

Consultation Paper

on

Draft Insurance (Special Purpose Business) Rules

FOREWORD

1. This paper is published by the Insurance Authority (“IA”) to consult the public on the draft rules to be made under section 129A of the Insurance Ordinance (Cap. 41) (which will be added upon commencement of Insurance (Amendment) Ordinance 2020), namely the Insurance (Special Purpose Business) Rules. The enclosed draft Insurance (Special Purpose Business) Rules which is being consulted on has been prepared in anticipation of the new regulatory regime for the issuance of insurance-linked securities in Hong Kong.
2. The IA welcomes written submissions on or before 16 October 2020 by any of the following means:
 - Mail: Insurance Authority
19/F, 41 Heung Yip Road
Wong Chuk Hang
Hong Kong
 - Fax: (852) 3899 9993
 - Email: ils@ia.org.hk
3. A feedback template is enclosed.
4. Any person making a submission on behalf of an organization is requested to provide details of such organization.
5. Submissions will be received on the basis that the IA may freely reproduce and publish them, in whole or in part, in any form, and use, adapt or develop any proposal put forward without seeking permission or providing acknowledgement of the party making such proposal.
6. Please note that name(s) of respondent(s), their affiliation(s) and the contents of their submissions may be referred to in any forms of documentation the IA may publish or release. If you do not wish your name, affiliation and/ or submission to be disclosed, please expressly state so in your submission.
7. Any personal data submitted will only be used for consultation and its related purposes. For access to or correction of any personal data contained in your submission, please contact –

Personal Data Privacy Officer
Insurance Authority
19/F, 41 Heung Yip Road
Wong Chuk Hang
Hong Kong

CONTENTS

		Page
CHAPTER 1	EXECUTIVE SUMMARY	4
CHAPTER 2	INTRODUCTION	5
CHAPTER 3	DISCUSSION OF THE DRAFT RULES	7
SCHEDULE	NEW SECTION 129A OF THE ORDINANCE	
ANNEX A	DRAFT INSURANCE (SPECIAL PURPOSE BUSINESS) RULES	
ANNEX B	FEEDBACK TEMPLATE	

CHAPTER 1

EXECUTIVE SUMMARY

1. With the potential for opportunities in Asia and arising from the Guangdong-Hong Kong-Macao Greater Bay Area development, the IA is committed to promoting Hong Kong as a preferred domicile for the issuance of insurance-linked securities (“ILS”). The Insurance (Amendment) Ordinance 2020 was enacted by the Legislative Council (“LegCo”) in July 2020 to provide for a bespoke regulatory framework for the issuance of ILS in Hong Kong through the formulation of special purpose insurers (“SPIs”), which will be a new type of authorized insurer under the Insurance Ordinance (Cap. 41) (“the Ordinance”).
2. ILS are defined as “securities issued through insurance securitization”¹ which are financial products not considered to be suitable for ordinary retail investors. Our policy intent is that the sale of ILS should be confined to qualified institutional investors by private placement, such that the interests of ordinary retail investors would be sufficiently protected.
3. The Insurance (Amendment) Ordinance 2020 will add several new provisions for the authorization and supervision of SPIs, as well as a new section 129A (extracted in the **SCHEDULE**) to the Ordinance to empower the IA to make rules to provide for restrictions on the sale of ILS, including the scope of eligible investors, a minimum investment size and relevant offences against the contravention of sales restrictions.
4. The draft Insurance (Special Purpose Business) Rules (“Rules”) to be made pursuant to section 129A of the Ordinance are accordingly published as **ANNEX A** for the purpose of inviting representations by the public. A feedback template is at **ANNEX B**.

¹ See section 129A(4) of the Ordinance, extracted in the **SCHEDULE**.

CHAPTER 2

INTRODUCTION

New regulatory regime for ILS issuance in Hong Kong

5. ILS are risk management tools that allow insurers/reinsurers to raise capital by offloading insured risks to the capital markets through securitization, and are often described as another form of reinsurance. They improve the underwriting capacity of the insurance industry, make insurance coverage more affordable and thereby enhance the insurance industry's sustainable development. For institutional investors, ILS provide an alternative investment uncorrelated to economic conditions (but to insurance risk), offering them an option to diversify their portfolios.
6. Given a rising trend of catastrophic events caused by climate change and urbanization, global issuance of ILS has grown substantially in recent years but their risk exposure is currently mainly confined to the United States and Europe. In 2019, the global issuance of ILS was approximately US \$11 billion, with Bermuda being the leading jurisdiction especially in respect of catastrophe bonds. There is potential for more ILS transactions in Asia. In particular, there are business opportunities arising from the Guangdong-Hong Kong-Macao Greater Bay Area development, with support from the Central Government for Mainland insurers to issue catastrophe bonds in Hong Kong.
7. The IA is committed to promoting Hong Kong as a preferred domicile for the issuance of ILS. The Insurance (Amendment) Ordinance 2020 provides for a regulatory framework for the issuance of ILS through the formation of SPIs, with a view to introducing a bespoke and streamlined regime on par with other ILS domiciles such as Bermuda and Singapore.
8. Under the new regulatory regime, SPIs will be authorized to carry on special purpose business ("SPB"), a new class of insurance business 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 company will need to meet certain requirements in order to be authorized by the IA as an SPI, including –
 - (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 SPB and at least two directors, all of whom should appear to the IA to be fit and proper persons having regard to section 14A of the Ordinance;
 - (c) the company intends to carry on only SPB but not any other class of insurance business;

