For discussion
on 3 June 2019

Legislative Council Panel on Financial Affairs

Legislative Proposals to Further the Development of the Insurance Sector

PURPOSE

This paper briefs Members on the legislative proposals to strengthen Hong Kong's competitiveness as an insurance hub.

BACKGROUND

2. Hong Kong's insurance industry is an integral part of our financial services industry. As at end-of 2018, there were 161 authorized insurers, including 16 professional reinsurers, with an annual gross premium income of $531.7 billion. It is the Government's objective to enhance Hong Kong's status as an international insurance hub and risk management centre, and help the insurance industry seize new business opportunities.

3. To enhance the competitive edge of Hong Kong's insurance industry, the Chief Executive and the Financial Secretary announced in the 2018 Policy Address and the 2019-20 Budget Speech respectively that the Government would –

(a) provide tax reliefs to promote the development of marine insurance and the underwriting of specialty risks (e.g. aviation, agriculture, catastrophe, political risk, war risk and trade credit, etc.) in Hong Kong;

(b) introduce legislative amendments to facilitate the issuance of insurance-linked securities ("ILS") in Hong Kong; and

(c) continue to look into measures that are conducive to the development of the insurance industry.

THE PROPOSALS

4. After intensive discussions with the industry, we propose to take forward the following tax and regulatory measures to enhance the competitiveness of the insurance industry.

(A) Profits Tax Concessions for the Insurance Sector

5. Hong Kong is one of the major insurance hubs in the world, alongside with London, New York, Switzerland, Bermuda, Singapore and Dubai. In the light of international competition, other insurance hubs have introduced different measures to enhance their own competitiveness. It is high time for Hong Kong to introduce new measures to keep our business and regulatory environment conducive to insurance business, especially reinsurance business and the underwriting of specialty risks.

6. At present, there are tax incentives at 50% of profits tax rate (i.e. 8.25% as the existing profits tax rate is 16.5%) for captive insurance business and reinsurance business of professional reinsurers in Hong Kong. To stay competitive in general insurance and reinsurance business, we propose to reduce profits tax rate by 50% (i.e. 8.25%) for all reinsurance business of direct insurers (see paragraphs 7 and 8 below), selected general insurance business of direct insurers (see paragraphs 9 to 10 below) and selected insurance brokerage business (see paragraph 11 below).

(I) Reinsurance business

7. At present, professional reinsurers already enjoy a tax concession at 50% of the profits tax rate for all classes of reinsurance business, whether long term or general. In addition to professional reinsurers, some direct insurers also have reinsurance business. Direct insurers comprise the following categories of insurers –

(a) authorized insurers which may carry on both insurance and reinsurance business of those classes of business (whether long term or general) authorized by the Insurance Authority ("IA");

(b) Lloyd's of London; and

(c) an association of underwriters approved by the IA.

8. We propose to extend the tax concession currently available to professional reinsurers to cover all classes of reinsurance business of direct insurers, so as to encourage direct insurers to start or expand their reinsurance business. This is conducive to our policy objective of developing Hong Kong as a reinsurance hub.

(II) General insurance business

9. According to the existing classification of general business under the Insurance Ordinance (Cap. 41) ("IO"), there is no dedicated class for marine insurance business or specialty insurance business, and insurers may underwrite any marine-related risks or specialty risks so long as they have obtained the authorization to carry on the relevant classes of insurance business under the IO. We propose to introduce a tax concession at 50% of the profits tax rate for direct insurers for their general insurance business <u>except</u> the following five types of risks of domestic nature –

(a) health business;
(b) mortgage guarantee business;
(c) motor vehicle, damage and liability business;
(d) employees' compensation business; and
(e) owners' corporation third party liability business.

10. The proposed scope covers all classes of general business that are relevant to the underwriting of marine-related risks or specialty risks under the prevailing market practice. It also offers flexibility for authorized direct insurers to underwrite specialty risks falling under different classes of general business under the IO having regard to evolving market circumstances in future.

(III) Insurance brokerage business

11. Insurance brokers serve as professional advisors of their clients in seeking the most appropriate insurance solutions in the market. Insurance brokers play an important role in tendering advice on where the risks should be placed. Lower costs as a result of reduced tax rate will make Hong Kong a more attractive location for placing of risks. We propose to introduce a tax concession at 50% of profits tax rate for licensed insurance broker companies in respect of their business of placing reinsurance risks and selected general risks placed with professional reinsurers or direct insurers in Hong Kong.

