

G.N. 3768

INSURANCE ORDINANCE (Chapter 41)

Pursuant to section 133(1) of the Insurance Ordinance (Chapter 41), the Guideline on Application for Authorization to Carry on Special Purpose Business (GL33) is published by the Insurance Authority.

This Guideline shall take effect from 30 June 2021.

25 June 2021

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**GUIDELINE ON
APPLICATION FOR AUTHORIZATION
TO CARRY ON
SPECIAL PURPOSE BUSINESS**

Insurance Authority

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1. Introduction

- 1.1 This Guideline is issued pursuant to section 133 of the Insurance Ordinance (Cap. 41) (“Ordinance”) in connection with the regime administered by the Insurance Authority (“IA”) for authorization of special purpose insurers (“SPIs”) to carry on special purpose business (“SPB”) in or from Hong Kong. SPB is defined in section 2(1) of the Ordinance to mean “the insurance business of effecting and carrying out contracts of insurance that are fully funded through insurance securitization”, and the meaning of “fully funded” must be interpreted in accordance with section 2(8) of the Ordinance.
- 1.2 In July 2020, amendments were introduced to the Ordinance by the Insurance (Amendment) Ordinance 2020 to enable the formation of SPIs specifically for issuing insurance-linked securities (“ILS”) in Hong Kong. These amendments subsequently came into effect on 29 March 2021. The SPB which an SPI would be authorized to carry on is a class of business separate from long term business and general business. This regime aims at strengthening the competitiveness of Hong Kong as a global risk management centre.
- 1.3 The operation of ILS typically involves an insurer/reinsurer (“cedant”) setting up and transferring risks to an SPI through a reinsurance/risk transfer contract, which in turn issues ILS to finance the full amount of such risks. As the purpose is to raise capital through securitization, the investors purchasing ILS should not be regarded as carrying on (re)insurance business for the purpose of the Ordinance solely by purchasing or holding such instruments or performing their obligations thereunder.
- 1.4 The core feature of SPB is that it must be “fully funded”, meaning that the value of the assets held by, or on behalf of the SPI for the benefit of the cedant(s), shall at all times be no less than the amount of liabilities borne by it under the reinsurance/risk transfer contract(s) entered into with the cedant(s). Please see **Annex A** for a typical structure of SPB/ILS.
- 1.5 As SPIs operate in a different way from other authorized insurers which carry on long term business or general business, the regulatory regime does not impose the same capital/solvency requirements on SPIs as are applied to other insurers. Instead SPIs are required to be “fully funded”.

2. Interpretation

- 2.1 In this Guideline, unless the context otherwise specifies:
- (a) “applicant” means a person applying to the IA for authorization to carry on SPB in or from Hong Kong as an SPI; and
 - (b) “administrator”, in relation to an authorized insurer that is an SPI (whether incorporated in Hong Kong or outside Hong Kong), means the individual who (alone or jointly with others) is responsible for the administration of the whole business of the SPI.
- 2.2 Unless otherwise specified, words and expressions used in this Guideline should have the same meanings as given to them in the Ordinance.

3. Purpose and Status of this Guideline

- 3.1 This Guideline elaborates on relevant provisions in the Ordinance concerning the regulation of SPIs and supervisory principles and requirements adopted by the IA in relation to SPIs. Prospective applicants should read this Guideline before applying for authorization of an SPI.
- 3.2 This Guideline should be read in conjunction with relevant provisions in the Ordinance as well as other related ordinances, rules, codes, circulars, and guidelines issued by the IA or other regulatory bodies from time to time.
- 3.3 This Guideline does not have the force of law, in that it is not subsidiary legislation, and should not be interpreted in a way that would override the provision of any law. The IA may from time to time amend the whole or any part of this Guideline.
- 3.4 This Guideline does not constitute legal advice. Please seek professional advice if you have any questions relating to the application or interpretation of this Guideline or relevant provisions in the Ordinance.

4. Requirements for Authorization of an SPI

- 4.1 Under section 6(1) of the Ordinance, no person shall carry on any class of insurance business in or from Hong Kong except a company authorized under section 8 or 8A of the Ordinance to carry on that class of insurance business, Lloyd’s or an association of underwriters approved by the IA.

