

Note on the Treatment of “Closely Linked” Entities that are Members of the Supervised Groups under the Group-wide Supervision Regime

Background

Section 95D of the Insurance Ordinance (Cap. 41) (“Ordinance”) provides that the supervised group of a designated insurance holding company (“DIHC”) consists of default members¹ mentioned in section 95D(1) of the Ordinance and any other entities which the Insurance Authority (“IA”) decides to include under section 95D(3) of the Ordinance, on the basis that the IA considers that the entity is closely linked to a default member of the group through any financial, contractual or operational relationship. When determining whether an entity is closely linked to a default member, the IA will look to assess the degree to which the relationship between the default member and entity is such that one can, in substance, govern the financial and operating policies of the other so as to obtain benefits from the other’s activities². Examples of entities that the IA may consider appropriate for inclusion under section 95D(3) of the Ordinance to be members of a supervised group include associates, joint ventures³, special purpose vehicles (“SPVs”) and investments (which may expose the supervised group to providing implicit support to the SPVs/investments, or to potential legal actions against the supervised group by investors in securities issued by the SPVs/investments) that are held, directly or indirectly by the DIHC or members of the supervised group.

The inclusion of an entity in a supervised group under section 95D(3) of the Ordinance would, among other matters, require the DIHC to take account of the entity and the potential risk and financial impact associated with the entity on its supervised group in the DIHC’s governance, risk management, solvency assessment, capital planning and supervisory reporting to the IA in respect of the supervised group. The IA may also take into account the entity (and the risk and potential financial impact of the entity in relation to the supervised group) when assessing whether the group capital requirements for the supervised group of a DIHC are commensurate with the risks associated with the group.

Certain provisions in the Ordinance, or requirements that may be imposed on a DIHC under certain provisions in the Ordinance, may require the DIHC to exercise its control or influence over members in the supervised group in order to ensure the requirement is complied with. The IA notes, however, that the degree of control and influence a DIHC may have in respect of an entity which has been included in its supervised group pursuant to section 95D(3) of the Ordinance (a “closely linked member”), may be more limited when compared to the degree of

¹ The “default members” of a supervised group are (a) the DIHC; (b) all subsidiaries of the DIHC; and (c) any other entities that are, according to the accounting standards applicable to the preparation of the specified financial statements, treated as members of the insurance group to which the DIHC belongs.

² Considerations for inclusion under section 95D(3) of the Ordinance can be found in A.S/2.11 to A.S/2.12 of the [Guideline on Group Supervision \(GL32\)](#).

³ The terms of “associates” and “joint ventures” shall have the same definitions in the [IAS 28 – Investments in Associates and Joint Ventures \(2011\)](#) issued by the International Accounting Standards Board (IASB).

control and influence it can exercise over a default member. Without limiting the IA's discretion to exercise any powers under Part XIA of the Ordinance, or limiting the interpretation of any provision under Part XIA of the Ordinance, we set out below certain general guidance on the IA's expectations regarding the steps a DIHC should take pursuant to particular provisions of the Ordinance and the Guideline on Group Supervision, in respect of closely linked members. It should be noted, however, that the manner in which a DIHC would be expected to exercise its control and influence on a closely linked member would depend on the nature, scale and complexity of risks associated with the closely linked member and this guidance is only general in nature and the exact steps a DIHC should take in any given situation, is situation-specific and would depend on the exact legal relationship, agreements and arrangements that are in place between the entity and the DIHC (or other default members of the supervised group).

This Note is not intended to be a comprehensive guide and does not constitute legal advice. This Note does not have the force of law and should not be interpreted in a way that would override the provision of any law. The IA reserves the right to review and update this Note from time to time. Unless otherwise specified, words and expressions in this Note shall have the same meanings as given to them in the Ordinance.

