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**Subcommittee on Insurance (Amendment) Ordinance 2020
(Commencement) Notice and Insurance (Special Purpose Business) Rules**

Background brief

Purpose

This paper provides background information on the Insurance (Amendment) Ordinance 2020 (Commencement) Notice and the Insurance (Special Purpose Business) Rules relating to the implementation of a new regulatory regime for insurance-linked securities ("ILS") businesses in Hong Kong, and summarizes the views and concerns raised by members of the Panel on Financial Affairs ("FA Panel") since 2019 on the proposed ILS regulatory regime.

Background

2. ILS are risk management tools that allow insurers/reinsurers to raise capital by offloading insured risks to the capital markets through securitization.¹ Unlike conventional reinsurance coverage whereby an insurer transfers a portion of its risk to another reinsurer by way of reinsurance, ILS enable insurers/reinsurers to transfer insurance risk to the capital markets. For institutional investors, ILS provide an alternative investment which is not correlated to economic conditions (but to insurance risk), thereby offering institutional investors an option to diversify their portfolios.

The Insurance (Amendment) Ordinance 2020

3. To make Hong Kong a more conducive domicile for ILS to capture the potential business opportunities which are expected to arise in Asia in the coming years, the Administration has decided to make legislative amendments

¹ A common form of insurance-linked securities ("ILS") is catastrophe bonds.

to allow for the formation of special purpose vehicles ("SPVs") specifically for issuing ILS in Hong Kong. Since ILS business involves contracts of transfer of insurance risk, it falls within the regulatory ambit of the Insurance Ordinance (Cap. 41) ("IO"). Given that the purpose and nature of ILS business is essentially the transfer of risks to the capital markets which is very different from the conventional insurance/reinsurance business, and that applying the existing stringent regulatory requirements under IO to ILS business (such as the capital and solvency requirements, reporting requirement, corporate governance requirement, etc.) may make issuance of ILS in Hong Kong costly and cumbersome, the Administration considers it necessary to create a simplified regulatory regime under IO for ILS.

4. The Administration introduced the Insurance (Amendment) Bill 2020 into the Legislative Council ("LegCo") in March 2020.² The Bill was passed by LegCo at the meeting of 17 July 2020 and enacted as the Insurance (Amendment) Ordinance 2020 ("Amendment Ordinance"). Apart from expanding the scope of insurable risks of captive insurers,³ the Amendment Ordinance provides for a new class of insurance business, namely special purpose business ("SPB")⁴ under IO to be regulated by the Insurance Authority ("IA"), for the purpose of acquiring insurance risk from another insurer/reinsurer under a reinsurance/risk transfer contract and then issuing ILS to investors to collateralize the risk acquired. A special purpose insurer ("SPI"), a new type of authorized insurer under IO, is an insurer authorized to carry on SPB only, and serves the functions of an SPV. In order to be authorized as an SPI, a company needs to meet the requirements set out in **Appendix I**.

5. The Administration considers that ILS are not suitable for ordinary retail investors, and so the policy intent is to confine the sale of ILS to qualified institutional investors (e.g. dedicated ILS funds and hedge funds) by private placement. The Amendment Ordinance empowers IA to prescribe detailed requirements on the sale of ILS by way of subsidiary legislation. IA may make rules on the financial, solvency and investor's sophistication requirements under

² The Insurance (Amendment) Bill 2020 was published in Gazette on 20 March 2020 and received its First Reading at the Legislative Council meeting of 10 June 2020.

³ The Insurance (Amendment) Ordinance 2020 amends the meaning of captive insurer in section 2(7) of the Insurance Ordinance (Cap. 41) ("IO") to widen the scope of insurable risks of a captive insurer.

⁴ According to the new section 2(1) of IO, "special purpose business" means insurance business of effecting and carrying out contracts of insurance that are fully funded through insurance securitization. "Insurance securitization", in relation to an insurer, means any debt or other financing arrangement entered into by the insurer with an investor, under which repayment or return to the investor is linked to a contract of insurance effected and carried out by the insurer.

the new section 129A of IO. Matters to be prescribed by such rules are set out in **Appendix II**.

6. Moreover, in order to prohibit qualified investors from "repackaging" ILS into other types of financial products for sale to retail investors and debar constituent funds of Mandatory Provident Fund Schemes ("MPF funds") from investing in ILS to better protect the interests of investors, the Administration plans to exclude funds targeting at the public (e.g. MPF funds, occupational retirement schemes and retail funds authorized by the Securities and Futures Commission ("SFC")) from being regarded as qualified investors.

