term of the policy, Mr I can surrender the policy and receive the cash value and dividends. The insurer becomes insolvent on 1 March 201X.

Suppose there are four scenarios:

(i) Mr I dies on 20 February 201X. The cash value and dividends are worth HKD945,082;

(ii) Mr I dies on 20 March 201X. The cash value and dividends are worth HKD948,078;

(iii) Mr I chooses to surrender his policy on 31 March 201X. The cash value and dividends are worth HKD950,075;

(iv) Mr I chooses to continue his policy.

In scenarios (i) and (ii), the cash value and dividends are lower than HKD1,100,000. Mrs I's claim should be HKD1,100,000. Mrs I will be entitled to receive HKD900,000 (HKD100,000 + 80% x HKD1,000,000)[17] from the PPF and to claim HKD200,000 from the assets of the insolvent insurer.

In scenario (iii), Mr I will be entitled to receive HKD780,060 (HKD100,000 + 80% x HKD850,075)[17] from the PPF and to claim HKD170,015 from the assets of the insolvent insurer.

In scenario (iv), if the liquidator is able to transfer his policy to another insurer, then the terms and conditions of the policy will be determined by the Court. Mr I will continue to pay the premium, and the premium level will be determined by the Court. If Mr I surrenders the policy, he will be entitled to claim from the new insurer. If Mr I dies, Mrs I will be entitled to claim from the new insurer. However, if the liquidator is unable to transfer Mr I's policy to another insurer, the policy will be terminated. Mr I will then be entitled to claim the cash value and declared dividends, and he may be entitled to an ex-gratia payment from the PPF[18].

16 Similar to the accumulated account value and declared dividends for universal life policies.

17 See paragraph 3.14.

18 The amount of the ex-gratia payment will be decided by the PPF to enable Mr I to procure a replacement policy with similar benefits from another insurer. The total payment from the PPF (cash value, dividends and ex-gratia payment) will be capped at HKD1,000,000 (see paragraph 3.19).

Example 10 – Building Owners' Corporation Third Party Liability Insurance Policy

The Owners' Corporation ("OC") of a building has a Third Party Liability Insurance Policy that covers legal liability for damages in respect of injuries or death of third parties as a result of the negligent acts of OC. The insured amount is HKD10,000,000 per event. It is a 1-year policy that will expire on 31 December 201X. The insurer becomes insolvent on 31 May 201X.

Suppose there are five scenarios:

(i) An accident happened on 1 March 201X, injuring Mr J. He submits a claim on 1 May 201X. The insurer agreed on 20 May 201X that the amount payable is HKD100,000. Mr J has not yet received the payment on 31 May 201X;

(ii) An accident happened on 15 May 201X, injuring Mrs K. She submits a claim to the liquidator on 15 June 201X. The claim adjustor confirms that the claim amount payable is HKD100,000;

(iii) An accident happened on 20 October 201X, in which Mrs L and Miss M were injured and Mr N died:

- *(a) Mrs L submits a claim to the liquidator on 30 November 201X. The claim adjustor confirms that the claim amount payable is HKD90,000;*
- *(b) Miss M submits a claim to the liquidator 18 months after the accident. The claim adjustor confirms that the claim amount payable is HKD200,000;*
- *(c) Mr N's wife submits a claim to the liquidator on 10 December 201X. The claim adjustor confirms that the claim amount payable is HKD1,300,000.*

In scenarios (i) and (ii), both Mr J and Mrs K will be entitled to compensation of HKD100,000 from the PPF.

In scenario (iii)(a), Mrs L will be entitled to compensation of HKD90,000 from the PPF.

In scenario (iii)(b), Miss M will be entitled to compensation of HKD180,000 (HKD100,000 + 80% x $100,000)[19] from the PPF, and to claim HKD20,000 from the assets of the insolvent insurer.

In scenario (iii)(c), Mr N's wife will be entitled to compensation of HKD1,000,000 from the PPF, and to claim HKD300,000 from the assets of the insolvent insurer.

[19] See paragraph 3.14.

Annex C

Proposed Conditions for Activating the PPF

(a) A winding up order has been made in Hong Kong that the insurer is unable to pay its debts;

(b) a winding up order has been made in Hong Kong on other grounds, and the IA is satisfied that the insurer is unlikely to be able to pay relevant claims in full;

(c) the insurer has declared that it cannot continue its business by reason of its liabilities and the IA is satisfied that the insurer is unlikely to be able to pay relevant claims in full;

(d) a manager / provisional liquidator / liquidator has been appointed and the IA is satisfied that the insurer is unlikely to be able to pay its debts or relevant claims in full;

(e) winding up proceedings have commenced and the IA is satisfied that the insurer is unlikely to be able to pay its debts or relevant claims in full;

(f) events similar to the above have occurred; or

(g) similar events concerning the insurer have occurred in any jurisdiction outside Hong Kong.