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The Insurance Regulatory Regime in Hong Kong

Ann Leung

Summary

- The author describes some recent developments in insurance regulation, including the plans to develop a new Independent Insurance Authority and changes to securities and futures regulation which will have an influence in the insurance markets.
- Like other sectors in Hong Kong's vibrant economy, insurance has traditionally been subject to the principle of minimum intervention. However in the light of the global financial crisis, the last few years has seen an incremental notching up of financial services regulation, though not nearly on the same scale as Europe and elsewhere.
- The industry is currently regulated by the Insurance Authority under the Insurance Companies Ordinance. Insurers and reinsurers are subject to light-touch regulation by the IA, and insurance intermediaries are self-regulated by industry bodies accredited by the regulator.
- The Government has been consulting on the formation of a new independent insurance regulator in 2013-14. This body would have strong powers to regulate and supervise across the market, and will include conduct of business requirements. In light of the enhanced oversight powers and duties, the IIA may be more vigilant in its supervision of industry practitioners.
- Meanwhile the Securities & Futures Commission (SFC) is currently conducting a public consultation on proposals to enhance its scrutiny of listing sponsors. The proposed regime will increase the listing sponsor's responsibilities towards due diligence and disclosure.
- There has also been a recent court ruling in Hong Kong over the disclosure of commission in insurance. As long as a commission is "normal" (in terms of amount and placement type) then there is no breach of the Prevention of Bribery Ordinance and no disclosure of the commission is necessary. However the court added that broker disclosure of the fact that commission will be received from the insurer would be considered "minimum good practice".

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CII Introduction: the last few years have seen major changes to financial services regulation in many jurisdictions, mainly in response to the global financial crisis. Some markets particularly the US and Europe will be dealing with significant reforms over the coming years. Hong Kong which has over the years enjoyed a light-touch approach to regulation generally, and self-regulation in the broker market is no exception to these reforms. Ann Leung from DLA Piper's Hong Kong office provides an overview of the key changes and their implications.

Hong Kong is, and has been for many years, a vibrant international financial centre. Much of its success as a major hub for local and international customers and investors is due to its free market economy, and a 'laissez-faire' approach adopted by the colonial Government of Hong Kong in the 1960s. The Government has, for a long time, abided by the principle of minimum intervention in market practices, and the insurance sector is no exception.

In recent times, however, Hong Kong has seen an incremental increase in regulatory oversight across the financial services industry. Against the backdrop of the Global Financial Crisis of 2008, this is hardly surprising. However, despite the heightened regulatory purview, Hong Kong is still a long way from adopting restrictive approaches in the financial services industry as one may find elsewhere such as Europe.

What is the Current Insurance Regulatory System in Hong Kong?

Regulation of the insurance industry in Hong Kong is effected by a mix of statutory requirements, regulatory supervision and self-regulation by the participants in the industry.

Established in 1997 as an office within the Hong Kong Government, the Office of the Commissioner of Insurance (OCI) administers the legislation governing the operation of insurance companies and insurance intermediaries in Hong Kong: the Insurance Companies Ordinance (Cap 41) (ICO).

The Insurance Authority (IA), which was established under the ICO, exercises prudential supervision of the insurance industry with a view to promoting general stability of the insurance industry and protecting the interests of policyholders. The IA has statutory powers under the ICO for prudential regulation of insurers, including in relation to capital adequacy, solvency margin, handling of assets and liabilities, proper keeping of financial information and fitness and properness of directors and controllers. The IA is also empowered to take interventionary actions to protect policyholders, such as imposing restrictions on the types of investments that may be held and requirements for maintaining assets in Hong Kong.

Despite the heightened regulatory purview, Hong Kong is still a long way from adopting restrictive approaches in the financial services industry as one may find elsewhere such as Europe.

The ICO sets out the framework for carrying on insurance business in or from Hong Kong, including insurer authorization, compliance and reporting requirements.

Insurers

The IA is responsible for licensing and regulating Hong Kong insurers and reinsurers (including Lloyds). The IA's role is to ensure compliance with the ICO by industry's practitioners and to issue codes of conduct relating to various aspects of the ICO.

Any company that wishes to carry on any class of insurance business in or from Hong Kong must be authorized under the ICO (certain exemptions apply such as to Lloyds' syndicates). The ICO sets out particulars of the authorization regime, which is based on capital and solvency margin requirements. A company applying to be authorized must have minimum amounts of paid-up share capital and solvency margin (ie the excess of assets over liabilities) as set out by the ICO. Different levels of capital and solvency margin requirement apply to different classes of insurance business (general, or life/long term insurance).

