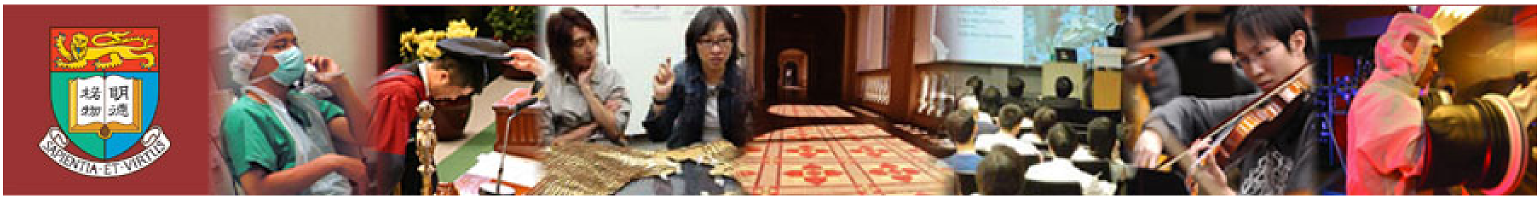

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A Study of Financial Sector Regulation in Hong Kong:

Towards A New Insurance Regulatory Regime

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Capstone project report submitted in partial fulfillment of the requirements

for the Master of Public Administration

Department of Politics and Public Administration

The University of Hong Kong

2013

DECLARATION

We declare that this Capstone Project Report, entitled A Study of Financial Sector Regulation in Hong Kong: Towards A New Insurance Regulatory Regime, represents our own work, except where due acknowledgement is made, and that it has not been previously included in a thesis, dissertation or report submitted to this University or to any other institution for a degree, diploma or other qualification.

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ABSTRACT

Financial stability and sustainability are always the prime concerns of most jurisdictions and countries around the world. The Hong Kong government has also been striving its best to maintain the status of Hong Kong as a leading financial centre in the region as well as pursue sound financial development as a whole. Nevertheless, the recent global financial crisis hit on the regulatory problems severely and revealed many regulatory issues on market conduct, consumer protection, unethical selling of financial products, and even mal-administration on certain financial industries which have drawn huge public concern. While the Hong Kong government has long been adopting the governing philosophy of financial conservatism and positive non-interventionism historically, yet there is overwhelming public urge to strengthen accountability and stringent control subsequent to the recent financial turmoil.

In the regulation of the financial sector, a wide array of policy tools is adopted. To assess the effectiveness and appropriateness of these policy tools by various parameters, it is surprising to see that all the financial industries in Hong Kong are regulated by independent statutory bodies except insurance industry, given its breadth and depth. With different institutional design and regulatory power, the insurance regulation over the market participants, including insurers and insurance intermediaries, are not on par with banking, securities and pension industries. As a result of different regulatory regimes and structures, regulated entities are prone to

take advantage on regulatory arbitrage which poses danger to the overall stability of the financial sector. In a macro view, it seems that the regulation of insurance industry is the weakest link amid the overall financial regulatory efforts rendered.

This project taps on the concept of three streams model by Kingdon (1995) which sets the scene for examining the current financial sector regulation, especially the insurance industry. By checking against the assessing criteria, namely legitimacy, effectiveness, accountability, due process, expertise, efficiency and autonomy, four core problems are identified in the insurance sector — insufficient power to regulate insurers, self-regulatory problems, outdated institutional design and difficult cross-boundary regulation over complicated products.

In resolving the regulatory problems in insurance industry, the project examines whether the improvement on certain policy tools could provide a quick solution in enhancing insurance regulation in Hong Kong. Theoretically speaking, the regulation on insurance industry could be strengthened to a certain extent through altering policy tools. But if at the very beginning, the design of the regulatory form does not tailor with its desired function, it should then be an opportune time to re-think whether a change in regulatory form is more desirable in order to better cope with the regulatory loopholes in the insurance industry and catch up with international standards in maintaining Hong Kong's international status as a financial hub.

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LIST OF ABBREVIATIONS

AML	Anti-money Laundering
APRA	Australian Prudential Regulation Authority
ASIC	Australian Securities and Investments Commission
BO	Banking Ordinance
DFS	New York State Department of Financial Services
FCA	Financial Conduct Authority
FSA	Financial Services Authority
FSTB	Financial Services and the Treasury Bureau
GDP	Gross Domestic Product
HKCIB	Hong Kong Confederation of Insurance Brokers
HKEx	Hong Kong Exchange
HKFE	Hong Kong Futures Exchange
HKFI	Hong Kong Federation of Insurers
HKMA	Hong Kong Monetary Authority
HKSAR	Hong Kong Special Administration Region
IA	Insurance Authority
ICO	Insurance Companies Ordinance
IIA	Independent Insurance Authority
ILAS	Investment-Linked Assurance Schemes
IMF	International Monetary Fund

LegCo	Legislative Council
MAS	Monetary Authority of Singapore
MPF	Mandatory Provident Fund
MPFA	Mandatory Provident Fund Schemes Authority
MPFO	Mandatory Provident Fund Schemes Ordinance
NPA	New Public Administration
OCI	Office of the Commissioner of Insurance
ORSO	Occupational Retirement Schemes Ordinance
PIBA	Professional Insurance Brokers Association
PRA	Prudential Regulation Authority
SEHK	Stock Exchange of Hong Kong
SFC	Securities and Futures Commission
SFO	Securities and Futures Ordinance
SFST	Secretary for Financial Services and the Treasury
SROs	Self-Regulatory Organizations

CHAPTER 1: INTRODUCTION

Focus and Objectives of the Project

This project addresses the financial sector regulation in Hong Kong, in particular the insurance regulatory system. Its objectives are to study the current regulatory system and examine shortcomings of the system in face of the dynamic financial market. By overseeing regulatory tools available for the government and exploring possible financial regulatory models over other international financial centres, some recommendations are proposed to fit the local financial environment most.

Why the Insurance Industry was Chosen for Study

Hong Kong remains one of the leading financial markets in the world after its handover to China in 1997[1]. As an international financial centre, Hong Kong performs its leading role in attracting foreign investors for investments and business operations in the past decades. To further promote the financial market development and maintain its leading status among international financial centres, an up-to-date, secure and comprehensive regulatory system is crucial to create a level-playing field for all participants, including financial institutions and customers in financial markets.

[1] According to the Financial Development Index 2012, Hong Kong is ranked the first of the world's leading financial systems and capital markets, followed by the United States and United Kingdom (World Economic Forum, 2012, p. xiii, Table 1). Hong Kong is also ranked the third international financial centre, following London and New York (Long Finance, 2012, p. 4, Table 1).

Within the four industries in the financial market regulation, namely banking, securities, insurance and pension, the insurance industry was chosen to be the focus in this project because of the significance of insurance and its wide coverage over the public. Unlike deposit or investment products which are optional to the public, insurance is necessary for protection against different kinds of risks, like death, disability and medical expenses.

Much attention is put on the insurance industry not only because it is heavily engaged in the provision of insurance products with substantial saving and investment elements, but also the unique position of the regulator of local insurance industry — the Office of the Commissioner of Insurance (OCI). While other local financial regulators take the form of independent statutory bodies, only OCI remains as a government department overseeing the insurance regulation. Its full dependence on government resources and existing regulatory system are less desirable that the International Monetary Fund (IMF) suggested more than a decade ago that there should be greater clarity in OCI's role and its operational independence status so as to enhance the effectiveness of insurance supervision in Hong Kong[2]. Due to other

[2] Established in 1999, the IMF is an organization of 188 countries (in July 2013), "working to foster global monetary cooperation, secure financial stability, facilitate international trade, promote high employment and sustainable economic growth, and reduce poverty around the world". Its Financial Sector Assessment Programme is a comprehensive and in-depth analysis of a country's financial sector. Its first report on Hong Kong was published in June 2003, which commented that the insurance supervisory function in Hong Kong could not be considered truly independent as long as OCI was part of the government. The institutional and governance framework of OCI would need to be more clearly defined, and to be made more transparent and accountable amid the IMF's forthcoming assessment on Hong Kong again in 2013. (IMF, 2003, 2013a & 2013b)

considerations, however, the Hong Kong government's only action was to consult the public on the establishment of an independent insurance regulator until mid-2010, in which divided voices and comments were received.

The existing insurance regulatory system is outdated and far lagged behind the pace of market development and public expectation. There has been increasing concern over the integrity, accountability and control of the giant financial institutions and the protection for consumers, especially on insurance products regulation where complicated financial products were commonly packaged as insurance products sold to individual investors. The Lehman Brothers mini-bond incident triggered the opening of a policy window as "an opportunity for advocates to push their pet solutions or to push attention to their special problems" (Kingdon, 1995, p. 203). It is deemed as an opportune time for a review on the current insurance regulatory system.

Regulatory Problems Revealed by Global Financial Crisis

With the rapid development of financial products and the ever-changing market environment, the existing insurance regulatory regime formulated more than three decades ago is far lagged behind the pace of market development and public expectation[3]. The global financial crisis in 2008 triggered by the US subprime mortgage crisis and the US government bailout of AIG revealed the failures of

[3] Currently, the regulation of insurance industry is mainly derived from the Insurance Companies Ordinance (Cap. 41), which was enacted in 1983.

corporate governance and risk management in financial institutions, and loopholes in the financial regulatory system, including the one in Hong Kong. It urged the need of managing the market conduct and ethics in the selling process and calling for more stringent regulation on the financial sector.

The mini-bonds relating to Lehman Brothers in Hong Kong were packaged as a safe investment product similar to the bonds issued by Hong Kong blue-chip companies. In fact, they were complex financial derivatives, including a mix of collateralized debt obligations and credit or equity-linked notes, which were later identified as 'poisonous products' at an indeterminable value. The packaging as a safe investment attracted many retirees and housewives to invest their life savings into the mini-bonds. The investors were not informed of the complicated nature of mini-bonds until their savings were fully vaporized at the collapse of Lehman Brothers.

The investigations into some 21,000 complaints against the mis-selling of mini-bonds caused hundreds of millions of losses to the investors also accentuated the problem of overlapping responsibilities between the financial regulators. The vague responsibilities of financial regulators and under-regulation over the financial markets reflected the inadequacies in the financial regulatory system to prevent crisis[4].

---

[4] After the collapse of Lehman Brothers in 2008, the Hong Kong Monetary Authority (HKMA) and Securities and Futures Commission (SFC) conducted their own investigations on the related mini-bonds and later jointly followed the issue with 16 distributing banks which subsequently agreed to offer a number of repurchase schemes to eligible investors in certain mini-bond products (HKMA, 2013a; SFC, 2013a).

Research Questions and Propositions: Theory and Practice

In view of the regulatory problems in the local financial market, this project examines different tools for regulation and explores better ways for regulation by using tools approach. The research questions are as follows:

- What types of regulatory tools can a government adopt to oversee and control the financial sector, including the insurance industry?

- What particular regulatory tools has the Hong Kong government actually adopted to oversee and control the insurance industry?

- According to what criteria can the appropriateness and effectiveness of the possible array of regulatory tools be evaluated?

- What other regulatory tools could be adopted by the Hong Kong government to more effectively oversee and control the insurance industry?

In this project, it is observed that there is a wide array of tools available for the government and each of them has its own strengths and weaknesses. It should be reckoned, however, that there is no single perfect tool which can solve a social problem. Instead, different mix of appropriate tools should be applied under different circumstances to fit for purpose. Notwithstanding the availability of a wide range of tools, a government is usually limited by its governing principles and tends to be conservative and risk-adverse in adopting new tools. The Hong Kong government is no exception. It appears to be cautious in carrying out any major changes or revising the existing regulatory system in face of any crisis or critical issues, with the current impeding political atmosphere. Given a more rapidly changing financial environment and international regulatory standard, it is time to look beyond the regulation, be innovative and adaptive to new tools, so as to keep abreast of the regulatory trend and maintain Hong Kong's competitiveness as an international financial centre.

Overview of Analytical Framework

Fundamental elements of financial sector regulation are related to why, how and how effective in terms of regulation and regulatory tools of regulators, which are reflected as reasons for regulation, how to regulate the financial institutions and their activities, and use and applicability of the regulatory tools. The three elements are found to align with the three streams, viz. problems stream, policy stream and political stream, by Kingdon (1995) which are used to analyze the policy process of government policy.

Under the Kingdon's (1995) three streams model, a focusing event pushes the government to pay attention to the problem and renders the coupling of three streams, which leads to the opening of a policy window and a golden opportunity for agenda setting. Similarly, when there is any focusing event happening in a market (usually a big failure in regulatory regime), the advocates will make use of this good opportunity to urge the government to review or renew the regulatory regime. The three streams model is therefore used for setting the conceptualized background of the analytical framework of this project for examining the current financial sector regulation, especially on the insurance industry.

With reference to the regulatory issues listed out by Freiberg (2010), a set of parameters are found in each of the three streams for examination and analysis. In the problems stream, there are four core and generic reasons for the need of regulation by government: market failure, public interest, risk management, and trust.

The policy stream describes how the government regulates the market through regulatory tools. Given a wide array of regulatory tools covering various areas, there are many classifications on types of tools according to different scholars. Having considered Freiberg's (2010) classification and financial activities being covered by this project, five board forms of regulatory tools are identified: command and control tools, economic tools, information tools, structural tools, and informational tools.

Of significance to the political stream, in evaluating how effective the regulatory tools are, reference are drawn to the generic situation of the financial sector and the criteria for assessing the use and applicability suggested by Baldwin, Cave and Lodge

(2012). The seven criteria are legitimacy, effectiveness, accountability, due process, expertise, efficiency, and autonomy.

The analytical framework provides a lens through which the financial sector regulation can be examined, especially the insurance industry. Based on the analysis and evaluation of the current regulatory regime, together with the overseas regulatory models and the global regulatory trend, some recommendations are proposed for the insurance regulatory regime in Hong Kong.

Research Methodology

There were many discussions between legislators and local communities on the review of financial market regulation in Hong Kong in the past years, as triggered by the Lehman Brothers mini-bond incident and global financial crisis. To conduct the research on regulation of local financial market, references were drawn to the discussion papers from the Legislative Council (LegCo), consultation documents and consultation conclusions of financial industries. Some time was spent on reading articles from newspapers, magazines and journals to grasp the latest development of the review of financial sector regulation and gather different views and comments from stakeholders, scholars and financial experts, including insurers, industry associations, insurance intermediaries, industry bodies, as well as the Consumer Council, political parties and professional bodies. To take a holistic view over financial sector regulation, researches were conducted by going through the websites and articles published by local and overseas regulators and governments.

Though discussions of the financial regulatory system and relevant decision making are confidential within the government and regulators, the above channels can provide the most updated and comprehensive information with views from different stakeholders and their considerations. With the impact of globalization nowadays, it is important that the research also covers overseas regulators with a wider perspective of the regulatory regime, in providing valuable and updated knowledge on examining how a regulatory framework could be evolved in both catching up with the international trend and fitting local situations more appropriately.

Chapters Outline

The project contains six chapters, including this Introduction. The Introduction gives an overview of the research project. It includes the background of the study and provides reasons for the research topic so chosen. Moreover, it highlights the research questions and propositions and gives an overview of the analytical framework. It also describes the research methodology and the arrangements of the paper.

Chapter 2 includes a literature review of regulatory tools of government and an analytical framework of the study integrating the three streams model — problems, policy and politics from Kingdon (1995). It further elaborates the five broad tools of regulation, assessing criteria of tools and their use and applicability in view of four generic aspects, namely regulatory power over the trade, soft regulation, institutional design and global regulation issues.

Chapter 3 provides an overview of the financial market in Hong Kong, including four major financial industries, the types of regulatory tools adopted by different regulators and cross-boundary regulation issues. It demonstrates the problems stream and policy stream described in Chapter 2.

Chapter 4 focuses on the insurance sector to examine the particular tools adopted in view of the local political context. It illustrates the political stream with an assessment of the current regulatory regime of insurance sector and further explains the deficiencies of the current regulatory system by applying the assessing criteria.

Chapter 5 examines the four alternatives available in the policy-making arena and tries to find out a model which is more suitable to fit for the changing socio-economic environment and conducive for the long term development of insurance industry in Hong Kong.

Chapter 6 concludes the paper by giving a summary of the research project. Other than an overview of the project findings, there is a final discussion on the way forward of insurance regulation moving towards the era of integrity, which can only be attained together with the effort of local and global government in the presence of financial stability in Hong Kong, in the region, and over the world.

Looking beyond, Hong Kong is coined by Times Magazine as "Nylonkong" (Elliot, 2008) which implied its status as an international financial centre on par with New York and London. Surely a robust and comprehensive regulatory system is indispensable for Hong Kong to keep pace with the rapid development of financial market. It is hoped that this project can work as a reference for a better regulatory regime of the financial sector in Hong Kong.

CHAPTER 2: ANALYTICAL FRAMEWORK

Introduction

Regulation surrounds all of us in our daily life, as part of the social order. Starting from the way we walk across a road, parking a car in a parking lot, waiting for a doctor in a clinic, even depositing monies in bank accounts; all these activities exert certain degree of control and binding by different entities. According to Baldwin, Scott and Hood (1998, p. 4), the very board definition of regulation comprises "all mechanisms of social control or influence affecting behavio[u]r, from whatever source, whether intentional or not". In a more specific way defined by Freiberg (2010, p. 4), regulation means "an intentional measure or intervention that seeks to change the behaviour of individuals or groups".

In a society, the regulatory roles are shared among different agencies and bodies, including government agencies and departments, non-governmental groups, trade and industry organizations, business and professional associations, etc. The government, however, still plays the most significant role in regulation in many aspects in a society as it has the legitimate state and power to carry out regulatory actions.

