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Essays on Improving the Regulation and Supervision of Insurance in PR China

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Essays on Improving the Regulation and Supervision of Insurance in PR China

Submitted

by

Chengming Li

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Abstract

This thesis consists of six chapters dealing with several issues related to the common theme of improving the insurance regulation and supervision in China based on China's realities and experience drawn from some selected regimes. Chapter 1 provides an overview of China's insurance industry and its regulatory framework with an aim at providing a platform for deeper discussions in the following chapters. In particular, it reviews the 2002 revision of *PRC Insurance Law*.

Chapter 2 critically examines the liberalisation process, competition issues and relevant legal framework in China's insurance sector in the context of the WTO accession and the international convergence of regulatory standards and practices.

Chapter 3 examines how China's insurance regulation and supervision can be effectively and efficiently improved by the implementation of market-based approaches, shifting some of responsibilities for supervision onto insurance firms and the insurance industry through greater corporate governance, active self-regulation by the industry, and reinforced insurers' transparency.

Chapter 4 addresses issues on the restructuring of China's insurance prudential regulation and supervision from four sides: the inefficiency of solvency management existing in the insurance industry, the framework of prudential regulation, the upgrade of *early warning system,* and the need to establish policyholder protection funds.

Chapter 5 demonstrates the urgent needs for both relaxing restrictions on insurers' investment and improving investment regulation, and discusses a set of regulatory measures that would both facilitate insurers' effective portfolio management and safeguard the soundness of the insurance sector.

Chapter 6 examines rate regulation and impacts of rate deregulation in China's non-life insurance markets, focusing on auto insurance as a typical case. By drawing experience from the rate regulation in the US property and casualty insurance, it shows that China needs certain legal environment to escort a gradual liberalisation of rate control.

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List of Abbreviations

ADB	Asian Development Bank
AIG	American International Group (US)
ALM	asset/liability management
CCCP	the Congress of the Chinese Communist Party
CEO	chief executive officer
CIRC	China's Insurance Regulatory Commission
CPIC	China Pacific Insurance Company
CSRC	China's Securities Regulatory Commission
DRC	Development Research Centre of the State Council, China
EC	European Commission
EU	European Union
FDI	foreign direct investment
FFIC	foreign-funded insurance companies
FSMA	Financial Services and Markets Act (the UK 2000)
GATS	The "General Agreement on Trade in Services"
GDP	gross domestic product
IAA	International Actuarial Association
IAC	The Insurance Association of China
IAD	Insurance Accounting Directive, the EU
IAIS	International Association of Insurance Supervisors
IASB	International Accounting Standards Board
IBNR	provision incurred but not reported
IRIS	Insurance Regulatory Information System (the US)
JV	a joint venture company
NAIC	National Association of Insurance Commissioners
NPC	the National People's Congress of China
PBOC	People's Bank of China
PICC	the People's Insurance Company of China
PPF	policyholder protection funds
PRC	People's Republic of China
OECD	Organisation for Economic Co-operation and Development
RBC	risk-based capital
Rmb	renminbi
SIFs	securities investment funds
SIM	a single insurance market
SOEs	state-owned enterprises
UK	United Kingdom
US	United States
WTO	World Trade Organisation

Introduction

This thesis is structured into six chapters concerned with different, but interwoven facets of improving insurance regulation and supervision in China.

a. Background

Insurance regulation can be broadly defined as a mechanism to govern the conduct of the participants in insurance markets.[1] It can be viewed from two broad angles: governmental regulation (involving the three aspects of its legislative, judicial and administrative functions) and self-regulation by either the insurance industry or insurance firms, or both.[2] Insurance supervision is "part of the executive power" for on-going supervision of the participators in the insurance market, which is normally carried out by an insurance supervisory authority.[3]

Regulation and supervision, as part of the means by which regulators attempt to improve the efficiency and safety of insurance markets, exist world-wide, and vary in different countries.[4] Insurance sectors in most developed countries have been experiencing a process of regulation, deregulation, and re-regulation. With advances of globalisation and liberalisation, competition in insurance markets has been becoming fiercer, and the role of insurance regulation and supervision is growing. Weak

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[1] See Brady, J.L., Mellinger J.H. & Scoles, K.N., (1995) *The Regulation of Insurance.* Insurance Institute of America p1-2 (1995). Developing a commonly accepted definition of insurance regulation seems to be difficult, because regulation itself, which includes insurance regulation as one specific type of regulation for the insurance market, is difficult to define because of the wide diversity of theories and views of regulation. As for a description of such diversity, see Mitnick, B. M (1980) *The Political Economy of Regulation: Creating, Designing and Removing Regulatory Reforms,* New York: Columbia University Press, p5-7.

[2] As for a brief description of insurance regulation, please see "Regulation", "Glossary of Insurance Policy Terms" OECD (2938) 1999, p72.

[3] *Id.* "Supervision", p87.

[4] For a deeper look at the divergence of insurance regulation and supervision in different countries, see Werner Pfennigstorf (1996) *Public Law of Insurance*, Volume IX, *International Encyclopaedia of Comparative Law* J.C.B.Mohr (Paul Siebeck), Tubingen, and Martinus Nijhoff Publishers. Also see "Insurance Regulation in OECD Countries, Asian Economies and CEEC and NIS Countries", and "Comparative Tables on Insurance Regulation and Supervision in OECD Countries (Paratte Report)" the Organisation of Economic Co-operation and Development (OECD) 2001, both available at <http://www.oecd.org>

regulation and supervision can be seen as the central causes of the financial crises that hit South East Asia, Russia and Latin America in recent years. This sounded the alarm to financial regulators. How create an effective and efficient insurance regulatory and supervisory system is a difficult issue facing regulators all over the world.

Along with the ever-deepening penetration of economic reforms, the Chinese insurance market is booming and playing an increasingly important role in the national economy.[5] During 1980-2002, insurance premium income grew at an average annual rate of nearly 34.4% which is much higher than the 15.65% nominal average annual growth rate of the GDP.[6] However, the market, although enjoying an enormous potential, [7] is still in its infancy.[8] The Chinese insurance sector is facing many constraints. The main problem is that the insurance industry, having been in a process of high-speed development in the last decade, is revealing a state of insufficient solvency as a whole industry. This is incidentally evidenced by features such as the major national insurers' low level of capitalisation and low level of solvency ratios, along with their low operation profitability in both underwriting and investment. Moreover, life insurers especially suffered huge losses due to negative interest margins since the People's Bank of China (PBOC) cut interest rates seven times. There exists a general lack of insurance awareness for consumers in China. Professional and service standards are currently low, which restricts the growth of the market, while shortages of actuaries and professional insurance management staff have contributed to poor business practices by insurers. The sector also suffers from the immature legal

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[5] For a discussion on the role of insurance in economic development, see Harold D. Skipper (1997) "Foreign insurers in emerging markets: issues and concerns" *Centre for Risk Management and Insurance*, Georgia State University, Occasional paper 97-2.

[6] It is estimated that the real annual growth rate of premium income during 1980-2001 is 20% whereas the real rate of GDP is 9.7%.

[7] It believes that China has many economic and social indicators of robust growth in its insurance demand. The ever increasing progress of the socio-economic development, the sustained GDP growth, the ever growing international trade, the increasing urbanisation and industrialisation, the enlargement of a middle class along with accumulation of people and wealth, the aging population, and the government's plan to transfer the social security and health care systems into the private sector, all indicate the growing dimension of risks and suggest the future demand for insurance business will be high in the decades to come.

[8] For example, measured by total premium volumes, in 2000, the size of the China insurance market (US$19,278mn) was only 8.1% of the UK market (US$236,960mn). See 2.3.5 "The combination of policies: opening up and protectionism", Chapter 2.

framework that is largely out of line with both the requirements for the industry's development and international standards and practices in a number of respects. Problems are related to the deficiency that exists in insurers' corporate governance and the industry's self-regulation and to the stiff regulation that bottlenecks insurers' investment. Many aspects of the current prudential regulatory and supervisory system need to be upgraded, and a gradual deregulation of prices is desirable. Other problems existing in the current system include the lack of an effective claims handling mechanism, the low level of truthfulness of and the poor information disclosure by insurance firms. In addition, China's legal system (including insurance legal system) relies too heavily on administrative bodies; rule of law reforms need to be strengthened.[9] Furthermore, China has to liberalise the insurance market to meet its obligations as a member of the World Trade Organisation (WTO), which makes competition in the market fiercer.

Along with the speeding up its transition to a market economy in a comprehensive way, China is to develop a modern and viable insurance market. Further boosting the development of the market needs a fair, competitive external environment and especially a suitable legal infrastructure[10] that is consistent with China's realities, WTO requirements, and emerging international regulatory standards. How to improve China's insurance regulatory and supervisory system based on China's realities and the overseas experiences so as to provide a fitting legal environment for sustainable development of the industry is an important issue calling for in-depth researches and discussions.

b. Objectives

This study selectively addresses issues on five inter-related aspects that appear to be urgent on improving the regulation and supervision of insurance market in China.

[9] A perfect legal system should be a trinity of legislation, jurisdiction, and administration. Legislation is the basis; jurisdiction is the crux whereas administration should be only complementary. In China, rampant judicial corruption seriously damaged public confidence in the legal system. See Editorial Comments. *Renmin Sifa (People's Judicature)* 1998 No.8, p1-3. In recent years, China has adopted strict measures to sort out this problem.

[10] Generally, in order to play its economic and financial roles, the insurance sector requires preconditions for its growth. Ultimately, the growth in per capita income and an improvement in distribution are major determinants of the growth of insurance demand. A stable macroeconomic environment and the existence of strong corporate governance promote the development of the sector and the confidence of business. A strong and consistent regulatory and supervisory system is needed for safeguarding the stability of the sector and the solvency of individual firms and protecting the interests of policyholders.

Areas covered include the opening up and liberalisation, market-based regulatory approaches, prudential regulation, investment regulation and market-oriented reforms on rate regulation. These selected areas are crucial to the insurance industry development in China, and probably are so for those in other emerging economies. The objectives of this study are to provide an overview of the regulatory and supervisory systems of China's insurance sector and probe some essential issues on improving the systems. More specifically, as a basic train of thoughts, this research seeks:

- to review the development of main aspects of regulatory and supervisory systems in the selected areas;
- to assess current situation of the systems, identify their strengths, vulnerabilities and risks;
- to ascertain their development needs;
- to compare and evaluate the systems with their counterparts in the US, the EU, and other regimes, and measure the systems against the standards developed by the International Association of Insurance Supervisors (IAIS) and other related international organisations, *e.g.* WTO, OECD, the European Union (EU), etc; and as a result,
- to make some recommendations hopefully helping strengthen the China's insurance regulatory and supervisory systems in the selected areas.

c. Research methodology

The study was carried out by using a set of research methods. It combines literature reviews, fieldwork, and analyses based on theoretical studies and author's past work experiences in law teaching, legal and accounting practices. The research findings, judgements, conclusions and recommendations have been reached by adopting comparative studies, economic analyses, quantitative and qualitative analyses while taking into views and opinions of scholars and experts.

The study has been based on a variety of primary sources (mainly statutory materials of international organisations and national jurisdictions) and secondary sources (the major reference sources: China Insurance Almanac 1998, 1999, 2000 and 2001 editions, China Statistics Almanacs, and China Economy Almanacs). As the draft of this thesis was completed in 2002, most primary sources, especially China's insurance law, regulations and rules, are those dated before 2003, except a few being updated to April 2003. Due to the availability of materials, information about the Chinese

insurance market are largely dated before 2001, with some being updated to the end of 2002. Basically, the secondary information about the evolution and current situations of insurance markets in China and some developed countries such as the US and the UK are from published documents and articles, and from information in publications of firms related to insurance business. They are mainly through such channels as related magazines, newspapers and websites. To further look into the situation of the Chinese insurance market, the author carried out investigations including some observations and interviews.

d. Basic assertions

Overall, this thesis asserts that the strategies for improving China's insurance regulatory and supervisory systems in the short-term and medium-term should aim to achieve the following objectives: protecting insurance entities' (especially policyholders) legitimate rights and benefits in the market; strengthening the financial resilience of insurers and safeguarding the stability of the market; increasing the industry's overall competitive ability in the post-WTO environment; combining market disciplines with government regulation and supervision, and balancing the fairness and efficiency of the market. To better integrate into the global market, China needs to actively adopt best practice in the world. It advocates the IAIS's assertions that as a transitional economy, insurance system reforms in China by drawing on overseas experiences and practices must take into account China's realities.[11] In addition, China needs to adapt the systems to changing conditions.