Insurance Intermediaries

There are two types of insurance intermediaries in Hong Kong: (i) insurance agents; and (ii) insurance brokers. Each is defined under the ICO. Put simply, an insurance agent acts for an insurer in arranging contracts of insurance, and an insurance broker acts for the policyholder in advising on and arranging contracts of insurance.

The proposed Independent Insurance Authority will comprise the existing powers of the IA plus enhanced powersto regulate insurers. These include powers to initiate investigations, search and seize material, prosecute offences summarily, and impose a range of regulatory sanctions in relation to misconduc.

Insurance intermediaries are, currently, self-regulated. This self-regulatory system has been in operation since 30 June 1995. Insurance brokers are regulated by one of two approved self-regulated organisations (SRO), namely the Confederation of Insurance Brokers (CIB), or the Professional Insurance Brokers Association (PIBA). Both of these bodies are regulated by the IA which has the power to impose conditions on them and to ensure that their members function properly and that policyholders are protected. Brokers who are members of CIB or PIBA are required to meet the "minimum requirements" provided for under the ICO, which relate to a broker's qualification and experience, and impose various duties on an insurance broker to keep proper records, hold requisite professional indemnity insurance and have minimum levels of capital and assets.

Insurance agents are regulated by the Hong Kong Federation of Insurers (HKFI), which was set up in August 1988. It plays an important role in the self-regulation of the insurance industry in Hong Kong as it has the authority to issue the codes of practice for insurers and insurance agents and enforce compliance with the codes.

A New Independent Insurance Authority

In July 2010, the Hong Kong Government published a public consultation paper to solicit views on its proposals to establish a statutory Independent Insurance Authority (IIA). The Government then released a paper in June 2011 setting out consultation feedback and a detailed process for establishing the IIA in 2013-2014.

The proposed IIA is expected to bring the insurance regulator in line with other financial services regulators in Hong Kong and internationally. As mentioned above, the current regulatory regime under the IA focuses on prudential regulation with a minimal market conduct enforcement role. The proposed IIA will retain the existing powers of the IA and, in addition, will have enhanced powers in relation to the regulation of insurers. These enhanced powers include express powers to initiate investigations, search and seize materials upon warrant, prosecute offences summarily, and impose a range of regulatory sanctions in relation to misconduct committed by insurers. These sanctions would include imposing fines, suspending/revoking a license, and prohibiting an insurer from applying to be licensed.

The new IIA will also have direct regulatory powers on the conduct of insurance intermediaries (including insurance intermediaries employed by banks), replacing the SROs that currently regulate insurance intermediaries. It will be responsible for the licensing and direct regulation of insurance intermediaries, and can impose conditions on the licenses as appropriate. The IIA will also have statutory power to set down conduct requirements of insurance intermediaries, the breach of which would carry statutory consequences (including criminal or supervisory sanctions).

Various structural changes will take place as part of the proposals. There will be a separate arm to police market conduct of insurers and insurers intermediaries; an independent Insurance Appeals Tribunal will be established to enhance the accountability of the IIA in the exercise of its powers, and there will be a Governing Board to ensure the proper exercise of its powers.

Market participants appear to have responded stoically to the proposed new regime. Although the proposed changes appear, at first glance, to involve a

vast departure from the existing regulatory regime, they are, on the whole, structural in nature. There is no hint of regulatory changes nor is there any proposal for changes to the licensing requirements. However, intermediaries will certainly be affected and, indeed, the SROs (the CIB and PIBA) are already in consultation with the IA and OCI on how best to merge the existing regimes into a cohesive and coherent one under the IIA. Also, in light of the enhanced oversight powers and duties, the IIA may be more vigilant in its supervision of industry practitioners. Independent regulators charged with effecting a statutory objective have shown themselves, overtime, to discharge their duties with some enthusiasm.

The Securities and Futures Commission

The Securities and Futures Commission (SFC), established in 1989, is an autonomous statutory body responsible for administering the laws governing the securities and futures markets in Hong Kong - the Hong Kong Government is not involved in the day-to-day regulation of the industry. Its purpose is to maintain and promote the fairness, efficiency, competitiveness, transparency and orderliness of the securities and futures industry and to provide protection for investors. The SFC has regulatory oversight of the Securities and Futures Ordinance (Cap 571) which came into force on 1 April 2003.

Recently, the SFC has proposed/implemented changes that reflect a growing trend towards closer regulatory scrutiny.

