



INSURANCE (AMENDMENT) BILL 2020

SUBMISSION

Introduction

1. The Insurance (Amendment) Bill 2020 (“the Bill”) was published in the Gazette on 20 March 2020. The Bill seeks to amend the Insurance Ordinance (Cap. 41) (“Ordinance”) to provide for a new regulatory regime for the insurance-linked securities (“ILS”) business and expand the scope of insurable risks of captive insurers set up in Hong Kong.
2. The Law Society has the following comments.

Comments on the Bill

3. Before we comment on the individual clauses of the Bill, we would like to point out that the “special purpose business” (“SPB”) appears to be a derivative of insurance products or a debt instrument. It is more of a financial product focusing on the nature of funding of contracts of insurance rather than on the nature of the contracts as contracts of insurance themselves; indeed the function of a special purpose insurer (“SPI”) is as a form of reinsurer of contracts of insurance within the existing Classes of insurance business and it is only the requirement that these SPB contracts be fully-funded by way of securitization that is novel, and it is likely that these securitized contracts will also require Securities and Futures Commission’s approval with consequent risks of duplication of regulation and delay. Consideration should therefore be given to whether it is appropriate to add this business as a new Class of insurance business under the Ordinance or, if a new Class of insurance business is added, whether a new supervisory body be established comprising members of both the Insurance Authority (“IA”) and the Securities and Futures Commission to authorize both the SPI and the relevant SPB contracts.

Special purpose business (Clause 3(2) of the Bill)

4. It appears that the definition of “special purpose business” is capable of including what would normally be regarded as “long term” or “general” business. While clause 3(2) of the Bill ensures that SPB does not also constitute general business, there seems to be no similar provision for long term business. It is therefore not clear if a number of provisions in the Ordinance that are specific to long term business would apply to “life” special purpose business. In addition, it is not clear on what grounds a SPI would not be regarded as carrying on the relevant classes of general or long term business to which its business relates (and for which it is not authorized under section 6 of the Ordinance). Query whether there should be a provision (in Schedule 1 or elsewhere) that ensures that a SPI is not regarded as carrying on any other class of insurance business when carrying on SPB.

Fully-funded (clause 3(4) of the Bill)

5. It is said that the core feature of ILS business is that it is fully funded. However, the definition and/or the requirement of “fully funded” is unclear. In addition, requirements regarding the nature and location of assets and the verification of the value of those assets (audit) will need to be clear.

Insurance securitization (clause 3(4) of the Bill)

6. The definition of “insurance securitization” is very wide (unlike the corresponding Singapore definition) and consideration should be given to whether it might accidentally capture other financing arrangements relevant to insurance business, such as premium financing, insurance-based swaps (e.g. longevity swaps), financial reinsurance arrangements including value-in-force monetization through reinsurance, conditional loans or otherwise, and even equity/debt arrangements of an insurer. While this issue is somewhat mitigated by the definition of “fully funded” in the new section 2(8), a number of arrangements not meant to be captured by this class of insurance business would arguably still fall within the definition. This issue, and the potential consequences, should be carefully considered. It is also unclear why the definition of “insurance securitization” refers to a single contract of insurance rather than one or more contracts of insurance (as per the Singapore approach).

Classes of insurance business (clause 4 of the Bill)

7. The intended effect of the new section 3(2)(b) is unclear since the definition of “special purpose business” presupposes a contract of insurance and it is therefore not necessary or appropriate to deem a contract belonging to SPB as a contract of insurance.
8. The carve-out of contracts belonging to the class of special insurance business may bring unintended ambiguity and uncertainty; this deeming provision was introduced to address retirement scheme management contracts (Classes G, H and I of long term business) where the contracts of retirement scheme management may not otherwise have actually constituted contracts of insurance.

Authorization (clause 8 of the Bill)

9. Section 8, new section 8A(2): This approach is problematic with regard to speed of approval. Industry representatives had suggested to have certain pre-approved administrators who would not have to be re-approved each time a new special purpose vehicle (“SPV”) is formed (i.e. a “licensed administrator” as a regulated person under the Ordinance). This approach does not seem to have been adopted.
10. Section 8, new section 8A(4): It is noted that only an individual may be an administrator and no corporate administrators will be permitted. This again may limit the speed of approval if any individual retires or is otherwise unavailable; a panel of pre-approved sub-administrators under an approved corporate administrator may be helpful.
11. Section 8, new section 8C: While this provides the IA with flexibility, it requires individual variations and reduces transparency for those seeking to set up SPVs and will require consistent application by the IA. A better approach may be for these sections to be capable of variation under subsidiary regulation or other instruments.

Notification of change in particulars, and Authority’s objection to appointment (Section 14 of the Ordinance)

12. It is not clear how section 14 of the Ordinance will apply to SPIs. For instance, do changes in shareholder controllers/managing directors/key persons in control functions have to be notified to the IA? The definition

of “controller” refers to section 9, which is not amended by the Bill, and while the section on approval of key persons has been disapplied, it is not clear how the reference in section 14 to such key persons should be construed.

13. It is not clear how the new function of “administrator” interacts with the “regulated activities” regime for intermediaries. It appears the regime would apply to administrators in the usual way, but should there be any exemptions/special rules?

Other comments

Inherent ILS risks

14. We set out below various risks inherent in the ILS market which may be of relevance and provide some context when considering the Bill and the necessary legal structures, though we recognize that some of these may be addressed through different captive structures and underlying regulation (to be promulgated in due course):
 - Credit risk: failure of the collateral structure or assets held as collateral;
 - Index risk: how is the index (typically an index specifying the magnitude of the insured catastrophe) compiled and is it consistent with the ILS trigger?
 - Correlation risk: is the ILS risk really uncorrelated to the financial markets?
 - Illegality risk: what is the effect of sanctions, bribery, money laundering or fraud on the ILS?
 - Indemnity product risk: what is the insured “event”, what is the effect of poor underwriting or claims handling, what is the cause of the loss and how are losses validated?
 - Placing risk: what is the effect of misrepresentation or non-disclosure and can these be managed through waiver clauses?
 - Execution risk: short time limits to ascertain loss and the effect of failure to comply with notice provisions;

- Regulatory risk: is the activity carried on a regulated activity (whether or not insurance) for which approval is required e.g. alternative investment funds or commodity interests?
- Drafting risk: drafting errors, inadequate exclusion clauses and misunderstandings in complex documentation.

Speed and ease of approval

15. It is observed that there is a link between the two main sections of the Bill in that captives are a potential user of ILS; and it is foreseeable that a number of SPIs will in fact be captives.
16. We consider that the key to success of the regime is the speed and ease of approval. In our view, the regulatory focus during the licensing process should be on an assessment of certainty of the contractual arrangements governing the SPI and the full collateralization of the policy limits of the risks ceded to the SPI. The SPI should also demonstrate that it has access to sound underwriting and servicing of claims as well as sound governance on the custody of assets.
17. We suggest that the IA consider developing a quick-form application approval process, maybe for “plain vanilla” applications where a set of minimum criteria specified in guidelines have all been met. For example, we would suggest that applications should include the sponsor’s business case and plan, evidence of the collateralized nature of the business and drafts of key documents such as the reinsurance agreement, collateralized trust agreement and service provider agreements.
18. In our view, it is imperative that the Bill creates a new structure that not only works but is also used by the industry for the benefit of Hong Kong and the transfer of major or catastrophe risks in China and elsewhere.

**The Law Society of Hong Kong
7 July 2020**