The remainder of this introduction briefly reviews each chapter which applies the above basic assertions to the process of specific issue research.

e. A brief description of each chapter

Chapter 1 provides a general observation on China's insurance industry and its regulatory framework with the aim of providing a background and a platform for further deeper discussions in the following chapters.

During the past decade, the insurance markets world-wide have been undergoing an unprecedented evolution in terms of their market structure, products and services, and their scope of operations and transactions, and firms' organisational structure. This

[11] "Guidance on Insurance Regulation and Supervision for Emerging Market Economies" IAIS September 1997.

evolution is being spurred by national and global competition, the integration of financial services markets, along with other economic, demographic, political, and technological forces. Subject to increasing external and internal pressures, insurance regulators world-wide have engaged in unprecedented efforts of regulation and supervision in an attempt to build a pro-competitive environment facilitating market innovations meanwhile protecting public interest. Section 1.2 provides an overview of this trend, generating its implications for China.

Since the founding of the PRC, the Chinese insurance industry and insurance regulatory and supervisory systems have undergone a long and tortuous process. Section 1.3 identifies the three stages of China's insurance development followed by analyses of the main factors that underlie achievements of the insurance sector in the last decade. It then discusses main problems facing the sector. Section 1.4 briefly reviews the history of China's insurance legislation and then outlines the current legislation framework. Section 1.5 as a main part of the chapter, introduces the first revision of the 1995 Insurance Law, and discusses the issues that are not (or not fully) covered by the new law. The chapter ends with a brief conclusion.

Chapter 2 deals with the issues on opening up and liberalisation of the market. As a member of the WTO, the liberalisation of foreign investment in the insurance market is inevitable. The urgent issue facing China's regulators is how to create a legal environment which enables China to initiate the useful and abolish the harmful of the opening up while honouring its commitments to the WTO. Beyond this, a broader issue is how to deal with the whole range liberalisation of the insurance sector.

The section 2.2 reviews the efforts to define the liberalisation in the insurance markets and practices concerning market access liberalisation in both developed and developing countries. These are followed by discussions on their implications for China. Section 2.3 focuses on insurance market opening up and liberalisation in China. It outlines the provisions concerning insurance in GATS as well as China's commitments. Then, it discusses a specific regulation concerning foreign direct investment (FDI) in the insurance sector, the *2001 Regulation for Administration of Foreign Funded Insurance Companies* (FFIC Regulations). Following this, the combined policies of opening up and local protection adopted by China are identified and analysed. Section 2.4 provides an observation on unhealthy competition seen in the market, which raises requirements for market liberalisation in a solid and step-by-step

manner in order to cultivate a competitive and efficient market. The chapter ends with addressing some regulatory issues relating to the liberalisation.

Effective insurance regulation can hardly be realised without the co-ordination of insurance firms and the insurance industry with regulatory authorities. As low quality of management is a common failing of Chinese state-owned insurers and one root of rampant unhealthy competition, improving the equality of insurers' management is crucial. Chapter 3 probes how insurance regulation and supervision within China could be improved by strengthening insurers' corporate governance and information disclosure and self-regulation of the insurance industry. Section 3.2 reviews the conceptual framework and importance of corporate governance for insurance regulation, and then observes the current situation of state-owned insurers' corporate governance which is not encouraging. It also examines two current topics: listing and shareholding, and presents the recommendations on the enhancement of corporate governance in the Chinese insurance sector. Section 3.3 examines the importance of information disclosure by insurers, the situation in China, and necessary measures needed for further improvements. Section 3.4 describes the current situation of self-regulation in the Chinese insurance industry and discusses areas to be enhanced.

The Chinese insurance sector is in a transition from a material regulation to a combination of prudential regulation and market performance regulation, with a future advance towards focusing on prudential regulation. To these ends, it is essential to restructure the current prudential regulation and supervision framework. Chapter 4 aims to discuss some selected issues on the restructuring by drawing on lessons of prudential regulation in the regimes of the US, the European Union (EU) and the IAIS. Section 4.2 observes current trends and developments of prudential regulations in some regimes. Section 4.3 examines the basic situation of solvency and risk management in the Chinese insurance industry, identifying and analysing deficiencies in the industry. Section 4.4 then provides an overview of and comments on the framework of prudential regulation and supervision in China. Section 4.5 discusses the issues on early warning system and section 4.6 deals with the issues concerning the establishment of policyholder protection system in China. The chapter concludes with some recommendations on improving prudential regulation and supervision in China.

The Chinese insurance industry has been suffering from severe investment deficiencies in terms of volume of and return on investment, which threat insurers' solvency and their further development. The problem can be traced back to a number of

causes, including strict restrictions on insurers' investment channels long imposed by the government, various immature markets, and insurers' unsophisticated investment skills. How to loosen government restrictions and create an appropriate legal environment for rational insurance investment are the issues to be addressed urgently.

Chapter 5 starts with a brief review of roles of insurers' investment, investment risks and the related regulatory issues. Then, section 5.3 provides an overview of the regulatory framework governing insurers' investment in China, together with a brief overview of the development of insurers' investment. Section 5.4 identifies the main problems in the investment to demonstrate the urgent needs for relaxing restrictions on the investment and improving investment regulation. Section 5.5 highlights that it would hardly archive a sound interaction between insurance funds and capital markets in the absence of insurers' efficient investment management and supportive infrastructure and effective regulation in the both sectors. Mainly based on "Selected Principles for the Regulation of Investments by Insurance Companies and Pension Funds"(OECD, 2000), section 5.6 discusses a set of issues related to creating a legal environment for insurers' effective portfolio management and risk control and at the same time safeguarding the soundness of the Chinese insurance sector. The chapter concludes by presenting some recommendations.

Finally, China has undergone reforms on its stiff insurance rate regulation over the past decade. The objectives are to accelerate competition among insurers thus expanding the options, service, and quality opened to consumers, ensure innovative new products reaching market quickly, and reduce negative effects of rate regulation. The *2002 Insurance Law* sets forth bases for premium rate regulation and deregulation. The following task is to improve the prior approval and file-and-use systems. As a transitional economy, China needs cautiously to adopt a comprehensive approach to rate deregulation by learning lessons from developed countries and taking into account realities and the needs of China. Section 6.2 in Chapter 6 presents some observations and discussions on rate regulation in property/casualty insurance in the US, with a focus on Californian Proposition 103, which could enlighten the rate reform in China. Section 6.3 gives a brief description of and comments on rate regulation in the insurance market. Then, section 6.4 focuses on rate regulation and deregulation in the auto insurance as a typical case, which is followed by discussions in section 6.5 on the finding that the current situation does not fit for market-based pricing. The chapter

concludes with some recommendations on appropriate measures that are needed to escort rate deregulation.

Chapter 1
Insurance industry and regulation system in China: general observations

1.1 Introduction

The insurance industry of China revived in 1979. Since then, after more than two decades of development, the industry has made great progress and played an ever more important role in China's socialist market economy. Meanwhile, the government has been steadily establishing a legal framework for the industry. This chapter provides an overview of China's insurance industry and its regulatory and supervisory system with the aim of providing background and a platform for further deeper discussions in the following chapters. Section 1.2 is an overview of insurance regulation and supervision. Section 1.3 provides a panoramic sight of the development of the Chinese insurance industry. In particular, it identifies factors that underlie achievements of the insurance sector in the last decade and main problems facing the sector. Section 1.4 briefly reviews the history of China's insurance legislation and then outlines the insurance legislation framework. Section 1.5, as the main part of this chapter, introduces the first revision of the *1995 Insurance Law*, and discusses some issues that are not (or not fully) covered by the new law. The chapter ends with a brief conclusion.

1.2 An overview of insurance regulation and supervision

1.2.1 Insurance regulation and market disciplines

Why regulate insurance business? Legislators, regulators, academics, professionals, and the regulated view this question from various angles: the objectives, rationale, and reasons of insurance regulation. In practice, these three aspects do not always coincide. The objectives of regulation normally refer to the purposes or the outcome it is trying to secure, the rationales of regulation explain why regulation is justified on economic and social criteria if the objectives are to be achieved, and the reasons for regulation

often deal with why in practice regulation takes place or its motivation.[1] Almost every law, regulation, rule, and ordinance on insurance manifests its general or specific regulatory objectives. Some of these objectives focus on making the insurance market operate productively, *e.g.* to maintain the safety and solidity of insurance undertakings, to facilitate development of an insurance market (mainly by promoting the efficiency of the market), or to defend the fairness, equality and reasonableness of insurance transactions. Some emphasise economic considerations which go beyond the frame of the insurance industry, *e.g.* to provide a supporting function in the development of the national economy, to complement social security, to control accumulated insurance funds and channel these funds to where the overall national economy is in need, or to assist control of foreign currency. There are also objectives that target social and political aspects, for example, to protect consumers (policyholders), and to execute local protectionism (including protecting the local insurance industry and the national economy).[2] Specific objectives in different countries and different periods vary, whereas in recent years there is an increasingly and commonly accepted view that the core objective of insurance regulation and supervision is to maintain efficient, fair, safe and stable insurance markets for the benefit and protection of policyholders.[3]

The rationale for government intervention in insurance market is justified by the regulatory function of addressing market failure. Western economies praise highly the principle that perfectly competitive markets ensure an improvement in social efficiency without any regulation.[4] The model of *perfect competition* has four assumptions: (1) many firms are in the industry, but each one produces an insignificant portion of total industry supply, and therefore has no power to affect the price of the product; (2) there are no barriers to entry into the industry; (3) all firms produce a homogeneous product;

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[1] See David Llewellyn (1999) *The Economic Rationale for Financial Regulation* the UK FSA Occasional Paper p8.

[2] Kimball divided the objectives of insurance regulation into two categories: the internal objectives and external objectives. The former centres on operation of insurance industry, while the latter concentrates on certain important public policies. See Kimball S.L. (1969) "An Approach to a General Theory of Insurance Regulation"

[3] Insurance Core Principles Methodology IAIS 2000.

[4] The neo-classical school of economics suggests that a highly competitive and fully informed market will result in an optimal allocation of resources. Consumers in such a market will purchase the products that maximise their own personal benefits by knowing the products and the prices. This will not permit inefficient providers to prosper, and therefore, no demand for regulation.

and (4) both producers and consumers have perfect knowledge of the market.[5] However, as economists admitted, *perfect competition* does not exist in reality. It is also widely recognised that even a perfect market can fail to produce efficient outcomes for a variety of reasons such as *externalities, imperfect competition, market misconduct,* and *information inadequacy and asymmetry.* Therefore, governments need to correct market failure by regulation.

On the other hand, the market is considered to be capable of playing a crucial role in disciplining participants. Western economists usually apply the *structure-conduct-performance* model as a basic framework for analysing insurance markets. According to Scherer and Ross,[6] the basic hypothesis of the theory is that market structure determines market conduct, which in turn determines market performance.[7] Furthermore, they believe that a market with easy entry and exit and a relatively large number of operators causes firms to behave independently and competitively, which, in turn, leads to good market performance. Western economists consider that competition facilitates the efficiency of markets in allocating resources.[8] When evaluating the structure and performance of insurance markets, they also often use the concept of *workable competition* as a benchmark.[9] They acclaim that in an insurance industry with

[5] John Sloman *Economics* 3rd ed. *Prentice Hall* 1997. Chapter 11.

[6] Scherer F. M. and David Ross (1990) *Industrial Market Structure and Economic Performance*, 3rd ed. *Rand McNally* Chicago.