(IV) Administrative provisions

12. We need to formulate administrative provisions to address enforcement issues arising from the provision of the new tax reliefs. Specifically, we propose to add –

(a) specific anti-avoidance provisions to deny tax concessions under the scenario where direct insurers buy reinsurance among themselves to cede part of their respective risks primarily for tax benefit rather than out of genuine risk management needs; and

(b) provisions for ascertainment of the assessable profits of qualifying business (i.e. the assessable profits of the business that are chargeable to profits tax at half rate) to prevent possible tax disputes on the amount of assessable profits entitled to the profits tax concession[1].

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[1] At present, sections 23 (Ascertainment of assessable profits of life insurance corporations) and 23A (Ascertainment of assessable profits of insurance corporations other than life insurance corporations) of the Inland Revenue Ordinance (Cap. 112) ("IRO") provide a basis of ascertaining the assessable profits of the whole insurance business, rather than individual classes of insurance business. However, under the new tax concessions in paragraphs 7 to 10, some insurance business of direct insurers would not be entitled to the tax concessions. It is thus necessary to add new provisions for ascertainment of the assessable profits of qualifying business.

(B) Facilitating the Issuance of ILS in Hong Kong

13. ILS, such as catastrophe bond, is a financial instrument that allows insurers to raise capital by offloading insured risks to the capital markets through securitization. To insurers, ILS is often described as another form of reinsurance. Unlike conventional reinsurance coverage whereby an insurer transfers a portion of its risk to another reinsurer by way of reinsurance, ILS enables insurers/reinsurers to transfer insurance risk to the capital markets. This improves the capacity of the insurance industry, makes the insurance coverage more affordable and thereby enhances the industry's sustainable development. For institutional investors, ILS provides an alternative investment which is not correlated to economic conditions (but to insurance risk), thereby offering institutional investors an option to diversify their portfolios.

14. The operation of ILS typically involves the setting up of a dedicated special purpose vehicle ("SPV") by an insurer/reinsurer (referred to as a "cedant"), followed by transfers of its insurance risk to the SPV through a reinsurance/risk transfer contract. The SPV then issues financial instruments to investors to raise capital to finance the full amount of the risk assumed by it under the reinsurance/risk transfer contract. The investors receive a return in terms of coupons comprising investment yield and the spread for risk premium. At maturity, the investors would redeem the proceeds of the ILS minus any claims payments made by the SPV to the cedant triggered under the reinsurance/risk transfer contract. The most common form of ILS is catastrophe bonds.

15. In recent years, the ILS market has grown substantially. The capacity provided by the capital markets has tripled since 2011. The issuance of ILS in 2017 was approximately US$12.6 billion globally[2]. Bermuda is the leading jurisdiction for the issuance of ILS, particularly catastrophe bonds. Compared with the United States and European markets, ILS transactions in Asia have been relatively infrequent. However, we need to make Hong Kong a more conducive domicile for ILS to capture business opportunities should the potential of ILS be realised gradually in Asia in future.

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[2] Source: Bermuda Insurance-Linked Securities (ILS) Market Report (Q4-2017), Bermuda Monetary Authority, June 2018 (link at: https://cdn.bma.bm/documents/2018-12-28-05-34-10-Q4-2017-Bermuda-ILS-Market-Report.pdf).

16. The core feature of ILS is that it is fully funded, which means the assets held at all times are no less than the prospective liabilities under the reinsurance/risk transfer contract(s) by which it acquires insurance risk. In other words, the entire insurance risk acquired by the SPV, typically set up by insurers/reinsurers, must be fully collateralized by funds raised through the issuance of ILS, the return on which is linked to the underlying insurance risk.

17. Since ILS business involves contracts of transfer of insurance risk, it falls within the regulatory ambit of the IO. However, the purpose and nature of ILS business is essentially the transfer of risks to the capital markets, making it very different from the conventional insurance/reinsurance business currently regulated under the IO. Moreover, applying the existing stringent regulatory requirements under the IO to ILS business (such as the capital and solvency requirements, reporting requirement, corporate governance requirement, etc.) makes issuance of ILS in Hong Kong extremely costly and cumbersome if not impractical. We therefore need to create a unique regulatory regime for ILS to promote Hong Kong as a domicile for ILS.

18. We propose to create a new regulatory regime under the IO which focuses on ensuring that an SPV set up for issuing ILS is fully funded at all times. Specifically, we propose to amend the IO to enable an SPV to be authorized as a special purpose reinsurer (being a new type of authorized insurer) solely 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.