- (d) the company complies with relevant requirements, including those on the sale of ILS, prescribed by rules made by the IA (being subsidiary legislation); and
- (e) the company pays prescribed fees to the IA for recovering its cost of regulating the SPI.

Requirements on the sale of ILS

- 9. ILS are sophisticated financial products and are considered unsuitable for the risk appetite of ordinary retail investors. There have also been calls for prohibiting institutional investors from “repackaging” ILS into other types of financial products for sale to retail investors, and debarring constituent funds of Mandatory Provident Fund Schemes (“MPF funds”) from investing in ILS.
- 10. As such, the intent of the Insurance (Amendment) Ordinance 2020 is to confine the sale of ILS to qualified investors, which will be institutional investors, by private placement. Funds targeting at the public, such as MPF funds, occupational retirement schemes and retail funds authorized by the Securities and Futures Commission (“SFC”), will not be regarded as qualified investors.
- 11. In order to put in place measures to protect the interests of ordinary retail investors, we also intend to impose a minimum amount of offer to sell ILS, as well as criminal sanctions against the sale of ILS to any person other than a qualified investor, or at an amount lower than the prescribed minimum amount.
- 12. The Insurance (Amendment) Ordinance 2020 will add a new section 129A to the Ordinance (set out in the **SCHEDULE**) to empower the IA to make rules on the requirements in paragraph 10 to 11 above.

Consultation

- 13. This paper is published by the IA to consult the public on the draft Rules (see **ANNEX A**) which will be made pursuant to new section 129A to the Ordinance. The draft Rules will be finalized after taking into account the feedback collected during this public consultation.
- 14. The Insurance (Amendment) Ordinance 2020 was enacted by LegCo in July 2020 and is expected to commence operation on a date to be appointed by the Secretary for Financial Services and the Treasury within the 2020-21 legislative session. Upon its commencement, the finalized draft Rules will be published in the Gazette for introduction into LegCo for negative vetting.

CHAPTER 3

DISCUSSION OF THE DRAFT RULES

15. The draft Rules (set out in **ANNEX A**) mainly serve the following three purposes –

- (i) defining “eligible investors” to whom ILS may be sold or offered for purchase;
- (ii) prescribing a minimum investment size for ILS; and
- (iii) prescribing the offences and the relevant penalties whereby (i) and (ii) are contravened.

16. We have elaborated on the policy intent and the underlying rationale of the provisions in the draft Rules below. The IA welcomes feedback in the form of responses to the specific questions.

Scope of eligible investors for ILS

17. Given the nature of the underlying risk of investing in ILS and the potential for substantial loss of investment upon the occurrence of a pre-defined trigger event, ILS are not considered to be financial products suitable for ordinary retail investors. As stated in paragraph 10 above, the policy intent of the Insurance (Amendment) Ordinance 2020 is to confine the sale of ILS to qualified institutional investors by private placement.

18. As set out in Rule 3(4) of the draft Rules, we propose that eligible investors of ILS should include the following types of institutional investors –

- (a) banks or authorized financial institutions;
- (b) insurance companies;
- (c) corporations carrying on business of the provision of investment services;
- (d) governments, central banks and multilateral agencies;
- (e) exchange companies; and
- (f) collective investment schemes excluding, as set out in Rule 3(2) of the draft Rules, retail funds authorized by SFC, MPF funds, approved pooled investment funds which can be invested by MPF funds, and occupational retirement schemes.

19. This requirement is not expected to have a material impact on the scope of potential investors because ILS are niche financial products which appeal mostly to sophisticated institutional investors with expertise in reinsurance underwriting. Currently, investors of ILS are mainly dedicated ILS funds, hedge funds, or other institutional investors with technical reinsurance knowledge looking to diversify investment risks. The proposed scope of eligible investors is intended to cover these types of investors as well as other potential institutional investors.

Question 1

Do you agree with the proposed scope of eligible investors for ILS? Are there any types of investors which may be added or excluded?