[7] *Market structure* contains a series of factors; the most significant are: the number of buyers and sellers and their size distribution, the height of barriers to access to/ exit from the market, cost structures, the character of buyer and seller information, and the degree of product differentiation. *Market conduct* refers to the actual behaviour (*i.e.* degree of independence) of firms in operation, *e.g.* setting prices and output levels, product design, advertising, innovation, and capital investment. *Market performance* is the actual results of company operations. It includes, for example, price, profit, output levels, solvency, efficiency of production and allocation, the rate of technological progress, and equity. This note is heavily drawn from Robert W. Klein (2001) "Conceptual framework for analysing insurance markets" Centre of Risks and Management, Georgia State University.

[8] John Sloman *Economics* 1997 Chapter 11.

[9] The concept of *workable competition* was developed to analyse the necessity of regulation or other forms of government intervention. According to Scherer and Ross, workable competition arguably exists when the structural characteristics of a market reasonably approximate the conditions for *perfect competition* and government intervention cannot improve the performance of the market. See *supra note* 6.

workable competition, the market is relatively diluted[10] and very diverse in terms of sellers, buyers, products, and distribution systems, and entry barriers are low. This competitive market structure leads to competitive conduct and good market performance, while profits appear to be in line with other industries of similar risk. Therefore, government intervention can hardly improve market performance significantly.[11] However, the market function in *workable competition* conditions could be distorted in the presence of inadequate information or distorted incentives.[12]

The need for regulation and the crucial part of market disciplines raise the question of properly balancing and integrating the two parts. The insurance regulation around the world continues to evolve as time goes on. Largely, changes in the last decade emerged in response to the driving forces such as globalisation, liberalisation, and technological advance, and in an effort to marry (sometimes the conflicting) objectives of market stability, efficiency and consumer protection. New approaches to regulation emphasise regulatory efficiency, market discipline, self-regulation by insurance industry and insurance firms, and prudential regulation. These regulatory methods represent a further shift away from command and control styles of regulation. In addition, the development and implementation of international standards of regulation and supervision are put on an increasing important place with the spreading of globalisation.[13]

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[10] Insurance industries usually use the 5-firm/10-firm concentration ratio (the market share of the top five/ten insurers) and the *Herfindahl-Hirschman Index* (the sum of the squared market shares of all insurers) to measure the market concentration. The merger guidelines established by the *Department of Justice* of the US consider markets with HHIs in excess of 2,000 to be highly concentrated, and, hence, mergers in such markets are subject to closer scrutiny. The US insurance market's HHI values are said to range from 184 to 808, with most lines falling between 200-300. The market is therefore generally considered competitive. See Robert W. Klein (2000) "Overview of the Insurance Market" *Centre of Risks and Management, Georgia State University*

[11] See Robert W. Klein (2000) "The Economics of Insurance" *Centre of Risks and Management, Georgia State University*

[12] See "Guidance on insurance regulation and supervision for emerging market economies" IAIS, 1997

[13] See David Zaring "International law by other means: the twilight existence of international financial regulatory organisations" *Texas International Law Journal* Spring 1998, and Thomas Oatley "The dilemmas of international financial regulation" *Regulation* Vol. 23 No.4

1.2.2 Internationalisation of regulation

The IAIS[14] and some international organisations (e.g. UN and OECD) are endeavouring to address regulatory divergence in insurance markets through proposing international standards and other harmonising activities, *e.g.* training and seminars. One paper of standards is "Insurance Core Principles Methodology" (the Methodology), which explains in detail the "Insurance Core Principles" (the Core Principles) issued by the IAIS. The methodology intends to provide criteria that enable IAIS members to conduct comprehensive, precise and consistent self-assessments of their compliance with the Core Principles. The other document that is particularly important for emerging economies is "Guidance on insurance regulation and supervision for emerging market economies", which probes roots of problems in insurance markets in merging economies and provides suggested measures and action plans to solve the problems.

1.2.3 Regulation vs. efficiency, cost-effectiveness

OECD countries underwent the first generation of regulatory reforms in the 1990s following the privatisation/deregulation experience that began in the 1970s.[15] The reforms, a "transition from state-led to market-led growth"[16], had a "fundamental objective to improve the efficiency of national economies and their ability or adapt to change and to remain competitive."[17] This was archived by enhancing "the performance, cost-effectiveness, or legal quality of regulations and related government

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[14] The IAIS was established in 1994 as a non-profit corporation in which insurance regulators and supervisors from more than 100 jurisdictions participate. It's aims are to: promote co-operation among insurance regulators; set international standards for insurance supervision; provide training to members; and co-ordinate work with regulators in the other financial sectors and international financial institutions. The IAIS is continuing to develop principles, standards and guidance papers of international standards for insurance regulation. See <http:www.iais.org>

[15] The roots of the reforms are the hidden costs of out-dated, rigid, and expanding regulation which revealed in "oil shocks, currency volatility and declining tariffs, growing awareness of the complexity of environmental degradation, and rapid regulatory inflation" in 1970s and 1980s. See "The OECD report on regulatory reform" OECD (2838) 1997. p14.

[16] Scott H. Jacobs (1999) "The second generation of regulatory reforms" Speech for IMF Conference on Second Generation Reform 8-9 November 1999, p1, and supra note 15.

[17] *Supra* note 15, p10.

formalities".[18] Accordingly, as a part of the reforms, there was a shift in insurance regulation from focusing on security to balancing between security, competitiveness, and regulatory cost-effectiveness.

In the past several years, some developed countries highlighted cost-effectiveness and competitiveness in insurance regulation (and in the regulation of banking, securities and other financial institutions), explicitly placing the two standards as regulatory priorities. For example, the *Financial Services and Markets Act* (FSMA) of the UK (which came into full effect on December 1, 2001) sets out the statutory principles of good regulation.[19] They emphasise: "the need to use the Financial Services Authority (FSA) 's resources in the most efficient and economic way; the responsibilities of senior management of regulated firms; the principle that a restriction imposed on a person or a firm should be proportionate to the benefits derived; desirability of facilitating innovation; desirability of facilitating competition; the desirability of maintaining the competitive position of the UK; and the need to minimise the adverse effects on competition in discharging the FSA's functions." The FSMA also requires the FSA to undertake and publish, as part of the consultation process, a cost benefit analysis of its proposed rules, or proposed general guidance on rules. In addition, the FSA is required to explain why it believes that making the proposed rules is compatible with its general duties (principally the statutory objectives and the principles of good regulation).[20] In its major report, "The future regulation of insurance",[21] the FSA detailed the action which the FSA had taken and stated its

[18] "Recommendation of the Council of the OECD on improving the quality of government regulation" OCDE/GD(95) March 1995. For the summary of benefits of the regulatory reforms, see Scott H. Jacobs (1999), supra note 16.

[19] FSMA art. 2.

[20] FSMA art. 6.

[21] Available at <http://www.fsa.co.uk>

intention to significantly change its style of, and approach to, insurance regulation.[22]

In the US, the Gramm-Leach-Bliley Act (GLBA), signed into law in November 1999, was proclaimed as bringing financial modernisation to the US and rationalising the US financial regulatory structure.[23] The Act created a new type of entity called a *financial holding company* (FHC), which ended the "financial depression" that was caused by prohibitions against convergence of the banking, securities, and insurance. Entities controlled by a FHC are regulated by function. For example, insurance activities are regulated by state regulators. The main impetus of the Act is to improve the efficiency and competitiveness of the financial services industry.

The Financial System Inquiry[24] carried out in Australia finds that the financial system has entered an era of accelerated change. This requires regulation to adapt both to facilitating greater competition and efficiency in the financial sector and securing the integrity and stability of the sector. The Inquiry emphasises that the financial system should be more strongly competitive and efficient. The reconfiguration of the regulatory framework would "create a flexible structure better able to adjust regulation to maintain cost effectiveness in the face of changing circumstances; provide a more clearly focused and accountable structure that meets (and helps form) legitimate community expectations for consumer protection and financial safety."[25]

The observations above provide China with some valuable implications. Both states and markets can not be perfect and, therefore, both perceptions that markets know the best and that regulation is counter productive are wrong. In order to play its economic and financial role, the insurance sector requires a framework of stable and liberal regulation that provides adequate incentives for efficiency and allows insurers to innovate. Insurance regulation must aim at creating a competitive market, safeguarding

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[22] This is primarily driven by the Baird report, an independent report commissioned by the FSA board into the FSA's regulation of Equitable Life. However, other recent issues also put the FSA under increasing pressure to reform the regulation of insurance by adopting a more proactive approach, similar to banking regulation. They include insurance company failures (e.g. The Independent), instances of mis-selling and business challenges to the insurance industry (e.g. the World Trade Centre losses). The report demonstrates the FSA's determination to significantly change the style of, and approach to, insurance company regulation.

[23] See Ivan E. Mattei & Wolcott B. Dunham, Jr (2000) "The new business of banking and insurance under the Gramm-Leach-Bliley" Practising Law Institute Corporate Law and Practice Course Handbook Series PLI Order No. B0-00QU.

[24] "Wallis Report" Australia, March 1997.

[25] *Id.* "Executive Summary".

the stability of the sector and the solvency of individual insurers, and protecting the interests of policyholders. The internationalisation trend reminds China of the need that, to integrate better into global (insurance) markets, China should consider to implement IAIS standards based on its own conditions. In addition, China needs to properly balance the objectives between security, competitiveness, and regulatory cost-effectiveness in its effort of improving insurance regulatory and supervisory system.

1.3 China's insurance industry

1.3.1 Brief history

a. Pre-founding of the PRC

The modern insurance industry in China was an outcome of the introduction of foreign insurance systems. In 1805, British merchants established the *Canton Insurance Society* in Guangzhou, which is quite commonly considered as the first insurance company to appear in China.[26] In 1865, China's first domestic capitalised insurance company named *YiHe Insurance Company* was opened in Shanghai, offering insurance coverage for shipments. Ten years later, the *BaoXian ZhaoShangJu* (*Commercial Bureau of Insurance*), the first Chinese insurance company with a far-reaching influence on the industry then, also appeared in Shanghai. In 1912, the *Hua'An HeQun Life Insurance Company* was established in Shanghai as the first domestic capital life insurance company of China. For the whole 19th century and up to the outbreak of World War II, the Chinese insurance market developed rapidly. Foreign capital, mainly British and American, however, monopolised the market, particularly the reinsurance market, even though there was a short period of growth in domestic capitalised insurance companies.[27] Statistics show that in 1933 foreign-owned companies took more than 87% premium income in Shanghai - the centre of China's insurance sector then - and in 1935 there were 166 foreign-owned insurance companies while the number of domestic companies was only 48. The period from 1936 to 1949 (when the *GuoMingDang* government retreated from the mainland) saw the flourishing of domestic insurance companies as a result of bureaucratic capital pouring into the

[26] However, this is debated. For a detailed discussion, see *Shanghai Baoxian* (*Shanghai Insurance*) Vol.6, 1992. p25-29.

[27] Chinese private, bureaucratic and warlord capital poured into the insurance industry during the World War I when westerns concentrated their efforts on the war.

insurance sector. Before the founding of the PRC, there were 232 insurance companies, of which 48 were foreign-owned.[28]

b. Post the founding of the PRC

1949 - 1957 This period saw the rectification and recovery of the insurance sector of the old days by the government of the new China. After the foundation of the PRC, the communist government put in order and took over insurance companies controlled by bureaucratic capital. It also reregistered the domestic privately owned insurance companies, closing two-thirds of them.[29] In addition, the government founded the state-owned *People's Insurance Company of China* (the former PICC),[30] and effectively forced foreign-owned insurance companies to withdraw from China's insurance market by mandating all businesses to insure with the national insurance company. These events marked a new era of the insurance development of China. During the three-year *Period of National Economic Recovery* and the *First Five-Year Plan*, the former PICC operated following the guidelines of "safeguarding state assets, ensuring production safety, facilitating flow of commodities, stabilising people's livings, organising private idle funds, and expanding the state funds".[31] It accordingly developed a variety of coverage, and gave strong support to the construction of the national economy. However, late in this period, a phase of gradual contraction emerged due to the government considering that the planned economy did not require commercial

[28] For the history of early development of China's insurance industry, see Wu Kequan & Wei Yuanjie (1997) *Jinii Shanghai Baoxian Shichang (Shanghai Insurance Market Today) Shanghai People's Publishing,* p1-18. Also Sun Shangqing & Ren Xingzhou (1997) *A Grand Market in China Retrospect and Prospect* New World Press p132.