- 4.2 Any company which intends to carry on SPB in or from Hong Kong must apply to the IA to be authorized as an SPI to carry on SPB in or from Hong Kong (SPB being one of the classes of insurance business listed in Part 1 of Schedule 1 to the Ordinance). Under section 2(1) of the Ordinance, an SPI is defined as “a company authorized under section 8A to carry on special purpose business only”, and SPB is defined as “the insurance business of effecting and carrying out contracts of insurance that are fully funded through insurance securitization.”
- 4.3 Section 7(1) of the Ordinance provides that any company may make an application in writing to the IA for authorization to carry on any class of insurance business in or from Hong Kong. A “company” for the purposes of the Ordinance is one formed and registered under the Companies Ordinance (Cap. 622), or one formed and registered under a former Companies Ordinance, including a non-Hong Kong company to which Part 16 of the Companies Ordinance (Cap. 622) applies.
- 4.4 Section 8A(2) of the Ordinance states that the IA must not authorize a company to carry on SPB in or from Hong Kong unless the following conditions are met:
- (a) the company has appointed two or more directors all of whom appear to the IA to be fit and proper persons to hold the positions;
 - (b) 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;
 - (c) the company complies with the relevant financial, solvency, investor’s sophistication and other requirements prescribed by rules made under section 129 or 129A of the Ordinance; and
 - (d) the company intends to carry on SPB only but not any other class of insurance business.
- 4.5 Paragraphs 4.7 to 4.19 below provide further general guidance to applicants on the type of matters the IA will take into account when considering an application for authorization to carry on SPB in or from Hong Kong.
- 4.6 Following authorization, within one month from the date on which the SPI begins to carry on SPB, it must appoint an auditor and serve on the IA a notice in writing stating that it has made the appointment, the date of the appointment, and the name and qualifications of the person appointed in accordance with section 15 of the Ordinance. The SPI and its auditor should also take note of the notification requirements under section 15A of the Ordinance.

Fitness and Properness of Administrator(s) and Directors

- 4.7 An SPI is expected to be run by at least one administrator, whose appointment needs to be approved by the IA in accordance with section 13A of the Ordinance. An administrator shall be regarded as a controller of the SPI as defined under section 13A(12)(a)(iii) of the Ordinance.
- 4.8 Pursuant to section 8A(2) of the Ordinance, the IA must be satisfied that the administrator(s) and directors of the applicant are fit and proper persons to hold such positions in the applicant before it may grant authorization. In considering whether a person is fit and proper for the position, the IA will take into account all relevant factors as set out in section 14A of the Ordinance, including qualifications, experience, ability to act competently, honestly and fairly, reliability and integrity, as well as financial status. The Guideline on “Fit and Proper” Criteria under the Insurance Ordinance (Cap. 41) (“GL4”) also provides general guidance on the matters the IA will consider when assessing the fitness and properness of prospective administrator(s) and directors of SPIs.
- 4.9 The administrator(s) and directors hold important positions in an SPI and are thus expected to demonstrate competence and integrity, to act independently and to avoid conflicts of interest when performing their duties and responsibilities. For this reason, the general principles on how the IA assesses a controller and director’s competence, integrity, and independence in section 3 (factors for determining “fit and proper” persons), section 4 (for individual administrators and directors) and section 5 (for directors who are bodies corporate) of GL4 are applicable to the administrator(s) and directors of SPIs. For the administrator(s), paragraphs 4.1 to 4.3 and 4.8 to 4.11 of GL4 apply while for directors, paragraphs 4.1 to 4.2, 4.5, 4.8 to 4.11, 5.1 and 5.3 of GL4 apply.

Financial and Solvency Requirements

- 4.10 For the purpose of authorization, the SPI must be fully funded, meaning that its full liabilities must be fully backed by assets including funds raised through debt or other financing arrangements (i.e., contractual arrangements) as specified in section 2(8) of the Ordinance.
- 4.11 Section 2(8) of the Ordinance provides that, for the purposes of the definition of SPB, a contract of insurance entered into between an insurer (i.e., the SPI) and a person as the cedant under the contract is fully funded if the value of the assets held under the terms of the contract by, or on behalf of, the insurer for the benefit of the cedant is not less than the amount of the insurer’s liabilities (whether actual or potential) under the contract at any time and under all reasonably foreseeable circumstances, taking into account:

- (a) the obligations of the insurer to the cedant under the contract; and
 - (b) the expenses the insurer expects to incur.
- 4.12 In evaluating whether the financial position and contractual arrangements of an SPI render it fully funded, the IA will consider, including but not limited to, the following factors:
- (a) the aggregate maximum liabilities (whether actual or potential) of the SPI under the reinsurance/risk transfer contract;
 - (b) the expenses the SPI expects to incur;
 - (c) the contractual arrangements or structures that the SPI has put in place to provide for its aggregate maximum liabilities, including the type and amount of assets being held for the cedant(s) under the reinsurance/risk transfer contract;
 - (d) the proposed offering size of the ILS and net proceeds to be received;
 - (e) the arrangements for holding the assets backing the liabilities of the SPI and the legal ownership of such assets;
 - (f) the payment obligations to investors under the contractual documentation in respect of the ILS;
 - (g) financial projections and investment strategies of the SPI, including types of invested assets and future premiums or other payments to be received by the SPI under any binding contractual commitments; and
 - (h) any other matters that the IA considers relevant.
- 4.13 The reinsurance/risk transfer contract between an SPI and its cedant(s) must include a clear and unequivocal limited recourse clause which ensures that the maximum amount recoverable from the SPI under the reinsurance/risk transfer contract is limited to the lower of:
- (a) aggregate limit under the reinsurance/risk transfer contract; or
 - (b) available assets held under the terms of the reinsurance/risk transfer contract by, or on behalf of, the SPI for the benefit of the cedant(s).

- 4.14 An SPI should be “bankruptcy remote” in that the SPI must not be a company within the same group of companies to which the cedant belongs, and the ILS investors must have no recourse to the assets of the cedant, in the event the SPI defaults on its payment obligations under the ILS it has issued. The applicant should obtain written legal advice to confirm the bankruptcy remoteness of the SPI in this respect¹. The applicant should fully disclose this essential feature in the offering and contractual documentation for the issuance of its ILS.
- 4.15 An SPI should expressly make known to all investors and potential investors of the ILS in writing that, under the terms of any debt issuance or other financing arrangement used to fund its insurance liabilities, the rights of providers of that debt or arrangement are fully subordinated to the claims of policy holders (i.e., the cedant(s)) under its reinsurance/risk transfer contract.
- 4.16 In respect of its investment strategies, an SPI should provide full disclosure of the investment guidelines governing the composition of assets to its cedant(s) and investor(s). The scope of disclosure is expected to cover types, issuers, and target credit ratings of the investments.

Sophistication of Investor

- 4.17 The Insurance (Special Purpose Business) Rules (Cap. 41P) (“SPB Rules”) only allows ILS issued by an SPI to be offered, sold to and purchased by institutional investors permitted thereunder (see paragraphs 10.3 and 10.4 below).
- 4.18 The IA expects the applicant and other persons involved in the offering or sale of ILS to comply with the SPB Rules and to disclose the sales restrictions on ILS to potential investor(s). The detailed requirements are set out in paragraph 10 below.

Other Criteria

- 4.19 Pursuant to section 8A of the Ordinance, an applicant is required to demonstrate to the satisfaction of the IA that it is able to meet the criteria below:
- (a) the applicant, as an SPI will have an administrator or at least one director resident in Hong Kong;
 - (b) the administrator(s) has sufficient knowledge and relevant experience of SPB and the administration of ILS in Hong Kong or other jurisdictions to manage the SPI and effectively oversee its activities;

¹ The legal advice should consider, without limitation, the laws at the place of incorporation of the SPI, the cedant and the cedant’s ultimate holding company.

- (c) the applicant keeps and maintains proper accounting and other records at any of its offices in Hong Kong, or offices of its accountant in Hong Kong, and will continue to do so when authorized as an SPI; and
- (d) the SPI, when authorized, will have in place sound and effective corporate governance and risk management frameworks that are proportionate to its risk profile. The frameworks should facilitate effective and efficient operations and address the organizational structure of the SPI, including segregation of duties and management of conflicts of interest.

5 Application for Authorization to Carry on SPB

- 5.1 A prospective applicant for authorization to carry on SPB in or from Hong Kong as an SPI is advised to approach the IA to discuss its proposals before completing an application form which may be obtained via ils@ia.org.hk.
- 5.2 To facilitate discussion, the prospective applicant should provide the IA with all relevant documents it has available at the time in relation to the matters listed in paragraph 4 above. The goal is to enable the prospective applicant and the IA to understand the nature of risks to be securitized, proposed structure of the ILS, targeted investors and administrator(s) involved. The authorization process of an SPI is illustrated in the flowchart at **Annex B**.