Insurance (Amendment) Ordinance 2020 (Commencement) Notice and Insurance (Special Purpose Business) Rules

7. The Insurance (Amendment) Ordinance 2020 (Commencement) Notice was made by the Secretary for Financial Services and the Treasury under section 1(2) of the Amendment Ordinance to appoint 29 March 2021 as the day on which the Amendment Ordinance came into operation.

8. The Insurance (Special Purpose Business) Rules were made by IA under the new section 129A of IO to provide for certain restrictions on the sale of ILS, including confining the sale of ILS to eligible ILS investors and specifying that the consideration for each transaction in which ILS were sold or offered to be sold must not be less than US\$250,000 or the equivalent of such amount in other currencies.

9. The two pieces of subsidiary legislation were gazetted on 22 January 2021 and tabled at LegCo on 27 January 2021 for negative vetting. The Insurance (Special Purpose Business) Rules will come into operation on 29 March 2021. The details of the two pieces of subsidiary legislation are set out in paragraphs 10 and 16 – 18 of the LegCo Brief (File Ref.: INS/2/3/2C) and paragraphs 8 – 10 of the Legal Service Division Report (LC Paper No. LS30/20-21).

Major views and concerns expressed by members of the Panel on Financial Affairs

10. At the meeting of FA Panel on 3 June 2019, the Administration briefed members on the legislative proposals to further the development of the insurance sector including the proposals to facilitate the insurance of ILS in Hong Kong and expand the scope of insurable risks of captive insurers. It further briefed FA Panel at the meeting on 2 November 2020 on the details for

implementing the new regulatory regime for ILS business including subsidiary legislation to regulate the sale of ILS. Members' views and concerns expressed at the meetings are summarized in the ensuing paragraphs.

Investor protection measures

11. Noting that the Administration had proposed to restrict the sale of ILS to institutional investors through private placement as ILS were high-risk investment products, some members enquired about measures to prohibit institutional investors from "repackaging" ILS into other types of financial products for selling to retail investors. Some members further pointed out that ILS were not ideal investment products for retirement purposes, and enquired whether MPF funds were allowed to invest in ILS. These members called on the Administration to remind MPF trustees that MPF funds should not be invested in ILS.

12. The Administration responded that discussion with SFC was underway on measures to restrict the sale of ILS in the primary market to institutional investors only. As ILS were financial instruments which enabled insurance companies to offload their insured risks to the capital markets through securitization, they were considered as another form of reinsurance. Regarding the investment of MPF funds in ILS, the Administration pointed out that under the Mandatory Provident Fund Schemes Ordinance (Cap. 485), MPF funds were required to comply with stringent investment restrictions. Specifically, the use of high-risk structured products and leveraging was prohibited, while the total amount invested in securities and permissible investments issued by a single issuer must not exceed 10% of the total assets of an MPF fund. As catastrophe bonds (the most common form of ILS) were short-term bonds (usually with maturities of less than four years), it was not envisaged that they could meet the investment objectives of MPF funds.

13. In response to some members' concern about whether confining the sale of ILS to institutional investors would have negative impact on the liquidity of ILS, the Administration reiterated that ILS were considered unsuitable for retail investors as they were highly specialized investment products. Given that the maturity period of ILS was relatively short in general (usually of three to four years), investors tended to hold ILS until maturity. As such, restricting the sale of ILS to institutional investors was not expected to affect the liquidity of ILS.

14. Some members enquired about how the risk of ILS would be assessed and whether it would be done by any parties such as credit rating agencies. The Administration advised that given the complex product structure, risk

assessment and pricing of ILS were usually taken up by institutions which had the relevant knowledge and expertise in reinsurance underwriting.

Minimum investment size of insurance-linked securities transactions

15. Members noted that the insurance industry had suggested lowering the proposed minimum investment size of US\$1 million or equivalent for each ILS transaction to, say US\$750,000 or US\$500,000 or equivalent, and asked whether the Administration and IA would consider the view.

16. The Administration advised that the proposed minimum investment size was set after making reference to international practices of ILS transactions. The Administration was mindful that ILS would be a relatively new risk management tool in Hong Kong and eligible institutional investors might prefer to start with a smaller investment size upon entering this new market. As such, IA would consider adjusting the proposed minimum investment threshold in the light of feedback received in the consultation exercise, views from the stakeholders, and the practices in global ILS markets.