[29] By October 1951, 28 privately-owned insurance companies still in operation were merged into the Xinfeng Insurance Company and the Taiping Insurance Company. Both of them withdrew from the domestic market to handle overseas market five years later.

[30] The former PICC (in comparison with the existing PICC, see note 38) was established on October 20, 1949 by unifying a number of state-owned people's insurance companies founded by the communist government in liberated areas during the civil war. By October 1951, the former PICC had established 468 branches and subsidiaries..

[31] The first National Insurance Conference organised by the PBOC in September 1949 set out these guidelines.

insurance whose roles were compensation.[32]

1958 - 1979 Insurance business in this period was all but suspended. Under the influence of the *Communist Wind* in the *Great Leap Forward* in 1958, insurance business became seen as a bourgeois product unnecessary for a socialist centrally-planned economy, and was accordingly abandoned. In October 1958, the WuHan national financial conference deemed that the role of insurance in China was defunct, so the domestic insurance business except international cargo and aviation insurance should be stopped after the spread of *People's Commune*.[33] From May 1959, the PICC which had become a department of the PBOC, survived only for the purpose of international trade, and handled just overseas insurance business.

1979 - Now The State Council decided in 1979 that the former PICC should resume all the domestic insurance business to suit the needs of reforms and the opening up to the outside world.[34] Since then, the national economy has been fast developing through continuous transformation of both the economic structure and mode of economic growth, and the insurance industry, as an important component of the national economy, has therefore expanded dramatically.

In 1980, China's insurance premium income stood at only Rmb460mn. In 2002, it came to over Rmb305.4bn (US$36.7bn). This figure is 663 times greater than that of the 1980, and averages a nominal annual growth of nearly 34.4%, which is much higher than the 15.65% nominal annual growth rate of the GDP. Life insurance income in 2002 made up 74.5 % of total premium income. This growth is coupled with steady increases of both *insurance density* (per capita premium income) and *insurance depth* (the proportion of premium income to GDP) (see Table 1.1). In company with the fast expansion of business, the total assets of insurers increased substantially, with over

[32] In 1953, the former PICC stopped insurance business in the rural areas. In 1955, it stopped compulsory property insurance in the six departments of railways, grain, post and tele-communications, geology, water conservancy, and transportation. Compulsory property insurance was totally cancelled two years later. For the history in this period, see Wu Kequan & Wei Yuanjie (1997) *supra note 28*, p18-24.

[33] See "Suggestion on the Issues of Finance Management of People's Commune in Rural Areas" The State Council, October 1958.

[34] See "Summary of Branch Governors Conference of the People's Bank of China" April 1979.

Rmb649.4bn (US$78.2bn) by 2002, 841 times greater than that by 1980.[35] The settlement of claims also went up. As the Table 1.2 shows, the settlement amounts arose from Rmb4.3bn in 1988 to Rmb80.1bn in 2001. The industry also contributed considerably to fiscal revenue. In 1998 alone, the industry paid Rmb4.82bn in business tax. Through the process of risk transfer, compensation, and taxation, the industry has massively contributed to sound economic stability and development.

Table 1.1 Size and Growth of Premium Income, Insurance Density and Insurance Depth During 1980-2002 in China

Year	Premium Income (Rmb billion Yuan)	Growth Over the Previous Year %	Insurance Density %	Insurance Depth (Rmb Yuan)
1980	0.46	-	0.10	0.47
1981	0.78	69.57	0.16	0.78
1982	1.03	32.05	0.20	1.01
1983	1.32	28.16	0.22	1.29
1984	2.00	51.52	0.28	1.93
1985	3.31	65.50	0.37	3.17
1986	4.58	38.37	0.45	4.33
1987	7.10	55.02	0.59	6.62
1988	10.95	54.23	0.73	10.05
1989	14.26	30.23	0.84	12.89
1990	17.85	25.18	0.96	15.76
1991	23.97	34.29	1.11	20.93
1992	37.80	57.70	1.42	32.71
1993	52.50	38.89	1.52	45.03
1994	63.00	20.00	1.35	52.57
1995	68.30	8.41	1.17	56.39
1996	77.60	13.62	1.14	63.40
1997	108.00	39.18	1.44	87.36
1998	124.73	15.49	1.57	100.89
1999	139.32	11.70	1.70	110.60
2000	159.58	14.54	1.78	126.07
2001	210.93	32.18	2.20	165.28
2002	305.31	44.74	2.98*	237.64*

Sources: China Insurance Almanacs, China Statistics Almanacs and financial reports of the former PICC.
**Zhongguo Zhengquan Bao (China Securities News)* February 20, 2003

Table 1.2 Insurance compensation and payments in China during 1988-2001(Rmb.bn)

Items	1988	1989	1990	1991	1992	1993	1994
Non-life	4.3	3.82	8.11	7.65	11.2	13.7	19.5
Life	na	1.37	2.6	3.35	5.88	9.1	10.1
	1995	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**
Non-life	24.2	25.9	27.6	55.6	51.0	52.7	59.8
Life	6.47	5.5	17.6	23.8	19.2	17.6	20.3

Source: *National Bureau of Statistics of the PRC* Gazettes 1988-2001

1.3.2 Underlying factors for the success

[35] See "Statistics" at <http://www.circ.gov.cn>

The cardinal factor for the rapid progress of China's insurance sector lies in ever deepening reforms; moreover, the implementation of the opening up policy including gradually liberalising the insurance market access for foreign insurance institutions is an indispensable driving force (see Chapter 2 for a detailed discussion). Reforms in the overall market orientation of the economy and the speedy development of the national economy have boosted ongoing demand for insurance. Meanwhile, the internal reform of the insurance industry, facilitated by the government, has stimulated the expansion of insurance supply. Opening up to the outside world has attracted huge foreign investment including the investment by overseas insurance firms, accelerating the whole national economy as well as insurance demand and supply.

a. National economy and insurance industry

The domestic economy of China performed well in the last two decades. According to "Economy Report- China" compiled by Asian Development Bank (ADB),[36] China's main economic indicators have been encouraging during 1992-2000 (Table 1.3). The GDP realised successive growths with an above 7.1 percent of annual growth rate (in 1999, the lowest rate during the period) in real terms. This growth was accompanied by both low *GDP deflator* and a low annual increase of the *consumer price index* (CPI) that had been kept since 1997. It was also assured by the steady increase of the total investment. Consumption demand grew steadily, along with continued improvement in the standard of living. The *unemployment rate* stood at 3.1 during 1997-2000. Although with the largest population in the world, China successfully implemented "birth control policy" thereby effectively alleviating pressures imposed on economic growth by the heavy population. The *exchange rate* was maintained stable after the government had devalued the Chinese currency in 1993. The statistics showed that there has been a quite stable relationship between China's national economic development and insurance business. In addition, some indictors from the National Bureau of Statistics of the PRC also revealed positive factors to the increase of insurance demands. Indexes such as *annual per capita disposable income* for both urban residents and farmers, the *total savings in financial institutions* including the savings of households, and *exports* and *imports* increased dramatically (Table 1.4). All these favourable economic circumstances acted positively on the insurance business.

[36] "Economy Report- China" *2001 Economic Outlook* ADB.

Table 1.3 China: Overall economic performance

	1992	1993	1994	1995	1996	1997	1998	1999	2000
GDP and Major Components (percent change from previous year, excepted as noted)									
Nominal GDP (US$ billion)	483	601.1	540.9	697.65	816.9	903.0	960.9	991.1	1,080
Real GDP	14.2	13.5	12.6	10.5	9.6	8.8	7.8	7.1	8.0
Total Consumption	14.2	9.3	8.0	9.2	9.3	6.1	6.8	7.9	10.4
Total Investment	12.9	24.9	15.6	15.5	10.4	7.1	14.4*	5.2	9.3*
Economic Indicators (percent change from previous year, except as noted)									
GDP Deflator	7.9	14.6	19.5	13.1	6.1	1.5	-1.3	-3.0	0.9
CPI	6.4	14.7	24.1	17.1	8.3	2.8	-0.8	-1.4	0.4
Short-Term Interest Rate (percent)	8.1	8.8	9.0	9.0	9.72	7.65	6.34**	5.58	5.58
Exchange Rate (RMB/US$)	5.5	5.76	8.62	8.35	8.31	8.28	8.28	8.28	8.28
Unemployment Rate (percent)	2.3	2.6	2.8	2.9	3.0	3.1	3.1	3.1	3.1
Population (millions)	1,171.7	1,185.2	1,198.5	1,211.2	1,223.9	1,236.7	1,248.1	1,259.1	1,265.8

* Real Investment in Fixed Assets Growth

** Three-month inter-bank rate.

Source: "Economy Report-China" *Economic Outlook 2001 ADB*

Table 1.4 Some economic indictors of China during 1992-2001

Items	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Total saving in financial institutions (Rmb trillion Yuan)	-	2.32	2.92	4.59	6.86	8.24	9.57	10.88	12.38	14.36
Savings of households	1.15	1.48	2.15	2.97	3.85	4.63	5.34	5.96	6.43	7.38
Annual per capita disposable income for urban residents (Rmb Yuan)	1,826	2,337	3,179	3,893	4,839	5,160	5,425	5,854	6,280	6,860
Annual per capita disposable income for farmers (Rmb Yuan)	784	921	1,220	1,578	1,926	2,090	2,160	2,210	2,253	2,366
Exports (US$ billion)	850	918	1,210	1,488	1,511	1,827	1,838	1,949	2,492	2,662
Imports (US$ billion)	806	1,040	1,157	1,321	1,388	1,424	1,402	1,658	2,251	2,436
Foreign direct investment (FDI US$ billion)	111.6	257.6	338	377	423.5	453	456	404	407	468

Source: *National Bureau of Statistics of the PRC* Gazettes 1992-2001

b. Reforms and insurance industry

Various reforms, which underpin the national economic growth, have direct influence on the increase of insurance demand. When the economic reform began in China's rural areas, it succeeded in mobilising the enthusiasm of the mass of farmers, releasing agriculture production power. To protect themselves from natural disasters and other kinds of risks, the increasingly successful farmers insured their corps, machinery, and their lives. The reform of the state owned enterprises (SOEs) not only sets them free from government control but also makes them responsible for their own losses. This created great demand for commercial insurance because enterprises needed to bear risks by themselves. The loss of the traditional *iron rice bowl* in state owned enterprises and

institutions has left state employees feeling unsecured. Furthermore, the ongoing reforms in the areas of pensions, housing, and medical system, etc. have already replaced the wide range of government-provided welfare with kinds of pensions, a housing mortgage system, and social security. These stimulated the demand for insurance, especially life insurance, as the new systems are less secure than the old ones mainly owing to inflation.

On the other hand, since reform and opening up to the outside world, China has also carried out a serious of reforms on the insurance system formed as it was under the conditions of the planned economy. These have enabled the industry to meet the ever-growing demand for insurance. Firstly, the government expanded market entities, introducing a competition mechanism into the industry. Secondly, in accordance with the *principle of separate operation and administration of property and life insurance*, the government separated the former PICC into three independent companies, *viz.* PICC, China Life, and China Re.[37] Thirdly, it allowed each company control over its own business and made them financially independence, thereby speeding up the process of the restructuring of the SOEs. The emphases on profit making and risk control made insurers responsive to market forces and focusing on internal control. The government encouraged the sitting up of shareholding limited companies as the main organisational form for insurers, gradually making that SOEs align with the lines of modern corporate system. Fourthly, the establishment of the China Insurance Regulatory Commission (CIRC) unified the various regulatory and supervisory responsibilities to strengthen regulation and supervision of the industry. In addition, the rapid expansion of the industry pushed the government to make tremendous efforts to create a competitive and fair legal environment. So far, China has been establishing a preliminary insurance regulation and supervision system that consists of legislation,[38] supervision, and governmental co-ordination, together with a judiciary and an arbitration system. Industry self-regulation is developing as well. All these measures

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[37] The former PICC, a state-owned monopoly, was initially transformed into the People's Insurance (Group) Co. of China in 1996, with four whole owned subsidiaries (Life, Property, Reinsurance, and PICC Hong Kong Ltd.), and then further split up into People's Insurance of China Co. (PICC), People's Insurance of China Co.(China Life), China Reinsurance Co. (China Re), and China Insurance Company (operating in Hong Kong) respectively in 1998. See Li Sin "A reshuffle in the insurance sector" China Economic News Vol.20 (May 10,1999), p6.