General principles

In general, if in order to achieve compliance with a provision under the Part XIA of the Ordinance (or a requirement imposed under a provision under Part XIA of the Ordinance), a DIHC is required to exercise its control or influence in respect of a closely linked member, but the legal rights of the DIHC in relation to the entity (whether in relation to the entity directly or in respect of another member of the group more closely linked to the entity) do not give the DIHC power to compel the entity to take such acts as may be necessary to ensure such compliance is achieved, then the DIHC should at a minimum take the following steps:

- (a) The DIHC should take reasonable steps which are within its control or influence in relation to the entity to achieve compliance (even if that control or influence is not sufficient to compel the entity to act in such a way as to achieve compliance);
- (b) The DIHC should notify the entity in writing of the DIHC's obligation to achieve compliance with the requirement under the Ordinance; and
- (c) The DIHC should raise the matter with the IA as early as practicable, by informing the IA of the reasons why its control and influence are insufficient to be able to procure compliance with the requirement imposed and what steps it has taken (or proposes to take) within the scope of its control and influence to try to secure compliance.

The steps the DIHC should take pursuant to (a) should include (where such rights exist) exercising any right in any contract or agreement with the entity, formally bringing the matter before the board of the entity, and ensuring that the appropriate senior management in the DIHC

engage in discussions with the senior management of the entity to attempt to resolve the matter. The DIHC should keep proper documentation on all the reasonable steps it takes and may be required to provide these to the IA for reference upon IA's request.

After the DIHC has raised the matter with the IA, the IA may consider the exercise of alternative powers under the Ordinance, if appropriate, taking into consideration the nature, scale and complexity of risks, and the specific facts, in relation to the DIHC to address the risk or other matters which arise from the DIHC not being able to achieve compliance with the provision or requirement.

The application of these general principles are further outlined in relation to specific provisions or requirements under Part XIA of the Ordinance below:

1 Requirements in relation to group capital (section 95ZI of the Ordinance)

1.1 According to section 95ZI(3) of the Ordinance, a DIHC must ensure that the group capital requirements (as specified under the Insurance (Group Capital) Rules (Cap. 41O) ("Group Capital Rules")) for its supervised group are at all times complied with.

1.2 In determination and calculation of the group capital adequacy requirements in relation to the supervised group of a DIHC, with regards to a closely linked member (of which the percentage shareholding held directly or indirectly, by the DIHC or another supervised group member in the same supervised group, is less than 100%), the proportionate minimum capital requirement, prescribed capital requirement and eligible capital resources applicable to the closely linked member should be included in the group minimum capital requirement (GMCR), group prescribed capital requirement (GPCR) and eligible group capital resources of the supervised group of the DIHC respectively in accordance with the Group Capital Rules, in particular Rules 4, 5 and 6.

2 Major acquisitions (section 95ZJ of the Ordinance)

2.1 According to section 95ZJ(1) of the Ordinance, a DIHC must not make a major acquisition or allow the making of a major acquisition by another member of the supervised group of the company, unless the acquisition has either been approved by the IA or has been assessed, through an assessment framework approved by the IA under section 95ZM of the Ordinance, as not material to the supervised group of the DIHC.

2.2 With regards to a closely linked member, the DIHC may or may not have the legal power to allow or not allow the making of a major acquisition by that entity. In this situation, the IA would expect the DIHC to take reasonable steps which are within the limits of its legal power to achieve compliance with section 95ZJ of the Ordinance and make it explicitly known to the entity (at board level) that the DIHC needs to comply with section 95ZJ of the Ordinance. These steps should be taken even if, despite these steps being taken by the DIHC, the entity cannot be prevented by the DIHC from proceeding with the acquisition

prior to the requirements in section 95ZJ being satisfied. Further, where such major acquisition cannot be prevented, despite such steps being taken by the DIHC, the DIHC would be expected to monitor and/or assess the risk and financial impact of the major acquisition to its supervised group in its risk management, solvency and capital planning, to liaise closely with the IA on this matter if there is no approved materiality assessment framework in place or if there is a materiality assessment framework approved by the IA and the transaction is material, and to put in place governance, to the extent that it is able to, to monitor transactions conducted by the entity.

3 *Power to require information and documents (section 95ZO of the Ordinance)*

3.1 According to section 95ZO(1) of the Ordinance, the IA may, by a written notice served on a DIHC, require the DIHC to provide information or produce documents about any matter that relates to any member of its supervised group. Per section 95ZY(1)(a) of the Ordinance, if a person fails to comply with a requirement imposed by the IA under section 95ZO, the person commits an offence. The IA is responsible for ensuring that any confidential information it receives from the DIHC or any member of its supervised group is held in strict confidence.