To help the study on the regulatory system, the regulatory tools approach is adopted to examine the essence of regulation — (i) Why do we need to regulate? (ii) How to execute the regulation? (iii) How effective is the regulation? These elements of regulation as explained by Freiberg (2010) together with the concept of three streams model proposed by Kingdon (1995) are applied to set the foundation of the analytical framework.

Addressing Regulation by the Three Streams Model

In setting up the analytical framework for the project, Kingdon's (1995) three streams model is applied. It presents a set of process focusing on the agenda setting in the policy process, where the problems, policy and political streams are three major dimensions of a public issue affect the setting of agenda in the government.

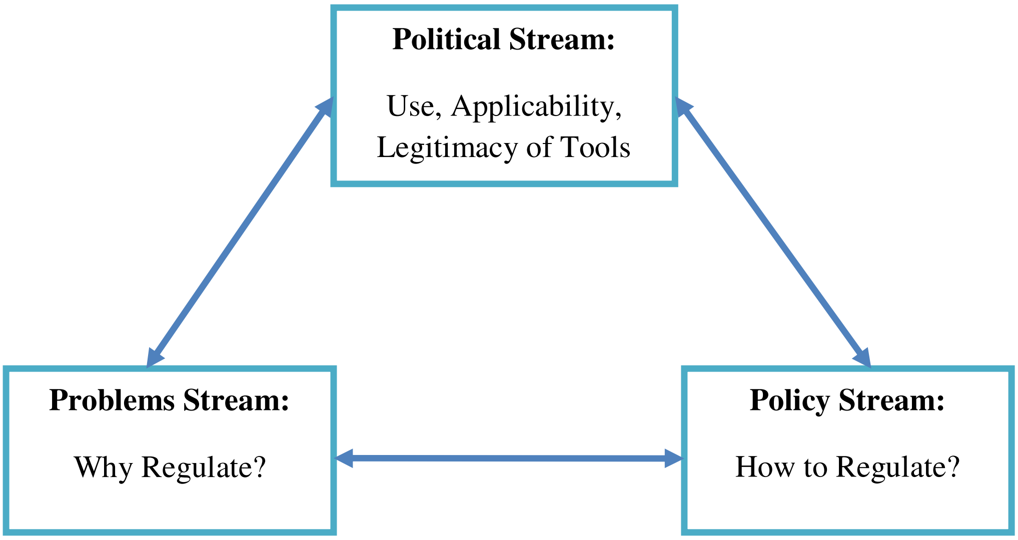
The focus of the project is on the review of current financial sector regulation, which is a forward-looking mode in realizing the regulatory tools, their use and application in practice and exploring ways to further improve the regulation, rather than a backward-looking study on the agenda setting process of a particular public event. However, Kingdon's (1995) three streams model still provides the broad conceptual basis of the analytical framework for the exploration and explanation of regulatory tools. The three streams – problems stream, policy stream and political stream – represent the important steps of regulation in explaining the reasons for regulation, the tools of regulation, and the use and applicability of tools.

According to Kingdon (1995), problems, policy and politics are necessities of policy process. The problems stream is related to problem recognition which attracts the attention of the government and the public. However, the "[p]roblems are often not self-evident by the indicators" (Kingdon, 1995, p. 94), but there should be a focusing event to push the government to get the attention to the problem. The policy stream describes how the government generates different policy proposals regarding the prevailing environment and how the policy alternatives are debated, selected among the policy communities composed of specialists in specific policy areas. The political stream, which is independent of the problems and policy streams, may go along its own dynamics and own rules, such as national mood, election results, change of administration, change of ideological or partisan distribution in the legislature, etc.

The three streams represent the important dimensions for the government policy making process; the model describes the interrelationships among them on how their coupling leads to the appearance of a policy window. Where there is a change in the political stream or the emergence of a new problem that captures the attention of government officials, the coupling of three streams leads to the opening of a policy window. Though the open window does not stay long, it generates a good opportunity for advocators to push their pet policy alternatives and try to take advantage of it.

The model provides a contextualized background for the analytical framework in the study of financial regulatory tools and their use and application in a particular public issue, and how the government can recognize the need for a review on the regulatory regime, which is shown in Figure 1 below.

Figure 1: Analytical Framework Integrating Regulations and Kingdon's Three Streams Model



In regulatory sense, the problems stream identifies the problems in a market where the issue becomes a defined problem so that the government "come[s] to believe that they should do something about them" (Kingdon, 1995, p. 109); in other words, it explains why regulation is needed. Reasons for regulation include the presence of market failure, protection of public interest, a way of risk management, and building trust between the public and the market (service or product providers). It also implies social values, norms and other external factors towards regulation by the general public. The policy stream corresponds to how to regulate the issue by the use of different regulatory tools; while the political stream relates to the use and applicability of tools and its legitimacy in a society. The level of use and applicability is then based on the result in the assessment of tools which evaluate how well the regulatory tools are applied to the situation.

In the same manner, the three streams represent the important dimensions for the government regulation. When there is a focusing event or any regulatory problem catching the attention of government, including a failure of regulatory issues which cannot be solved by regulatory tools or an inability to use and apply of regulatory tools, a chance arises for advocates to act on the review or reform of the regulatory system to maintain its effectiveness and suitability. Details of three streams are discussed in the following sections.

Problems Stream: Why Regulate?

As the first step of designing regulatory tools, it is necessary to understand the problems and reasons of regulation. There are many problems that require government regulation. For simplicity, four core reasons for regulation identified by Freiberg (2010, pp. 5-16) are adopted: (i) Market Failure; (ii) Public Interest; (iii) Risk Management; and (iv) Trust.

Market Failure

The fundamental reason for regulation is to deal with market failure, which emerges from the modern economics considering the properties of an idealized economy. The maximizing behaviour of producers and consumers would lead to the efficient allocation of available resources through invisible hand, producing the Paretoefficient allocation of goods (Weimer and Vining, 1999, p. 74). The market, however, is always inefficient due to many reasons.

Monopoly is one of the reasons. With too few suppliers in the market, the market competition is limited. Hence the supply of goods and services as well as their prices are distorted that the government would regulate the number of suppliers to balance the market.

Another cause of market failure is externalities. As explained by Weimer and Vining (1999, p. 94), "an externality is any valued impact, positive or negative, resulting from any action that affects someone who did not fully consent to it through participation in voluntary exchange". If actions taken by a market participant lead to some negative impact to another market participant, then market failure occurs.

Information asymmetry also contributes to market failure which renders adversarial relationship between producers and consumers. Weimer and Vining (1999, p. 107) cited that "information itself has public good characteristics… there may be differences in the level of information relating to the attributes of an externality between the generator of the externality and the affected party". While there is lack of market transparency with limited access to information, it will definitely hinder the operation of an efficient market.

Public Interest

To a larger extent, the government would act on behalf of its citizens for the 'collective good', the welfare of the society or community, or in the 'public interest' (McLean, 2004, p. 45). Public interest might not only imply the interest of majority of a society, but also the benefits of affected groups, no matter they are representing only a small part of the population. By Freiberg (2010, pp. 7-8), public interest "seeks to reconcile individual and collective as well as present and future interests in society through democratic processes". Other than utilitarian side, public interest also shows the desired regulatory outcomes, such as accountability, transparency and human rights.

Risk Management

In modern risk theories, a major role of the government is to manage and distribute risks, which relates to a wide range of aspects including social, environmental, economic, technical, health and other threats. Risk and regulation are closely related that risk assessment and management are deemed as the leading principles underpinning the strategy for regulation.

Trust

The ultimate goal of regulation is better understood as in a broader sense for achieving the social order. Regulation is applied for gaining trust and confidence in the system as a whole, which is considered as a constituent part of all social interactions since social interaction requires regularity and predictability.

The presence of problems is not powerful enough; a focusing event is therefore necessary to catch the attention of the public and the government to the problems. Focusing event may serve as an advance warning or an indication of a widespread problem that needs attention such that it brings people's awareness of the problems and the government considers that it is time to do something about them.

Policy Stream: How to Regulate?

Regulatory tool is a general concept to be conceived as any things of cultural significance used by the government to influence human behaviour. The government may utilize different tools or instruments for regulation, but the meaning of 'tools' or 'instrument' is not specific and sometimes even vague. As defined by Salamon (2002, p. 19), it is "an identifiable method through which collective action is structured to address a public problem". Gunningham and Grabosky (1998, p. 37) also explained that "instruments are the tools employed by institutions to do what they wish to do".

Given an array of regulatory tools, there is no consensus on the classification on type of tools. Still, some scholars tried to classify the regulatory tools by different models. One of the earliest models was made by Hood (1983, p. 21), where the tools of government were classified by the role of government where they are used (either detecting or effecting) and the resources which the government enlist, including nodality (information), authority (legal or official power), treasure (monetary resources) and organization (capacity). McDonnell and Elmore (1987, p. 134) emphasized the strategies of invention which government can use into mandates, inducements, capacity-building and system-changing. Furthermore, according to the underlying modality of control which aims to influence human behaviour, Morgan and Yeung (2007, p. 80) classified the regulatory instruments and techniques into command (legal rules), competition (economic instruments), communication (social norms, disclosure, advertising), consensus (cooperation, contracts, partnerships and self-regulation) and code (architecture and techno-regulation).

Based on Freiberg's (2010) classification and the practical consideration on the study of financial sector regulation in this project, five board forms of power or tools of government are identified: (i) Command and Control Tools; (ii) Economic Tools, (iii) Transactional Tools; (iv) Structural Tools; and (v) Informational Tools.

Command and Control Tools

Command and control is state-based regulation focusing mainly on prescriptive rules that prohibit or restrict the behaviour and conduct, backed by sanctions; or the specification of any activity and subsequent penalty (Gunningham and Grabosky, 1998, p. 5). Regulatory sanctions are the essential feature of regulatory enforcement of legislation and compliance is to be achieved by punishing those who have offended the legislation.

Command and control is the major form of regulatory tools of state regulation, where the role of state is the legislator or rule maker in making and implementing all types of laws in a society (Freiberg, 2010, p. 21). It includes three categories of legislative instruments — primary legislation, delegated legislation (subordinate legislation) and quasi-legislation (soft law). Both primary and delegated legislation [5] carry the authority of state and use the legal rules set by the state to enforce regulation, while quasi-legislation is a range of rules, codes of conduct, standards, guidelines, agreements and ethics and values complied by regulatees which do not form part of the explicit government regulations (Freiberg, 2010, pp. 179-186).

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5 According to Freiberg (2010, pp. 183-184), primary legislation such as criminal, civil and administrative laws sets the objectives of regulation, specifies offences and penalties, appoints the regulatory agencies, defines their power and provides them with ranges of regulatory options and power to create delegated legislation or guidelines in relation to the legislation. It is usually supported by delegated or subordinate legislation which includes legal instruments, such as statutory rules, regulations, by-laws, ordinances, rules of court and ministerial orders, set by agencies or bodies, other than the legislature, whose power is conferred by the primary legislation or the state.

Apart from the soft law, the government also exercises its power or authority to allow or disallow various forms of conduct, through licensing, accreditation, certification, registration, permission and litigation. They are generalized as authorization which confers benefits by authorizing or permitting certain conduct which can direct or prohibit activities. Authorization is able to address some kinds of risks, like externalities and information asymmetries[6]. But it is mainly a preventive tool rather than punitive tool, and a proactive means of minimizing the risk of the occurrence of harm.

Among the various forms of regulatory tools, legislation plays an important and essential role that creates, shapes and enforces regulatory tools. It forms the foundation of regulation because of its ability to give effect on the mechanism of legal organizations for purpose of adoption and use of other types of tools addressed below through a legitimated authority. For example, some market-based regulations like taxes and quota are necessarily underpinned by coercive legal sanctions applying at another level to generate the legal obligation to pay.

[6] In some aspects, authorization is similar to informational regulation because it serves as a means to address information asymmetries (Freiberg, 2010, p. 141). For example, the government can control the entry of people into the professions through mandating the requirements before they can practice their professional knowledge or expertise to the general public.

Economic Tools

To carry out economic regulation or tools[7], the government aims at "ensuring competitive markets for goods and services by providing, limiting or preventing access to a market, and avoiding consumer and other harms when such markets are not feasible" (May, 2002, p. 157), or "altering the costs and benefits of certain actions, and hence introducing a change in the economic, social and environmental behaviour of individuals and firms" (Government of Victoria, 2007, p. 2-10).

Under the economic tools approach, a government can 'make a market' or 'influence a market'. If the market failure is due to the absence of a market, the government may create such a market as a regulatory tool or policy. This can be as simple as an auction, tender and tradable permit scheme. On the other hand, the government can alter the market conditions by influencing an existing market by different tools or policies, for example, changing the level and quality of information available in the market, regulating the price, raising taxes and levies, offering bounties and subsidies, providing tax expenditures, etc. All of the above approaches aim to alter both the supply and demand sides of the market to encourage a more efficient market (Freiberg, 2010, pp. 114-126).

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[7] Economic tools are developed with the emergence of new public management which assesses the government by market or economic theories. It emphasizes the efficient allocation of resources at the point of 'equilibrium', where there is no other allocation of resources would make anyone in a society better off without making anyone worse off, with the goal of an overall efficient use of capital available, and hence achieving market efficiency. Under market efficiency, it is necessary for governments to regulate or intervene in the market when market failure occurs; that means when markets fail to allocate resources efficiently with the presence of monopolies, externalities, or asymmetric information (Freiberg, 2010, pp. 108-109).

Informational Tools

Information regulation aims to regulate through disclosure or transparency and to enhance information available to the target audience. It enables access to information about products or services that others do not have. Other than disclosure, information regulation also includes performance indicators, credit ratings and capability, advice and attitude change.

Information regulation is effective to make the regulated activity public and demonstrate the occurrence of government regulation when any harm has been identified. It also encourages others to take action against the non-compliance by publicising the harm to the public (Yeung, 2005, p. 37).

Transactional Tools

Transactional tools of regulation, as defined by Freiberg (2010, p. 132), involve "regulation that occurs through the direct interaction between parties via a contract, grant agreement or other financial agreement under which the parties have a right to enter into the arrangement or negotiate its terms". It can be in the form of contracts, procurement contracts, contract disqualification and grants.

Regulation by contracts is direct and focused, where rights and responsibilities of relevant parties can be clearly delineated and make them more accountable. While contracts are private agreements, they may not be subject to change under the regular administrative review which is confined by public power or parliamentary scrutiny (Saunders and Yam, 2004, pp. 55 & 61).

Structural Tools

Structural tools are a form of regulation which structure behaviour of people by removing or limiting choices available for market participants such that they act in accordance with the desired regulatory pattern. It is common in places where "processes are limited by human capacities and frailties, and that failures are inevitable due to cognitive, physical or organizational limitations" (Freiberg, 2010, p. 158).

Regulators can alter the structural process which affects the human behaviour in four dimensions — physical design, process design, environmental design and technology. Physical design is the basic form of structural regulation by creating spaces to limit the physical movement of people or removing instruments of harm. Process design structures the activities or tasks involved in the regulated activities or type of businesses systematically to influence human behaviour and reduce non-compliance. Environmental design aims to change the attitudes of people and hence their behaviour. By using technology, regulators work through the design of system to prevent certain forms of behaviour and activities to operate in the realm of information technology (Freiberg, 2010, pp. 159-165).

Interrelationships and Interdependencies of Tools

The five board forms of regulations mentioned above are just part of the whole picture. Other forms of regulatory tools, such as authorization, registration, permission, licencing, contracting, etc. are other important tools that are heavily engaged in the daily operations and activities among business and professional fields in the society[8]. In view of the increasingly complicated market, what matter most is not only the choice of regulatory tools, but the correct and appropriate mix of tools.

In reality, the application of tools is far more complex than the concept of tools, because a tool is a 'package' of different elements with multiple facets, including the nature of good or activity, its delivery vehicle, the delivery system and a set of rules defining the relationships of entities within the system (Salamon, 2002, p. 20). In view of the multi-dimension nature of tools, the complication of the human behaviour and the social, legal and political cultures affecting the success of tools application, regulation usually consists of more than one tool which appear in bundles. In the financial sector regulation, regulators adopt different regulatory tools for effective regulation over their regulated entities and persons. A mix of different tools,

8 Freiberg (2010, pp. 83-84) argued that state is only one of the actors among the many actors. Other regulatory players, such as markets, associations, organizations, regulatory agencies, and even the international organizations are also important actors working with the state to achieve the regulatory outcomes. Though there are many regulatory players, one should not overlook that the government plays multi-roles in regulation: as economic actors, authorizers, facilitators, trading partners and information providers, so as to influence human behaviour from different dimensions of regulation and achieve desired regulatory outcomes.

including cross-sector regulation, is commonly found nowadays in the complex financial market. Application of various tools is discussed in Chapter 3.

Political Stream: Use, Applicability and Legitimacy of Tools

Regulatory tools may be classified into five broad forms as discussed above, but the application of regulatory tools to the policy problem is far more complicated. It is the fact that no tools are perfect to be fit for a public problem which usually involves multi-parties, nor is it possible to address a problem by use of a single tool. In addition, the efficiency of tools also depends on other variables such as social, legal, and environmental factors. Hence the forms of the regulation might not follow its functions; or in other words, regulatory tools might not be shaped by its application or use.

In reality, the use and applicability of regulatory tools may not be rational or logical, in which the process is akin to the concept of "garbage can model of organizational choice" described by Cohen, March and Olsen (1972) for the agenda setting process of public policy making. Under the model, it is difficult to impute a set of preference to the decision situation which can satisfy the standard consistency requirements for a theory of choice[9]. It is common that the decision situations do not meet the

[9] The garbage model argues that a choice opportunity is "a garbage can into which various kinds of problems and solutions are dumped by participants as they are generated. The mix of garbage in a single can depends on the mix of cans available, on the labels attached to the alternative cans, on what garbage is currently being produced, and on the speed with which garbage is collected and removed from the scene" (Cohen, March and Olsen, 1972, p. 2).

conditions for the classical models of decision making. Similarly, an organization or the government usually operates based on an array of inconsistent and ill-defined preferences, rather than a coherent structure. So forms of regulation do not necessary follow its functions.