[38] See section 1.4. "The regulation and supervision in the insurance industry in China"

greatly attributed to enhancing the overall scope and strength of the insurance industry, and an effective increase in its supply capacity.

c. The development of a increasingly competitive market

Before 1986, China had only one insurance company, which was the former PICC, and the market was highly monopolised. Since then, according to the needs of insurance market development, the regulators have successively licensed a number of insurance companies. According to the CIRC, by 2001, China already had 52 insurance companies. Among them, 25 companies are Chinese-funded insurers (see Table 1.5), and the remaining 27 companies are foreign-funded insurers (see Table 1.6). More and more entrants have given the market a more competitive image; market oriented competition has also vigorously promoted the insurance companies' efforts in

Table 1.5. Chinese domestic insurers

1.Name	2.Year of App/Est.	3. Sector	4.Ownership	5 National/regional
Ming An Insurance(Hong Kong)	1982	P	Branch	Hainan
Ming An Insurance(Hong Kong)	1982	P	Branch	Shenzhen
PICC	1998	P	State-owned	N
China Life	1998	L	State-owned	N
China Re	1998	Reinsurance	State-owned	N
Xinjiang Corps Insurance Co.	1986	P	State-owned	R
Ping An Insurance Co. Ltd.	1988	Composite	Share-hold	N
China Pacific Insurance Co. (CPIC).	1991	Composite	Share-hold	N
New China Life Insurance Co. Ltd..	1996	L	Share-hold	N
Taikang Life Insurance Co. Ltd.	1996	L	Share-hold	R
Huatai Property Insurance Co. Ltd.	1996	P	Share-hold	R
Sinosafe Property Insurance Co. Ltd.	1996	P	Share-hold	R
Yong An Property Insurance Co. Ltd.	1996	P	Share-hold	R
Tian An Property Insurance Co. Ltd.	1997	P	Share-hold	R
Dazhong Property Insurance Co. Ltd.	1997	P	Share-hold	R
Zhong Hong	1998	L	Share-hold	R
Ming Sheng*	2001	L	Share-hold	R
Oriental	2001			
Sheng Ming	2001			
Heng'an	2001			

*Ming Sheng is the first First private insurer established in China

Table 2.1 Foreign insurers or reinsurers approved to write insurance or reinsurance in China

1.Name	2.Investor(s) countries	3.Year of App/Est	4. Sector	5. Branch/JV	)perational origin
AIA	AIG (US)	1994	P	Branch	Shanghai
AIA	AIG (US)	1995	P	Branch	Shanghai
Tokio Marine & Fire	Tokio Marine & Fire (Japan)	1995	P	Branch	Guangzhou
AIU	AIG (US)	1996	L	JV	Shanghai
AIU	AIG (US)	1996	P	Branch	Shanghai
Zhong Hong Life	Manulife Financial, (Canada) with Sinochem, (China)	1997	L	JV	Shanghai
Winterthur	Winterthur (Switzerland)	1997	L	JV	Shanghai
Allianz-Dazhong	Allianz, (Germany) with Dazhong, (China)	1997	L	JV	Shanghai
CPIC-Aetna	CPIC, (China) with Aetna, (US)	1998	P	Branch	Shanghai
AXA-Minmetals	UAP & Mining Corp, (France) with China Metals, (China)	1998	L	JV	Shanghai
Royal & SunAlliance	Royal & SunAlliance (UK)	1999	P	Branch	Shenzhen
China Life-CMG	China Life, (China) with Colonial Mutual Life, (Australia)	1999	P	Branch	Foshan
AIU	AIG (US)	1999	L	Branch	Foshan
AIU	AIG (US)	2000	L	JV	Shanghai
AIA	AIG (US)	2000	L	JV	Shanghai
John Hancock-TianAn	John Hancock, (US) with TianAn (China)	2000	L	JV	Shanghai
Citic-Prudential	Prudential (UK) with Citic (China)	2000	L	JV	
ING Pacific-Antai	ING (Netherland) with Antai (China)	2000	P	Branch	Shanghai
	Generali (Italy)	2000	L	JV	
Chubb	Chubb (US)	2000	L		
	Sun Life (Canada)	2000	L		
	New York Life (US)	2001	L		
	MetLife (US)	2001	L		
	TransAmerica (US)	2001	L		
	CNP (France)	2001	P	Branch	
	CGNU (UK)	2001	L	JV	Shanghai
	Royal & SunAlliance (UK)	2001	L	Branch	
	Aegon (Dutch) with China National Offshore Oil, (China)	2001	P	Branch	
	AXA (France)	2001	P		
	Allianz (Germany)	2001	L		
	Gerling(Germany)	2001	L		
	Scadinavia (Denmark)	2001	P	Branch	Shanghai
	Surich (Sweden)				

	Mitsui Sumitomo Marine & Fire(Japan)				
	(Japan)	2001	L	Branch	Beijin
	(Korea)	2001	L	Branch	Dongguan
AIA	AIG (US)	2001	L	Branch	Suzhou
AIA	*AIG (US)*	2001	L	Branch	Jiangmen
AIA	*AIG (US)*	2002	L	JV	Tianjin
AIA	*AIG (US)*	2002	L	JV	Shenzhen
	Standard Life (UK) with Taida Investment (China)	2002	Reins.		
	CIGNA (US)	2002	Reins.		
	Munich Re (Germany)	2002	L	Equity purchase	
	Swiss Re (Switzland)				
	Fortis (Belgium-Dutch) with TaiPing Life (China)				

* Companies in italics are preparing to start business by Oct.2002.

transforming their management concepts to gradually establish and strengthen a consciousness of service, competition, effectiveness, and development, so guiding the insurance market from a quantitative expansion towards qualitative improvement.

e. Emerging intermediaries

In the era of the former PICC's monopoly, business was done mainly by its staff with some agents including such as transportation enterprises in transportation insurance, and community social workers in life insurance. There were no incorporated intermediaries before 1998 when the British *Sedgwick Group* obtained a trial license to conduct insurance brokerage business. Since then, domestic intermediary organs have started from scratch. Various insurance intermediaries, such as loss adjusters and brokers, have emerged, and insurance agents have flourished with 650,000 individual agents and 35 agent companies operating by 2001.

f. Diversifying products

The industry once had only 30 or so varieties of products, mainly made up of property insurance and accidental injury insurance (with very limited coverage such as fire, transportation, individual endowment insurance, industrial life and marine). Owing to the demand generated by ongoing market reforms, the industry has had to develop its product varieties. By 1999, there were more than 2,000 insurance varieties (see Table 1.7 and 1.8). In recent years, this preliminary diversification expanded with life, accident, health, property, liability, credit and guarantee insurance advancing side by side. In particular, the structure of the industry fundamentally changed at the end of 1997 when life insurance premium made up Rmb60bn, 56% of the total premium collected, surpassing property insurance premium for the first time. In some cities, this reverse was even higher. For example, by 1998, in Beijing, life premium was 72.5% of the total premiums, in Shanghai, 67.8%, and in Guangzhou, 63.5%. Since the first investment-linked product in China was launched by Ping An in late 1999, many new life insurance products including various investment-linked products and participating products have been launched, firmly supporting the growth of life insurance.[39] A variety of products played an important role in both structural transformation of

[39] It was reported that in 2001, traditional non-participating, investment-linked and participating business amounted to 39%, 27% and 24% respectively. See Paul Headey, John Law and Carol Zhang "China life insurance market: can the foreign entrants compete?" *Milliman Asia* April 2002.

enterprises and raising social security. It also promoted China's foreign trade and international economic and technical co-operation.

Table 1.7 Premium income in different kinds of life insurance in 1999 (Rmb mn)

Products	Detailed kinds of products	Premium income
Group insurance	Fixed-term life insurance	132
	Double risks life insurance	9,128
	Whole life insurance	223
	Annuity	11,528
	Accident insurance	5,598
	Health insurance	1,275
Subtotal		22,486
Individual insurance	Fixed-term life insurance	191
	Double risks life insurance	19,801
	Whole life insurance	24,526
	Annuity	10,165
	Accident insurance	1,008
	Health insurance	2,863
Subtotal		58,554
Total		81,040

Source: *Shanghai Baoxian (Shanghai Insurance)* 2000, No.4.

Table 1.8 Premium income in different kinds of property insurance in 1999 (Rmb mn)

Products	Detailed kinds of products	Premium income
Property insurance	Enterprise property insurance	11,132
	Domestic property insurance	1,224
	Motor vehicle and third party liability insurance	30,615
	Aeroplane insurance	467
	Ship insurance	1,105
	Transportation of goods insurance	3,464
	Construction, installation project and third party liability insurance	552
	Machinery damage insurance	483
	Space flight and nuclear power insurance	153
	Other kinds of property insurance	520
Subtotal		49,715
Liability insurance	Product liability insurance	174
	Employer's liability insurance	1,025
	Public liability insurance	176
	Other kinds of liability insurance	257
Subtotal		1,632
Credit insurance	Credit insurance	239
Guarantee insurance	Guarantee insurance	141
Agriculture insurance	Agriculture insurance	632
Total		52,359

Source: *Shanghai Baoxian (Shanghai Insurance)* 2000, No.4.

1.3.3 Main problems and major concerns

a. Economic significance

The economic significance of the industry to the national economy is not yet substantial. Firstly, the industry had only 52 undertakings (life, non-life, and reinsurance companies) by 2001. Secondly, by 1999, it provided jobs for about 221,000 employees, among them 178,000 employed by state-owned companies,[40] and 43,000 by other kinds of companies, representing 0.03% of the total employees in the country (705,860,000).[41] Thirdly, by 2000, its turnover, which reached RMB159.58 billions (US$ 19,278 million) in terms of premium, represented some 1.79 % of the GDP, ranking 61st in the world in terms of *insurance density*. Fourthly, compared with foreign insurance companies, domestic insurance companies hold insignificant amounts of the total assets, and what is worse, some have serious problems with solvency. By 2002, the total assets of insurers in China reached Rmb649.4bn (US$78.2bn). By comparison, the value of the total assets managed by Allianz Group (Germany), a leading insurer in the world, reached Euro989bn at that time.[42] Fifth, amounts of investments by the industry reached Rmb171.258bn in 2001, which are insignificant, only 1.79 % of the GDP (Rmb9,587.728bn).

b. Market structure: from a monopoly to an oligopoly

The lack of sufficient, effective and orderly competition is a serious concern facing China's insurance. With the implementation of reforms and opening up policy, China's insurance market began to liberalise gradually. The former PICC's monopoly was broken up. However, by examining the structure of the industry, it is clear that the market is still highly concentrated with the top five domestic companies, namely, PICC, China Life, Ping An, CPIC, and China Re., having the lion share. Of the 52 companies operating in China, only eight are allowed to operate on a national level. Other local domestic companies and foreign companies are limited to particular regions, resulting in very small market shares. The market share of foreign companies