6 Information and Documents

- 6.1 The applicant is required to complete and submit the application form together with information and documents for the IA to assess the application, including but not limited to:
 - (a) particulars of the applicant (i.e., the proposed SPI), its prospective administrator(s) and directors, the cedant(s), professional advisors and service providers (with confirmation that such service providers have the requisite licence registration, permission or authorization to perform their services);
 - (b) Form A/Form B of Schedule 2 to the Ordinance for the proposed administrator(s) and directors of the SPI in support of the application for authorization;
 - (c) written and binding undertaking from the SPI and/or written representation from the placement agent(s)/arranger(s) of such proposed ILS transaction, committing to comply with the SPB Rules;
 - (d) types of perils to be covered and respective triggering events;

- (e) investment strategies and types of potential investments;
- (f) financial projections of the SPI for a period of three years or up to the maturity date of the ILS, whichever is longer;
- (g) copies of the financial statements of the cedant(s), where appropriate;
- (h) draft term sheet and draft offering document(s) for the ILS;
- (i) draft indenture;
- (j) draft reinsurance/risk transfer contract to be entered into by the SPI and cedant(s), and in which the aggregate maximum amount of liabilities shall be specified;
- (k) draft contractual documentation for the ILS, specifying the targeted size of issuance, confirmations of fully-funded arrangement², bankruptcy remoteness arrangement, assets custodial arrangement and sales restrictions clauses³; and
- (l) a detailed written explanation of how the SPI will, for as long as it remains authorized, satisfy the “fully-funded” requirement, drawing reference to relevant terms in the documents listed in this paragraph.

7 Fees Payable

- 7.1 There is no need to pay any fee on submission of an application.
- 7.2 Payment of an annual fee is required upon authorization of an SPI and on each subsequent anniversary date of authorization. The annual fee payable under section 13(1) of the Ordinance is prescribed in the Insurance (Authorization and Annual Fees) Regulation (Cap. 41C).

² The applicant is required to take into account liabilities arising from the reinsurance/risk transfer contract and operating expenses throughout the period when obligations borne by the SPI are in force.

³ The SPI should cause the sales restrictions enshrined in the SPB Rules to be appropriately disclosed in the contractual documentation of ILS primary issuances and use its best efforts to procure subsequent purchasers to make similar disclosure in contractual documentation of ILS secondary transactions.

8 Reuse of SPI and Roll Forward of Reinsurance/Risk Transfer Contract

- 8.1 An SPI or its cedant(s) shall declare when making its application to the IA as to whether the SPI is intended to be reused for other ILS transactions in future. If so, the SPI must obtain confirmation from the IA that there is no objection before it enters into any reinsurance/risk transfer contract to be backed by a new ILS issuance. In considering whether to object to the reuse of SPI, the IA expects the SPI to provide updated information and documents relating to the proposed new ILS transactions, including those set out in paragraph 6.1 above.
- 8.2 If the SPI is intended to be reused for issuance of a series of ILS or to be reused by renewing a reinsurance/risk transfer contract or used/reused to roll forward all or part of the assets which were used originally to fully fund the matching liabilities, the contractual documentation must disclose the allocation of assets to different contracts and the aggregated limit of each contract in order to demonstrate that the SPI will meet the fully-funded requirement at all times.

9 Filing Requirements on SPI

- 9.1 Section 17(1) of the Ordinance provides that:

“Every authorized insurer shall, in accordance with section 20, submit to the Authority accounts, statements and other information as required by Schedule 3, and the information so submitted shall be in accordance with section 8(4).”
- 9.2 Sections 20 and 21 of the Ordinance set out certain requirements relating to submission of accounts, statements and other information to the IA and the Registrar of Companies, respectively.
- 9.3 Under section 8C of the Ordinance, the IA may modify or vary any requirements under section 17, 20 or 21 in relation to an SPI for the period and in the ways as it considers appropriate. Due to the unique nature of SPB, SPIs will be subject to simplified reporting requirements, the details of which will be communicated to the SPI and formalized at the time of authorization. In general, SPIs shall submit the required information in standard returns specified by the IA (which shall include a director’s report, balance sheet, revenue account and profit and loss account, and other information as the IA considers necessary).

10 Restrictions on the Sales of ILS

10.1 The SPI and other persons involved in an ILS transaction must not contravene the SPB Rules governing the offering or selling of ILS in respect of primary issuances as well as transactions in the secondary market. An applicant must fully disclose these restrictions in contractual and offering documentations for the ILS that it issues.