Nonetheless, the use and applicability of regulatory tools (i.e. how well the system of regulation is suitable, acceptable or good for a particular public problem) can still be assessed based on four generic situations of a regulatory system:

(i) Regulatory Power over the Trade: it mainly focuses on the application of legislative instruments — whether the authority (or regulator) has appropriate and sufficient regulatory power over the licencees or regulatees in a trade industry;

(ii) Soft Regulation (i.e. quasi-legislation): whether the regulatory system works well in soft regulation which does not form part of the explicit government regulations;

(iii) Institutional Design: whether the regulatory tools are able to work well under a specific institutional design, particularly in balancing the tensions between integration and autonomy[10] during its application; and

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[10] When an authority (or regulator) has greater power in the institutional design, it enjoys greater autonomy and has lower level of integration with other authorities or the government. On the contrary, when an authority (or regulator) has less power in the institutional design, it is less autonomous but more integrated with other authorities or the government. In determining such a balance usually triggers a lot of discussions and debates among different authorities, the government, the trade and the public.

(iv) Cross-Boundary / Global Environment Issues: how well the regulatory system joins and works together effectively with regulatory systems in other trade/industry or country, given the increasingly integrated environment and trend of globalization.

Drawing reference to the criteria for assessing the tools of regulation suggested by Baldwin, Cave and Lodge (2012, pp. 26-31) and the generic situations of the regulatory nature, seven assessment criteria are identified: (i) Legitimacy; (ii) Effectiveness; (iii) Accountability; (iv) Due Process; (v) Expertise; (vi) Efficiency; and (vii) Autonomy.

Legitimacy

As the most fundamental assessment criteria, legitimacy reflects the legal validity or legality of the regulatory tools. The concept of legitimacy (Beetham, 1991, pp. 15-16) embodies three distinct elements, including (i) its conformity to established rules; (ii) the justifiability of the rules by reference to shared beliefs; and (iii) the express consent of the subordinate, or of the most significant among them, to the particular relations of power. A tool of regulation is deemed legitimate only if it fulfills three levels of character.

The idea of legitimacy is an extension of the legislative mandate. Legislative mandate suggests that the regulatory action deserves support or worthy of support (i.e. legitimate) when it is authorized by the legislature, which is the origin of democracy authority. Regulators are deemed to fulfill its mandate if they achieve the result of a regulatory action as instructed by the legislature of which its representatives are chosen by the public (Baldwin, Cave and Lodge, 2012, pp. 27-28). One needs to be careful in judging the regulatory actions by this criterion because mandate does not always satisfy its purpose under various circumstances. To allow more freedom for regulators to deal with the unforeseeable problems in future, such as dynamic challenges and risks and advancement of technology, regulatory statutes seldom include precise objectives but broad discretions and objectives. Hence the implementation of mandate would depend on the interpretation based on the judgment of regulators.

Effectiveness

Measurement of the extent on whether an activity achieves its intended objectives is the effectiveness of tools of regulation, which is also the most basic criterion for gauging the success of public action (Salamon, 2002, p. 23). Effectiveness of a tool is judged independent of costs, but it is not easy to measure the effectiveness of public action. The purposes and objectives of programmes are often ambiguous, setting precise indicators are technically difficult, and there are opportunities to influence the program objectives. Effectiveness of any tools also varies with the circumstances. It is therefore important to figure out particular tools which are likely to be most effective under specified circumstances.

Accountability

Accountability refers to the situation where regulators are properly accountable to, or controlled by, democratic institutions, such as the legislature. A regulatory agency might be accountable for its interpretation of its mandate to representative body and hence it is necessary to exercise its power in an acceptable way (Baldwin, Cave and Lodge, 2012, p. 28). It can also refer to whether regulators in the regulatory system can be held responsible for their actions and decisions (Priest, 1997, p. 275). Accountability is increasingly important in good governance and public administration nowadays, except that it involves extra resources, which might affect the pursuit of effective pursuit of regulatory objectives.

Due Process

Due process deals with whether procedures used by regulators are fair, accessible and open. It also includes the level of participation of consumers and affected parties to the regulatory decisions and policy process. The rationale behind is that it is legitimate to have proper democratic influence over regulation if due process is observed (Baldwin, Cave and Lodge, 2012, p. 29). It also relates to the accessibility and transparency of regulatory system to regulatees, their clientele and the interested public (Priest, 1997, p. 275). In this criterion, the guiding principle of choosing stakeholders to participate in the regulatory decisions and process is important, because there are trade-offs between more participation and effective decision making and implementation of the mandate.

Expertise

Exercise of regulatory functions requires expert judgment. Experts are those with professional knowledge to consider the competing options or values and information to come up with the most appropriate decision and achieve the best results, which shows the belief of "trust to my expertise" (Baldwin, Cave and Lodge, 2012, pp. 29-30). With the affluence of information in the new era, the trust and reliance of the public towards experts is weaker than before. To increase the credibility of experts, it is important for experts to explain the issue and their decisions to the public.

Efficiency

Efficiency means to achieve regulatory objectives at the lowest attainable cost given the prices of all inputs and the state of knowledge regulating in a productive efficiency. Baldwin, Cave and Lodge (2012, pp. 30-31) made reference to allocative efficiency (it is impossible to redistribute goods to make a consumer better off without making anyone worse off) and dynamic efficiency (where it encourages desirable process and product innovation and whether the system produces flexible responses to changes in demand).

Autonomy

The criterion of autonomy is specific to some trade or industries where the independency of tools of regulation is important to the use and applicability of tools. As a contrast to integration, some regulatory tools are required to be autonomous such that the tools are not be easily affected by external factor or environment, no matter the pressure from the public and stakeholders, or even the government.

In the study of insurance regulatory regime in Chapter 4, four generic situations are applied to observe the operation of insurance sector, where the use and application of relevant regulatory tools are assessed according to seven assessing criteria.

Concluding Considerations

The three streams model conceives three dimensions (problems, policy and politics) as necessary aspects in policy making process. When there are changes in problems or political streams catching the government's attention, the coupling of three streams may lead to the opening of a policy window as an opportunity for agenda setting. Similarly, when there is a regulatory problem catches the attention of the public and the government, the problems, policy and politics of regulation may also merge together which creates a golden opportunity for a review or even a reform on the regulatory regime.

While the reasons of regulation, tools of regulation and use and applicability of tools represent the problems, policy and political streams respectively, how does the framework apply to the financial sector regulation in Hong Kong? And how well does the current regulatory system work based on the assessment criteria proposed in the framework? The analytical framework sets a foundation to bring out Chapters 3 and 4. The problems and policy streams of regulation are discussed in Chapter 3, including a discussion of the 'real' application of regulatory tools by local financial regulators, whereas political stream is discussed in Chapter 4 involving a detailed evaluation of current insurance regulation in Hong Kong.

CHAPTER 3: OVERVIEW OF FINANCIAL SECTOR REGULATION IN HONG KONG

This chapter describes the overall financial sector regulatory regime in Hong Kong, including the current situation of local financial market as well as the regulatory system over four major financial sectors — banking, securities, insurance and pension. Through the analytical lens of problems stream (why) and policy stream (how), this chapter examines reasons of regulating the financial market in Hong Kong and regulatory tools adopted by different regulators. It also discusses the problems on regulating hybrid products with cross-boundary characteristics, and the interrelationships and interdependencies across the four major financial industries. Finally, a comparison of regulatory tools adopted by different financial industries emerges the limitation of the existing insurance regulatory regime, which is lagged behind the development of the financial market and public expectation.

Current Situation of Financial Sector in Hong Kong

The financial sector in Hong Kong comprises mainly the banking, securities, insurance and pension industries. As one of the four key industries, the financial sector performs a vital role to the local economy[11]. More than 220,000 persons are

[11] There are four key industries in Hong Kong: (i) financial services (including banking, insurance and other financial services); (ii) tourism (including inbound and outbound tourism); (iii) trade and logistics; and (iv) professional services and other producer services. Their value added in aggregate amounted to HK$1,113 billion or 58.5% of Hong Kong's GDP in 2011. (Census and Statistics Department, 2013a, p. FC4).

engaged in the financial sector, representing 6.3% of the total employed population in Hong Kong[12]. More importantly, the financial sector generated value added of HK$307 billion or 16% of our Gross Domestic Product (GDP) in 2011[13].

Unlike some jurisdictions where there is only a single regulator of the financial industry[14], Hong Kong regulates different financial services by separate regulatory bodies. The four financial regulators are: (i) Hong Kong Monetary Authority (HKMA); (ii) Securities and Futures Commission (SFC); (iii) OCI; and (iv) Mandatory Provident Fund Schemes Authority (MPFA) for the purposes of protecting the interests of depositors, investors, policyholders and pensioners respectively. An introduction of each financial industry and the respective regulator is discussed below.

Banking Industry

Hong Kong is one of the world's largest banking centre, with 200 banking institutions from 34 jurisdictions and a network of more than 1,400 branches at the year-end of

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12 The total employment of Hong Kong was 3,579,500 at the year-end of 2012. (Census and Statistics Department, 2013a, pp. FC5 & FC6).

13 Hong Kong's GDP at basic prices in 2011 was HK$1,903 billion. (Census and Statistics Department, 2013a, pp. FC4 & FC6).

14 In some jurisdictions, the regulation of all financial services is under a single regulator, e.g. the former Financial Services Authority (FSA) of the United Kingdom, the Authorié de Contrôle Prudential of France, the Federal Financial Supervisory Authority of Germany, the Financial Services Agency of Japan and the Monetary Authority of Singapore (MAS). On the other hand, some jurisdictions like China, Italy and the United States have separate regulators for different financial services.

2012 (HKMA, 2013b). Under the three-tier banking system, there are 155 licensed banks, 21 restricted licence banks and 24 deposit-taking companies, collectively known as 'authorized institutions'[15]. Total assets of all authorized institutions amounted to HK$14,858 billion whereas their total deposit liabilities to customers reached nearly HK$8,296 billion (HKMA, 2013b), which is almost four times of Hong Kong's GDP of HK$2,084 billion in 2012 (Census and Statistics Department, 2013b).

The banking industry is regulated by the HKMA established as an independent body in 1993. Its Chief Executive is appointed the Monetary Authority by the Exchange Fund Ordinance (Cap. 63), and is also empowered to exercise the functions under the Banking Ordinance (Cap. 155) (BO), including authorization, suspension and revocation of banks and deposit-taking companies and assumption of control over their business (Hsu, 1999).

Securities Industry

The securities and futures markets are operated under The Stock Exchange of Hong Kong (SEHK) and Hong Kong Futures Exchange (HKFE)[16]. Hong Kong is among

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[15] Only licensed banks may conduct full banking services, including in particular the provision of current and savings accounts and acceptance of deposits of any size and maturity. Restricted licence banks may take deposits of any maturity of HK$500,000 or above. Deposit-taking companies may take deposits of HK$100,000 or above with an original maturity of at least three months. (HKMA, 2012)

[16] SEHK (operates the securities market), HKFE (operates the derivatives market) and Hong Kong Securities Clearing Company Limited (responsible for central clearing and settlement system of

the top five global listing markets, with a total market capitalization of HK$21,953 billion as at 31 March 2013 and an average daily turnover of HK$74 billion in the first quarter of 2013 (SFC, 2013b). There were around 1,500 listed companies and 30 automated trading services providers as at 31 March 2013. Moreover, there were 39,300 licensed persons, including 1,800 securities brokerage firms, futures dealers, securities margin financiers, and their representatives (Government of HKSAR, 2012).

The securities industry is regulated by the SFC, which is an independent regulator established in 1989 to execute the Securities and Futures Ordinance (Cap. 571) (SFO). Similar to HKMA, SFC also has a wide range of investigative, remedial and disciplinary powers under the SFO to regulate the securities and futures markets in Hong Kong, including the listed companies, trading services providers and licensed persons mentioned above.

Insurance Industry

As one of the most open insurance centre in the world, Hong Kong had 154 authorized insurers in Hong Kong, including 44 long term (life) insurers, 91 general (non-life) insurers and 19 composite (life and non-life) insurers (OCI, 2013a). The total premiums in 2012 amounted to HK$255 billion (HK$39 billion from general

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market) are hold by Hong Kong Exchange (HKEx), which is a listed company act as the operator and frontline regulator of central securities and derivatives markets in Hong Kong. HKEx mainly regulates listed issuers, administers listing, trading and clearing rules, and serves the wholesale customers of exchanges and clearing houses.

business and HK$216 billion from long term business) (OCI, 2013b), accounting for more than 12.5% of Hong Kong's GDP. The insurance sector also provides lots of job opportunities for the industry. There are more than 73,000 individual insurance intermediaries[17].

The insurance industry is regulated by the OCI, which is a government department under the Financial Services and the Treasury Bureau (FSTB). OCI is headed by the Commissioner of Insurance, appointed by the Chief Executive as the Insurance Authority (IA) under the Insurance Companies Ordinance (Cap. 41) (ICO). The regulatory framework of insurance is divided into two parts — OCI authorizes and directly regulates the insurers, while the insurance intermediaries are regulated under the self-regulatory system which is maintained by industry bodies, including the Hong Kong Federation of Insurers (HKFI) and two approved bodies of insurance brokers[18]. Unlike the banking, securities and pension industries, OCI does not regulate the insurance products available in the market, which are treated as private contracts between insurers and policyholders.

[17] These insurance intermediaries include 9,028 chief executives and technical representatives of 613 broker firms, 27,868 responsible officers and technical representatives of 2,406 agency firms, and 36,875 individual agents as at 31 March 2013. (OCI, 2013a).

[18] The two approved bodies of insurance brokers are The Hong Kong Confederation of Insurance Brokers (HKCIB) and the Professional Insurance Brokers Association (PIBA).

Pension Industry

The pension industry refers to the mandatory provident fund (MPF) system[19] and includes the voluntary occupational retirement schemes (also called the ORSO schemes)[20]. As a mandatory scheme, the coverage of MPF system is extremely wide and growing rapidly. It covers more than 3.16 million employees. As at 31 March 2013, the total asset values amounted to HK$717 billion (MPFA, 2013), representing 35% of Hong Kong's GDP in 2012. There were 19 approved trustees and around 33,900 registered intermediaries for the MPF schemes, providing 41 MPF schemes with 469 approved constituent funds and 300 approved pooled investment funds available in the market (MPFA, 2013).

The MPF system is regulated by the MPFA, which is established in 1998 under the Mandatory Provident Fund Schemes Ordinance (Cap. 485) (MPFO) in 1995 to regulate, supervise and monitor the MPF system and the trustees. MPFA does not directly regulate the registered intermediaries selling MPF schemes, where the intermediaries are all licencees of insurance, banking or securities sector who are regulated by the frontline regulators.

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19 The MPF system is a privately managed, employment-related mandatory system of provident fund schemes for the retirement of local workforce upon the age of 65. Employer and employee, or self-employed person, are each required to make contributions of 5% of the relevant income of the employee, or self-employed person.

20 ORSO schemes referring to those schemes registered under the Occupational Retirement Schemes Ordinance (ORSO), which are exempted schemes under the MPF system.

A Synthesis of the Four Industries and their Regulation

The regulation of financial market in Hong Kong, comprising the four industries as mentioned above, is headed by the Financial Secretary, who oversees the formulation and implementation of policies in financial, monetary, trade and employment as well as economic matters. The Financial Secretary is supported by the Secretary for Financial Services and the Treasury (SFST), through the Permanent Secretary for Financial Services, to direct and formulate government policies and relevant regulatory issues with the goals, among other things, to maintain and enhance Hong Kong's status as a major international financial centre, and to co-ordinate with various financial regulators to ensure Hong Kong's regulatory regime meeting the needs of modern commerce.

The four components of financial sector are important and have their own significant contributions to the overall economic development in Hong Kong. However, one should not overlook that the pivotal interrelationships and independencies among the four industries. The rapid development of financial market results in increasingly complicated financial products nowadays, which contributes to the importance of cross-boundary regulation requiring closer and more advanced communication among different regulators. The emergence of more variety of financial products explains part of the regulatory problems on one hand and affects the applicability and effectiveness of regulatory tools adopted by regulators on the other, both of which are discussed in details in Chapter 4.

Figure 2 summarizes the key features of the four financial markets and their respective regulators.

Figure 2: Financial Markets and Respective Regulators in Hong Kong

Financial Industry Sectors	Banking	Securities	Insurance	Pension
Regulator (year of establishment)	HKMA (1993)	SFC (1989)	OCI (1990)	MPFA (1998)
Institutional set-up	Independent Authority	Independent Authority	Government Department	Independent Authority
Governing body / Reporting to	Financial Secretary	Board of Directors	Financial Secretary via SFST	Management Board
Sources of finance	Exchange Fund (100%)	Levies (76%) Fees (16%) Investment (8%)	Government revenue (100%)	Investment returns on Capital Grant (97%) Fees (3%)
Staffing	~800	~600	~130	~700
Staff costs	~HK$900 million	~HK$650 million	No separate staff costs, subsumed under FSTB	~HK$400 million
Number of Regulated entities	155 Licensed banks 21 Restricted licence banks 24 Deposit-taking companies All banking employees	3 Exchanges companies (under due filing with SFC and SEHK/FEHK) ~1,500 Listed companies ~40,000 Licensed persons	~160 Authorized insurers ~70,000 Insurance intermediaries (under the regulation of self-regulatory orga[illegible]	19 Approved trustees ~30,000 MPF intermediaries
Regulated products	Deposits	Investment products (e.g. MPF funds, ILAS)	No [illegible] insurance pro[illegible]	~40 MPF schemes ~5,300 ORSO schemes ~850 MPF investment funds

Sources: Respective websites and latest annual reports of HKMA, SFC, OCI and MPFA

Problems Stream: Reasons for Regulating the Financial Sector

Given the significance of financial sector, any distress or crisis in the financial sector would materially affect Hong Kong's economic and political stability (Feng, 2007; Feng and Mee, 2008; HKFI, 1998). It has long been found that social habits or informal mechanisms are inadequate for protecting people from the harm when the market fails to deliver the desired products, or there is lack of public confidence in the market. Then, naturally, the public look for the government to act on their behalf to produce some regulatory measures and control the behaviour of both producers and consumers. Before proceeding to the reasons for regulating financial sector, it is necessary first to look for how the Hong Kong government governs the economy as a whole.