1. Proposals to enhance scrutiny of IPO listing sponsors.

In May, the SFC launched a two-month public consultation on proposals to enhance its scrutiny of listing sponsors. Listing sponsors, typically banks or corporate finance houses, prepare a company's listing documents and perform due diligence to ensure compliance with relevant listing rules. There is no definite timetable for implementing the proposed regulatory changes. The consultation process ends on 6 July.

The proposals combining new and existing sponsor requirements will become part of the Code of Conduct for Persons Licensed by or Registered with the SFC. The proposed regime will increase the listing sponsor's responsibilities towards due diligence and disclosure. In particular, sponsors would have to be "reasonably satisfied" that information in the prospectus is "true, accurate and complete", and demonstrate that it was reasonable to rely on accountants', auditors', valuers' and other experts' reports in the prospectus. Although sponsors are not required to repeat the work done by experts, they would be expected to test the information provided in the reports to ensure that the information in the prospectus is "credible and coherent".

The proposals would also include clarifying sections 40 and 40A of the Companies Ordinance that a sponsor has civil and criminal liability for untrue statements (including material omissions) in a prospectus. Under section 40A, a person is liable to a fine of up to HK$700,000 and a term of imprisonment of up to three years for conviction on indictment or a fine of up to HK$150,000 and imprisonment of up to 12 months upon summary conviction.

The SFC's proposal is a reflection of a long-term trend towards better corporate governance in the HK finance industry.

The proposal is also a response to the fact that many issuers are not in Hong Kong, and there needs to be a recourse to locally-based market participants.

The proposal to increase the prospectus liability of sponsors was first ventilated in 2005 by the SFC, but it was considered premature at that time to proceed as the new non-statutory sponsor regime had not yet been fully implemented. In recent years, there have been a number of cases where listing sponsors have failed to address issues that were fundamental to the listing applications. The most recent case of note relates to the SFC's finding that Mega Capital (Asia) Company Limited, a sponsor, failed to discharge its sponsor's duties in relation to the listing application of Hontex International Holdings Company Limited in 2009. The SFC fined Mega Capital HK$42 million fine

and revoked its sponsor license to advise on corporate finance.

The SFC's proposal is a reflection of a long-term trend towards better corporate governance in the HK finance industry. The proposal is also a response to the fact that many issuers are not in Hong Kong, and there needs to be a recourse to locally based market participants. This proposed increase in regulatory scrutiny has caught the attention of the financial market and sponsors are unlikely to welcome the changes which would increase their liability and responsibilities. The proposal would also have a direct impact on the insurance sector - any cost and liabilities falling on sponsors could well come back to bite issuers under indemnities contained in Underwriting Agreements (which would undoubtedly be beefed-up in response to the changes) and trigger the "Offering Underwriter" insuring clause in IPO policies.

2. Amendments to listing rules affecting D&O insurance

With effect on 1 April 2012, the Hong Kong Stock Exchange (which is regulated by the SFC) amended the Rules Governing the Listing of Securities on the Stock Exchange of Hong Kong ("Listing Rules") to change the D&O insurance requirements for issuers (i.e. companies that are in the process of applying to be listed and those that already are listed companies on the Main Board of the Stock Exchange of Hong Kong) from being a Recommended Best Practice to being a Code Provision. That is, the requirement for appropriate insurance cover in respect of legal action against its directors has been upgraded. Issuers now have to comply with the new rules by obtaining D&O insurance, or explain why they have not done so under a "comply or explain" mechanism, whereby issuers are expected to account for their compliance with the Code Provisions for the relevant accounting period in their interim and annual reports.

In the event an issuer chooses to deviate from any of the Code Provisions listed in the Listing Rules, it must give detailed reasons for its deviation. In contrast, previously issuers were merely encouraged but not required to state whether they have complied with a Recommended Best Practice or to provide considered reasons for any such deviation. Therefore, the fact that the requirement for issuers to purchase D&O insurance in respect of legal action has been promoted from an RBP to CP suggests that, unless there is good reason for not doing so, issuers are expected to fully comply and arrange for the relevant insurance policies for their directors and officers. It is difficult to see what could constitute good reasons not to have "appropriate" D&O insurance, particularly as D&O insurance is relatively competitively priced in Hong Kong.

While this change will hopefully be beneficial to the insurance sector (by increasing purchase of D&O cover for directors of listed companies), it is a further reflection of the trend towards better risk management and corporate governance in the financial industry in Hong Kong.