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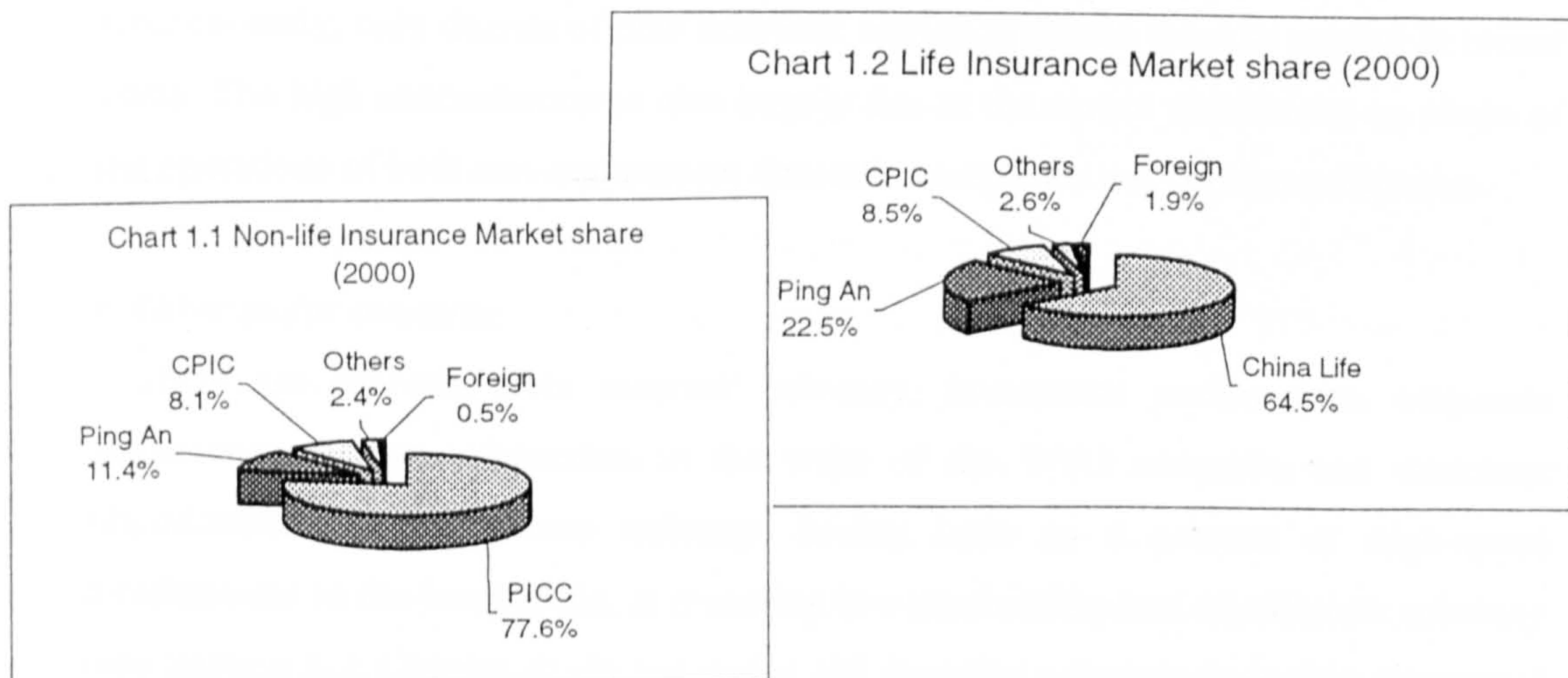
[40] <http://www.stats.gov.cn/yearbook2000> (visited on November 19, 2002)

[41] *Id.*

[42] "Annual Report 2002" Allianz Group, at <http://www.allianz.com>

together is minuscule, less than 2% of the total premium income in 2000.[43] Both life and non-life insurance markets are highly concentrated with oligopoly seen in both national and regional markets, while the monopoly of China Re. in the reinsurance industry ended only in 2002.[44]

In the national market, there were ten domestic insurers and nine foreign insurers operating in the non-life insurance market by 2001. Four of the ten domestic insurers conducted business on a nation-wide basis as national insurers, while the remaining domestic insurers were regional players. Foreign insurers were confined primarily to Shanghai, with the exception of AIG, which has branches in other Chinese cities, such as Guangzhou, Shenzhen, and Foshan. The top three companies - PICC, China Pacific, and Ping An - scooped nearly 97 % of the market share in 2000, with the remaining share distributed among the other domestic companies and the foreign insurers (see Chart 1.1). The life insurance market saw a similar situation. Six domestic insurers and ten foreign insurers operated in the market by 2001. The combined share of the top three companies- China Life, Ping An, and China Pacific - was nearly 96 % in 2000 (see Chart 1.2).



In regional markets, the situation is similar to those of the national. The four top companies are dominant in most areas. However, the level of competition within regional markets varies greatly, characterised by the big gaps between eastern and western China, and between rich and poor areas. The more advanced eastern areas and coastal cities, especially some large cities such as Shanghai, Guangzhou, and Beijing witness fierce competition, whereas the slower economic areas in the central and

[43] "China: No Room to Grow?" The *Economist Intelligence Unit Ltd.* June 19, 2000.

[44] Swiss Re. and Munich Re. got their licences for doing reinsurance business in China in 2002.

western China have more low-level business. For example, in 2000 there are 19 insurers operating in Shanghai, the first city opened to foreign insurers and a particularly attractive market with 12 million people and GDP per capita over US$3,000 and premiums Rmb127.69bn (US$15.4bn).[45] By contrast, there were only four insurers, *viz.* PICC, China Life, Ping An, and CPIC in He Nan province, with life premiums just about Rmb3.03bn in 1999.[46] In Shan Xi province, which locates in west area of China, with famous city Xi An as its capital, there were five insurers and premiums only recorded Rmb2.4bn in 2000.[47] In most county-level cities, only PICC and China Life are serving the market.

The concentration of the market has its roots in China's insurance history, and stems from nation-wide business networks and the communication and relationship with customers built by the former PICC during its long time monopoly and domination over the market. PICC, China Life and China Re., the three successors to the former PICC, inherited this legacy and consequently enjoyed a very competitive edge. The second reason is that China was very cautious in granting licenses to new domestic insurance companies, and applied protectionist policies to prevent foreign access. Consequently, only dozens of new domestic entries squeezed into the market in recent years. The high concentration is also largely due to the severe restrictions on scope of the operations of both non-mainstream domestic companies and foreign companies.

c. Other major concerns

There are concerns over insurers' solvency, investment performance, corporate governance, fiercer competition in the wake of the WTO accession and insurance liberalisation. The insurance industry, having been in a process of high-speed development in the last decade, is revealing low profitability and insufficient solvency (see Section 4.2, Chapter 4). In particular, life insurers' solvency is greatly threatened by the serious problem of interest-driven loss, as they had sold large quantities of expensive fixed-interest-rate insurance policies at the peak of business during 1996-1999 (see Section 5.4.3, Chapter 5). Investment by insurers in terms of investment volume of and return on investment is deficient, threatening insurers' solvency and their further development (see Chapter 5). The sector also suffers from the current legal

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[45] *Shanghai Bao Xian (Shanghai Insurance)* 2001, No 4.

[46] Cai ShiNan and Hu XianRui "Analysis of trends in the insurance market of HuNan" *Jirong Lilun Yu Shijian (Finance Theories and Practices)* 2000, No.5.

framework that is largely out of line with both the requirements for the industry's development and international standards and practices in a number of respects. Problems are related to the deficiency that exists in insurers' corporate governance and the industry's self-regulation, the low level of truthfulness of insurance firms, poor information disclosure by insurance firms (see Chapter 3), and the stiff regulation that bottlenecks insurers' investment. Many aspects of the current prudential regulatory and supervisory system need to be upgraded (see Chapter 4), and a gradual deregulation of prices is indispensable (see Chapter 6). In addition, China has to liberalise the insurance market to meet its obligations as a member of the WTO, which makes competition in the market fiercer (see Chapter 2). Perhaps one major challenge is that the Chinese culture does not look upon insurance favourably, as insurance is a relative new industry in China, compared to banking. There exists a general lack of insurance awareness for consumers in China.[48] Insurance firms have to operate rather carefully to win consumers' trust; regulators need to monitor insurers' operations closely.

1.4 The regulation and supervision of the insurance industry in China

1.4.1 A brief history of China's insurance legislation

The first specific regulation on insurance in China's contemporary history, the *Insurance Industry Rules* (7 chapters and 105 articles) was drafted in 1907, but failed to be ratified by the Qing Dynasty. In 1917, the *Northern Government* issued the *Insurance Industry Act* (42 articles), and in 1929 the government of Republic of China promulgated the *Insurance law* which was lately revised in 2001. Before World War II, English laws were substantially applicable in China, as British and American companies dominated the market, and the foreign insurers' association in Shanghai set

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[47] At <http://www.drcnet.org> November 26, 2001.

[48] A survey by the Development Research Centre (DRC) of the State Council indicates that the Chinese insurance market is still underdeveloped and insurance awareness needs improving. The survey polled 22,182 families in 50 cities. Only 6 percent of those families said they had enough insurance knowledge, while 36 percent said they knew little about insurance. It also showed Chinese citizens prefer saving money in banks or paying for house loans. Only 9 percent of consumers chose to invest in commercial insurance. Xinhua News Agency, August 15, 2002.

out policies, clauses, premium rates and commission rates in the English language.[49]

The evolution of insurance legal system in the PRC was in its tortuous way similar to that of the country's whole legal system in its over 50-year history. It can be roughly divided into two periods: pre-1980, when the insurance legal system declined markedly from its early establishment; and post-1980, a period of revival and prosperity.

Following the foundation of the PRC, the new government proceeded to abolish all the legislation of its defeated adversary, and promulgated a series of laws and regulations governing compulsory insurance and commercial insurance. These were seen as beneficial to the revival of the new-born country's economy.[50] It also founded the former PICC which was designated as both a monopolised company and an industry regulator. However, the *Legal Nihilism* generated in the *Movement of Anti-Rightists* in 1957, together with *the Culture Revolution* which began in 1966, demolished almost the whole legal system of the PRC. Only three compulsory insurance laws[51] remained before 1980 when a notice was issued by the PBOC to overwhelmingly restore the former PICC's business.[52] The restoration aimed to support the important reforms which had been implemented in other sectors of the economy.

In the 1980's, the construction of a new regulatory framework for the insurance sector was initiated. The first steps were the issuance of the *1983 Regulations on Contracts for Property Insurance*, and then the *1985 Provisional Regulations on the Administration of Insurance Enterprises* which restored competition to the insurance industry and transferred the regulatory function of the former PICC to the PBOC. More legislative activities took place in 1990s. The *1992 Provisional Measures on the Administration of Insurance Institutions with Foreign Investment in Shanghai* (1992 Shanghai Measures) was the first legislation addressing foreign insurers' market access. Then, the most important event was that the long-awaited promulgation of *1995 Insurance Law*. Following the law, some supporting legislation and implementing regulations were promulgated, including the *1996 Provisional Regulations for the Administration of Insurance* (Administration Regulations). A great change took place

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[49] See Kequan Wu and Yuanjie Wei (1997) *Jinri Shanghai Baoxian Shichang (Shanghai Insurance Market Today)* Shanghai People's Publishing July 1997, p1-18.

[50] In early 1950s, a series of compulsory insurance laws were promulgated in lines of aviation, passenger transport by railways and ships.

[51] *Id.*

[52] See "Notice of PBOC regarding the restoration of insurance business" The State Council 1980. This notice is widely seen as an important document initiating the resurrection of China's insurance sector.

in November 1998 with the establishment of the industry watchdog, the CIRC. It resulted from the separate administration of banking, securities activities, and insurance in order to deepen financial reforms and minimise financial risks. Since its establishment, the CIRC has been making great efforts to strengthen regulation and supervision. Besides the *2000 Insurance Company Regulations*, main legislative activities include four regulations in 2001, including: the *Administrative Regulations on Foreign-Invested Insurance Companies* (2001 FIIC Regulations) issued by the State Council, the *Administrative Rules on Insurance Brokerage Companies*, the *Administrative Rules on Insurance Appraisal Institutions*, and the *Administrative Rules on Insurance Agency Institutions*. The most important event is that the first revision of the *1995 Insurance Law* was passed in 2002. Apart from these, more new regulations are in the process of drafting. The CIRC has announced it will promulgate regulations on corporate governance of insurance companies; administration measures on the use of insurance funds; penalty measures on illegal behaviours in insurance business; administration measures on reinsurance; and administrative measures on information disclosure of insurance companies.

