

立法會 *Legislative Council*

LC Paper No. CB(1)607/20-21

Ref : CB1/SS/11/20

Paper for the House Committee meeting on 26 February 2021

Report of the Subcommittee on Insurance (Amendment) Ordinance 2020 (Commencement) Notice and Insurance (Special Purpose Business) Rules

Purpose

This paper reports on the deliberations of the Subcommittee on Insurance (Amendment) Ordinance 2020 (Commencement) Notice and Insurance (Special Purpose Business) Rules ("the Subcommittee").

Background

2. Insurance-linked securities ("ILS") is a risk management tool that enables insurers or reinsurers to offload risks that they have underwritten to the capital market by way of securitization, and are often treated as an alternative form of reinsurance. From the perspective of institutional investors, ILS offers an exposure uncorrelated to economic cycles, thereby achieving diversification.

3. To make Hong Kong a more conducive domicile for ILS in order to capture the potential business opportunities expected to arise in Asia, the Administration introduced the Insurance (Amendment) Bill 2020 into the Legislative Council ("LegCo") in March 2020, amending the Insurance Ordinance (Cap. 41) ("IO") to provide for, inter alia, a streamlined regulatory regime for special purpose insurers ("SPIs") specifically for issuing ILS in Hong Kong. Under the Bill, the Insurance Authority ("IA") is empowered to authorize SPIs for the sole purpose of carrying out special purpose business ("SPB")¹ which essentially involves the acquisition of insurance risk from

¹ According to the new section 2(1) of the Insurance Ordinance (Cap. 41), "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.

another insurer/reinsurer under a reinsurance/risk transfer contract and then the issue of ILS to investors to collateralize the risk acquired. Due to the complexities and risks of ILS, they are considered unsuitable for ordinary retail investors. The Bill thus also empowers IA to prescribe restrictions on the sale of ILS by rules made under the new section 129A of IO. The policy intent is to confine the sale of ILS to qualified institutional investors by private placement. The Bill was passed by LegCo at the meeting of 17 July 2020 and enacted as the Insurance (Amendment) Ordinance 2020 ("the Amendment Ordinance").

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

4. The Insurance (Amendment) Ordinance 2020 (Commencement) Notice ("the Commencement Notice") is 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 comes into operation. The Insurance (Special Purpose Business) Rules ("SPB Rules") are made by IA under the new section 129A of IO to provide for 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 are sold or offered to be sold must not be less than US\$250,000 or the equivalent of such amount in other currencies. The two pieces of subsidiary legislation were gazetted on 22 January 2021 and tabled at LegCo on 27 January 2021 for scrutiny under the negative vetting procedure. The SPB Rules will come into operation on 29 March 2021.

The Subcommittee

5. At the House Committee meeting on 29 January 2021, Members agreed to form a subcommittee to study the Commencement Notice and the SPB Rules. The membership list of the Subcommittee is in the **Appendix**. Under the chairmanship of Mr WONG Ting-kwong, the Subcommittee has held one meeting with the Administration and IA to examine the two pieces of subsidiary legislation.

6. To allow sufficient time for the Subcommittee to scrutinize the Commencement Notice and the SPB Rules, the Chairman moved a motion at the Council meeting of 24 February 2021 to extend the scrutiny period of the two pieces of subsidiary legislation to the Council meeting of 17 March 2021. The motion was passed.

Deliberations of the Subcommittee

7. The Subcommittee supports the implementation of the new regulatory regime, as it will facilitate the development of ILS business in Hong Kong and enable Hong Kong to seize the potential business opportunities in Asia in the coming years. The deliberations of the Subcommittee are summarized in the ensuing paragraphs.

Investor protection measures

8. Subcommittee members including Mr WONG Ting-kwong and Mr Holden CHOW have stressed the need to put in place sufficient measures to protect ordinary retail investors, in particular to prohibit the "repackaging" of ILS into other types of financial products (e.g. derivative products) for selling to such investors. They have enquired about measures to be taken by the relevant financial regulators in this regard.