3. ILAS

On the life insurance side, market regulators have also sought to enhance oversight over recent years. In mid-2010, the SFC issued a Code on Investment-linked Assurance Schemes, setting out enhanced requirements relating to the sale of Investment-linked Assurance Schemes (ILAS) products, to ensure customers purchase ILAS products that are suitable and consistent with their requirements and risk appetite. A key aspect of the Code was the implementation of the Cooling Off Period, where potential policyholders must be allowed to withdraw unconditionally from the ILAS product within the stated cooling-off period. The rationale behind this is that life insurance policies represent long-term commitments and purchases should be allowed to re-consider, within a reasonable period of time, their decision to purchase the product.

Shortly after the introduction of SFC's ILAS Code, the HKFI issued a directive in January 2011 setting out a requirement that every application for an ILAS product must include, or be accompanied by, a financial needs analysis form and a risk profile questionnaire, which are designed to ascertain the purchaser's financial position and risk

appetite/investment expectations. The HKFI directed that no insurers can opt out of the initiative. To further educate the public about ILAS products, the HKFI produced a pamphlet in January 2011 titled "Questions you need to ask before taking out an ILAS product", which must be distributed to potential policyholders at the point of sale with effect from February 2011.

Brokers' Commission Disclosure

In addition, a topic of current interest in the insurance industry is the issue of broker commissions and whether they constitute a breach of the Prevention of Bribery Ordinance Cap 201. In January 2012, the Court of First Instance of the High Court of Hong Kong Special Administrative Region held in the case of *Hobbins v Royal Skandia Life Assurance Ltd & Anor* that, so long as a commission is "normal" (of normal amount and placement type) then there is no breach of the Bribery Ordinance and no disclosure of the commission is necessary. The Judge also made a comment in obiter that disclosure by a broker of the fact that he will receive a commission from the insurer would be considered "minimum good practice". Although this provides some clarity to the industry, many questions remain unanswered.

The outcome of Hobbins v Royal Skandia was that disclosure by a broker of the fact that commission is received from the insurer would be considered "minimum good practice".

Payment of commissions have always been a tricky subject for insurance brokers, as they are customarily paid by the insurer and not the customer. This gives rise to difficulties relating to a broker's common law fiduciary duties not to make a secret profit and not to be in a position of conflict. The very nature of a broker's commission seems to be at odds with his duties to the client. This issue has plagued the Hong Kong insurance industry for some years, ever since the Independent Commission Against Corruption made informal comments in 2009 that brokerage commission could be a breach of the PBO.

Interestingly, this is an area where the IA has not been overly eager to step into, unfortunately, leaving it to the SROs and the market to attempt to arrive at a solution. Market participants have been left in a state of flux until the recent court ruling. The judgment, however, is on appeal (to be heard in December 2012), such that the industry must need wait a little while longer for the issue to be put to rest.

Conclusion

It is clear that, around the globe, there is a continuing trend towards better corporate governance, heightened risk management and more rigorous regulatory oversight of the financial markets. Hong Kong is no exception to this paradigm, as can be seen in the advent of the proposed IIA and the various measures put in place by the SFC in recent years to promote better customer protection. However, compared to the Solvency II directive that is currently in the centre of the European arena, the reforms implemented and proposed by the Hong Kong Government are far from extreme. Unlike Europe, there is no proposed regulatory overhaul in Hong Kong (such as that proposed in Solvency II) calling for an establishment of risk-based capital requirements for insurers. Of course, it is not an impossibility that this may happen in the future, although history would suggest that any such dramatic development is many years away. For now, though, participants of the Hong Kong finance sector can continue much as they have in the past with conservative, incremental changes gradually tightening the financial services regulatory regime.

If you have any questions or comments about this Thinkpiece, and/or would like to be added to a mailing list to receive new articles by email, please contact us: thinkpiece@cii.co.uk: +44 (0)20 7417 4783.

Ann Leung is a Senior Associate with the Hong Kong office of DLA Piper, a leading global law firm, and has extensive experience in the insurance industry advising on a broad range of matters, with a focus on accountant professional liability, D&O liability, brokers' E&O and insurance regulatory. Ann is qualified in Hong Kong, Australia (NSW), and England & Wales. After practising for 4 years as a junior lawyer predominantly in the insurance litigation field in Australia, Ann worked in London as a solicitor in financial services and commercial litigation, with a focus on insurance related work, in the process gaining her qualifications as a solicitor in England & Wales. In 2009 she returned to her roots in Hong Kong, working for DLA Piper's insurance team, focusing on litigation and regulatory issues. Ann is a regular blogger for DLA Piper's *Insurance Flashlight*, an Asia-Pacific online blog geared towards providing insurance practitioners with the most up to date and relevant information available.

