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Panel on Financial Affairs

Meeting on 2 November 2020

Background brief on regulation of insurance-linked securities

Purpose

This paper provides background information and summarizes the discussion of the Panel on Financial Affairs ("FA Panel") at the meeting on 3 June 2019 on issues relating to the new regulatory regime for facilitating the issuance of insurance-linked securities ("ILS") in Hong Kong.

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.

3. The operation of ILS typically involves the setting up of a dedicated special purpose vehicle ("SPV") by an insurer/a reinsurer (referred to as a "cedant"), followed by transferring 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

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

reinsurance/risk transfer contract. The core feature of ILS business 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 must be fully collateralized by funds raised through the issuance of ILS, the return on which is linked to the underlying insurance risk.

4. 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 Chief Executive and the Financial Secretary announced in the 2018 Policy Address and the 2019-2020 Budget Speech respectively that the Government would make legislative amendments to allow for the formation of SPVs specifically for issuing ILS in Hong Kong with a view to enriching the risk management tools available in the Hong Kong market.

The Insurance (Amendment) Ordinance 2020

5. Since ILS business involves contracts of transfer of insurance risk, it falls within the regulatory ambit of the Insurance Ordinance (Cap. 41) ("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 IO. Moreover, 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 extremely costly and cumbersome. Hence, the Administration considers it necessary to create a simplified regulatory regime under IO for ILS.

6. 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"). The Amendment Ordinance provides a new class of insurance business, namely special purpose business ("SPB")[3] under IO and regulated by the Insurance Authority ("IA") for the purpose of acquiring insurance risk from another insurer/reinsurer 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] 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.

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 as mentioned in paragraph 3 above. In order to be authorized as an SPI, a company needs to meet the requirements set out in **Appendix I**.

Requirements on the sale of insurance-linked securities

7. Given the nature of the underlying risk of investing in ILS and the potential for loss of investment upon the occurrence of a predefined trigger event, the Administration considers that ILS are not suitable for ordinary retail investors. Hence 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 as well as the fee proposals under the new section 129A of IO to –

(a) prescribe the types of investors to which 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,[4] 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.

8. 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

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[4] The Administration considers it necessary to empower the Insurance Authority to prescribe offences for contravention of rules on sale restrictions of ILS 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).

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.

Major views and concerns expressed by Members

9. 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. Members' views and concerns on issues relating to ILS expressed at the meeting are summarized in the ensuing paragraphs.

10. Noting that the Administration had proposed to restrict the selling of ILS to institutional investors through private placement as ILS were high-risk investment products, Panel members enquired about measures to prohibit institutional investors from "repackaging" ILS into other types of financial products for selling to retail investors. Some members also sought clarification on whether relatively small insurance companies could benefit from the proposed regulatory regime for ILS, and whether there would be tax concessions for ILS.

11. 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. Given that the issuance of ILS could expand the total insurance capacity of the industry, it was envisaged that the entire insurance industry could benefit. While the Administration had no plan to provide tax concessions to ILS at the moment, it would continue to keep in view prevailing international developments.

12. Some members enquired whether MPF funds were allowed to invest in ILS. Pointing out that ILS were not ideal investment products for retirement purposes, they called on the Administration to remind MPF trustees that MPF funds should not be invested in ILS.

13. 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.

Latest development

14. The Administration will brief FA Panel at the meeting on 2 November 2020 the proposed requirements to regulate the sales of ILS and related fee proposals.

References

15. A list of relevant papers is in **Appendix II**.

Council Business Division 1
Legislative Council Secretariat
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Appendix I

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 (File Ref: INS/2/3/2C))

Appendix II

List of relevant papers

Date	Event	Paper
3 June 2019	Meeting of the FA Panel	Administration's paper (LC Paper No. CB(1)1110/18-19(05)) Minutes (paragraphs 37-55) (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 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