Changing Governing Philosophy for Economic Policy

In the colonial period, the Hong Kong government's economic policy was governed by the positive non-interventionism, which the government accounted it as one of the success factors in the economic development of Hong Kong before 1980s. "[I]t is normally futile and damaging to the growth rate of an economy, particularly an open economy, for the government to attempt to plan the allocation of resources available to private sector and to frustrate the operation of market forces …" (by the former Financial Secretary Sir Philip Haddon-Cave and quoted by Yam (1998)). Under this philosophy, the government was the staunch believer of free economy and market competition where market actions were considered as more efficient than government actions, and it always upheld the approach of 'big market, small government' in its governance. This governing philosophy worked well in the past because the participation of civil society in government policies was limited at that time. The regulation on financial industries was also one the same line that regulation would only be imposed on a 'problem-solving basis' when problems occurred which could not be fixed by the market.

However, the introduction of direct elections to the LegCo in 1991 has rendered an increasingly less manageable political environment. The rise of party politics and new political players demanded a share of power by criticizing government policies. The situation in the past decade was even worse. The institutional design of political system under 'one country, two systems' arrangement cannot bring about fully fledged democracy in the postcolonial period, renders Hong Kong as a "semi-democracy state" (Lee et al., 2013, pp. 1-3). Given the semi-democracy circumstance and the rapidly growing civil society, traditional means of public participation through advisory committees can no longer work well in such dynamic political environment. The government gets no choice but has to start changing its governing philosophy to intervene the market during undesirable situations.

Both the changes in political atmosphere and financial market cause the financial regulators to adjust their regulatory strategies more proactively. Other than the changes of political environment, there are many other generic reasons for the government to intervene and regulate the financial industries more frequently and intensively than before. In Chapter 2, four core reasons are cited for the need of regulation by Freiberg (2010, pp.

5-16), namely market failure, public interest, risk management and trust. In reality, these reasons can be found in all financial industries mentioned above.

As a Remedy to Market Failure

The major reason for financial sector regulation is to deal with the market failure, which is attributed to many factors. The first one is information asymmetry that renders adversarial relationship between producers (financial institutions) and consumers (investors). Comparing to other industries, the financial sector always involve transactions of technical and professional knowledge. With the rapid development of financial market in the past decades, there are more and more complicated financial products being available for individual investors, such as exchanged traded funds, real estate investment trust, mini-bonds and investment-linked insurance schemes (ILAS). The complex nature of these financial contracts makes it difficult for financial practitioners to understand, let alone individual consumers without relevant knowledge. It renders the unequal bargaining power between financial institutions and consumers and the latter are vulnerable to abusive marketing by the former. Regulation is therefore deemed necessary to ensure that contracts offered by financial institutions are fair, selling strategy is appropriate and the price is reasonable.

Another reason leading to market failure is to curtail the power of monopoly. Since the entry barrier of being providers (i.e. financial institutions) of financial products are usually very high[21], with stringent requirements on its assets, capital and solvency ratios, the ones who can join the financial market are either conglomerates or international financial corporations. Hence the market participants in financial industry are prone to business collusions and mergers, which reduce market competition, monopolize the market and control the prices easily.

To Protect Public Interest

The second rationale explained by Freiberg (2010, p. 6) for the regulation of financial sector is due to the public interest — the government regulates for the collective interests or welfare of the society or community. Similarly, the financial sector is an industry that is vested in the public interest. Majority of services provided by financial institutions, especially the banking, pension and insurance services, are deemed necessary for the general public. It has long been held that financial services are pervasive in its influence and sometimes, the failure of financial market, like insurance, can affect persons that are not directly involved in the transaction, which can be considered as public interest.

In addition, financial products are fiduciary nature (Vaughan and Vaughan, 1999, p. 95). Individuals make use of financial products to accumulate adequate cash flow for particular use in future (like deposits or pension schemes) or protect against financial loss

[21] For example, a bank shall meet the minimum capital adequacy ratio and liquidity ratio requirements under Parts XVII and XVIII of the BO and an insurer the minimum paid-up capital (say, HK$10 million for a general business insurer) and solvency (say, also HK$10 million for a general business insurer) requirements under sections 8 and 10 of the ICO respectively. It is noted that these are the minimum requirements and actual amounts are usually much higher.

at a later time (like insurance). It is important to the public welfare that financial institutions should fulfill their promises to repay consumers or indemnify insured in future. Financial services are therefore subject to government regulation because of its fiduciary nature which holds vast sums of money in trust for the public.

As a Way to Manage Risk

Regulation is considered as the management and distribution of unacceptable risks (Morgan and Yeung, 2007, pp. 13-14). As shown in the history of financial market, there is a natural tendency in financial industry where market participants tend to challenge each other in fight for greater market share by the keenest sort of cut-throat competition without properly considering the relevant risks involved[22]. This may result in inadequate prices and some of the market participants are forced to close down after a period of time. The phenomenon is common in insurance market that the excessive price cut would not be aware because of its special nature — the full cost of an insurance contract will only be incurred until the insurance contract has reached its full term. It would lead to "destructive competition" where all insurers might be forced to cut their prices below costs to retain their market share which will lead to great financial risk in long term (Vaughan and Vaughan, 1999, p. 96). This also explains the government or regulators do

[22] One of the examples is Anglo Starlite Insurance Company Limited which was placed into provisional liquidation on 8 May 2009 following an investigation by the Insurance Authority. It was generally believed that the cut-throat competition among mobile insurers led to the close down of Anglo Starlite. Another example was found in banking industry (OCI, 2009). In mid-2010, there was a competition of market share by banks that all of them cut the mortgage rate to a risky level. HKMA investigated the situation and communicated with banks, followed by the prudential measures for residential mortgage loans that regulated the lowest mortgage rate of at least 2% offered by banks to enhance risk management of banking system (HKMA, 2010).

affect the price of financial products during the time of irregular market, even though Hong Kong is a free financial market.

Financial stability of institutions is another concern over risk management which requires regulation. As it is impossible for consumers to properly assess financial institutions' financial strength in relation to its prices and quality of services, it is essential for the government to impose high capital and liquidity requirements and constrain institutions' investments and other transactions to reduce the probability of insolvency to zero. Regulation can avoid excessive financial risk and help the institutions better manage their risks for longer term development.

To Build Trust in the Community

Freiberg (2010, p. 6) explained that "at the broadest level, the role of government regulation is to create order and engender trust and confidence in the system as a whole". This rationale is particularly important after the Lehman Brothers mini-bond incident in 2008, where thousands of investors entrusted the banking employees in buying the mini-bonds as secured investment products but finally turned up in losing all of their savings overnight. In rebuilding customers' confidence, local regulators, as led by the Hong Kong government, have implemented a series of measures to enhance regulatory requirements[23] for the sales of certain financial products, such as the extension of

[23] In response to the public outcry for more stringent regulations on the sales of financial products after the Lehman Brothers mini-bond incident, HKMA, SFC and OCI introduced a serious of measures to reduce the problem of risk suitability mismatch between customers and financial products in mid-2011,

cooling-off period, prohibition of offering gifts or financial incentives to promote financial products, assessment of customers' risk tolerance level by conducting financial needs analysis and risk profile questionnaire, audio-recording of salient parts of sales process, etc.

Having gone through the situations and reasons why the regulation of financial sector is necessary and beneficial to the industry, public and society for building trust and nurture an environment conducive to the development of financial sector in long term. But what regulatory tools do regulators apply to financial industries and how do they apply with different mix and match according to the characteristics of operation and products?

Policy Stream: Regulatory Tools in the Financial Sector

In the regulation of financial sector, regulators take various kinds of regulatory tools targeting different licencees and financial transactions or activities. These regulatory tools, largely based on Freiberg's (2010) classification, can be divided into five broad forms, including command and control, economic, information, transactional and structural, but to a different extent based on their own circumstances and historical development. A summary of these regulatory tools adopted by different financial regulators is shown in Figure 3.

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especially on the sales of ILAS products and Unlisted Structured Investment Products to vulnerable customers (examples include (i) the elderly (aged 65 or above); (ii) visually impaired; (iii) illiterate or those with low education level (primary or below); and (iv) those who have limited means and/or no regular sources of income). All licencees of these regulators are required to follow the new requirements and provide adequate training for front-line employees (HKMA, 2011).

Figure 3: Regulatory Tools Adopted by Different Financial Regulators

Regulatory Tools	Banking	Securities	Insurance	Pension
Command & Control	BO (Cap. 155) + codes and guidelines : Legal - authorization Enforcement power: investigation and sanctions	SFO (Cap. 571) + codes and guidelines : Legal - licensing Extensive enforcement power	ICO (Cap. 41) + guidance notes and guidelines : Legal - authorization Enforcement power: limited intervention and withdrawal	MPFSO (Cap. 485) + codes and guidelines : Legal - approval Extensive enforcement power
Economic	Limited power on financial penalties Deposit Protection Scheme	Financial penalties Investor Compensation Fund Unified Exchange Compensation Fund	Very limited power on financial penalties Limited financial compensation (motor + employees compensation)	Compulsory contributions Financial penalties MPF Compensation Fund
Informational	Financial disclosure Market statistics Additional financial information Complaint statistics	Product disclosure Market information Complaint statistics Enforcement news	Financial disclosure Market statistics No complaint statistics	Product disclosure Fee disclosure Complaint statistics
Transactional	Advertisement	Sales and marketing activities	No regulation on insurance contracts	Sales and marketing activities
Structural	3-tier system HK Association of Banks DTC Association	HKEx is the holding company of SEHK and HKFE which are both operators and frontline regulators	Direct super[illegible]urers Self-regulat[illegible]ediaries by HKFI an[illegible]IARB, HKCIB, PII[illegible]	MPF system (employers, employees, trustees)

Sources: Respective websites and latest annual reports of HKMA, SFC, OCI and MPFA

Command and Control Tools

Command and control has always been the major form of regulatory tools to permit or restrict any specific entities, products or activities, the financial sector is no exception. Majority of regulatory powers of regulators come from the legislation, including BO, SFO, ICO and MPFSO which are extended by subsidiary legislation and regulatory codes or guidelines. Through the legislation and specific codes and guidelines, financial market is restricted to those who have obtained authorization[24] and registration[25], including the financial institutions and their employees and representatives, subject to on-going regulation and supervision by regulators. Nevertheless, the scope and intensity of command and control vary among regulators due to their different regulatory philosophies, historical developments and special industry features.

For instance, SFC and MPFA are empowered under their legislations to exercise the most extensive enforcement and investigation powers; the former can impose a wide

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24 Companies are prohibited to carry on banking or insurance business or their names are restricted to use the word ‘bank’ or ‘insurance’ unless they have obtained proper authorization from HKMA under section 97 of the BO and OCI under section 56A of the ICO respectively. Moreover, chief executives, directors and controllers such as key shareholders of a bank or insurer are required to fulfill the fit and proper criteria stipulated by regulators to run the bank or insurer under the BO and ICO respectively, of which some of them are even required to obtain prior approval from the respective regulators.

25 Those persons engaging in securities dealing and MPF selling are required to be licensed directly by SFC and MPFA under the respective licensing systems but insurance intermediaries are indirectly regulated by OCI through their registrations with the self-regulatory organizations (SROs). In respect of products, approvals of investment and MPF schemes should be obtained from SFC and MPFA but deposits are only supervised by HKMA and insurance products are even not regulated by OCI at all.

range of supervisory, monitoring and enforceable regulatory sanctions on listed companies and licensed persons but the latter can only impose fines on employers mainly. Similarly, HKMA and OCI have similar supervisory and regulatory powers such as financial and control regulations (e.g. capital requirements, liquidity or solvency, and corporate governance); the former is empowered to carry out investigations but the latter has neither investigation nor sanction powers under the legislation.

Economic Tools

Different economic tools are applied to the financial industries to help the market moving to the equilibrium and achieving a more efficient market. Regulators (except OCI) may impose penalties for licencees against their illegal activities or undesirable actions against the consumers' interests. On the other hand, various kinds of protection funds are set up to further protect consumers' interests in the financial transactions. For example, the public are protected by the Deposit Protection Scheme for their local currency or foreign currency deposits in banks, while securities investors and MPF Schemes members are under the protection of Investor Compensation Fund and MPF Compensation Funds respectively, for their loss of benefits that are attributable to the misfeasance or illegal conduct committed by relevant financial institutions or their licensed intermediaries[26].

[26] In the event of a bank failure, the Deposit Protection Scheme administered by the Hong Kong Deposit Protection Board will pay a compensation of up to a maximum of HK$500,000 to each depositor under the Deposit Protection Scheme Ordinance (Cap. 581). Similarly, if there is any

In comparison to other financial industries, the insurance industry has less comprehensive protection over the policyholders. Insurance compensation funds are only available for the compulsory insurance (i.e. employees' compensation insurance and motor insurance) and administered by the industry bodies. However, the compensation of policyholders in face of the insolvency risk of insurers for other classes of insurance business under the Policyholder Protection Fund is still under consideration and development[27].

Informational Tools

As it is costly, if not impossible, for the public to obtain the information of financial institutions, such as their financial strengths, capital and liquidity requirements and accounting reports for reference, information disclosure has always been an important regulatory tool for regulators. In Hong Kong, financial institutions are required to

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default of exchange participants and financial or MPF intermediaries, securities investors and MPF Schemes members will be under the respective protection of the Investor Compensation Fund administered by the Investor Compensation Company Limited under Part XII of the SFO with a compensation of up to HK$150,000, and the Compensation Fund administered by the MPFA with a compensation for the accrued benefits under section 17 of the MPFO. Sources: Respective websites of HKMA, SFC and MPFA.

27 For any insolvency of insurers, there are currently two compensation funds for the compulsory insurance businesses of employees' compensation and motor vehicles. These compensation funds are administered by the Employees' Compensation Insurer Insolvency Bureau and the Motor Insurers' Bureau of Hong Kong respectively. On the other, the consultation conclusions of the Policyholder Protection Fund proposal for other classes of insurance business was released in January 2012 and the relevant legislative proposal will be tabled on the LegCo in 2013-14. (FSTB and OCI, 2012).

report their financial situation to regulators regularly[28]; and disclose financial, market and complaints related information and statistics to the public, so that consumers are able to obtain the latest information about changes in the industry. However, the level of information disclosure is not subject to same standard over different industries. For example, insurance industry has an exception that complaint statistics of both insurers and insurance intermediaries are not disclosed while those of other industries are disclosed and announced publicly.

After the Lehman Brothers mini-bond incident, financial institutions are required to disclose the risk-related factors and information of financial products in a more explicit way so that consumers have adequate understanding of their acceptable risks level to make informed decisions. For example, SFC standardized the presentation structure for a range of investment products in the Product Key Fact Statements[29] so that investors can grasp the key issues and risks of a product before investing. For the selling of ILAS products[30], insurance intermediaries are required to conduct

28 For example, the Monetary Statistics Ordinance (Cap. 356) requires authorized institutions to submit statistical returns to HKMA for the purpose of monitoring the developments of the monetary sector.

29 Investment products marketed to public, namely funds, ILAS and unlisted structured investment products, are required to provide a Product Key Fact Statement containing a concise and user friendly summary, in plain language with key features and risks of a product, including name and type of product, name of issuer, quick facts, how does it work, key risks, fees and charges, etc. (IEC, 2013)

30 ILAS product is an example of complex insurance products. It is a life insurance policy issued by an insurance company with the net premiums paid by policyholder invested in underlying funds according to their investment options or in any manner at the ILAS's issuers discretion. Different from traditional insurance, the return of ILAS upon maturity is subject to the performance of underlying funds with no guarantee, except for death benefits. Despite any forms of investment, the nature of an ILAS remains an insurance contract between the ILAS issuer and the investor or policyholder. As such, the underlying funds invested by consumers under an ILAS are the assets

financial needs analysis and risk profile questionnaire to assess the financial situation and risk appetite of consumers and to determine if a particular product and its underlying investment choices are suitable for them. More disclosure requirements are to be made by insurers and insurance intermediaries since mid-2013, such as the commission disclosure in the new compulsory Important Fact Statements (providing a summary of product feature, similar to Product Key Fact Statements) and post-sale calls extended from vulnerable customers to all customers (HKFI, 2013).

Transactional Tools

Financial regulators have other kinds of restrictions on the transactions of financial products, particularly on the promotion strategies targeting individual investors. Both SFC and MPFA have regulatory guidelines on the sales and marketing of financial products, while HKMA has certain restrictions on the advertisement of authorized institutions (including banks or restricted licence banks).

However, insurance industry has very limited regulation by transactional tools. Regulation on insurers' marketing strategies by OCI is limited. As insurance contracts are treated as business contracts between insurers and consumers, OCI largely does not regulate contents of contracts or details of transactions.

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of the ILAS-issuing insurance company and subject to the credit and insolvency risk of the ILAS issuer.

