For discussion
on 2 November 2020

Legislative Council Panel on Financial Affairs

Update on the Regulation of Insurance-linked Securities

PURPOSE

This paper keeps Members informed of the latest development on implementing a new regulatory regime for insurance-linked securities ("ILS") business in Hong Kong.

BACKGROUND

2. 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. Global issuance of ILS has expanded substantially in recent years[1] amidst a rising trend of catastrophic events caused by climate change and increased urbanization, but the risk coverage is still mainly confined to the United States and Europe. In order to facilitate Hong Kong to seize the potential business opportunities in Asia, particularly those generated by the Guangdong-Hong Kong-Macao Greater Bay Area ("GBA") development[2], the Government gazetted the Insurance (Amendment) Bill 2020 in March 2020 to provide for, inter alia, a new regulatory regime for ILS business under the Insurance Ordinance (Cap. 41) ("IO").

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[1] According to the Artemis Catastrophe Bond and Insurance-linked Securities Deal Directory ("Artemis Deal Directory"), the total amount of global ILS issuance increased from US$5.4 billion (26 issuances) in 2010 to US$11.1 billion (65 issuances) in 2019.

[2] After the meeting of the Leading Group for the Development of GBA held on 6 November 2019, the Central Government announced a series of policy measures, including supporting Mainland insurers to issue catastrophe bonds (a common form of ILS) in Hong Kong to facilitate development of the local bond market.

LATEST DEVELOPMENT

4. After enactment of the Insurance (Amendment) Ordinance 2020 ("the Amendment Ordinance") in July 2020, we have followed up with various preparatory work including drafting of subsidiary legislation as well as formulating implementation details and market development plan. The latest position is set out in paragraphs 5 to 13 below.

(A) Subsidiary legislation

Regulations to prescribe the fees payable

5. Under the new ILS regulatory regime, a special purpose insurer ("SPI") will be authorised under the new section 8A of the IO for the purpose of carrying on special purpose business ("SPB")[3]. The SPI so authorized has to be fully-funded, i.e. all liabilities owed to the cedant must be fully backed by assets including funds raised through debt or other financing arrangements.

6. According to section 13(1) of the IO, every authorized insurer should pay to the IA prescribed fees first upon authorization and thereafter on an annual basis. At present, an insurer authorized to carry on long term or general business is required to pay a fixed annual fee of $300,000 and a variable fee[4] under the Insurance (Authorization and Annual Fees) Regulation (Cap. 41C), while a captive insurer has to pay a reduced annual fee of $30,000 and a variable fee.

7. Since the authorization and subsequent regulation of SPIs are expected to be much simpler than that for a traditional insurer and after taking into account the practice adopted by other major jurisdictions[5], the IA **proposes** that –

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[3] SPB is a new class of business involving effecting and carrying out contracts of insurance that are fully funded through insurance securitization according to the revised section 2(1) of the IO.

[4] The variable fee is determined by multiplying insurance liabilities of an authorized insurer by the rate as specified in Schedule 3 to Cap. 41C, corresponding to the reference period in which the payment due date falls.

[5] Bermuda and Singapore are charging a fixed and all-inclusive annual fee on SPIs formed for the issuance of ILS. The annual fee charged by Bermuda is US$8,500 (about HK$66,300), which will increase to US$15,000 (about HK$117,000) in 2021. For Singapore, the annual fee is pitched at S$5,000 (about HK$27,500).

(a) a fixed fee of $15,000 be charged upon the authorization of each SPI and thereafter on an annual basis, with no variable fee; and

(b) various user fees currently provided for under the Insurance (Prescribed Fees) Regulation (Cap. 41B) which seek to recover the costs of providing specific services by the IA should be applicable to the authorization and regulation of SPIs[6].

Rules to prescribe restrictions on the sale of ILS

8. Given its complex product structure and the prospect of losing a substantial part of the sum invested on occurrence of a trigger event, ILS are considered unsuitable for ordinary retail investors. The Amendment Ordinance thus stipulates that the IA may prescribe restrictions on the sale of ILS by way of subsidiary legislation[7]. Our policy intention is to confine ILS only to eligible institutional investors by private placement.

9. The IA conducted a public consultation exercise on the draft rules prescribing restrictions on sale of ILS during the period from 4 September to 16 October 2020[8]. On eligible institutional investors, the IA **proposes** that it should comprise the following –

(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 the Securities and Futures Commission, Mandatory

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6 Some typical user fees include $18,000 for approval of the appointment of a controller; $18,000 for approval of the appointment of a director; and $5,000 for the appointment of an auditor.

7 Under the new section 129A of the IO, the IA is empowered to make rules to –
(a) prohibit the sale of, or the making of an offer to sell, ILS to any person other than an investor falling within a type to be prescribed in the rules;
(b) prohibit the sale of, or the making of any offer to sell, ILS at an amount lower than that prescribed in the rules; and
(c) prescribe offences for contravention of the rules in (a) and (b) above, with penalty levels not exceeding: for an offence of which a person is convicted on indictment, a fine of $200,000 and imprisonment for two years; for an offence of which a person is summarily convicted, a fine at level 6 and imprisonment for six months.

8 The Consultation Paper on Draft Insurance (Special Purpose Business) is available for access at https://www.ia.org.hk/en/infocenter/files/Consultation_Paper_on_Draft_Insurance_Special_Purpose_Business_Rules_ENG.pdf.

Provident Fund ("MPF") funds, approved pooled investment funds which can be invested by MPF funds and occupational retirement schemes.

10. Making reference to recent market data[9], the IA **proposes** to prescribe a minimum investment size of US$1 million or equivalent for each ILS transaction. To achieve adequate deterrence, the IA further **proposes** that a person contravening the sales restrictions commits an offence and is liable on conviction on indictment to a fine of HK$200,000 and imprisonment for two years; or on summary conviction to a fine at level 6 and imprisonment for six months.

11. The IA will finalize the rules prescribing restrictions on the sale of ILS taking into account feedbacks received and international practices, with view to striking a reasonable balance between market development and protection of ordinary retail investors.

(B) Implementation details and market development

12. In addition to drafting of subsidiary legislation, the IA is drawing up guidelines and operational procedures for authorization and regulation of SPIs, as well as acquiring the necessary in-house capabilities. This is done through proactive engagement with parties on the ILS value chain and sourcing of professional consultancy support. Meanwhile, the Government and the IA are keeping abreast of opportunities opened up by the GBA development.

13. Regarding sale restrictions, the IA will put in place a vigorous supervisory framework in communication with other financial regulators and review its efficacy against evolving market conditions.

WAY FORWARD

14. We aim to table the subsidiary legislation at the Legislative Council for negative vetting within the first quarter of 2021, and will step up collaboration with the insurance industry to promote ILS business in Hong Kong.

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[9] According to Artemis Deal Directory, the average issue size of ILS in 2019 is US$170 million (about HK$1.3 billion). The IA also gleaned from recent market data that the subscription size of ILS by private placement is normally between US$5 to $10 million (about HK$39 to $78 million) but the threshold is set at a much lower level of US$1 million (about HK $7.8 million) or less.

ADVICE SOUGHT

15. Members are invited to note the content of this paper.

Financial Services and the Treasury Bureau
Insurance Authority
October 2020