Sale of insurance-linked securities to institutional investors

17. On members' enquiries about the types of institutions constituting the eligible investors of ILS, and how investments in ILS would be accounted for in the institutional investors' capital adequacy requirements, the Administration advised that the eligible institutional investors for ILS would broadly include a number of categories including (a) banks or authorized financial institutions; (b) insurance companies (including reinsurance companies); (c) corporations carrying on the business of providing investment services; (d) governments, central banks and multilateral agencies; (e) authorized exchange companies; and (f) collective investment schemes but excluding those retail funds authorized by SFC, MPF funds, approved pooled investment funds which could be invested by MPF funds and occupational retirement schemes. As regards capital adequacy requirements, the Administration pointed out that it would be up to the institutional investors to act in accordance with the standards and requirements set by their respective regulatory bodies.

Latest development

18. At the House Committee meeting on 29 January 2021, Members agreed to form a subcommittee to study the two pieces of subsidiary legislation.

Relevant papers

19. A list of relevant papers is in the **Appendix III**.

Council Business Division 1
Legislative Council Secretariat
9 February 2021

Requirements for authorizing as a special purpose insurer

- (a) the company will be fully-funded, meaning that the full liabilities of the company to the cedant must be fully backed by assets including funds raised through debt or other financing arrangements;
- (b) the company appoints an administrator as a controller to manage the special purpose business ("SPB"), including administration of its assets and any outsourced operations and notifying the Insurance Authority ("IA") of any non-compliance. The administrator is required to meet the fit and proper requirement;
- (c) the company appoints at least two directors to ensure accountability and responsibility. Directors should also be subject to the fit and proper requirement;
- (d) the company intends to carry on SPB only but not any other class of insurance business;
- (e) the company complies with the relevant financial, solvency, investor's sophistication and other requirements prescribed by rules made by IA (being subsidiary legislation) under section 129 and the new section 129A of the Insurance Ordinance (Cap. 41) ("IO"); and
- (f) the company pays prescribed fees to IA for recovering the cost of IA in regulating the special purpose insurer. The fees will be prescribed in regulations to be made by the Chief Executive in Council (being subsidiary legislation) under section 128 of IO.

(Source: Paragraph 9 of Legislative Council Brief on the Insurance (Amendment) Bill 2020 (File Ref: INS/2/3/2C))

Appendix II

Matters for which the Insurance Authority may make rules under the new section 129A of Insurance Ordinance (Cap. 41)

- (a) prescribe the types of investors to which insurance-linked securities ("ILS") may be sold or offered to be sold (hereafter called "qualified investors");
- (b) prohibit the sale of, or the making of an offer to sell, ILS to any person other than a qualified investor;
- (c) prohibit the sale of, or the making of any offer to sell, ILS to a qualified investor at an amount lower than a prescribed amount; and
- (d) prescribe offences for contravention of the rules in (b) and (c) above,¹ with penalty levels not exceeding: (i) for an offence of which a person is convicted on indictment, a fine of \$200,000 and imprisonment for two years; and (ii) for an offence of which a person is summarily convicted, a fine at level 6 and imprisonment for six months.

(Source: Paragraph 7 of background brief on regulation of insurance-linked securities prepared by the Legislative Council Secretariat for the meeting of Panel on Financial Affairs on 2 November 2020 (LC. Paper No. CB(1)48/20-21(06)))

¹ The Administration considers it necessary to empower the Insurance Authority to prescribe offences for contravention of rules on sale restrictions of insurance-linked securities so as to provide deterrent effect for the protection of ordinary retail investors, and such arrangement is consistent with the practice relating to business conduct of intermediaries under section 168(4) of the Securities and Futures Ordinance (Cap. 571).

Appendix III

List of relevant papers

Date	Event	Paper
3 June 2019	Meeting of the Panel on Financial Affairs ("FA Panel")	Administration's paper (LC Paper No. CB(1)1110/18-19(05)) Minutes (LC Paper No. CB(1)1342/18-19)
April 2020	Special meeting of Finance Committee for examination of Estimates of Expenditure 2020-2021	Written questions raised by Members in relation to ILS (Reply serial numbers: FSTB(FS)009)
17 July 2020	The Legislative Council ("LegCo") passed the Insurance (Amendment) Bill 2020	Legislative Council Brief (File Ref: INS/2/3/2C) Legal Service Division Report (LC Paper No. LS94/19-20) (LC Paper No. LS106/19-20) Hansard The Bill passed
2 November 2020	Meeting of FA Panel	Administration's paper (LC Paper No. CB(1)48/20-21(05)) Minutes (LC Paper No. CB(1)427/20-21)

Date	Event	Paper
27 January 2021	The Insurance (Amendment) Ordinance 2020 (Commencement) Notice and the Insurance (Special Purpose Business) Rules were tabled in LegCo	Content of the subsidiary legislation 1 and 2 (L.N. 7 and L.N. 8 of 2021) Legislative Council Brief (File ref.: INS/2/3/2C) Legal Service Division Report (LC Paper No. LS30/20-21)