Structural Tools

The regulatory regime and its structure designed by each financial regulator is not the same due to the unique characteristics of products offered and transactions involved. Banks are allocated into different categories under the 3-tier system where deposit-taking institutions operate under different restrictions to reduce risks. Securities and futures markets are operated under the regulation of HKEx with two subsidiaries SEHK and HKFE, responsible for the stock exchange market and futures exchange market respectively, but also reporting to SFC under a 'due filing' system[31]. Under the tri-party arrangement, MPF schemes are also held in trust of authorized trustees under the stringent regulation of MPFA.

Structural regulation of insurance, however, is different from others (that the whole market is regulated by a single independent regulator), where only half of the regime is in the control of a government department (i.e. OCI) while the other half is in the hand of three industry bodies.

31 Under the due filing system, a prospective listed company must file applications and materials with SFC via SEHK. Although SEHK is the frontline regulators of the securities market, SFC retains the direct regulation of the market and can exercise enforcement powers against persons providing false or misleading listing information. (SFC, 2013c).

Cross-Boundary Regulation

Emergence of hybrid-products in the rapid development of financial industries has blurred the boundaries between traditional financial industries. Traditional regulatory tools discussed above are no longer as efficient and effective as they were in the old days. For instance, ILAS products are investment-linked products issued by insurers with both investment and insurance elements but are sold to individual consumers by bank employees or insurance intermediaries. If there is a complaint over an ILAS product, it needs the cooperation of SFC, OCI and HKMA to finish the investigation. As ILAS products are authorized by SFC for fulfilling investment products requirements, they are issued by insurer under the supervision of OCI; and the process of sales usually take place in an authorized institution subject to regulation of HKMA. The typical investigation and complaint handling process may not be useful for ILAS products.

To catch up with the market development, regulators are required to merge or revise their regulatory tools for those complicated products. A platform for mutual assistance and information exchange is essential for different regulators to closely collaborate with each other to carry out effective regulation over the possible loopholes across the industries, though each regulator may have its own concern and agenda over the cross-boundary regulatory issues[32].

[32] Regardless of the fact that the four regulators have signed various kinds of agreements such as memorandum of understanding on specific operations and information exchange.

Concluding Considerations

Given the significance of financial sector to the economy of Hong Kong, the existing financial regulatory regime is a comprehensive one to deal with the problems of market failure, protecting public interest, managing risk and building trust. Though regulators have been applying different regulatory tools according to the unique characteristics of respective financial industries, regulatory regime over four industries are not unified in terms of their institutional set-up, financing and operations, accountability, efficiency and effectiveness.

Both HKMA and OCI are part of the Hong Kong government and ultimately report to the Financial Secretary but their establishment and staffing arrangements are totally different. HKMA, SFC and MPFA are independent bodies with own finances and budgets but OCI remains as a government department and fully financed by government revenues. Owing to the constraints of government budget, OCI is the smallest among the regulators but it regulates the highest number of regulated entities[33]. On products regulation, other regulators regulate their respective products but OCI does not.

[33] As at 31 March 2013, OCI had a total staff of some 130 (including 100 professional grade staff and 30 general grade staff). The establishment of OCI is very small in view of the number of regulated entities and registered persons (163 authorized insurers under direct regulation of OCI and around 70,000 insurance intermediaries under self-regulatory system) (OCI, 2013a).

Regulatory tools adopted by OCI are similar to HKMA based on the legal background of the ICO and BO. However, the power of HKMA is more extensive and protection for consumers is more comprehensive than those of OCI after its own developments for decades. For example, the Deposit Protection Scheme for the protection of bank customers was established in 2006 but the Policyholder Protection Fund is still being developed for the insurance industry. Another major difference between OCI and other regulators is the structural tool where the self-regulatory system for intermediaries still remains in the insurance industry whereas those in the banking and securities markets have ceased for a long time.

The preliminary comparison of regulatory tools accentuated the limitation of OCI's development compared to other financial regulators in the past decades owing to its dependent status as a government department. The next chapter evaluates the Hong Kong insurance regulatory regime in details.

CHAPTER 4: EVALUATON OF EXISTING INSURANCE REGULATION

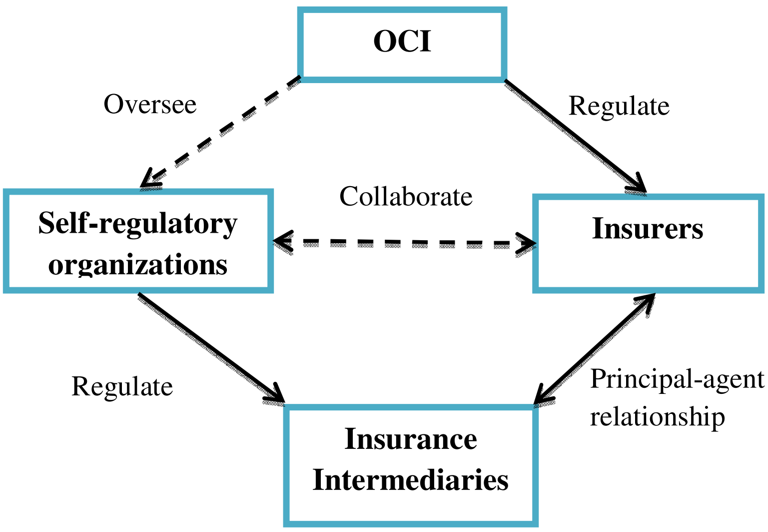
This chapter considers the political streams for the financial sector regulation. It assesses the use, applicability and legitimacy of the regulatory tools in the existing insurance industry against the seven criteria set out in Chapter 2. There is an introduction on the regulatory regime of insurance sector in Hong Kong, and a thorough assessment on whether such regime is suitable in the context of the Hong Kong insurance industry. During the assessment, four generic situations, including the regulatory power over the trade, soft regulation, institutional design and global environment, are applied specifically in the insurance regulation, with reference to criteria suggested by Baldwin, Cave and Lodge (2012, pp. 26-31), namely legitimacy, effectiveness, accountability, due process, expertise, efficiency and autonomy.

Overview of Regulatory Framework of the Insurance Industry in Hong Kong

The insurance industry in Hong Kong is regulated by OCI, which was established in 1990. OCI is led by a public officer, the IA, who is appointed by the Chief Executive of the Hong Kong Special Administrative Region (HKSAR). The IA is supported by a group of professional civil servants to discharge his function.

Currently, OCI is a government department subsumes under the FSTB. It is the only financial regulator which is still under the governmental structure. Contrary to the ideal principle of function over form, OCI's function is greatly confined by its form while it takes on the role as a government body to perform its statutory functions to: (i) regulate and supervise the insurance industry (including insurers and insurance intermediaries) for the promotion of the general stability of insurance industry and (ii) protect policyholders. OCI delivers its functions based on the regulatory power derived from IA under the legislation, including the power in authorization of insurers and regulation and supervision of insurers' on-going compliance with the legislation. However, OCI does not regulate the insurance intermediaries (including agents and brokers) direct, and allows the self-regulatory organizations (SROs) to do so. The relationship between OCI, insurers, SROs and insurance intermediaries are illustrated in Figure 4 below.

Figure 4: Regulatory Arrangements of Insurance Industry in Hong Kong



On the power arrangement, OCI adopts the idea of elitism in governance and constitutes elites to govern the insurers. These elites (insurance officers) have the power to conduct regular and special financial examinations and on-site inspections of insurers, or impose restrictions on their new business of insurers or its investment portfolio, custody of their assets, etc. Other than elitism, OCI depends on self-regulatory regime of insurance intermediaries in the form of pluralism, where regulatory power over insurance intermediaries is dispersed to SROs, which exert influence by using their resources. Different SROs are expected to have a role in ensuring stability of the insurance industry and protecting the rights of policyholders in the insurance industry.

In the old days when OCI was newly established, the involvement of SROs has its merit to avoid dominance of power concentrated in the elitist management of OCI. Self-regulatory regime allows those familiar with the industry operation to have a better position in grasping the crux of problems. OCI does not have the power to regulate the intermediaries directly, but allows SROs to manage their performance based on the soft regulations and make sure that insurance intermediaries comply with the Code of Practice endorsed by IA. Supported by such soft regulation, SROs are responsible for handling all complaints against insurance intermediaries, including investigation, adjudication and imposition of disciplinary action. Therefore, the regulation of insurance intermediaries heavily depends on the self-regulatory regime by SROs.

However, such forms of regulation over insurance industry do not help OCI perform its functions ideally. Problems were exacerbated with the prevalence of hybrid insurance products. The financial crisis in 2008, in which thousands investors suffered from the mini-bonds incident, act as the focusing event which triggered the public outcry for more protection of consumers and finally caught the government's attention to the need to carry out a review of the insurance regulatory regime. In mid-2010, the government finally conducted a public consultation on the proposed establishment of an independent Insurance Authority (IIA), an independent statutory body which can exercise its power over insurance regulation with more regulatory power and financial capacity.

Evaluation of Current Insurance Regulatory Regime

To further evaluate the appropriateness and effectiveness of the insurance regulatory regime in Hong Kong, four generic situations of regulation are examined, including (i) regulatory power over the trade, (ii) soft regulation, (iii) institutional design and (iv) cross-boundary / global environment.

First, the regulatory power over the trade of insurance products mainly focuses on the application of the legislative instruments, which refers to the appropriateness and sufficiency of regulatory power over the insurers in the existing system. Second, the soft regulation does not form part of the explicit government regulations, but it has an important role for effective regulation and its performance is heavily relied on the level of compliance by SROs and other stakeholders. In the insurance industry, soft regulation is in the form of codes of conduct, standards and guidelines for SROs as well as agreement, ethics and values complied by the regulatees. Third, the institutional design of insurance regulator is another important aspect affecting whether the regulatory tools function well under the institutional design in balancing between integration and autonomy during its application. Finally, apart from the local context, the insurance regulatory regime should be able to maintain its efficiency and effectiveness in collaboration with other regulatory regimes in the financial sector locally (cross-boundary regulation) and globally given an increasingly integrated environment and trend of globalization.

These four aspects are identified as focuses of regulation, as they are the fundamental circumstances of regulation and cover particular criteria affecting the use and applicability of regulation — internal and external considerations, statutory and soft regulation, local and global integration, which are all interrelated with each other in terms of regulatory sense. In applying the seven assessing criteria over the four generic situations, some are related to one aspect, while some are related to few of them.

Through the four generic lens, inadequacies in the existing insurance regulatory regime are detected, including (i) insufficient regulatory power over insurers, (ii) self-regulatory problems (such as conflict of interest, favourism and lag in monitoring over insurance intermediaries), (iii) outdated institutional design and (iv) difficult cross-boundary regulation over complicated insurance products in the competitive market. The inadequacies reflect that the current form of regulation over insurance industry fails to cater the need in achieving its functions. The original intent to protect policyholders with a dispersed power between self-regulatory regime and a limited power conferred on IA delimit OCI to safeguard the public interest in the dynamic and competitive market. The inadequacies are further elaborated in the following sections.

Insufficient Regulatory Power over Insurers

Legitimate power is of utmost importance for a regulator, and regulation over insurers mainly covers two broad areas — issuing licences for insurers and conducting prudential regulation on insurers' financial sustainability, such as ensuring insurers to meet the minimum paid-up capital and solvency requirements. OCI, however, has insufficient regulatory power to discharge its duty. The ICO has become outdated as it was enacted in early 1980s but has not gone through thorough amendments or modifications over the years to catch up with the changing market environment. Checking against the seven criteria, this aspect is related to two of them — Effectiveness and Due Process.

Effectiveness in Regulating Insurers and Business Conducts

Effectiveness of OCI in regulating insurers is delimited due to insufficient power conferred on IA. The ICO allows IA to authorize insurers to conduct insurance business in Hong Kong (by issuing licences) provided that they fulfill the requirements at least. However, IA does not have the power to de-authorize insurers (by withdrawing licences) if they fail to meet the on-going compliance requirements or misconduct in running businesses. IA can only impose interventions, for example, to restrict their new businesses of the insurer or require them to maintain a certain amount of assets in Hong Kong to protect the interest of policyholders. Consequently, OCI performs as an organization for issuing licences, rather than a regulator upholding the quality of service providers in the insurance industry.

On prudential regulation, even if irregularities are detected in the provision of services and business conduct, OCI does not have the power to initiate investigation or enter the premises of the regulated entities to conduct inspections, nor does it has the power to impose supervisory sanctions in the form of public reprimands and fines to punish misconduct in the market. All of such regulatory power is commonly found in other financial regulators, and deemed necessary for effective enforcement of breaches of financial market regulatory requirements[34]. OCI hence heavily relies on the self-discipline of insurers as it lacks the power of thorough investigation over suspected non-compliance cases.

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[34] Under the Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) Ordinance (Cap. 615) which has become effective since 1 April 2012, all financial regulators (including HKMA, SFC, OCI and MPFA) are empowered with full set of regulatory power to enforce the statutory anti-money laundering (AML) requirements, such as enter into premises of regulated entities to conduct inspections, initiate investigations, make enquiries, access to records and documents, apply to Court of First Instance for court orders in the course of inspection and investigations, impose supervisory sanctions such as public reprimands and fines, etc. Such regulatory power is on par with the existing regulatory power conferred on HKMA, SFC And MPFA and hence not a new thing for these financial regulators. However, the full set of regulatory power is new to OCI that it is the additional power on top of OCI's power over insurers. Though OCI owns the full set of regulatory power under AML Ordinance, it is only available in the ambit of AML-related enforcements, and not for the prudential regulation over insurers.

Due Process in Financial Sector Regulation

According to Baldwin and Cave (1999, p. 79), due process is significant as "public support is merited because the regulator uses procedures that are fair, accessible and open". The underlying rationale of such a claim is that proper democratic influence over regulation is ensured by due process being observed so that this influence has a legitimating effect.

However, in the terms of investigation power and punitive measures, regulation by OCI is more lenient and lax as compared to other local financial regulators, such as SFC and HKMA, which leads to inconsistency in overall regulatory regime in Hong Kong. The SFO and BO confer power of imposition of economic sanctions on SFC and HKMA respectively, such as financial penalties against misconduct in the aspects of sales and marketing activities, while OCI has no economic sanctions towards insurers for non-compliance with requirements under ICO.

On information disclosure, SFC and HKMA protect the general public by diminishing asymmetric information in the market. Financial institutions are required to disclose all investment-related information to the public, including investment products details, market information, and actions taken in view of the latest guidelines and code of conduct applicable to them; while SFC and HKMA disclose enforcement and market information to the public regularly, including complaints statistics[35] and updated regulatory requirements on enforcement. On the contrary, OCI does not have such mechanism to disclose any information of complaints and disciplinary actions taken against insurers.

Fairness must both be done and seen to be done. All discrepancies of regulatory actions, enforcement procedures and complaints handlings contribute an impression for the public that regulation by OCI is more lenient than regulation by SFC and HKMA. Also, OCI is comparatively less accessible and open to protect the rights of policyholders and ensure stability of the insurance market.

Self-regulation Problems over Insurance Intermediaries

Baldwin and Cave (1999, p. 78) states that "regulatory statutes often give regulators scope for exercising judgment and devising solutions…because legislators have limited information and expertise in specialist". However, the current insurance regulatory system lacks a clear scope for execution of judgment due to a fragmented distribution of powers. The regulation of insurance intermediaries is characterized by pluralism. Pursuant to ICO, IA has the legislative mandate to regulate insurers and their businesses under the ICO, but he has no direct power to regulate insurance intermediaries, in which the regulatory power are scattered over different SROs. It

[35] In handling of complaints, SFC and HKMA list out the complaints statistics regularly, including investigations conducted, actions taken towards the licencees (such as period of licence suspension, public reprimand, name of financial institutions or banks, etc.) and some detailed information of the cases if necessary.

coincides with the definition of pluralism stated by Smith (2006, p. 26) that "the state was fragmented into multiple power centres and checkpoints". Pluralist advocates stress that diversity is deemed as a social good that prevents the dominance of one particular idea and power should be dispersed and not allowed to accumulate into the state.

The self-regulation problems over insurance intermediaries are related to three assessing criteria — Legislative Mandate, Effectiveness and Due Process.

Legislative Mandate for Imposing Legitimate Power for Regulation

Insurance regulation covers mainly two aspects — prudential regulation of insurers and conduct regulation over insurance intermediaries. Instead of imposing direct regulation over insurance intermediaries, OCI depends on SROs to exert a direct regulatory power over the intermediaries under the self-regulatory regime. In fact, SROs are industry bodies rather than a regulator.

While there is no explicit wording in the ICO providing legislative mandate on the regulation over insurance intermediaries, SROs wholly rely on the Code of Practice endorsed by IA to make sure that their members, i.e. insurance intermediaries, comply with the Code of Practice. Added that the institutional set-up of SROs is not tailor-made for regulatory function, both the institution and power of SROs lack legislative mandate over the regulation of insurance intermediaries.

Effectiveness in Provision of Services

The original intent of self-regulatory arrangement is to have a dispersed power for better use of expertise and knowledge among groups when OCI was established in early 1990s. SROs would be in a better position to grasp the crux of problems as they are more familiar with the industry operation as well as to handle and resolve the problems swiftly. Meanwhile, the government would like to establish an associational relationship, rather than a command relationship, with SROs at that time.

However, SROs are found to be ineffective in providing the services as reflected in some operational problems when the policyholders lodge complaints against insurance intermediaries. The problems exacerbated after the financial crisis in 2008 with an upsurge of complaints cases. SROs generally lack the capacity to act, the will to act, and the commitment to act appropriately. The capacity of SROs is unable to handle the regulation over insurance intermediaries, as they are industry bodies which do not have adequate manpower resources and expertise (given that majority of complaints are related to medical claims) to handle the complaints. Even different panels are set up to handle complaints; all panel members are volunteers on part-time basis. Hence it is not uncommon to see the huge amount of complaints backlog which might be outstanding for years.