1.4.2 China's insurance legislative structure

After over two decade of efforts on legislation, China has already established a primary legal framework on insurance that consists of documents with different legal effects[53] governing administrative, civil, and criminal areas respectively.

The *Insurance Law* falls within both administrative law and civil law. Having both distilled the distinct experiences of China's industry and codified internationally recognised insurance principles, the *1995 Insurance Law* is the first attempt to create a national regulatory structure for the burgeoning China's insurance business. The law contains general principles governing insurance activities, and provisions relating to

[53] Under the Chinese Jurisprudence, a hierarchy of legal provisions exists: 1. Constitutional law, the basic law of the country; 2. Laws and regulations related to specific areas and legislated by the National People's Congress (NPC) and its Standing Committee, with legal effects just inferior to the constitutional law; 3. Regulations, rules, orders, and notices enacted by the State Council and its subordinate departments; 4. Regional regulations and rules legislated by provisional congresses and governments with provisional legal effects; 5. Regional rules, orders enacted by congresses and governments at county level with local legal effects.

insurance contracts, insurance companies and insurance administration.[54] The other three main regulations are: the *1996 Administration Regulations* promulgated by the PBOC, the *2000 Insurance Company Regulations* promulgated by the CIRC, and the *2001 FIIC Regulations* by the State council. The *1996 Administration Regulations* lay down in more detail the comprehensive criteria for implementing the *1995 Insurance Law*. The *2000 Insurance Company Regulations* embrace general principles of regulation of insurance companies. Its main sections include establishment of insurance companies and branches, operation, control on policy and rate, insurance funds and investment, solvency, reinsurance, supervision and inspections, and penalties. The *2001 FIIC Regulations* set forth a new framework for foreign investment in the insurance industry following China's accession to the WTO, which in fact supersedes the *1992 Shanghai Measures*.

The main body of insurance legislation is administrative regulations and rules. Before the CIRC took responsibility for governing the insurance industry, the old PICC and PBOC laid down a number of administrative rules.[55] Since its establishment, the CIRC has reviewed or revised about a hundred old rules made by its predecessors, and set out a number of new rules.[56] The State Council and some relevant ministries, *e.g.* the *Ministry of Finance*, also laid down administrative regulations and rules concerning insurance taxation and accounting among others.[57] There are also a number of regulations and administrative rules at different levels of regional congresses and governments.[58]

Regarding the civil law regime, besides the *Insurance law*, there are some other laws and regulations governing insurance contracts. For example, the *1992 Maritime Law* contains provisions covering the insurance of maritime activities. The *1985 General*

[54] For the commentary of the law, See Edward Epstein and Andrew Hallworth (1996) "The new insurance law of the People's republic of China" *International Law Review* 1996, No.2, p61-63.

[55] For example, on life insurance, the *Urgent Notice of PBOC to Adjust Nominal Rate By Insurance Companies* (1996); on reinsurance, the *Conditions of Compulsory Ceding to PICC* (PBOC 1996); and on licensing administration, the *supplementary Notice of PBOC on Issues Concerning the Examination and Approval of Branch Office of An Insurance company* (1996).

[56] For example, *the Notice of CIRC for Consolidation of Motor Insurance Market* (1999). It is the first rule issued by the CIRC.

[57] For example, the State Council's *1998 Notice Concerning Some Issues About the Adjustment of Taxation Policies on Financial and Insurance Institutions*, and the Ministry of *Finance's 1999 Accounting Rules for Insurance Enterprises*.

[58] For example, the *1992 Shanghai Measures*, issued by the Congress of Shanghai Municipality.

Principles of Civil Law is an important statute stipulating general principles regarding contracts, agency and product liability, etc. The *1999 Contract Law* governs all kinds of contracts, including insurance contracts, in addition to the relevant provisions in the *Insurance Law.*

In the criminal law regime, the *1979 Criminal (revised in 1997)* sets out various crimes involving in insurance business and their related penalties. The *1995 Decision of the Standing Committee of the National People's Congress on Punishing Crimes of Disrupting the Financial Order* lays down detailed provisions for the punishment of violations committed by insurance firms, the insured or beneficiaries.

In practice, judicial interpretations and case law in China to some extent contribute to the law making process. The *Supreme People's Court* has issued a number of judicial interpretations as guidance when laws and regulations are phrased in general terms. Such interpretations of applicable law are binding on judges at all levels below. There are some judicial interpretations for insurance cases.[59] As regards case law, China is a country with a statutory law tradition, making case law only a guide theoretically. However, in fact, precedents are among the considerations that the Chinese judges make when they hear cases. Since 1985, the *Supreme People's Court* has been selecting some cases[60] from its own jurisdiction, as well as from those of lower courts for publication in the *Supreme Court Gazette.* Most published cases are lower court decisions, but the Supreme Court edits or rewrites the opinions. In addition, lower courts may be given (even decisive) opinions on specific cases through the reporting channels of judicial system.

1.5 The revision of PRC Insurance Law: a transitional change

The first revision of the *1995 PRC Insurance Law* was passed at the 30th Session of the Standing Committee of the 9th National People's Congress of China (the Standing Committee of the NPC) on October 28, 2002 and became effective on January 1, 2003. Li Peng, the chairman of the Standing Committee of the NPC, said at the 28th session of the committee, that the decision to revise the *1995 Insurance Law* would better protect

[59] For example, the *1996 Interpretation of the Supreme People's Court for Several Issues on Goods Transport by Railways.* This document contains the standards for judging when a situation such as valued policy, or under-insurance, exists in insurance contracts relating to goods transport by railways. It can be retrieved at <http://www.chinalaw.com>

[60] There were dozen insurance cases published in the Supreme People's Court Gazette by 2001.

the legal rights of the insured and insurers, improve the supervision of the insurance market, and promote the healthy development in the insurance sector.[61] However, on closer analyses, the amendments concentrate only on the aspects of regulation and supervision, and leave untouched those provisions relating to contracts which also need revising.[62] In addition, the legislators obviously manifested their caution towards addressing the some major issues on liberalisation in the insurance market, *e.g.* the need to dismantle the restrictions on insurers' investment activities. Generally, the new revision, although seen as an important step towards upgrading China's insurance legal framework, is a transitional measure, and consequently, it seems that the law needs further amendments in the near future.

1.5.1 Background

The *1995 Insurance Law* ended a period in which there was no basic law governing the insurance business in the PRC, and marked a new era in the development of the Chinese insurance industry. As the first comprehensive national law for the insurance industry, the law had played an important role in spurring the industry's development since its introduction. It provided a legal framework for the protection of the legal rights of the insured, ensured the healthy operation of insurance companies, and laid down a foundation for China to further open up its doors to foreign investment in the industry.

As both the external and internal environments of the insurance industry have seen significant changes since the promulgation of the law, many provisions in the law became outdated and needed amendments. For instance, since the promulgation, the Chinese insurance market grew rapidly. Premium income in 2002 came to over Rmb305.4bn (US$36.7bn). That figure is over four times that for 1995 (US$8.2bn). Secondly, some large Chinese insurers have grown to be on an equal footing with foreign insurers. For instance, China Life, Ping An and CIPC were ranked 13th, 23rd, and 28th respectively in top 100 life insurers in Asia in 2001 by *Asia Week* magazine.[63] Thirdly, while in 1995 there were only 9 insurers operating on the mainland, the figure had increased to 52 by 2001. The large number of new market entrants, together with

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[61] "China's legislation updates Insurance Law" At <http://www.cei.gov.cn> October 29,2002.

[62] The *1995 Insurance Law* contained both insurance regulation and supervision and insurance contract law.

the split of former PICC into three individual insurers, ended the period of monopoly and led to a much more competitive market. Under the pressure of competition, domestic insurers, with the help of the regulators, made fruitful efforts in the improvement of their risk management and self-regulation. For example, Ping An, whose branch in Shenzhen achieved an international quality award (ISO 9001: 2000) from BSI Asia, was named by *Capital* magazine as "the best insurance service company" in China.[64] Meanwhile, various insurance intermediaries flourished. Regarding the changes in the regulatory and supervisory environment, the most significant event was the establishment of the CIRC, which replaced the PBOC as the state insurance regulator. Finally, as China became a full member of the WTO, it is necessary to bring China's *Insurance Law* into line with international practices and adaptable to the new conditions.

The process of revision had lasted for nearly four years. As early as in 1999, the CIRC invited experts to Shanghai to discuss the revision of the law. In the early 2001, the regulator set up a revision panel to prepare a draft amendment based on researches which summarised experience and opinions gathered from the parties concerned. The draft was submitted to the State Council and then, after being modified by the Law Department of the State Council, submitted to the NPC in June 2002. It finally got the green light after several modifications in congressional discussions.

1.5.2 The aims of the revision

According to Wu DinFu, newly appointed chairman of the CIRC, the main objectives of the revision are to honour China's WTO commitments, better protect the interests of the insured, and strengthen regulation and supervision over insurance companies. Furthermore, it also aims to ensure that China's insurance sector is in line with international practices, and enhance reforms and development within the industry.[65]

1.5.3 Main aspects of the amendments

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[63] *Asia Week* 2002, January. p7-13.

[64] At <http://www.bsi-global.com> and <http://www.pa18.com> visited at June 6, 2002.

[65] "Wu DingFu speaking on the new Insurance Law" at <http://www.drenet.org> October 10, 2002.

Regarding changes to the numbering of articles, among the total 152 articles in the original *Insurance Law,* 33 articles have been revised, another 2 merged into one, and furthermore, 6 new articles are added, leaving the new law with 158 articles altogether. In summary, the amendments concentrate on the following aspects.

a. Honouring commitments to the WTO

The new law abolishes the rigid requirement on re-insurance for non-life insurance business, to bring it into line with China's commitments on entry to the WTO. Under the previous law (art.101), 20 per cent of each non-life insurance policy had to be re-insured (in fact, with China Re. the state-owned reinsurer). As part of China's WTO commitments, the ratio should be reduced at the rate of 5 percent every year with the requirement to be completely abolished in four years. The new law accordingly removes the statutory reinsurance requirement, and replaces it with a statement (art.102) that insurers shall handle re-insurance business in accordance with CIRC regulations.[66]

In addition, art.154 echoes the commitment that foreign-funded insurance organisations can be in the forms of a joint venture, a subsidiary or a branch of a foreign insurer. By contrast, the previous art.148 only permits two forms: insurers with foreign shareholding and branches of foreign insurers.

b. Revising those provisions incompatible with the development pace of the insurance sector

The new law ratifies the status of the CIRC as a state insurance regulator. Previously, the law designated "financial regulatory and supervisory authority" (in fact the PBOC) as the insurance regulator.

Given the establishment of agent companies, the new law repeals the previous provision (old art.124) that insurance agents should not be entrusted with two (or more) life insurers, and states (art.129) that only individual agents can not represent more than one life insurer. In practice, the previous provision hindered the development of the

[66] In October 2002, the CIRC issued the *Administrative Rules for Business Scope and Operational Capital Required to Establish Reinsurance Companies.* According to the regulations, newly-established life or non-life insurance companies should have a threshold paid-up capital of Rmb200bn (US$24.18mn) or convertible foreign capital of the same value while insurance companies running both businesses need Rmb300mn (US$36.28mn) or the same amount of convertible foreign capital.

professional and pluralistic insurance agent, and encouraged a monopoly of the existing insurance business, which acted against fair competition in the insurance industry. The relaxation on institutional agents makes such agents as banks, securities houses and post offices no longer limited to being agents for only one insurer.

The new law vindicates the practice of bringing life insurers into reinsurance, which was established by the CIRC *1999 Compulsory Ceding Conditions* which superseded the provision in the *1995 Insurance Law* that required only non-life insurers to reinsure their business.