Minimum investment size of ILS

20. As an additional safeguard of the interests of retail investors, the IA is empowered to prescribe a minimum investment size for ILS. According to market data, in 2019, the average issue size of ILS is about US \$170 million² (about HK \$1.3 billion). Having made reference to prevailing ILS transactions and offering documents, we understand that the subscription size of ILS by private placement is commonly within the range of US \$5 to \$10 million (about HK \$39 to \$78 million) but the subscription threshold is usually set at a lower level at say US \$1 million (about HK \$7.8 million).
21. Our objective is to set an investment threshold which will effectively discourage the sale of ILS or the “repackaging” of ILS for sale to ordinary investors, while minimizing any impact on the competitiveness of Hong Kong as an ILS domicile. As such, we propose to prescribe in Rule 3(1)(c) of the draft Rules a minimum investment size of US \$1 million or equivalent.

Question 2

Do you agree with the proposed minimum investment size for ILS? If not, what are the reasons?

² According to the Artemis Catastrophe Bond and Insurance-linked Securities Deal Directory, in 2019, there were 65 ILS issuances globally with a total value of about US \$11 billion (about HK \$86 billion).

Offences and penalties

22. We propose that a person commits an offence if he enters into or offers to enter into an agreement, or invite, induce, attempt to invite or induce another person to enter into an agreement for that other person to acquire, subscribe or underwrite ILS or to dispose of ILS to that other person, unless –
- (a) that other person is an eligible investor (defined in Rule 3(4) of the draft Rules);
 - (b) that other person is not an excluded person (defined in Rule 3(2) of the draft Rules); and
 - (c) the consideration is of an amount not lower than the minimum investment size (prescribed in Rule 3(1)(c) of the draft Rules).
23. The formulation of the proposed offence in Rule 3 of the draft Rules aims to sufficiently cover the sales activities of ILS in both the primary and secondary markets.
24. A person who commits the offence will be liable to penalty levels prescribed in subsection (3) of the new section 129A of the Ordinance.

Question 3

Do you agree with the formulation of the offence in Rule 3 of the draft Rules? If not, what are the reasons?

129A. Authority may make rules for special purpose business

(1) The Authority may by rules—

(a) prohibit any sale of, or the making of any offer to sell, insurance-linked securities to any person other than an investor falling within a type prescribed in the rules; and

(b) prohibit any sale of, or the making of any offer to sell, insurance-linked securities at an amount lower than that prescribed in the rules.

(2) Rules made under this section may prescribe offences for contravention of the rules, punishable by a fine or imprisonment, or both.

(3) The maximum penalty that may be prescribed under subsection (2) is—

(a) for an offence of which a person is convicted on indictment—a fine of \$200,000 and imprisonment for 2 years; and

(b) for an offence of which a person is summarily convicted—a fine at level 6 and imprisonment for 6 months.

(4) In this section—

insurance-linked securities (保險相連證券) means securities issued through insurance securitization.

Insurance (Special Purpose Business) Rules

(Made by the Insurance Authority under sections 129A of the Insurance Ordinance (Cap. 41))

1. Commencement

These Rules come into operation on the day on which section 8A of the Insurance (Amendment) Ordinance 2020 comes into operation.

2. Interpretation

In these rules –

authorized financial institution (認可財務機構) means an authorized institution as defined in section 2(1) of the Banking Ordinance (Cap. 155);

bank (銀行) means any institution carrying on business similar to—

- (a) the banking business within the meaning of the Banking Ordinance (Cap. 155) as carried on by an authorized institution; or
- (b) the business of taking deposits within the meaning of the Banking Ordinance (Cap. 155) as carried on by an authorized institution;

corporation (法團) means a corporation as defined in section 1 of schedule 1 of the Securities and Futures Ordinance (Cap. 571);

collective investment scheme (集體投資計劃) means a collective investment scheme as defined in section 1 of schedule 1 to the Securities and Futures Ordinance (Cap. 571);

eligible ILS investor (合資格保險相連證券投資者) has the meaning assigned to it in rule 3;

insurance-linked securities (保險相連證券) has the meaning assigned to it in section 129A of the Ordinance;

public (公眾、大眾) means the public of Hong Kong, and includes any class of that public.

recognized clearing house (認可結算所), **recognized exchange company** (認可交易所), **recognized exchange controller** (認可控制人) and **recognized investor compensation company** (認可投資者賠償公司) have the same meanings given to them in section 1 of schedule 1 to the Securities and Futures Ordinance (Cap. 571).