It is not surprising that SROs do not have the will to regulate insurance intermediaries and handle complaints effectively. As SROs are fully financed by insurers and their members (i.e. insurance intermediaries), there is a conflict of interest in the self-regulatory regime. The commitment of SROs to regulate appropriately is also questionable. It is difficult to dispel public perception on the bias towards the insurance intermediaries because all complaints are processed by panels under SROs which are insurance practitioners. Even the current composition of these panels consists of both insurance and independent adjudicators, public still query about the impartiality of the panels' decisions.

Missing Due Process

As the set-up of SROs is for the function of industry bodies, their operational procedures are not as formal and well-defined as those of statutory regulators. It is difficult for SROs to perform the role of regulators effectively and efficiently, let alone the openness, fairness and accessibility which are the even higher requirements for regulators.

Outdated Institutional Design

As part of the government establishment, OCI is the only non-independent financial regulator in Hong Kong. The institutional design is so outdated that this regulatory regime can no longer be found in any other developed countries. Problems as shown from three assessing criteria — accountability, autonomy and expertise — are attributed to the outdated institutional design.

Limited Accountability to the Public

Public governance is accountability, which is a public organization's obligations "to demonstrate that work has been conducted in compliance with agreed rules and standards or to report fairly and accurately on performance results vis-à-vis mandated roles and/or plans" (OECD, 2010). Baldwin and Cave (1999, p. 287) also stated that the utilities regulators should be accountable to the judges, super-agencies, monitoring bodies, the government and the parliament, which requires for democratic decision-making on social issues. However, the institutional design of OCI (including its extended session of the self-regulatory regime over insurance intermediaries) fails to address the accountability demanded by the public or the LegCo, but is only accountable to the government. Such limited accountability becomes obsolete that it does not align with the principle of public governance so as to ensure a better compliance with agreed rules and standards for the competitive markets.

Competitive markets for products and services can be expected to control providers and offer a degree of consumer empowerment (Baldwin and Cave, 1999, p. 290). It reflects the demand for consumer protection by the general public. Accountability is crucial in building up the public confidence and enhancing good governance.

Limited Autonomy on Policy and Management

Roness et al. (2008, pp. 160-161) identified two kinds of autonomy — policy autonomy and managerial autonomy. Policy autonomy refers to the degree of independence that the organization can choose its policy instruments whereas managerial autonomy describes an organization's choice and use of resources, both human and financial resources. With the presence of autonomy, the public is concerned over the control mechanisms and instruments towards the organization which reflect the level of protection to consumers and the community as a whole.

OCI operates with a limitation of policy autonomy. Given regulation inspection and supervision over the insurance companies, OCI should have performed effectively and kept the stability of insurance sector. OCI, however, is limited by the existing government structure as it is only a government department subsumed under the FSTB, which dominates the policy formulation. OCI becomes a sheer follower of the bureau's direction with limited policy autonomy[36]. To worsen the situation, OCI falls short of many powerful policy instruments, such as issuing public reprimand, issuing fines, withdrawal of insurers' licenses and is further limited by its status of policy autonomy.

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[36] Other than FSTB's policy direction, OCI's decisions may also subject to government officials' direction. According to sections 2(2) and 11(2) of the ICO, both the Chief Executive of HKSAR and Financial Secretary have the power to direct or re-determine the decisions of OCI in some cases; though the control mechanism is designed for exceptional circumstances which rarely happens, they do affect the policy autonomy of OCI.

Regarding managerial decisions, OCI is under a low level of managerial autonomy with a high degree of control. As a part of the government establishment, OCI is accountable to the upper level of the hierarchy, including the SFST, the Financial Secretary and the Chief Executive and their offices. They are mainly the managerial level of the organization, but rarely other stakeholders, such as policyholders and the LegCo. OCI has to be abided by the statutory scrutiny of its administrative and operational procedures by the integrity bodies[37], as well as the strict governmental regulations and procedures, such as Civil Service Regulations, which is applicable to all government departments. In the same manner, OCI's financial decisions are also strictly monitored by the government as its financial budget as part of FSTB is sought from the government budget approved by the LegCo and its expenditure is subject to the public audit of the Audit Commission.

Lack of Financial Expertise

Baldwin and Cave (1999, pp. 287-289) states that regulatory statutes often give regulators scope for exercising judgment and devising solutions. As a regulator, OCI is obliged to protect the interests of consumers by controlling product standards and prices where the market fails to do this. As strictly bounded by rigid governmental rules and procedures, the institutional structure delimits OCI's efficiency in execution of its regulatory power efficiently because it does not incorporate sufficient pool of

[37] Integrity bodies in Hong Kong include the Ombudsman (responsible for handling complaints against the maladministration of government departments and public bodies) and Independent Commission Against Corruption (responsible for combating corruption).

expertise. Moreover, OCI's major staff are mostly civil servants that may lack market experience and not able to catch up with fast-changing market with numerous new products and financial derivatives. They have to rely on the HKFI or other industry bodies for updated market practice and knowledge.

Difficult Cross-Boundary Regulation over Complex Insurance Products

Insurance products develop quickly over time. A wide range of complex insurance products are available for retail customers, for instance the ILAS products. ILAS products comprise both securities and insurance elements issued by insurers, hence no longer a pure insurance product under the regulation of OCI and self-regulatory regime of SROs. With the affluence of complex insurance products, the traditional boundaries between financial sectors, including securities, banking, insurance and pension, become blurred. Though with insurance element, ILAS products may be sold by bank employees, who are regulated by HKMA and the relevant SROs, instead of OCI directly. The financial derivatives with insurance-related products fall beyond the scope of OCI to regulate.

Due Process over Cross-boundary Regulation

When there is no longer discrete boundary between securities, banking, insurance and pension, the problem for providing fair regulatory procedures arises. It takes a longer time for complainants to lodge the complaints to the responsible regulators because an investment product may be concurrently regulated by two or three regulations, and the complexity of products requires specialist and expertise advice for categorization. As mentioned earlier, the regulatory power by OCI is less comprehensive compared with other regulators and hence regulatory operations are different among different regulators (even the regulatory power, statutory requirements and sanctions are the same). Such discrepancies over regulation may lead to unfair competition between regulated entities across financial industries and hamper the stability of financial system of Hong Kong.

Cross-boundary products also cause the problem of regulatory arbitrage in which regulated entities (i.e. insurers and insurance intermediaries) can capitalize on the loopholes among different regulatory regimes and circumvent unfavourable requirements and disciplinary sanctions, as a result of inconsistent regulation by different regulators.

Efficiency for Suitable Level of Regulation

Echoing with the need of due process, a just level of regulation is demanded. Some financial products may be regulated by more than one regulator, while some products may fall between the grey areas between regulators without proper regulation. For instance, the equity-linked notes are mainly regulated by SFC with the help of HKMA and subject to stringent sales and marketing regulations, while ILAS products are fall between the vague regulatory boundaries of SFC, HKMA and OCI that none of the regulator is solely responsible for the regulation. This leads to the problem of over-regulation over some financial products and under-regulation over the others. What closely linked with the regulation is the level of available resources. With uneven level of regulation, some specific areas fall short of financial expertise while the over-regulated areas have a waste of resources.

Concluding Considerations

In the application of analytical framework, the political stream, being independent of other streams, acts as the most important aspect in the three streams model that shows the use and applicability of insurance regulatory tools. In order to evaluate the appropriateness and effectiveness of regulatory tools in the insurance industry, four generic situations are identified to check against the seven criteria, viz. legitimacy, effectiveness, accountability, due process, expertise, efficiency and autonomy. As such, four major areas of regulatory problems are found — insufficient regulatory power over insurers, self-regulation problems over insurance intermediaries, outdated institutional design and difficult cross-boundary regulation over complex insurance products; each of them is related to one or more than one assessing criteria.

The existing insurance regulatory regime is far behind satisfactory. Starting from the regulatory design covering regulation on insurers and the self-regulatory regime of insurance intermediaries, and extending from the internal problem of institutional design to the external problem of inability to regulate cross-boundary insurance products, the problematic regulations over insurance industry are far more than merely the use and applicability of regulatory tools.

With further thoughts, though the improvement of regulatory regime and empowerment of OCI by amending the ICO can solve some of the problems (like more effective and stringent control over insurance intermediaries by direct regulation of OCI), the leverage point of an effective and efficient regulatory regime rely on the suitable forms of the institutions (i.e. OCI). It would be more appropriate for the government to rethink the institutional design of OCI (forms) which is the most powerful 'tool' to carry out its regulatory function over the insurance industry.

If it is the right direction to go, how many types of forms are available for the future OCI? What is the latest trend of regulatory forms among other overseas financial centres? Which one is the most suitable for the local financial sector and conducive for the healthy development of financial market in long term? The next chapter comprises a thorough discussion about forms and functions of OCI.

CHAPTER 5: A NEW INSURANCE REGULATORY REGIME: ALTERNATIVES & RECOMMENDATIONS

The previous chapter identified four major problems through an evaluation of the performance and effectiveness of insurance regulation by OCI by means of seven criteria. Following the regulatory tools approach, there should be some recommendations in the existing insurance regulatory regime by a change of policy tools to rectify the problems found in OCI, and achieve a better and more effective regulatory regime. In other words, if OCI is empowered with a new set of enhanced policy tools, the problems so identified should be resolved. The findings of this project, however, show that the current situation may not follow this rationale.

While measuring against the appropriateness and effectiveness of various policy tools, one should go back to a basic question — what sort of functions are the regulator going to perform and could the form adopted by the regulator facilitates the effective delivery of its functions?

Assessing Four Possible Alternatives

In this chapter, various insurance regulatory models, both in Hong Kong and overseas, are examined. 'Function and Form' is one of the analytical couplets in public administration. The function of a body corporate should dictate the form. It is found that different jurisdictions adopt different regulatory models in regulating the insurance market. For example, the UK and Singapore have opted for super-regulator for years while the US adopts independent regulators for different financial sectors.

In the followings, there is a detailed assessment on four alternatives for setting up a new insurance regulatory regime in Hong Kong, which will be systematically criticized by seven criteria so as to analyze the pros and cons of each alternative. The four alternatives can be divided into two categories — regulatory tools approach (Option 1) and regulatory forms approach (Options 2 to 4):

Option 1: Remaining Status Quo — to Enhance the Regulatory Power of OCI and Self-Regulatory Regime of SROs;

Option 2: Establishing an Independent Regulatory Body — to Establish an IIA as a Fully Independent Regulatory Body for Insurance Industry;

Option 3: Merging with Another Financial Regulator — to Merge such as HKMA or MPFA; and

Option 4: Establishing a Super Regulator — to Oversee all Financial Industries as a Whole.

Option 1 is the only alternative which examines whether enhancing the regulatory power of OCI by altering certain policy tools is a solution in strengthening insurance regulation in Hong Kong. However, it is found that a mere change in the adoption of policy tools may not address the problem of insufficient regulation. The 'real' problems of insurance regulation (such as those related to limited accountability, limited autonomy and lack of expertise) go beyond the use and applicability of regulatory tools, but on the institutional design (i.e. form) of OCI. As a matter of fact, the form which the regulator takes on is of prime importance as it set the framework of its function and power. Drawing reference to overseas experience, different forms of insurance regulators are categorized into three major categories, which are reflected in Options 2, 3 and 4. Finally, an overall assessment is made in determining which form an insurance regulator in Hong Kong may take on by referencing to some overseas models.

Option 1: Remaining Status Quo by Enhancing Regulatory Power of OCI and Self-Regulatory Regime of SROs

Although it is mentioned before that OCI is an obsolete model based on an outdated legislation, sharing power between OCI and SROs is not without merits. While OCI works through the self-regulation of SROs, the advantage of self-regulation is that regulators are familiar with industry operation and would be in a better position to handle complaints and respond to market situation promptly with professional knowledge.

Given the fact that OCI is a government department, the government can exert direct control and influence over it particularly on policy directions[38]. In addition, as OCI is

[38] While regulators are responsible for frontline regulation of regulated entities, the government coordinates the regulatory policies over the whole financial sector, and more importantly, oversees whether the regulators are utilizing public resources appropriately and effectively. There are

fully funded by the government, it can have secure funding for the daily operation and will not suffer from financial uncertainty since financial stability is also vital for the effective day-to-day operation of regulators. Last but not least, while staff of OCI are civil servants, they are bound to be politically neutral in policy formulation.

However, as identified in Chapter 4, there are many inadequacies on the insurance regulation, including the regulatory problems over the regulation of both insurers and insurance intermediaries. OCI does not have full set of regulatory power to oversee the financial conditions of insurers, while the nature of SROs as industry bodies fully financed by the insurers, so that there is potential conflict of interest and SROs tend to adopt a more lax attitude in handling complaints against the industry. These problems are related to the legitimacy of OCI's regulatory power, which originates from the obsolete legislation (i.e. ICO).

To tackle the existing regulatory problems, the government can improve the regulatory tools of OCI so that some areas of regulation could be enhanced, such as legitimacy, due process and efficiency. In order to enhance the legitimacy and power of OCI as the regulator for insurance industry, one of the possible alternatives is to strengthen its regulator power as well as its status rested with SROs. For instance, the government can revise the outdated ICO and confer full set of regulatory power

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overseas examples showing that independent regulators may develop as an 'independent kingdom' and out of government's control which might not regulate the industry effectively and promote the financial stability of its country. For details, please see the example of FSA in Option 4 below.

on OCI particularly over the aspects of enquiry, investigation and sanction. At the same time, the revised ICO can stipulate OCI's legitimate control on SROs in the supervision of insurance intermediaries explicitly[39], and widen representation in view of the composition of the committees of SROs to include more varieties of independent members such as academia and representatives from the Consumer Council to impose a better check and balance mechanism to deal with various complaints.

The enhancement of OCI's regulatory power and self-regulatory regime of SROs, however, can only solve small part of the operational inadequacies of OCI and SROs. Even if the legitimacy and regulatory power of OCI are enhanced, majority of the critical criteria of an effective and efficient financial regulator — autonomy, accountability and expertise — still could not be attained.

As OCI is a still government department where its resources are highly depends on the public resources, which affects its public image and investigation work. Public perception on its autonomy and accountability are limited as being an insurance regulator. OCI can only perform as machinery for policy implementation, merely to ensure achievement and compliance with the stipulated objectives in the ICO. Nevertheless, it lacks the avenue for policy formulation and policy evaluation.

[39] The current ICO does not explicitly stipulate the regulatory power arrangement between the IA (i.e. OCI) and SROs or OCI's role in the regulation over insurance intermediaries. Pursuant to sections 67 and 70 of ICO, the government only requires the SROs to issue Code of Conduct for the administration of insurance agents and sets the minimum requirements for insurance brokers.

Nevertheless, OCI is not accountable to either the public or the LegCo as being a publicly-financed regulator. The inability to change its level of accountability fails to meet public expectation and fulfill good public governance.

Similarly, problems of openness, transparency and expertise will not be solved due to the governmental nature of OCI which are required to follow rigid rules and regulations. OCI will not be able to recruit the market talents who are in touch with the latest changes of financial market, nor can it deploy its resources in a flexible way, such as enlisting more professionals to cope with sudden increase of complaints and workload after the financial crisis. OCI's ability to regulate cross-boundary complex insurance products will not be altered significantly, given that its investigation and prosecution procedures are not on par with those of other independent financial regulators, like SFC, HKMA and MPFA.

Figure 5 summarizes the impact on OCI with a change of policy tools.

Figure 5: Summary of Impacts on OCI with Changes of Policy Tools

Area To Be Addressed	*Possible Changes of Policy Tools*	*Possible Impacts Of Changes*
Legitimacy	● To give full set of regulatory power, including investigative and sanction power ● To revise the outdated piece of legislation	May be improved
Due process	● To strengthen the regulator power of OCI and its status rested with SROs ● To enhance transparency by information disclosure ● To co-ordinate with other financial regulators to ensure fair regulatory procedures and avoid overlapping in regulatory effort	May be improved
Expertise	● Governmental nature comprising mainly civil servants ● Lack of professional support	Unlikely to be improved
Efficiency	● To set up a platform for collaboration with other financial regulators such as SFC, HKMA and MPFA to reduce regulatory arbitrage	May be improved
Effectiveness	● To exercise more effective and stringent control over insurance intermediaries by direct regulation of OCI	May be improved
Accountability	● To widen representation in view of the composition of the commit	Slightly improved
Autonomy	● Restricted by the form of being a government department	Unlikely to be improved

As a follow-up on the regulatory tools approach, Option 1 proposes many changes on the tools of OCI in the hope of improving the existing regulatory problems. As many of the regulatory inadequacies are closely linked to the forms, rather than the functions of OCI; the crux of regulatory problems falls on the change of forms of OCI. In short, the adoption of enhanced policy tools could not rectify all the problems that OCI are facing, such as the issue of accountability, autonomy and expertise. Therefore, it is necessary to examine a broader approach in searching for better alternatives for the future insurance regulatory regime in Hong Kong. Options 2, 3 and 4 are all in the form of independent regulators, but in different modes addressing different aspects of regulation in the market. Analysis is done on the preferred mode which is more appropriate for the Hong Kong context (i.e. fit for purpose).

Option 2: Establishing an Independent Regulatory Body for Insurance Industry

As OCI takes up the legitimate role or function of regulator for insurance industry, it is opined that OCI should be independent from the government structure and transform into a statutory body in order to discharge its statutory functions with legal validity.

The proposal on the establishment of an independent insurance regulator (i.e. IIA) has long been an item in the government agenda, which first appeared in the Policy Address 1996. Yet, the proposal remained stagnant for many years as there were fierce oppositions from the industry practitioners and the government could not reach a consensus on whether to set up a 'super-regulator' to regulate and supervise all financial services providers, akin to the Monetary Authority of Singapore (MAS)[40] in Singapore; or to establish an IIA in parallel with other financial regulators which regulate different sectors of the financial market, akin to the practice in China[41].

