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Hong Kong's new regulatory regime for insurance-linked securities

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8 April 2021

Insurance-linked securities are up-and-coming alternative investment products which offer investors the potential for lucrative returns along with the benefit of portfolio diversification. Hong Kong is well positioned to become a leading insurance-linked securities trading hub in Asia, with its established capital market, sound legal system and privileged access to the Mainland China market.

Both the Mainland China and Hong Kong governments have demonstrated clear interest in supporting Hong Kong to develop a trading platform for insurance-linked securities and encouraging insurers to manage risks through such platform. In response to these policy initiatives, a new regulatory regime has been introduced to facilitate the trading of insurance-linked securities in Hong Kong.

What are insurance-linked securities?

Insurance-linked securities are risk management tools which allow insurers and re-insurers to delegate the risk of an insurance payout to investors in the capital market who are willing to assume the risk for high returns through securitization.

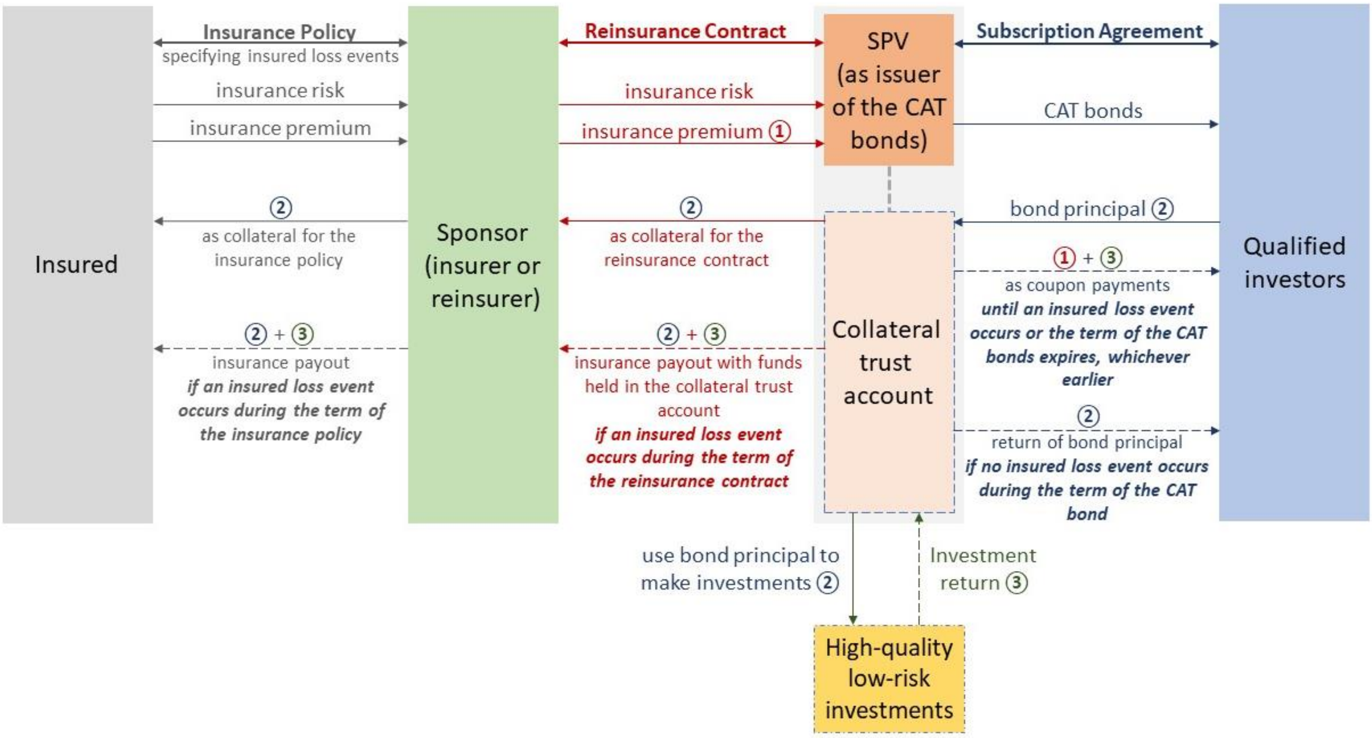
The value of insurance-linked securities are correlated with the occurrence of insured loss events and are independent from the financial performance of the issuer and the general performance of the financial market. This, coupled with the low volatility of their values, makes insurance-linked securities an attractive tool for investors to diversify their investment portfolio and manage their investment risks.

From the issuer's perspectives, insurance-linked securities offer an alternative way to diversify, thereby reducing their dependency on the traditional reinsurance market.

