

Hong Kong opens the door to insurance-linked securities business

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Introduction

With the sharp rise in the number of natural and other large-scale catastrophic events in recent years and the challenges posed by climate change, the demand for innovative solutions in risk management is driving changes to the traditional reinsurance model. Insurance-linked securities (ILS) first came on the market around two decades ago and since then the market has grown rapidly, with global issuance reaching approximately US\$11 billion by 2019.

In response to the rising popularity of ILS in Asia, on 20 March 2020 the Hong Kong government published the Insurance (Amendment) Bill 2020 (the IA Amendment Bill) in the gazette, with a view to providing a new regulatory regime for ILS and making Hong Kong a more "conducive domicile" for ILS-related business opportunities.

In this article, we discuss the unique nature of ILS investments, the opportunities arising out of the emerging ILS landscape in the Guangdong-Hong Kong-Macau Greater Bay Area, as well as certain key provisions in the proposed ILS regime.

What is ILS?

ILS is broadly understood to refer to financial instruments whose values are linked to insurance loss events. A common form of ILS is catastrophe bonds. ILS structures typically involve the transferring of insurance risks by insurers (often referred to as sponsors) to a dedicated special purpose vehicle (SPV) through a risk transfer contract, which will, in turn, offload the insured risk onto capital market participants through securitization, such that the risks assumed by the SPV will be fully financed. Proceeds received from the securities offering will be transferred to a collateral trust and invested to generate a stable return. In return for that assumption of risk, investors receive coupons, made up of a combination of investment yield and the premium paid by the sponsors. At maturity, if no qualifying event has taken place during the on-risk period, the ILS will be redeemed at 100 percent of face value. However, in the event that a qualifying event that meets the requirements set out in the risk transfer contract occurs, funds will be withdrawn from the collateral trust to make payments to the sponsors to meet claims, causing the redemption amount payable on the ILS to be reduced accordingly.

Unlike the traditional reinsurance model, whereby insurers transfer part or all of its risks to a reinsurer, ILS provides a platform for such risks to be channeled into the capital markets, which provides a channel for more diversified growth of the sector. For investors, ILS serves as an

alternative investment instrument which is not directly correlated to the credit risk of the sponsors, or economic risks in the overall market, thus offering an ideal vehicle for investment diversification. For those reasons, appetite for ILS products is likely to continue to grow globally.

Regional opportunities

While there has been limited ILS activity in the Asia-Pacific region to date due to its low insurance penetration, the market dynamics will very likely change in the future as the regional economy strives to strengthen climate risk resilience. Insurance Australia Group issued the first catastrophe bond under their ILS grant scheme in Singapore in February 2019 whereby the Monetary Authority of Singapore offered to fund the upfront issuance costs – more are expected to follow.

In Hong Kong, the chief executive announced a new financial innovation initiative in the 2018 policy address that the government will make amendments to the Insurance Ordinance (Cap.41) (IO) to allow the formation of SPVs specifically for issuing ILS to be domiciled in Hong Kong. This is in line with the direction set out in the third meeting of the leading group for the development of the Greater Bay Area convened in November 2019 in which the Chinese central government announced certain policy measures relating to the insurance sector, one of which was to support mainland insurers in issuing catastrophe bonds in Hong Kong. It is believed that as the third biggest financial hub in the world, with its developed legal system and its sophisticated bond and capital markets, Hong Kong has a strategic advantage in its quest to become the Asia ILS hub.

The Insurance (Amendment Bill) 2020

Amongst other proposed amendments, the IA Amendment Bill proposed to add "special purpose business" (SPB) as a new class of insurance business, which essentially involves acquiring insurance risks from another insurer or reinsurer and then issuing ILS to investors to collateralize the risk. An insurer authorized to carry on SPB only is referred to as a special purpose insurer (SPI), which will be a new type of authorized insurer under the IO.

In order to be authorized as an SPI, a company will have to meet the following requirements:

- The company is fully funded, which means that all the liabilities of the company have to be fully backed by assets.
- The company has appointed at least two directors, all of whom appear to the Insurance Authority (IA) to be fit and proper persons to hold the positions.
- The company has appointed an administrator as a controller who appears to the IA to be a fit and proper person to hold the position.
- The company complies with the relevant financial, solvency, investor sophistication, and other requirements prescribed by rules made under section 129 or 129A of the IO.
- The company intends to carry on SPB only, but not any other class of insurance business.
- The company has paid the prescribed fees to the IA.

Given the nature of the underlying risks and the potential losses which could be triggered upon the occurrence of a qualifying event, the financial branch of the Financial Services and Treasury Bureau does not consider ILS to be a product suitable for ordinary retail investors. It is therefore intended that ILS should only be marketed and sold to qualifying institutional investors (e.g., dedicated ILS funds and hedge funds) by way of private placement. Funds targeting the general

public (such as Mandatory Provident Funds, occupational retirement schemes, and retail funds authorized by the Securities and Futures Commission) will be excluded from being regarded as qualifying institutional investors. A minimum offering amount will be imposed when selling ILS, and criminal sanctions will be imposed on anyone selling ILS to a person other than a qualifying institutional investor.

Given the ever evolving nature of the financial markets, it was proposed that detailed requirements on the sale of ILS would be prescribed by way of subsidiary legislation.

Originally, the first reading and commencement of the second reading debate on the IA Amendment Bill was set down for 25 March 2020 but meetings of the legislative council have been postponed due to the COVID-19 pandemic.

Conclusion

ILS are attractive to institutional investors as a risk diversification tool as they have little or no correlation with economic cycles or financial market movements. In parallel, ILS allows reinsurers to transfer certain risks to capital markets by securitizing insured risks. This explains why ILS represented about 15 percent of global reinsurer capital in each of the prior three years.

As China rolls out its "Belt and Road" and "Greater Bay Area" initiatives, Hong Kong is in a unique position to tap opportunities in the fast-growing reinsurance market in mainland China, and will benefit from increased ILS activity as mainland Chinese insurers seek alternative tools to manage risks. Notwithstanding the recent trade tensions between China and the United States, facts on the ground point to the fact that Hong Kong continues to act as a bridge between international investors and the mainland China market and remains the largest offshore Renminbi business hub. For example, we have seen a wave of U.S.-listed Chinese companies seeking secondary listings in Hong Kong, which could boost Hong Kong's capital markets. Provided that Hong Kong continues to offer stable and flexible capital markets with free flow of capital, and a sound and independent legal system, we believe that it will continue to be attractive as a hub for ILS, an area with obvious development potential.

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