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Reflective Questions

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Learning Outcomes

- To gain an understanding of the insurance regulatory environment in Hong Kong.
- To be able to summarise and state the significance of the key changes to insurance regulation currently under consideration in that jurisdiction.

1. The formation of the new Independent Insurance Authority will represent some major changes to insurance regulation in Hong Kong. What are the key changes from the existing regime? How will this affect the supervision of firms including both providers and intermediaries?

2. Why do you think the author has included a section on the changes to the Securities and Futures Commission in an article about insurance regulation? In what ways will firms be influenced by these changes and how do you see them affecting you directly?

3. The author mentions a court ruling concerning the disclosure of commission from brokers. Commission disclosure and whether to establish rules governing the form and content and sales process, has been a recurring debate in many jurisdictions over recent years. What are your views towards the ruling about commission disclosure, and how do you see this working in practice?

4. The author begins her article by stating that "despite the heightened regulatory purview, Hong Kong is still a long way from adopting restrictive approaches in the financial services industry as one may find elsewhere such as Europe." Thinking about some of the major regulatory changes in progress in some other jurisdictions such as the United Kingdom, Europe and the United States, in what way is Hong Kong's approach unique to warrant this distinction?

The CII Thinkpiece Series

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Recent or revelant articles in the series:

No.80: **Climate Change: Implications for the UK and the Rest of the World**, Professor Sir John Beddington CMG, FRS (18 June 2012).

The UK Government's Chief Scientific Adviser discusses the potential implications of a two-degree warming of the climate. Possible negative consequences include; a rise in sea levels, increase in prevalence of heat waves and an increase in the number of extreme weather events such as storms and droughts. There is also the possibility of breaching tipping points in the climate system which if crossed could result in irreversible climate change.

No.79: **Moving Beyond the Uncertainty of Climate Change Risk: Applying Measurement, Mitigation and Diversification to the World's Most Challenging Risk**, by John Coomber (14 June).

Chairman of ClimateWise and former CEO of SwissRe suggests areas worthy of thought for insurers and insurance brokers. He argues that climate change will lead to an inexorable increase in property risk, and insurers should therefore seek to engage with affected communities to provide information, coverage and risk mitigation skills to a new customer base.

No.78: **The Southern Surge Revisited: Robust Trends in South Asian Insurance**, by Vanessa Rossi (28 May).

Independent economic analyst Vanessa Rossi examines the insurance sector growth prospects in India, Malaysia, Singapore and Indonesia; revisiting this subject after an earlier CII report in 2010. Two years later, the latest data reveal that despite negative outlooks for the short-term, the new data points to a boost to prospects for insurance market expansion over the long run.

No.77: **The Money Myth?**, by Alex Davidson (18 May).

With technological advances and ever more complicated investment vehicles, it is easy to forget that financial markets are driven by humans and human nature. Lessons from the past, whether based on fact or mythology, can teach us a lot and we would do well today to remember this. The author offers up examples from classical mythology that show human nature has changed little in 2,500 years and provides five rules to help would be investors bear this in mind.

No.76: **Is the Renminbi the New Dollar? Chinese Monetary Policy and the Global Reserve Currency System**, by Andrew Leung (14 May).

The author focuses on monetary policy in China and its potential implications, arguing that any drastic appreciation of the Renminbi (RMB) is likely to cause catastrophic job losses and social instability in the country. As a consequence, Leung argues that China must retain an independent RMB exchange rate, allowing for only gradual and measured appreciation.

No.75: **Converging Ideas: Building a European-Wide Supervisory Culture in Insurance and Pensions**, by Gabriel Bernardino (4 May).

The European Insurance & Occupational Pensions Authority (EIOPA) was formed in January 2011, at a time when many in the industry were still wondering how a pan-European insurance "supervisor-of-supervisors" could operate in practice without compromising the work of the national authorities. In this article, Gabriel Bernadino, Chair of EIOPA provides a perspective on the Authority's first year of operation.

No.67: **Insurance Regulation in 2012: Finding Solutions to the "British Dilemma"**, by Mark Hoban MP (11 January 2011).

Financial Secretary Mark Hoban MP summarises the UK Treasury's latest work in insurance regulation, including the UK regulatory reforms, Solvency II, and response to the European Court's gender ruling. He the UK's dominance in the global insurance markets both retail and wholesale which cannot be underestimated, and any regulatory reforms must be reflective of the unique issues in this sector.