The most commonly traded insurance-linked securities are catastrophe bonds (commonly called as CAT bonds) where the underlying events insured against are catastrophes and natural disasters. Other types of insurance-linked securities include industry loss warranties, collateralized reinsurance instruments, and reinsurance sidecars.

How are CAT bonds typically structured?

The diagram below illustrates the typical roles of different parties in the structure of CAT bonds.



1. The bond's sponsor (usually an insurer or a re-insurer) forms a special purpose vehicle ("**SPV**") and enters into a reinsurance contract with the SPV, under which the sponsor will transfer an insurance risk, and pay an insurance premium, to the SPV.

2. The SPV issuer issues the CAT bonds to qualified investors in the capital market and enters into a subscription agreement with such investors to raise the bond principal to be used as collaterals for the reinsurance contract between the SPV and the sponsor.

3. The SPV issuer holds the bond principal in a collateral trust account and uses it to make high quality, low risk investments.

4. The SPV issuer makes periodic coupon payments to the qualified investors during the term of the CAT bonds with the insurance premium received from the sponsor and any investment returns from the bond principal.

5. If an insured loss event occurs before the CAT bonds mature, the SPV issuer will cease to make coupon payments to the qualified investors. It will then reimburse the sponsor in accordance with the reinsurance agreement with funds from the collateral trust account, and transfer any remaining balance to the qualified investors.

6. If no insured loss event occurs before the CAT bonds mature, the SPV issuer will repay the bond principal to the qualified investors when the term expires.

New regulatory regime for insurance-linked securities

The Insurance (Amendment) Ordinance 2020 and the Insurance (Special Purpose Business) Rules set out a new regulatory regime specifically designed for the trading of insurance-linked securities in Hong Kong. The new regime became effective on 29 March 2021.

1. Insurance (Amendment) Ordinance 2020

The Insurance (Amendment) Ordinance 2020 introduces a new class of insurance business, namely special purpose business ("**SPB**"), and a new type of authorized insurer, namely special purpose insurers ("**SPI**").

SPB is defined as the business of effecting and carrying out insurance contracts that are fully funded through insurance securitization. This means that the proceeds from the sale of insurance-linked securities must sufficiently cover the issuer's potential liabilities under the underlying insurance contracts.

The Insurance (Amendment) Ordinance 2020 stipulates that an SPB may only be carried on by an SPI. To be authorized as an SPI, an entity must:

- appoint at least two fit and proper directors;
- appoint a fit and proper administrator as its controller;
- carry on SPB as its sole insurance business; and
- comply with any additional requirements prescribed by the Insurance Authority, including those stipulated in the Insurance (Special Purpose Business) Rules.

2. Insurance (Special Purpose Business) Rules

Addressing concerns that certain investors may not have the risk appetite for investments in insurance-linked securities, the Insurance (Special Purpose Business) Rules debars unsuitable investors by restricting trading activities to certain eligible investors and imposing a minimum investment size of US$250,000.

Eligible investors include banks and authorized financial institutions, insurance companies, corporations providing investment services, governments, central banks and multilateral agencies, authorized exchange companies, and collective investment schemes (excluding retail funds, pooled investment funds invested into by Mandatory Provident Fund schemes and occupational retirement schemes).

A person who fails to comply with such trading limitations commits a criminal offence and may be subject to a fine of HK$200,000 and imprisonment of 2 years.

Interaction with the Securities and Futures Ordinance

Considering the nature of insurance-linked securities and the broad definition of "securities" under the Securities and Futures Ordinance of Hong Kong, it is likely that insurance-linked securities will fall within the ambit of, and be subject to, such ordinance. Therefore, persons who deal with, advise on or trade in insurance-linked securities may be required to hold a license issued by the Securities and Futures Commission of Hong Kong.

What's next?

To expedite the growth of the insurance-linked securities market in Hong Kong, the Hong Kong government has proposed to launch a pilot grant scheme for insurance-linked securities issuers for a duration of two years. Under this scheme, issuers of insurance-linked securities will be entitled to claim a government grant of up to HK$12 million to cover the cost of issuing such securities. Details of the scheme will be announced by the Insurance Authority in due course.

Once an insurance-linked securities market is developed, Hong Kong can provide opportunities for Mainland China insurers and entities to transfer risks to qualified investors via such insurance-linked securities market. Hong Kong may also pave the way for becoming a leading reinsurance and risk management center in Asia.

The author would like to thank Ms. Cici Ng (trainee solicitor) for her contribution in this article.

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