

## HONG KONG INSURANCE INDUSTRY WELCOMES NEW ILS REGULATORY REGIME AND EXPANSION OF CAPTIVE INSURANCE BUSINESS

In a move to further promote Hong Kong's insurance business in Asia and the Guangdong-Hong Kong-Macao Greater Bay Area, the new regulatory regime for insurance-linked securities (ILS) and the rules relating to the expansion of captive insurance business will come into operation on 29 March 2021. Together with the group-wide supervision framework<sup>1</sup> that will come into effect on the same day, the government continues its effort in boosting Hong Kong's status as an international insurance hub and risk management centre.

### INTRODUCTION

#### The new ILS regulatory regime

ILS are risk and capital management tools that enable an insurer or a reinsurer to offload insurance risks to the capital markets through securitization. The operation of ILS involves the setting up by an insurer or reinsurer of a dedicated special purpose vehicle enabling the transfer of its insurance risk through a reinsurance/ risk transfer contract and the issuance of a security to investors which funds the insurance risk exposure. The investment performance of the security is linked to the loss experience on the reinsurance contract.

With a view to broadening the risk management tools in the Hong Kong financial market, the government is adding a new class of insurance business - "special purpose business" and introducing a new regulatory regime for the ILS business. The new ILS regulatory regime will come into operation on 29 March 2021.

To facilitate the new ILS platform, the government has also proposed to launch a two-year Pilot ILS Grant Scheme in its [2021-22 Budget Speech](#) with the objective of attracting insurance enterprises or organisations to issue ILS in Hong Kong. It is a positive development that Hong Kong is implementing a scheme similar to the Monetary Authority of Singapore's ILS grant scheme which has been effective in promoting the development of Singapore's ILS market.

#### Key issues

- The new ILS regulatory regime and the expansion of captive insurance business in Hong Kong will come into effect on 29 March 2021.
- The latest developments demonstrate the Hong Kong government's ambition in consolidating Hong Kong's role as an international risk management hub.
- Hong Kong will be better positioned to facilitate future insurance-related opportunities particularly those emerging from mainland China.

<sup>1</sup> [Hong Kong Insurance Group-Wide Supervision Framework to Commence on 29 March 2021](#), Clifford Chance, January 2021

### Expansion of Captive Insurance Business

Captive insurance is a tool used by multinational companies for risk management and to save insurance premiums spent on an external insurance provider. The industry considers that the existing scope of insurable risks by captive insurers is unduly restrictive and not conducive to effective global risk management strategy. The government had accordingly proposed to expand the scope of insurable risks by captive insurers set up in Hong Kong to meet the risk management needs of multinational companies.

## **REGULATION OF A NEW CLASS OF INSURANCE BUSINESS – SPECIAL PURPOSE BUSINESS**

Enacted in July 2020, the [Insurance \(Amendment\) Ordinance 2020](#) provides for a new ILS regulatory regime and introduces a new class of general insurance business known as "special purpose business".

In order to carry on special purpose businesses, a company must be authorized by the Hong Kong Insurance Authority (IA) under section 8A of the Insurance Ordinance (Cap. 41) and comply with certain requirements. These include (i) the appointment of two or more directors and an administrator (as a "controller" of the company) that are considered to be fit and proper to the IA; (ii) compliance with the relevant financial, solvency, investor's sophistication and other prescribed requirements; and (iii) the intention of the company to carry on special purpose business only but not any other class of insurance business. The IA will also have certain intervention powers such as the powers to conduct inspection and impose disciplinary actions.

The IA will be empowered to make rules to prescribe the types of investors to which ILS may be sold (eligible ILS investors). Given the complex nature of ILS, the IA made it clear that ILS are unsuitable for ordinary retail investors and are solely confined to eligible investors by private placement only. As such, the Insurance (Special Purpose Business) Rules (SPB Rules) will be introduced to restrict the distribution of ILS to eligible ILS investors only. As examples, eligible ILS investors include licensed corporations/ registered institutions regulated by the Securities and Futures Commission (SFC), banks, authorized insurers (including those similarly regulated outside Hong Kong). Funds targeting the general public such as the Mandatory Provident Fund Schemes and occupational retirement schemes will not be regarded as eligible ILS investors.