3.2 Pursuant to section 95ZZ(4) of the Ordinance, however, it is a defence for the DIHC to prove that at the time of the alleged offence that (a) the information or document was not in the possession or control of the DIHC; and (b) the DIHC had taken all reasonable steps to exercise its control or influence to procure the provision of the information or document by any member of its supervised group to the DIHC. Accordingly, in relation to a closely linked member, and over which the DIHC's control or influence may be limited, the IA would expect the DIHC to take all reasonable steps within the limits of its control or influence to procure the provision of the information or document (but would not expect the DIHC to have to go beyond this).

3.3 If the DIHC envisages that there may be difficulties in providing the relevant information or documents required by the IA under a written notice served pursuant to section 95ZO(1) of the Ordinance, the DIHC should bring this to the attention of the IA. The IA may then consider the exercise of alternative powers under the Ordinance, if appropriate, taking into consideration the nature, scale and complexity of risks, and the specific facts, in relation to the DIHC to address the risk or other matters which gave rise to the imposition of the requirement under section 95ZO(1) of the Ordinance. The DIHC should, however, still proceed with taking all reasonable steps within the limits of its control or influence in respect of the member to achieve compliance.

4 *Power to require report (section 95ZP of the Ordinance)*

4.1 According to section 95ZP(1) of the Ordinance, the IA may require a DIHC to provide (or appoint a person to provide) a report to the IA in respect of any matter that relates to any member of its supervised group.

4.2 If the report required by the IA is in respect of any matter that relates to a closely linked member, the DIHC should take reasonable steps within the limits of its control or influence in respect of the member to ensure the information is made available for the report to be prepared. If the DIHC envisages that it may face difficulties in providing a report which is sufficiently comprehensive to address the matters relating to the member, due to the limits of the DIHC's control or influence with regards to the member to ensure the member provides sufficient information for the preparation of the report, the DIHC should raise this matter with the IA. The report should still be prepared and provided in this instance (unless the IA expressly withdraws the requirement imposed) but may include qualifications based on the information that was unable to be obtained despite the DIHC seeking to exercise its control and influence to obtain such information. The IA may then consider the exercise of alternative powers under the Ordinance, if appropriate, taking into consideration the nature, scale and complexity of risks, and the specific facts, in relation to the DIHC to address the risk or other matters which gave rise to the request for the report to be provided.

5 *Power to require compliance with restrictions on transfer of assets (section 95ZQ of the Ordinance)*

5.1 According to section 95ZQ(2) of the Ordinance, the IA may require a DIHC to ensure that other members of its supervised group (a) refrain from transferring assets to any related entity; and (b) comply with any restrictions specified by the IA on the transfer of assets of the members to a related entity.

5.2 A DIHC should take all reasonable steps within its control or influence in relation to other members in its supervised group to ensure that a requirement under section 95ZQ(2) of the Ordinance is complied with. With regards to a closely linked member, the DIHC should take all reasonable steps within the limits of its control or influence in respect of the member to achieve such compliance. Even though this control or influence over the member may be limited in this respect, the DIHC should certainly communicate the restriction to the member and should at the very least procure that the default members in its supervised group do not transfer assets to (and, where appropriate, receive assets from) such a member except in circumstances approved by the IA.

5.3 If the DIHC envisages that it may face difficulties in procuring compliance with a requirement imposed under section 95ZQ(2) of the Ordinance, it should raise this matter to the attention of the IA. The IA may then consider the exercise of alternative powers under the Ordinance, applying the principle of proportionality and taking into consideration the nature, scale and complexity of risks, and the specific facts, in relation to the DIHC to address the risk or other matters which gave rise to the imposition of the requirement under section 95ZQ(2) of the Ordinance. The DIHC should, however, still proceed with taking all reasonable steps within the limits of its control or influence in respect of the member to achieve compliance.

5.4 The legislation provides that a breach of section 95ZQ of the Ordinance is an offence under section 95ZY(1)(a) of the Ordinance. A defence is available to the DIHC under section 95ZZ(6) of the Ordinance where the DIHC has taken all reasonable steps to exercise the DIHC's control or influence in relation to the member to procure the matter.