DRAFT

3. Restrictions on sale of insurance-linked securities

- (1) A person must not enter into or offer to enter into an agreement with another person, or invite or induce or attempt to invite or induce another person to enter into an agreement for that other person to acquire, subscribe or underwrite insurance-linked securities or to dispose of insurance-linked securities to that other person, unless—
 - (a) that other person is an eligible ILS investor;
 - (b) that other person is not a person mentioned sub-rule (2); and
 - (c) the consideration for which the insurance-linked securities are to be acquired, subscribed, underwritten, or disposed of under the agreement is not less than one million United States dollars (US\$1,000,000) or the equivalent of such amount in other currencies.

- (2) A person referred to in sub-rule (1)(b) of this rule 3, is—
 - (a) Any collective investment scheme authorized under section 104 of the Securities and Futures Ordinance (Cap. 571);

 - (b) any registered scheme as defined in section 2(1) of the Mandatory Provided Fund Schemes Ordinance (Cap. 485), or its constituent fund as defined in section 2 of the Mandatory Provident Fund Schemes (General) Regulation (Cap. 485 sub. leg. A), or any scheme which is an approved pooled investment fund as defined in section 6 of the Mandatory Provident Fund Schemes (General) Regulation (Cap. 485 sub. leg. A), or any person who, in relation to any such registered scheme, is an approved trustee or service provider as defined in section 2(1) of that Ordinance; and

 - (c) any scheme which—
 - (i) is a registered scheme as defined in section 2(1) of the Occupational Retirement Schemes Ordinance (Cap. 426); or
 - (ii) is an offshore scheme as defined in section 2(1) of that Ordinance,or any person who, in relation to any such scheme, is an administrator as defined in section 2(1) of that Ordinance.

- (3) A person who contravenes sub-rule (1) commits an offence and is liable—
 - (a) on conviction on indictment to a fine of \$200,000 and to imprisonment for 2 years; or
 - (b) on summary conviction to a fine at level 6 and imprisonment for 6 months.

DRAFT

(4) In this rule—

eligible ILS investor (合資格保險相連證券投資者) means—

- (a) any recognized exchange company, recognized clearing house, recognized exchange controller or recognized investor compensation company, or any corporation authorized to provide automated trading services under section 95(2) of Securities and Futures Ordinance (Cap. 571);
- (b) any licensed corporation or registered institution as defined under the Securities and Futures Ordinance (Cap. 571), or any other corporation carrying on business of the provision of investment services and regulated under the law of any place outside Hong Kong;
- (c) any authorized financial institution, or any bank which is not an authorized financial institution but is regulated under the law of any place outside Hong Kong;
- (d) any insurer authorized under this Ordinance, or any other person carrying on insurance business and regulated under the law of any place outside Hong Kong;
- (e) any scheme which—
 - (i) is a collective investment scheme that is not the subject of any advertisement, invitation or document that is or contains an invitation to the public to do any act referred to in section 103(1)(b) of the Securities and Futures Ordinance (Cap. 571) and is not authorized, and not required to be authorized, under section 105(1) of the Securities and Futures Ordinance (Cap. 571); or
 - (ii) is similarly constituted under the law of any place outside Hong Kong and, if it is regulated under the law of such place, is permitted to be operated under the law of such place,or any person by whom any such scheme is operated;
- (f) any government (other than a municipal government authority), any institution which performs the functions of a central bank, or any multilateral agency;
- (g) any corporation which is
 - (i) a wholly owned subsidiary of—
 - (A) a licensed corporation or registered institution as defined under the Securities and Futures Ordinance (Cap. 571), or other corporation carrying on business of the provision of investment services and regulated under the law of any place outside Hong Kong; or
 - (B) an authorized financial institution, or any bank which is not an authorized financial institution but is regulated under the law of any place outside Hong Kong;

DRAFT

- (ii) a holding company which holds all the issued share capital of—
 - (A) a licensed corporation or registered institution as defined under the Securities and Futures Ordinance (Cap. 571), or other corporation carrying on business of the provision of investment services and regulated under the law of any place outside Hong Kong; or
 - (B) an authorized financial institution, or any bank which is not an authorized financial institution but is regulated under the law of any place outside Hong Kong; or
- (iii) any other wholly owned subsidiary of a holding company referred to in subparagraph (ii).

**Feedback to Consultation Paper on the Draft Insurance
(Special Purpose Business) Rules**

(Comments should be sent to the Insurance Authority on or before 16 October 2020.)

To: Insurance Authority

(email: ils@ia.org.hk)

Name of Respondent:

Contact Person (if Respondent is an organization):

Contact Details:

Question 1

Do you agree with the proposed scope of eligible investors for ILS? Are there any types of investors which may be added or excluded?

Question 2

Do you agree with the proposed minimum investment size for ILS? If not, what are the reasons?

Question 3

Do you agree with the formulation of the offence in Rule 3 of the draft Rules? If not, what are the reasons?