With such a paradigm shift into an independent regulator, IIA will turn into a highly integrated model, taking up all the tasks from policy formulation, policy implementation to policy evaluation. These three tasks require high degree of co-ordination and design tools, action tools and review tools which need to be devised cautiously and prudently with lots of expertise.

From the macro view over the whole financial sector, with the proposed establishment of IIA, the government now adopts the idea of pluralism in the regulation of financial providers, of which different powers are vested in different financial regulators over a specific area. Unlike OCI which is adopting a hybrid of the concepts of the Old Public Administration that concerns over putting and maintaining the system in place, and the New Public Management that emphasizes on outputs and efficiency, IIA is adopting the ideas of New Public Administration (NPA) that focuses on values include equity, participation, justice and responsiveness.

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[40] MAS is an independent regulator which regulates the whole financial services industry, including banking, securities and insurance, in Singapore. There is no independent regulator for pension industry in Singapore because the Central Provident Fund (compulsory comprehensive savings plan for retirement, healthcare, and housing needs) is administered by the Singaporean government.

[41] The different financial industries in China are regulated by independent regulators, including China Banking Regulatory Commission, China Securities Regulatory Commission and China Insurance Regulatory Commission.

Another advantage of the proposed IIA is that it will have its governing board and standing committees which consist of representatives from different interested parties and will directly "provide leadership and direction and … guide the IIA in development of a corporate strategy", which can guarantee a higher degree of accountability (FSTB, 2011, p. 13). In other words, IIA can enjoy a high level of operational and financial autonomy as well as be more accountable to its stakeholders.

At present, OCI oversees the intermediaries via SROs indirectly and public doubt whether self-regulatory bodies sponsored or supported by industry members would play an effective role in monitoring members' compliance. With the direct control and monitoring of intermediaries by IIA, the regulation over insurance intermediaries will be more stringent and systemic than the current regulation. This can increase the effectiveness and legitimacy of regulation over intermediaries. However, such a rapid and sudden change of regulatory mode inevitably leads to more confrontation with those intermediaries which both the government and IIA should take extra care[42].

As the objectives in setting up an IIA include (i) enhancing protection of policyholders, (ii) maintaining public confidence in insurance market, (iii) contributing to the financial stability and (iv) reducing market misconduct, it is able to attain higher flexibility in dynamic financial environment and has on par status with other financial regulators to

42 In the latest public consultation on the key legislative proposals on the IIA conducted by FSTB in early 2013, many oppositions against IIA's direct regulation over insurance intermediaries were received. Though the proposed regime is comparable to the existing regulatory regime for intermediaries regulated by SFC and MPFA, both SROs and their members (i.e. intermediaries) greatly objected the proposed legislation and worried about the stringent regulation over them and the wide range of disciplinary sanctions to be imposed on them by IIA. (FSTB, 2013)

facilitate negotiation and collaboration, which helps IIA having more effective and transparent regulation than the current OCI.

In promoting open and inclusive policy making, representatives from outside parties into the governing board of IIA are crucial. There might be skepticism among the industry practitioners that the composition of future members will affect the technicality of the professional operation resulting in concerns of having non-professionals regulating the professionals. Also, as IIA is obligated to foster better cooperation on market development and enhance civic engagement in policy initiatives, there is worry over the diversified perspectives or views may lead to disharmony in the insurance industry due to increasing expectation from the public.

However, in view of cross-boundary selling, setting up independent regulators for different financial industries may not fully resolve the issue of regulatory arbitrage and overlapping regulatory effort. In the proposed establishment of IIA, it is proposed that HKMA will be vested with powers similar to IIA for HKMA to regulate bank staff selling insurance products, such that both HKMA and IIA will regulate different intermediaries under different circumstances. Caution should be taken to avoid any overlap in regulatory efforts resulting in increased supervisory costs. Regulatory gaps may still exist as a result of ambiguity in respective roles and responsibilities of different regulators. It is vital to set out framework for mutual assistance and information exchange to facilitate effective discharge of their respective regulatory duties. Likewise, inconsistency in regulation can lead to regulatory arbitrage to the detriment of consumer interests, whereby insurers or insurance intermediaries could capitalize on loopholes in the regulatory system in order to circumvent unfavorable regulation and disciplinary sanction.

Option 3: Merging with Another Financial Regulator such as HKMA / MPFA

Another alternative for insurance regulation in Hong Kong is to merge OCI with another financial regulator, such as HKMA or MPFA. The merged regulator is more possible with HKMA or MPFA because insurance intermediaries are usually regulated by OCI, HKMA and MPFA concurrently where cross-boundary nature of insurance products going into banking and pension area.

The pioneer of merged regulator can be found in US. If one examines the US model, it is noticed that the insurance industry in the US is regulated by the individual state governments separately, which is known as state-based insurance regulation system. Under such regulatory structure, each state regulator regulates its own insurance market independently. The Federal Insurance Office[43] is part of the federal government to coordinate and develop federal policy on regulatory issues and monitor the insurance industry in a macro level, but it is neither a regulator nor a supervisor. There are some other common platforms for the discussion of insurance model laws and regulation, like

[43] Federal Insurance Office was established by the Dodd-Frank Wall Street Reform and Consumer Protection Act after the global financial crisis in 2008. It is authorized to monitor the insurance industry and look for any loopholes in the current state-based regulatory system. Together with Financial Stability Oversight Council (which was also established by the above Reform), they are both responsible for identifying the risks detrimental to financial stability, including insurance market.

National Association of Insurance Commissioners[44], providing some degree of uniformity between states, but these models are not effective unless they are adopted by individual state regulators.

The financial sector regulation model in New York is chosen for illustration as an example because it is an international financial centre comparable to Hong Kong. Following a serious of financial regulation reforms after the global financial crisis in 2008, one of the changes is the creation of the New York State Department of Financial Services (DFS)[45]. DFS is the consolidation of functions of the New York State Banking Department and the New York State Insurance Department, which were former state agencies regulating and supervising banking and insurance businesses respectively. These former state agencies have limited regulation because they only focused on certain types of regulated institutions. The state government believes that the merged agency, DFS, can modernize the regulation over regulated entities by overseeing a broader array of financial services and products, so that it can have a macro view on regulated institutions. The merit of this model of merged regulator is that it follows international indicator in measuring regulatory efficacy. It can also possess regulatory expertise.

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44 The National Association of Insurance commissioners is the standard-setting and regulatory support organization created and governed by the chief insurance regulators from 50 states. State insurance regulators establish standards or best industry practice, conduct peer review and coordinate regulatory oversight in US.

45 DFS, established in October 2011, aims to keep pace with the rapid and dynamic evolution of these industries, to guard against financial crises and to protect customers and market from fraud. DFS directly regulates institutions related to banking and insurance businesses. It also supervises the financial products and services, including those subject to the provision of the Insurance Law and the Banking Law, investigates real estates and homeowner issues and monitors the capital markets like state and municipal retirement plans.

DFS comprises a banking division and an insurance division. The former supervises, through chartering, licensing, registering, and examining safety and soundness, among other actions, nearly 1,900 banking and other financial institutions while the latter supervises all insurance companies (around 1,700 insurers) that do business in New York. They have clearly defined and shared responsibilities. It helps reducing certain degree of regulatory arbitrage as compared with individual independent regulators.

However, as banking and insurance regulation come under two divisions, arbitrage might still exist. Internally, they might also compete for resources particularly when there is outcry of crisis where prompt action and risk management is imminent. As the merged regulator has only been operating for less than two years during which no financial crisis occurs, it is difficult to measure the effectiveness and efficiency of this new model or assess its responsiveness to any regulatory failure.

Option 4: Establishing a Super-Regulator Overseeing All Financial Industries as a Whole

Other than independent financial regulators, super-regulator is a regulatory model commonly found in many countries, including Singapore, Japan, France and Germany. Though their regulatory structures may vary from each other, these regulators are usually responsible for all financial activities in the market, including prudential regulation and conduct supervision of regulated entities.

In Singapore, MAS[46] takes on the form of a super-regulator which oversees financial services industry including banking, securities, insurance and pension. Other than acting as the central bank of Singapore to manage the official foreign reserves, it also conducts integrated supervision of financial services and financial stability surveillance. MAS can specify whether a contravention of a direction is a criminal offence. It can also issue guidelines, codes, practice notes and circular.

Besides the Singapore's model, the former Financial Services Authority (FSA)[47] of the UK was also a demonstration of the super-regulator model. FSA was responsible for the regulation of the financial services industry in the UK between 2001 and 2013. It operated independently of government and was funded entirely by the firms it regulated through fines, fees and compulsory levies. FSA was responsible for the overall scope of regulatory activities and power, regulating over 29,000 firms in the financial sector.

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46 MAS was established in 1971 to provide for the exercise of control over and the resolution of financial institutions and their related entities by the MAS and other authorities, and to establish a framework for the issue of securities by the MAS and the regulation of primary dealers of such securities. It regulates commercial banks, merchant banks, finance companies, insurance, securities, futures and fund management, financial adviser, money brokers, money-changing and remittance businesses, business trusts, trusts companies, payment and settlement systems. MAS also act as the central bank of Singapore, including the conduct of monetary policy, the issuance of currency, the oversight of payment systems and serving as banker and financial agent of the government.

47 Established in 2001, FSA was responsible for the regulation of all financial industries in UK. Other than its core work on the regulation of financial institutions, FSA emphasized on the providing an effective retail market for financial products and protecting retail consumers to get fair deal, so as to raise the confidence and capability of consumers and market. Objectives of the FSA were to (i) maintain confidence in the financial system (market confidence); (ii) contribute to the protection and enhancement of stability of the UK financial system (financial stability); (iii) secure the appropriate degree of protection for consumers (consumer protection); and (iv) reduce the extent to which it is possible for a business carried on by a regulated person to be used for a purpose connected with financial crime (reduction of financial crime).

However, the super-regulator model faced many challenges and criticisms in dealing with the changing environment and increasing public expectation, and it is evolving too.

As a risk-based regulator, FSA spent more time to oversee those institutions deemed to pose the biggest risk. However, the collapse of Northern Rock Bank in early 2008 revealed many weakness and loopholes of the regulation by FSA. Though there were many early warning signs suggesting the weaknesses of the Northern Rock, FSA failed to actively seek further information and notice the serious capital shortfall of the bank for proper regulatory action. Finally, Northern Rock was nationalized with £100 billion liabilities taken on the UK government's books (Seib, 2008). The failure of FSA was not only on its regulation, but also its nature of 'independent kingdom' which was out of government's control. As FSA operated like a private company, its high turnover rate had led to inconsistent regulation, where the responsible head for regulating the Bank has changed thrice in 2.5 years. While there were wide criticisms on effectiveness of the regulation by FSA, its staff still received bonuses of around £20 million (a 40% increase on the previous year) one month after the bail-out of Northern Rock Bank (Watts, 2009).

In face of the public outcry on the performance of FSA in the regulation of financial sector, the UK government decided to restructure financial sector regulation and abolished the FSA on 1 April 2013. Its responsibilities were then split between two new agencies, the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA) and PRA is responsible for the prudential regulation of financial firms, such as banks, building societies and insurers, while FCA promotes the policies related to financial activities and business conduct of financial system. In addition, a Financial Policy Committee is also set up under the Bank of England which acts for the overall financial stability in the UK.

Overall Analysis of the Four Alternatives

To analyze the four alternatives and compare them with each other, five parameters acting as important indicators contributing to an effective and efficient financial regulator are identified, namely, (i) Degree of Command and Control, (ii) Degree of Autonomy, (iii) Degree of Equity, (iv) Level of Accountability and (v) Level of Transparency.

Figure 6: Comparison of Four Alternatives by Five Parameters

	OCI	IIA	Merged Regulator	Super-Regulator
Degree of Command and Control	Low	High	High	Very High
Degree of Autonomy	Low	Medium	High	Very High
Degree of Equity	Low	Medium	High	High
Level of Accountability	Low	High	High	High
Level of Transparency	Low	High	High	High

In Figure 6, it is observed that OCI is relatively low in various parameters and the super-regulator is very high on the other side of the spectrum. However, there is an idiom 'too far is as bad as not enough'. While measuring the performance against all the above-mentioned parameters, the highest attainment of them may not always be desirable. For instance, while some scholars advocate the concept of "steering rather than rowing" (Denhardt and Denhardt, 2003, p. 14), is it really the best option for the regulator to exercise full command and control? In addition, there are many questions subject to public debate and consideration as follows:

- Given such a scope and power, will a super-regulator become complacent and lead to empire building which goes beyond government control and public scrutiny? Will it then do something that contravene to the public policy and government directives in view of public interest?

- As for the issue of transparency, people usually consider some information may be commercially sensitive in nature. What sort of information is required to be protected against disclosure to regulators? How far should information of regulation be appropriately and necessarily released to the public in view of transparency? Will there be leakage of pre-mature information or confused information which may affect the operation of normal financial market adversely?

- How to justify a balance between regulation and public interest considerations to make such information available? Certain information may affect the confidence in financial market and institution, and thus affect financial stability. Should it be kept confidential or be released immediately under an overriding public interest? In balancing interest of various parties and attaining equity, will there be issue of moral hazard among market participants? In view of conflicting views in policy issues, should the regulator be accountable to the legislature, government, public or investors with vested interests? For sure, it is not uncommon to see opposing agenda from various stakeholders, including the government, the LegCo and the general public over the same regulatory issue.

Recommendation

Having examined the above four options, it is found that the most appropriate option for insurance regulation in Hong Kong would be the setting up of IIA, taking into account the political, compliance and resources considerations. Given the pros and cons of various alternatives and the overseas models, it is difficult to have a universal perfect model across the territory given the diversity in political, social, economic and cultural background. While referencing on the overseas experiences, certain constraints are detected and whether the recommended option could sustain depends much on its receptiveness in the local context. Therefore, the government must proceed prudently and cautiously with the proposed establishment of IIA which is deemed as a critical change in regulatory form.

Political Considerations

A critical factor that leads to the success of policy formulation and decision is the balancing the interest and influence of various policy actors that involve lots of negotiations, compromises and trade-offs. According to Kingdon (1995, p. 145) "the political stream flows along independently of the problems and policy streams, which is composed of public mood, pressure group campaigns, election results, partisan or ideological distribution in Congress, and changes of administration."

When deciding on a most appropriate alternative for the regulation of insurance industry in Hong Kong, the power struggle of policy actors should be tactfully managed in order to ensure policy support and compliance at the implementation stage.

There are three main categories of policy actors in the pursuit of establishing IIA, namely the government as the policy initiator, mainly senior government officials in FSTB, the supportive side (including the non-governmental organizations like the Consumer Council and various political parties) and the opposing side (including the SROs, intermediaries, insurance agents and related bodies). While the government proposes IIA as the future regulatory framework for insurance industry, different policy actors have struggled to exert influence on the proposal by different strategies to alter the societal pulse in support for their own stances, which rendered a crowding political environment. The greatest opposition comes from the industry practitioners lest the tightening of control and regulation would make life and business difficult for them.

It is highly predictable that if the government goes for the third and fourth alternatives in advocating the merging with other existing financial regulators or setting up a super-regulator, it will face much greater opposition and resistant not only the insurance industry, but also the banking and securities ones. The respective regulatory systems of SFC, HKMA and MPFA are all well established and have been performing satisfactorily over the years, a tremendous reform and a revolutionary change might affect the financial stability and sustainability which are the prime concern of Hong Kong as a regional financial hub. Being an important policy entrepreneur, the government will need to take a longer time to capture the market sentiment, gauge support as well as to lobby those opposition forces. With such a drastic change on the financial regulation and the current political environment, the government may suffer from a major setback and the policy window may lapse again.

Instead of pushing forward the proposal of a super-regulator which might cause a high degree of uncertainty and hindrance, the imminent policy goal of the government might focus on combating undesirable market conduct instead of which regulatory regime to depend on. Again, it is the analytical couplet of 'form follows function'.

The reality of the situation is that there is no perfect regulatory regime that fits all. In considering an appropriate model that fit for purpose, the model must cater for the unique environment and market in Hong Kong. The proposed establishment of IIA might not be an ideal alternative but it is undoubtedly a compromise among policy actors. Albeit all these, the establishment of IIA is at least a leap forward in rationalizing and strengthening the regulation of insurance industry given the political constraint.