6 Power to require action in relation to supervised group (section 95ZR of the Ordinance)

6.1 Pursuant to section 95ZR(1) of the Ordinance, the IA may require a DIHC to take any action in relation to the affairs, business or property of its supervised group as the IA considers appropriate. This may include the IA requiring a DIHC to ensure that other members of its supervised group, or any one or more of them, do or refrain from doing anything.

6.2 A DIHC should take all reasonable steps within its control or influence in relation to other members in its supervised group to ensure that a requirement under section 95ZR(1) of the Ordinance is complied with. With regards to a closely linked member, the DIHC should take all reasonable steps within the limits of its control or influence in respect of the member to ensure such compliance, even though this control or influence may not be sufficient to bring about compliance.

6.3 If the DIHC envisages that it may face difficulties in procuring compliance with a requirement imposed under section 95ZR(1) of the Ordinance, it should raise this matter to the attention of the IA. The IA may then consider the exercise of alternative powers under the Ordinance, applying the principle of proportionality and taking into consideration the nature, scale and complexity of risks, and the specific facts, in relation to the DIHC to address the risk or other matters which gave rise to the imposition of the requirement under section 95ZR(1) of the Ordinance. The DIHC should, however, still proceed with taking all reasonable steps within the limits of its control or influence in respect of the member to achieve compliance.

6.4 The legislation provides that a breach of section 95ZR of the Ordinance is an offence under section 95ZY(1)(a) of the Ordinance. A defence is available to the DIHC under 95ZZ(6) of the Ordinance where the DIHC has taken all reasonable steps to exercise the DIHC's control or influence in relation to the member to procure the matter.

7 Power to conduct inspection (section 95ZZE of the Ordinance)

7.1 Pursuant to section 95ZZE of the Ordinance, the IA may exercise certain inspection powers. Such powers include, pursuant to section 95ZZE(3) of the Ordinance, the IA's inspector requiring the DIHC (a) to give the inspector access to a business record of any member of the supervised group, (b) to produce to the inspector, within the time and at a place specified in the requirement, a business record of any member of the group; and (c) to answer a question concerning a business record of any member of the group or a

transaction or activity that was undertaken in the course of, or may affect, the business conduct by any member of the group. Pursuant to section 95ZZE(4) of the Ordinance, a requirement imposed under section 95ZZE(3) of the Ordinance on a DIHC may also include a requirement for a DIHC to ensure the doing of an act mentioned in section 95ZZE(3)(a), (b) or (c) by another member of its supervised group.

7.2 In practice, the IA will generally communicate with a DIHC prior to conducting an inspection. If the DIHC envisages that it may face difficulties in procuring compliance with a requirement imposed under section 95ZZE of the Ordinance, it should raise this matter to the attention of the IA during these communications.

7.3 The legislation provides that a breach of section 95ZZE(3) of the Ordinance without reasonable excuse is an offence under section 95ZZJ(1) of the Ordinance.

8 *Compliance with the Guideline on Group Supervision – Guideline 32 (“GL32”)*

8.1 As paragraph 3 of GL32 makes clear, GL 32 is principle-based. It sets broad Principles in each Module of the guideline along with Standards which a DIHC’s supervised group should generally meet in order to satisfy these Principles. As paragraph 3 of GL32 also makes clear, the manner in which the Standards in GL32 should be applied by a DIHC would depend on the nature, scale and complexity of risks associated with the business operations of its supervised group. To the extent, therefore, there are limitations on the degree of the control and influence a DIHC may exercise over a particular entity in its supervised group, this shall be taken into account in considering how the Standards in GL32 apply to the DIHC and its supervised group, provided the Principles in GL32 continue to be met. For example, assume a DIHC does not have sufficient legal control or influence over (e.g. may not have majority ownership in) a particular entity in its supervised group (a closely linked member), such that the DIHC cannot ensure the closely linked member adopts the risk management and internal control framework for the supervised group. In this situation, the DIHC should take reasonable steps to ensure that the risk management and control system for the supervised group includes controls to monitor the closely linked member’s risk management and control system and to mitigate the risks associated with the closely linked member to the extent they pose a material risk to the rest of the supervised group.

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