10.2 Rule 3(1) of the SPB Rules limits the scope of persons to whom ILS may be offered or sold. The relevant provisions are:

“A person must not enter into, or offer to enter into, an agreement with another person, or invite or induce, or attempt to invite or induce, another person to enter into an agreement, for that other person to acquire, subscribe for or underwrite insurance linked securities, or to dispose of insurance linked securities to that other person, unless:

- (a) that other person is an eligible ILS investor;*
- (b) that other person is not a person mentioned in subrule (2); and*
- (c) the consideration for which the insurance linked securities are to be acquired, subscribed for, underwritten, or disposed of under the agreement is not less than US\$250,000 or the equivalent of such amount in other currencies.”*

10.3 Rule 3(4) of the SPB Rules limits eligible ILS investors to:

- (a) banks or authorized financial institutions;
- (b) insurance companies (including reinsurance companies);
- (c) licensed corporations;
- (d) other corporations carrying on business of the provision of investment services and regulated under the laws of any place outside Hong Kong;
- (e) governments, central banks and multilateral agencies;
- (f) authorized exchange companies; and
- (g) collective investment schemes excluding those promoted, offered, or sold to the public in Hong Kong and required to be authorized by the Securities and Futures Commission (“SFC”).

- 10.4 Rule 3(2) of the SPB Rules reinforces the prohibition against offering or selling ILS to retail investors by excluding from the persons to whom ILS may be offered or sold, retail funds authorized by the SFC, Mandatory Provident Fund (“MPF”) schemes and funds, approved pooled investment funds into which MPF funds could invest, occupational retirement schemes and any person in the capacity as operator of such schemes.
- 10.5 Given the definition of ILS in section 129A of the Ordinance, the prohibitions on offering or selling of ILS also apply to any financial products backed by ILS (i.e., repackaged products) or which derive their value from ILS as underlying assets (i.e., derivatives).
- 10.6 Rule 3(1)(c) of the SPB Rules further imposes a minimum investment size of US\$250,000 or equivalent for each ILS transaction. An SPI and ILS investor must not sell or offer to sell any ILS below this threshold which must be disclosed in contractual documentations.
- 10.7 An SPI is required to implement adequate procedures to ensure that existing and prospective investors are persons to whom ILS may be offered or sold or by whom ILS may be purchased under the SPB Rules. An intermediary involved in an ILS transaction must also observe the sales restrictions in the SPB Rules as well as guidelines, codes, circulars, and other requirements issued by the IA and other regulatory authorities from time to time.
- 10.8 Any person who contravenes the SPB Rules commits a criminal offence and may be subject to the penalties stated therein. Applicants are reminded to comply with applicable requirements imposed by other regulatory authorities.

11 Enquiries

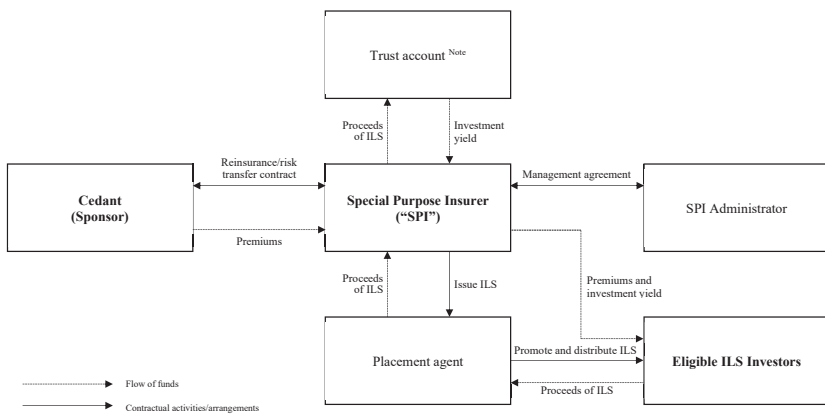
- 11.1 If you have any questions regarding application for authorization, please write to the IA by email to ils@ia.org.hk.

12 Commencement

- 12.1 This Guideline shall take effect from 30 June 2021.

June 2021

Typical Structure of Special Purpose Business/Insurance-linked Securities (“ILS”)



Note: The proceeds of ILS are held on a trust account and invested in accordance with investment guidelines.

Authorization Process of Special Purpose Insurer (“SPI”)