Compliance Considerations

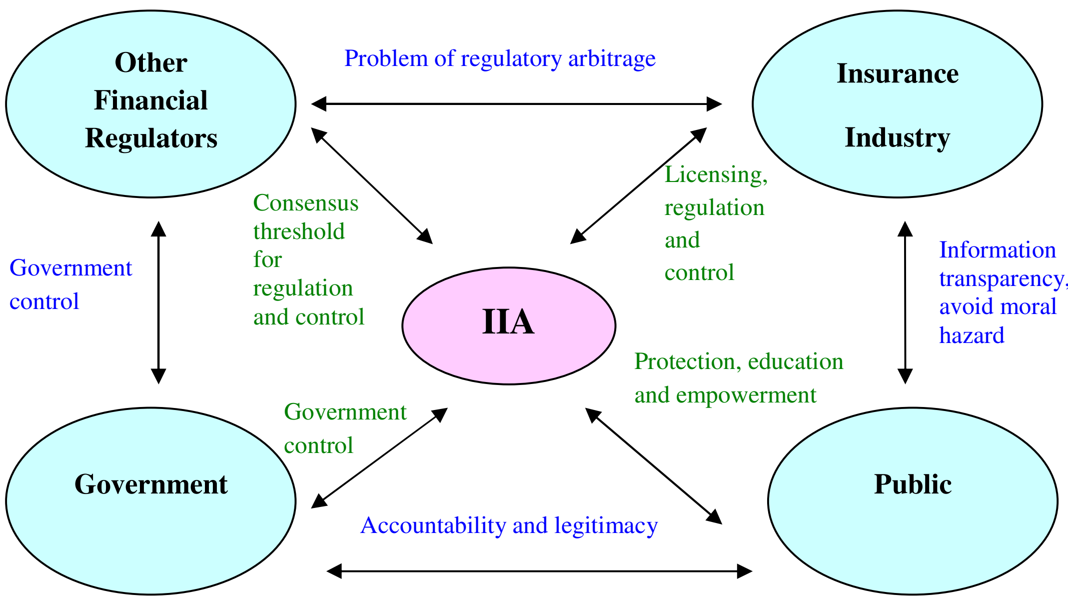
Another important aspect of contemplation is the barriers to compliance and implementation in view of the diversity of policy actors and political environment. Weaver (2013, p. 8) highlighted that any non-compliance with a public policy would come from complex roots, rather than any specific barriers for any separate individual target populations. Actually, there are relationships and interactions among different barriers and targets, such as multiple barriers for individual targets, target heterogeneity, multiple targets, and complex and on-going compliance.

For the regulation of insurance industry, there are so many stakeholders involved whom interact with each other. In the proposal of IIA establishment, Figure 7 shows that the multiple players include not only the insurance industry practitioners, but also the counterparts in other financial sectors such as banking and securities, and the general public as a vast majority of them are policyholders. The multi-dimensional relationship illustrates that compliance issues are more than ordinary regulatory work between IIA and industry practitioners, but also rely on the support of the public, good coordination work with other regulators and overall financial policy direction by the government.

Similarly, there are barriers to compliant behaviour in setting up a super-regulator such as monitoring and enforcement barriers, as well as capacity barriers which include the issues of resources and autonomy. The operations of different financial industries are distinct from each other that the regulatory guidelines cannot be aligned in details, such as the exact amount of capital ratio and liquidity. Rather, performance-based or risk-based regulations prevail in a merged- or super-regulator that may render an increasing tendency to non-compliance.

The government as a policy entrepreneur has to examine all potential barriers for policy implementation in order to secure successful implementation of the new regulatory regime in the finance sector. The considerations include whether the government could rally support from stakeholders and garner co-ordinated efforts from various financial industries, whether the scope is manageable given the large numbers of practitioners and the scope of services rendered and how to secure a high level of conformity.

Figure 7: Multi-Dimensional Relationship between IIA and Different Key Stakeholders



Resources Considerations

Availability and exigency of resources is also a crucial factor for consideration. A separate independent entity, IIA, would be a better solution which could focus more on that specific sector and thus understand the need of the stakeholders. This is because regulation of insurance industry requires expertise and technical knowledge given its large scope with large number of practitioners (i.e. over 160 insurance companies and 68,000 insurance intermediaries). Existing resources in terms of regulatory system and professional staff can be retained, so that there will be a smoother transition of the regulatory work from the current OCI to the newly established IIA in future.

A merged- or super-regulator is less desirable in terms of resources. Merging of different regulators requires a fundamental change of the regulatory concept and relevant ordinances where traditional boundaries of financial industries may no longer exist. Different regulatory work under a merged- or super-regulator is usually divided by the functions of regulation, including the prudential regulation and market conduct of market participants, which are usually further divided by the size of regulated entities, consumer protection, market stability, etc. It will take a longer time to revise the existing regulatory regime in banking, securities and pension industries and provide extra training for enhancing professional knowledge of existing staff so that they will become generalists in financial regulation. The lengthy process might not be able to cope with the imminent need at present to enhance consumer protection and strengthen control over risk and crisis management of the insurance industry.

The establishment of IIA is not affecting the existing regime too much, which incur less barriers for compliance and easier to get compromise among various policy actors. Furthermore, relatively lesser resources will be required than setting up a super-regulator. On one hand there will be more regulatory control on insurers and intermediaries. On the other, its independent status with a representative governing board can enhance protection of policyholders and assume greater flexibility in risk management. It is also hoped that IIA can gain greater public confidence and increase competitiveness on innovative policies as IIA has to compare its effectiveness, efficiency and equity with the other regulators. However, there must be an inter-industry platform to strengthen communication and collaboration of various financial regulators to avoid over- or under-regulatory effort.

To conclude, after examining various alternatives, it is found that the proposed establishment of IIA with power and status on par with other financial regulators in Hong Kong is highly supported, which could fit the situation of Hong Kong most. Nevertheless, a periodic review system should be implemented in view of the changing socio-economic and political environment, both locally and globally, in order to keep pace of the latest global financial development.

A Snapshot of Latest Development

As for the latest development, it is observed that another innovative alternative, i.e. the twin-peak regulatory regime, may be treated as a transformed model of super-regulator.

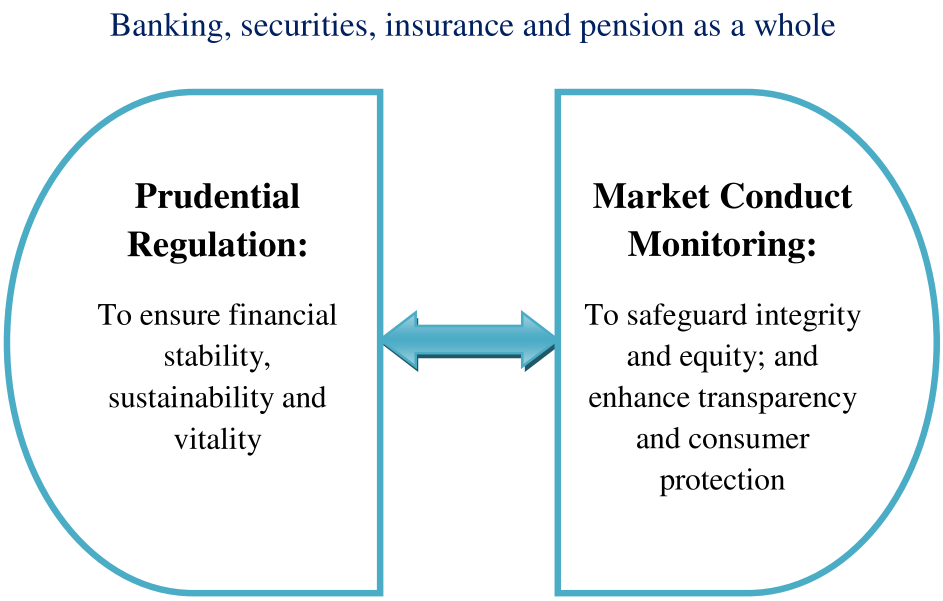
The distinctive feature of this twin-peak model is that it has the concept of super-regulator in mind that oversees banking, insurance, securities and pension as a whole, but the regulatory framework is divided by means of functionalities, i.e. prudential regulation and market conduct. Examples of such new model include the current financial regulator PRA and FCA in the UK; and the Australian Prudential Regulation Authority (APRA) and Australian Securities and Investments Commission (ASIC) in Australia. The separation of functionality can streamline the investigation and supervision operations over financial institutions by focusing on two most important aspects of regulation — prudential regulation and market conduct monitoring. Prudential regulation focuses on stability, sustainability and vitality to ensures financial soundness or regulated entities and do not affect the stability of whole financial system. At the same time, market conduct monitoring pays specific attention to safeguarding integrity, equity, enhancing market transparency and consumer protection by eliminating unacceptable market practices and ensuring suitability of financial products for customers.

As mentioned above, the UK abolished the super-regulator model and set up two new authorities, PRA and FCA, to replace FSA in April 2013. PRA is responsible for the prudential regulation and supervision of banks, building societies, credit unions, insurers and major investment firms, and in total it regulates around 1,700 financial firms. PRA works alongside FCA creating a 'twin peaks' regulatory structure in the UK. FCA is responsible for promoting effective market competition and for the conduct regulation of all financial services firms. It also aims to prevent market abuse and ensuring that consumers get a fair deal from financial firms. Moreover, FCA operated the prudential regulation of those financial services firms not supervised by PRA, such as asset managers and independent financial advisers.

Australia is also adopting this twin peak regulatory regime by splitting largely on the functionalities as prudential regulation and market conduct to be overseen by APRA and ASIC respectively.

The Australian Government established APRA for prudential regulation of insurance companies and ASIC for the conduct of intermediaries. Banks, building societies, credit unions, life and general insurance companies and most of the superannuation industry are supervised by APRA. APRA continuously oversees the activities of the financial institutions to ensure that they comply with prudential standards, are in sound financial condition and have adequate and effective governance and risk management systems with an aim to promoting stability and confidence in the Australian financial system. APRA is funded largely by the industries that it supervises and all levies collected are used for supervision of the financial industry.

Figure 8: An Innovative Alternative: Twin-Peak Regulatory Regime in Overseeing Financial Sector



In view of the changing socio-economic and political environment, both locally and globally, the regulatory framework for financial sector is swinging back and forth like the pendulum of a clock. This gradual regime may take time to evolve and is experiencing the theory of "Incrementalism" in policy and decision-making which was advocated by Lindblom (1959).

The setting up of IIA for Hong Kong is also adopting the approach in taking baby-steps and the "Muddling Through" (Lindblom, 1959) in decision-making processes. In other words, policy change will be evolutionary rather than revolutionary under most circumstances.

Concluding Comments

In this chapter, four possible alternatives in enhancing insurance regulation in Hong Kong have been examined. It is realized that a change in regulatory form could be a better solution than a reactive problem-fixing approach by improving certain policy tools.

In comparing the three regulatory form (i.e. Options 2 to 4), it is noticed that the degree of command and control, degree of autonomy, degree of equity, level of accountability and level of transparency vary. Besides analyzing the aforesaid parameters, the government must also cogitate the political, resources and compliance issues before putting forward a new piece of legislation. Having considered all constraints in the local context, it is believed that setting up an IIA (i.e. Option 2) is more appropriate at the present political, economic, and social environment in Hong Kong.

With such evolutionary approach, it is hoped that the insurance regulation in Hong Kong can be strengthened, with greater focus on integrity, equity and market transparency, which is a prime concern after the breakout of financial crisis in 2008.

CHAPTER 6: CONCLUSION

As one of the major pillar in the Hong Kong economy, the financial sector performs a vital role to its economy. Notwithstanding Hong Kong is recognized as one of the international financial centre with a leading financial market in the region, it is surprising that our insurance regulatory regime is far lagged behind the need of market advancement and international regulatory standard. The Lehman Brothers mini-bond incident raised public awareness of the effectiveness of the financial regulatory system and the level of consumer protection provided by financial regulators. The incident also acted as the focusing event to open a policy window for the review of insurance regulatory regime which has remained stagnant for more than a decade due to divided opinions and oppositions from industry practitioners.

Summary of the Project and its Findings

To improve the existing regulatory regime and enhance consumer protection, this project examines a range of regulatory tools and explores a number of better alternatives for the insurance regulation. The following questions are studied:

- What types of regulatory tools can a government adopt to oversee and control the financial sector, including the insurance industry?
- What particular regulatory tools has the Hong Kong government actually adopted to oversee and control the insurance industry?

- According to what criteria can the appropriateness and effectiveness of the possible array of regulatory tools be evaluated?
- What other regulatory tools could be adopted by the Hong Kong government to more effectively oversee and control the insurance industry?

Kingdon's (1995) three streams model enlightens the project with three fundamental elements of the financial sector regulation, including why, how and how effective of regulation or regulatory tools. The problems, policy and political streams set the major dimensions of government agenda setting, and align with three elements of regulation — why, how and how effective respectively. With the coupling of three elements in insurance regulation, added with the Lehman Brothers mini-bond incident as the focusing event, there appears a policy window for the government to reactivate the discussion on the insurance regulatory regime.

The reasons for government regulation of the financial market are examined in view of market failure, public interest protection, risk management and trust building. In carrying out the regulation, five broad forms of regulatory tools are available for the government to regulate the financial sector, namely command and control tools, economic tools, transactional tools, structural tools and information tools. A mix of tools is adopted by OCI in the regulation of insurance industry, but of different extent and degree compared with SFC, HKMA and MPFA, mainly due to the constraints of the ICO and its institutional design.

The appropriateness and effectiveness of current regulatory tools are evaluated by seven criteria, namely legitimacy, effectiveness, accountability, due process, expertise, efficiency and autonomy. Checking against the criteria, four core regulatory problems are reflected in the current insurance regulatory regime. The fundamental problem is that OCI generally lacks insufficient regulatory power under the ICO, and hence it has insufficient power to regulate both insurers and insurance intermediaries. Following the institutional structure of OCI as part of the government, it has very limited autonomy and accountability which cannot meet the basic requirements in the demand of public governance. Regulatory ineffectiveness of OCI also spillovers to other financial regulators like SFC and HKMA that many cross-boundary regulatory problems arise where regulated entities can easily manipulate the loopholes by regulatory arbitrage.

To explore possible alternatives for improving the insurance regulatory regime, the possibility and effectiveness of changing the existing regulatory tools are analyzed. However, it is found that the regulatory problems in insurance industry go beyond the tools level. The leverage point of an appropriate and effective regime depends on the forms of regulation which follows the functions of regulator. Having studied a number of overseas models of insurance regulators and having considered the political, compliance and resource aspects, it seems that the establishment of an IIA is the most appropriate and feasible way to start with and to deal with the opposing parties.

However, there is no single perfect tool in the world which solves all regulatory problems. In face of the rapidly changing environment, many overseas regulators have undergone review or reform in search for a better form to regulate market players and protect individual consumers. In short, there is no stop for an appropriate and effective regulatory regime which should keep track of market pace and development all the time.

Heading to the Era of Integrity

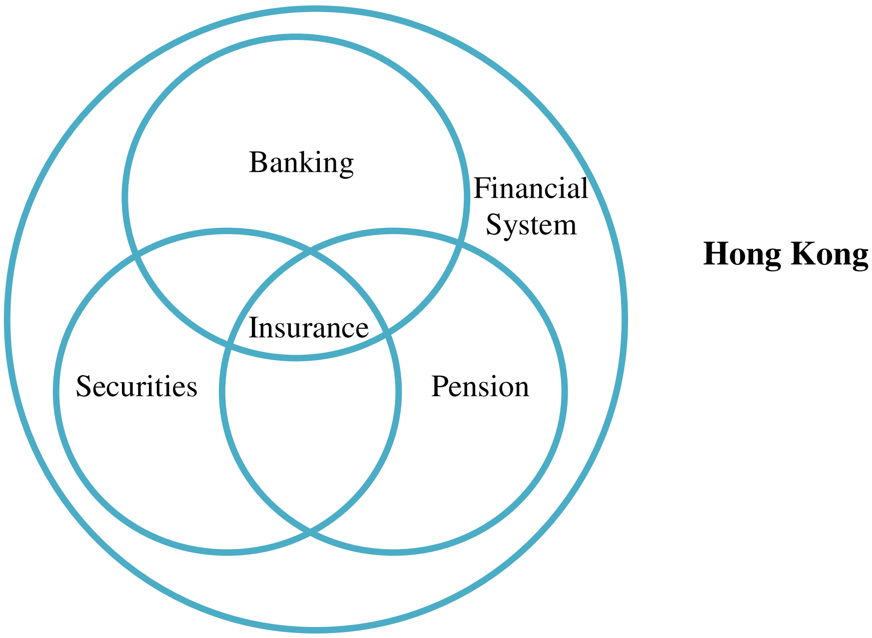
To maintain Hong Kong's status as an international financial centre and promote the development of financial market, the Hong Kong government finally has made its effort in striving towards the era of integrity as advocated in the NPA. With the opening of a policy window, the government launched two public consultations on the broad framework and detailed proposals for the establishment of IIA in 2010 and 2011 respectively, and the key legislative proposals are concluded in June 2013 following a public consultation in late 2012. This illustrates that the government would like to move OCI from the concept of the Old Public Administration which only interested in maintaining the current system in place to the era of integrity under NPA where outputs and efficiency are emphasized, focusing on values of equity, participation, justice and responsiveness.

Final Thoughts

Another analytical couplet in public administration — bits and wholes — should not be neglected. Though the focus of this project is on the regulation of insurance industry which is a necessity for the promotion of insurance market development in long term, one should not overlook the importance of stability of the whole financial sector which provides the basis for the market development.

In the local perspective, the Hong Kong government strives to balance the interests and achieve stability in every single industry in the financial sector, including banking, securities, insurance and pension. Figure 9 shows that the four industries are the 'bits' that interlock and interact with each other in Hong Kong financial sector. The integration of the whole sector would maintain the overall stability of financial system in Hong Kong, which is the 'whole' of the local financial stability.

Figure 9: Financial Stability: Local Perspective



Taking a holistic view on the global prospective as shown in Figure 10, the whole of Hong Kong financial sector becomes a 'bit' of the global financial system. The stability of local financial system links closely with the regional financial stability, like Guangdong, Shenzhen, Macau and Taiwan.

Figure 10: Financial Stability: Global Perspective

To a larger extent, the stability at both local and regional stability levels are also important for maintaining the stability of the 'whole' of the global financial system, where the three hierarchical financial systems are interlocked and their stability also interact with each other.

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Overseas

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Australian Securities Investments Commission (ASIC): www.asic.gov.au

Financial Conduct Authority (FCA): www.fca.org.uk

Financial Services Authority (FSA): www.fsa.gov.uk

Monetary Authority of Singapore (MAS): www.mas.gov.sg

National Association of Insurance Commissioners (NAIC): www.naic.org

New York State Department of Financial Services (DFS): www.dfs.ny.gov

Prudential Regulatory Authority (PRA): www.bankofengland.co.uk/PRA