9. The Administration and IA have advised that there are measures in the SPB Rules to prevent the sale of ILS to retail investors. Firstly, the sale of ILS is to be confined to eligible ILS investors which are all institutional investors. As set out in rule 3(4) of the SPB Rules, eligible ILS investors include: (a) banks or authorized financial institutions; (b) insurance companies (including reinsurance companies); (c) corporations carrying on business of the provision of investment services; (d) governments, central banks and multilateral agencies; (e) authorized exchange companies; and (f) collective investment schemes. Rule 3(2) of the SPB Rules further provides that ILS cannot be sold to certain types of collective investment schemes including retail funds authorized by the Securities and Futures Commission ("SFC"), Mandatory Provident Fund ("MPF") funds, approved pooled investment funds which can be invested by MPF funds, and occupational retirement schemes. Secondly, for the purpose of the SPB Rules, the definition of "securities" in section 1, Part 1 of Schedule 1 to the Securities and Futures Ordinance (Cap. 571) (which includes derivative products and structured products) applies. Thus, "repackaging" ILS into financial products (e.g. derivative products or structured products linked to ILS) for sale to ordinary retail investors is prohibited under the SPB Rules. Thirdly, rule 3(1)(c) of the SPB Rules specifies that the investment size for each ILS transaction must not be less than US\$250,000 (or the equivalent amount in other currencies). The imposition of a minimum investment size for ILS provides an additional safeguard by discouraging the re-selling or "repackaging" of ILS to less sophisticated institutional investors. Lastly, to provide deterrence, rule 3(3) of the SPB Rules provides that a person who contravenes the sale restrictions of ILS commits an offence and is liable on conviction on indictment to a fine of HK\$200,000 and in the case of an individual, also to an imprisonment for two years; or on summary conviction to a fine at level 6 (i.e. HK\$100,000) and in the case of an individual, also to an imprisonment for six months.

10. IA has stressed that when a company applies for SPI authorization from IA, it has to provide relevant documents and information on the potential investors of the ILS to be issued. SPIs are also required to keep and update registers of ILS investors for IA's regular inspection.

Division of work among relevant financial regulators under the new regulatory regime for insurance linked securities business

11. Given that eligible ILS investors include institutional investors other than insurance companies, such as banks (which are regulated by the Hong Kong Monetary Authority ("HKMA")) and corporations licensed by the SFC, members have enquired about the demarcation of work between IA and other relevant regulators under the new regulatory regime, including enforcement of the SPB Rules, monitoring the compliance of SPIs, and handling complaints relating to the sale of ILS.

12. IA has explained that it is the regulator to administer and enforce this new regulatory regime which is under IO. As the sale of ILS is relevant to other financial regulators (e.g. HKMA and SFC), IA will maintain close contact and collaboration with them through existing platforms. For example, while IA will handle complaints regarding the sale of ILS, it may seek SFC's assistance in conducting related investigations if a SFC licensee is involved.

Development of the insurance-linked securities market

13. Mr CHAN Kin-por has enquired whether IA had taken into account views of the insurance industry in formulating the SPB Rules so as to facilitate the development of the ILS market in Hong Kong. IA has advised that it had conducted a six-week public consultation exercise on the draft SPB Rules. While the respondents generally found IA's proposals acceptable, there were calls for a lower minimum investment size to facilitate the development of the ILS market and make Hong Kong a competitive ILS domicile. IA has taken on board views from industry stakeholders and reduced the minimum investment size for ILS from US\$1 million (or the equivalent in other currencies) as proposed in the consultation document to US\$ 250,000 (or the equivalent in other currencies) in the SPB Rules.

14. On members' enquiry about the latest development of ILS business in other comparable jurisdictions, the Administration has responded that in 2020, Bermuda and Singapore accounted for some 80% and 7.5% of global ILS transactions respectively, and Cayman Islands ranked third. A number of other jurisdictions including the United Kingdom are actively developing their ILS markets.

Recommendation

15. The Subcommittee will not propose amendments to the two pieces of subsidiary legislation and notes that the Administration will not move amendments to the subsidiary legislation.

Advice sought

16. Members are invited to note the deliberations of the Subcommittee.

Council Business Division 1
Legislative Council Secretariat
25 February 2021

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

Membership list

Chairman Hon WONG Ting-kwong, GBS, JP

Members Hon CHAN Kin-por, GBS, JP
Hon Holden CHOW Ho-ding

(Total : 3 members)

Clerk Ms Connie SZETO

Legal Adviser Mr Mark LAM