19. Given the nature of the underlying risk of investment in ILS and the potential for loss of investment upon the occurrence of a predefined trigger event (e.g. an earthquake), ILS is not considered to be an investment suitable for individual investors. We therefore propose to restrict the selling of ILS to institutional investors through private placement. Since the risks associated with ILS are generally not correlated with economic conditions, potential investors would probably be unit trusts, mutual funds or other institutional investors looking to diversify their investment portfolios.

(C) Expanding the scope of insurable risks by captive insurers set up in Hong Kong

20. A captive insurer is an insurance company set up by its parent company with the primary purpose of insuring and reinsuring the risks of the companies in the group to which the captive insurer belongs. Captive insurance provides multinationals with the ability to deploy a more holistic risk management strategy across their international business, and saving insurance premium spent on an external insurance provider[3].

21. At present, captive insurers are regulated under the IO. Captive insurers can only underwrite risks in relation to those companies within the captive insurer's "group of companies"[4], including –

(a) a company which belongs to the "group of companies" to which the captive insurer belongs;

(b) a company in which either the captive insurer itself or a company in the same "group of companies" holds at least 20% of the voting power; or

(c) a company which is a subsidiary of a company in (b) above.

22. The industry considers that the existing scope of insurable risks by captive insurers is too restrictive and not conducive to effective global risk management strategy when multinationals expand further globally. The major problems are –

(a) at present, the risks which a captive insurer can insure/reinsure are limited to the risks of companies formed and registered in Hong Kong under the Companies Ordinance (Cap. 622) ("CO") and the risks of companies incorporated outside Hong Kong that establishes a place of business in Hong Kong. This means multinationals cannot

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3 In general, captive insurers retain a certain amount of risks within the group of companies (usually high frequency attritional losses) and buy reinsurance for catastrophic exposures from external reinsurers.

4 Under the Companies Ordinance (Cap. 622), "group of companies" means any two or more bodies corporate one of which is the holding company of the other (or others).

use a Hong Kong captive insurer to cover its overseas companies that are not registered in Hong Kong under the CO and without a place of business in Hong Kong;

(b) multinationals generally hold less than 20% of the voting power of a company when they enter into a new market or diversify their investments. The current regulation, however, does not allow Hong Kong captive insurer to insure/reinsure risks of a company with an ownership stake at less than 20%; and

(c) some multinationals investing in infrastructural projects may assume the risk management responsibility for other companies (e.g. sub-contractors) participating in a project even though these contractor-companies are not within the same group of companies. The current regulation does not allow a Hong Kong captive insurer to insure/reinsure such risks even though the responsibility for managing the risks (and hence the risk itself) ultimately lies with the group of companies to which the captive insurer belongs.

23. We propose to amend the IO so that the following risks can also be insured/reinsured by a Hong Kong captive insurer –

(a) the risks of a body corporate within the "group of companies" to which the captive insurer belongs that is incorporated outside Hong Kong and does not have a place of business in Hong Kong;

(b) in cases where the "group of companies" to which the captive insurer belongs hold less than 20% of the voting power of a body corporate, the amount of risks of that body corporate in proportion to the percentage of ownership by the "group of companies". In other words, if the "group of companies" to which the captive insurer belongs has a 10% stake in a body corporate, the captive insurer may insure/reinsure up to 10% of the total amount of risks of that corporate; and

(c) the risks of an unrelated body corporate (i.e. not within the same group of companies to which the captive insurer belongs), provided that the captive insurer or a body corporate in the same group of companies to which the captive insurer belongs is given a full risk management mandate, i.e. the unrelated body corporate has explicitly agreed to give the captive insurer or a body corporate in the same group of companies to which the captive insurer belongs full risk management control in the form of a written contract.

FINANCIAL IMPLICATIONS

24. The Government and the IA will absorb the resources needed to implement the proposed profits tax concessions and regulatory changes related to ILS and captive insurance business. It would be difficult to estimate the revenue forgone arising from the tax relief proposals as the incentive intends to attract business which otherwise would not be domiciled in Hong Kong. That said, it is expected that the revenue forgone is unlikely to be significant and will be offset partly by increase in business activities in Hong Kong.

WAY FORWARD

25. The legislative proposals will involve amendments to the IRO and IO. We target to introduce the relevant amendment bills into the Legislative Council in the 2019-20 legislative session.

26. In addition, we recognize that a sufficient pool of expertise in Hong Kong is also important for the sustainable development of the insurance industry. The Government started in August 2016 a Pilot Programme to enhance the training and development of talents for the insurance industry. We will report the progress of the Pilot Programme to the Panel in due course.

ADVICE SOUGHT

27. Members are invited to comment on the proposals as set out in paragraphs 4 to 23 above.

Financial Services and the Treasury Bureau
Insurance Authority
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