The Administration and the IA indicated, during the deliberation of the SPB Rules at the Legislative Council, that the definition of "securities" in section 1, Part 1 of Schedule 1 to the Securities and Futures Ordinance (Cap. 571) ("SFO") (which includes derivative products and structured products) applies for the purposes of the SPB Rule, so the act of "repackaging" ILS into derivative products or structured products linked to ILS for sale to ordinary retail investors is also prohibited.

Contravention of the SPB Rules will result in a fine or imprisonment or both. The maximum penalty that may be prescribed under the rules is:

- a fine of HK\$200,000 and imprisonment for two years for conviction on indictment; and
- a fine of HK\$100,000 and imprisonment for six months on summary conviction.

## SCOPE OF INSURABLE RISKS OF CAPTIVE INSURERS EXPANDED

The Insurance Ordinance will be amended to expand the scope of insurable risks of captive insurers. In general, a captive insurer (relevant company) is an insurance company set up by its parent company with the primary purpose of insuring and reinsuring the risks of the companies in the group to which the captive insurer belongs.

The industry considers the existing scope of insurable risks by captive insurers to be too restrictive. For example, the risks which a captive insurer can insure/reinsure are limited to the risks of companies formed and registered in Hong Kong, and the risks of companies incorporated outside Hong Kong that establishes a place of business in Hong Kong.

To facilitate multinational insurance companies in managing risk management, the scope of insurable risks of a captive insurer will be expanded to include the risks of a body corporate within the "corporate group"<sup>2</sup> to which the captive insurer belongs – this includes group companies that are incorporated outside Hong Kong and does not have a place of business in Hong Kong.

In addition, captive insurers will be allowed to underwrite the proportional share of risk of another group company to which the captive insurer or certain group member(s) is exposed to directly, as well as other risks (where the captive insurer or certain group member(s) have control, oversight, management and sufficient connection).

## IMPLICATIONS

The regulation of ILS has been discussed within the industry for some time now. Given a rising trend of catastrophic events caused by climate change, the government has noted that the global issuance of ILS has grown substantially in recent years but the risk exposure of such ILS is currently mainly confined to the United States and Europe. The latest regulatory changes will allow Hong Kong to be a more conducive domicile for ILS in Asia, including facilitating the transfer of natural catastrophe risk by Mainland insurers/ reinsurers through Hong Kong. The industry also welcomes the Pilot Insurance-linked Securities Grant Scheme announced in the 2021-22 Budget which should further attract insurance enterprises or organisations to issue ILS in Hong Kong. The amount of grant for each issuance will be capped at HK\$12 million, with further details to be announced by the government in due course.

The interaction between the new ILS regime and the current licensing requirements under the SFO, and the demarcation of work between the IA and other financial regulators, are matters to be further considered. The IA has stated that it is the primary regulator to administer and enforce the new regime under Insurance Ordinance, yet the SPB Rules do not alter requirements under the SFO and ILS products caught by the definition of "securities" under the SFO or activities connected with the sale of ILS products falling within ambit of the SFO appear to also be subject to the regulation of the SFC. That raises questions as to, for example, whether parties involved in the distribution of ILS require a licence from the SFC, and how the IA and the SFC will co-operate, in respect of the new ILS regime, under the new Memorandum of Understanding signed in September 2020, the key features of which include joint inspections and investigations and referrals of enforcement cases.

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<sup>2</sup> A new term "relevant company's corporate group" will be added in the Insurance Ordinance to specify the members in the captive insurer's group of companies.

Noting that risk management underscores the resilience of enterprises in coping with the changing risk landscape and the need to help the Hong Kong insurance industry to capitalise on the business opportunities arising from the Belt and Road initiative, the Hong Kong government is committed to building Hong Kong into a risk management centre. The expansion of the scope of captive insurance business is seen as a positive move by the government that will boost demand of multinationals, including Mainland enterprises going global, to set up their captive insurance business in Hong Kong.

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