The new law also eases restrictions on insurers' investment of their funds, although they are still banned from running securities firms and other businesses. To reduce possible financial risks, the *1995 Insurance Law* only allowed insurers to invest their funds through restricted channels, including bank deposits and treasury bonds, and proscribed insurers from using their funds to establish securities companies or invest in other companies (old art.104). With the gradual liberalisation of investment restrictions by the authorities in the last seven years, insurers have been allowed to invest directly into the inter-bank market and indirectly in the stock markets via mutual funds. Accordingly, the new law (art.105) states that insurance funds should not be used to establish securities or companies enterprises who have nothing to do with the insurance business.

c. Deregulating term and premium rate controls

The most significant change in this revision is perhaps on terms and premium rates regulation. The amended law allows insurers to establish their own terms and premium rates, ending the practice of the regulatory commission setting the terms and rates. It states (art.107) that insurance rates and items related to public interests, compulsory insurance and new forms of life insurance, and so on, should be approved by the insurance regulatory authority who should adhere to the principles of safeguarding public interests and prohibiting unfair competition. The law empowers the CIRC with the right to set out the scope of rate and term approval and related executive rules. Terms and rates relating to other kinds of insurance business except for aforementioned ones should be submitted to the CIRC for the record. By contrast, the 1995 law (old art.106) required that the basic terms and premium rates for the main types of risk had to be formulated by the authority, while terms and premium rates for other types of risk could be set by insurers and then had to be submitted to the authority for the record. It

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is believed that this relaxation of terms and premium rates regulation will propel the relatively fragile domestic insurers to be involved in competition.

d. Strengthening prudential regulation and supervision

The new law clarifies the insurance regulator's duty of prudential regulation by adding a new article (art.108) which states that "insurance regulatory and supervisory authority shall set out and improve regulatory and supervisory indexes for insurers' solvency, and monitor insurers' solvency margins." This manifests the importance of the issue. In addition, the new law also emphasises the infrastructure of prudential regulation.

Firstly, it revises the previously imprecise provisions on reserves. According to *the 1995 Insurance Law*, non-life insurers were obliged to set aside no less than 50% of the retained insurance premiums of the current year to the *unearned premium reserve,*[67] and life insurers were required to allocate the full value of the effective life insurance policies to the *life assurance reserve.* However, non-life insurers in practice often chose more precise methods, *e.g.* "1/8", "1/24" or "1/365" to allocate the *unearned premium reserve*, while the definition of "the full value of the effective life insurance policies" seems to be blurring. Instead, the new law sets out principles for building a reserve system, which states (art.94) that insurance companies shall allocate various reserves according to the principles of safeguarding the benefits of the insured and guaranteeing their solvencies; the insurance regulator is responsible for setting out details of reserve standards.

Secondly, it expands the actuary system from only life insurance business to both life and non-life insurance business, requiring all insurance companies to establish their own actuarial reporting systems (art.121).

Thirdly, it consolidates the financial reporting system by adding more requirements to insurers' existing duties. Besides the existing requirement of filing annual financial reports no later than three months after the end of the financial year as well as monthly business statistics statements for each previous month,[68] insurers are required by the new law to record their insurance business in business reports, financial statements, actuarial reports, and other statements, documents and data, based on facts. Falsified records, misleading representations and material omissions are prohibited.

[67] The *1995 Insurance Law*, Art. 93,

[68] The *1995 Insurance Law*, Art. 117, 118.

e. Keeping in line with international practices

According to the *1995 Insurance Law* and the tradition in the Chinese insurance industry, insurers have been normally divided into two main kinds: property insurers (dealing with property, liability, credit and surety insurance) and life insurers (operating life, accident, and health insurance). To be more in line with the common practice in the world, the new law allows property insurers to sell accident and short-term health insurance policies, which were previously solely undertaken by life insurers. This stipulation follows the division of life and non-life insurance that is accepted internationally. Meanwhile, the revised law still maintains the previous provision that an individual insurer cannot sell non-life and life insurance at the same time.

f. Consolidating supervision

The revised law consolidates the provisions in the chapter of "legal responsibilities", linking them to China's current *Criminal Law* and associated rules. 12 articles of a total of 38 new articles are within this aspect (art. 139,140, 142-150, and 152), with some relating to the supervision of insurers' activities. The new law makes it clear that insurers and their personnel will be criminally liable in frauds and other crimes according to the *Criminal Law* if they commit crimes by frauds or defaults of contract. It also outlaws various deceptive trade practices by insurance brokers or agents. The new law increases the sums of fines that the regulators can impose; it also grants regulators the power to inquire into insurers' deposits in financial institutions.

1.5.4 Comments

a. Insurers' investment channels

One of the most highlighted issues is that the step towards investment liberalisation is apparently not as big as was expected by domestic insurers.[69] Removal of stiff investment restrictions, especially allowing insurers more easily to use idle funds, *e.g.* directly to invest into stock markets, and freely to establish special investment companies, have been long called for by domestic insurers who are facing an investment bottleneck caused by the restrictions that hampered the growth of China's

[69] See "The new Insurance Law: stepping on a same stage" *Caijin Zhoukan (Financial Weeks)* November 11, 2002.

insurance sector in the last decade. Although there are some slight changes on the issue of investment, insurers are still not allowed to establish special investment companies which could help invest their large quantities of idle funds. All investment schemes, including the acquisition of shares or setting up of joint ventures, must be approved by the CIRC.

The legislators' caution in a bid to weed out possible financial risks reflects their concerns over the present conditions of insurers' investment. China's underdeveloped financial markets, especially volatile stock markets, limit opening investment vehicles to insurers. For example, Securities investment funds recorded an average capital return rate of 12 percent in 2000, but this rate sharply fell to 2.25% in 2001.[70] Currently, non-performing loans amount to over 30 percent of the total assets of the whole banking industry. This may trigger crises which could spread over the whole financial system if financial institutions' (including insurers') activities are not kept under a proper control. Furthermore, domestic insurers normally lack sophisticated investment skills, leaving their investment performance poor in the past years.

While the legislators reasonably worry about the stride of investment liberalisation, experiences have shown that stiff investment policies have often threatened to choke off domestic insurers' sustainable growth, especially as they grow rapidly and more foreign rivals began to enter the market. This requires insurance investment channels to be further expanded to take full advantage of the funds available for insurers and the economy, enabling insurers to create healthy fund circulation. Further, the development of healthy stock markets needs a sound interaction between insurance and stock markets, especially the full display of life insurers' role of important institutional investors. Meanwhile, the contradiction between investment demand and backward investment environment requires the regulators to delicately balance the relationship between them.

b. New chance for non-life insurers

China has long lacked sufficient coverage of passenger injury and death for insured vehicles, due to the prohibition against non-life insurers operating such a business. That property insurers can operate short-term health insurance and accident insurance with the approval of the CIRC is expected to greatly stimulate non-life insurers' business,

[70] At <http://www.netrisk.com/news/dailynews> August 23, 2002.

especially the auto insurance business. It will also trigger competition on these two lines between non-life and life insurers.

c. Bancassurance and co-operating distributions

The lifting of the restrictions on institutional life-insurance agents will give further impetus to bancassurance and other kinds of co-operating distributions. In recent years, insurers have been increasingly competing for connections with banks, securities houses and post offices in areas such as cross-selling, payment handling and e-commerce. For example, branches of Ping An and the Industrial and Commercial Bank of China (ICBC) both in Beijing are co-operating, with the ICBC Beijing branch's 30 or so outlets acting as sales agents of Ping An. In the life insurance sector, bancassurance sales have risen to become, after personal and group life insurance, the third-largest source of revenue for life insurers. In addition, global insurers entering China are likely to rely on the bancassurance method in their expansion. These factors, together with the fact that banks and other institutional agents are no longer limited by law to acting as sales agents for only one insurer, will intensify the competition between insurers to tie up with banks and other institutions as their sales agents.

One big concern over increased competition is that it may spark a fierce rivalry among insurers, who will probably resort to price war to gain more institutional outlets. In the past, banks usually charged insurers different rates of commissions according to locations and products. Since the new law deregulated premium rate control, allowing insurers to set premium rates themselves, insurers may scramble for more institutional outlets by increasing commissions. The CIRC needs to pay close attention to the concern to ensure financial prudence in the spread of bancassurance and co-operating distributions. Since both Chinese banks and insurers suffer from weak capital bases, the regulator needs to emphasise capital adequacy for insurers, and their risk management ability. It also needs to impose disclosure standards for commissions and other material information, thereby allowing the public more effectively to compare insurers and their co-operating institutional agents.

d. Conglomerate and integrated regulation

In contrast to the international trend towards convergence of financial institutions and integrated financial regulation, China is still adopting separate operation and separate supervision of banks, security houses and insurers. Nevertheless, with the

competition in the financial sector and the WTO accession, the business of these financial institutions has become overlapping. For example, Ping An and CPIC have been organised as financial holding groups controlling separate non-life, life, securities and trust subsidiaries. On the other hand, enterprises in other sectors are actively setting foot in the insurance area. For example, China International Trust and Investment Corp. (CITIC) and China Everbright, the two domestic financial giants, have set up life joint ventures with Prudential of the UK and Sun Life of Canada respectively. The new law does not refer to supervision of these financial groups. It predicates that the strategic alliances and convergence between insurers and enterprises in other sectors will become yet more intense. This raises the question of proper co-ordination between the PBOC, the CIRC and China Securities Regulatory Commission (CSRC).

e. Premium rate deregulation

Rate deregulation under the new law, which shifts the rate-setting burden from regulators to insurers, and establishes *prior approval* and *file-and-use* systems, reflects a functional transition for the regulator. With the appearance of the market economy embryo, China's authorities have realised that the government should not interfere in the economic operations of insurers, since their performances are best judged by the market, and their survival or demise should also be determined by the market. Accordingly, the CIRC needs to alter its function from a controller to a supervisor. However, because of the current market and legal conditions, China needs to adopt a gradualist policy for rate deregulation.

China has long been practising strict rate regulation characterised by statutory rates and a prior approval system. This regulatory model has been proved to have many shortcomings. Unified statutory prices are rigid and not necessarily compatible with different insurers' conditions. Statutory premium rates in most cases appear to be higher than rates would be in a natural equilibrium, thus resulting in either extra profits, or, in a few cases, artificially low prices. These pricing irregularities hindered insurers' initiatives to compete with each other healthily, and led to the whole industry becoming less competitive and less competent. Therefore, China needs to build a competitive pricing system - market-based pricing, which can only work effectively in a well-functioning competitive market. Moreover, market-based pricing requires a set of standards and rules (including prudential regulation) to assess premium rates and ensure that they are not excessive, inadequate or unfairly discriminatory.

The key concern with market-based pricing in China's insurance sector is over the conflict between the urgent need for rate deregulation and the *de facto* immaturity of those preconditions required for rate deregulation: China's insurance market is still far from maturity, and lacks complete competition. In addition, the current rate standards, prudential regulation and market performance regulations need improving. These require China to gradually liberalise rate controls while actively creating the required conditions, including, most importantly, a competitive insurance market, and a set of rate standards together with rate approval and filing rules and procedures.[71] Other essential elements to ensure that competitive pricing works effectively include prudential regulation to indirectly force insurers to make appropriate pricing decisions, and regulation of market performance to monitor insurers' actual pricing and other marketing behaviour.

f. Market performance regulation and prudential regulation

With 12 (art.127-129, 131, 134,136,139-143, and 149) of the 38 new articles relating to the market conduct of insurers and insurance intermediaries, the new law shows that China is adopting a regulatory strategy that focuses on both prudential regulation and market performance regulation. In contrast to the trend in some developed countries, which focuses on prudential regulation, this strategy suits China's current conditions that the insurance market is still immature and not healthily competitive. An emerging economy, such as China, must pay close attention to market performance regulation when stressing prudential regulation. This is highlighted by the need for consumer protection mainly due to the scarce insurance knowledge of consumers and the problem of imperfect information disclosure by insurers.

Nevertheless, regarding prudential regulation, China still needs to make further efforts. The new law lays down only principles on prudential regulation, so the CIRC needs to set out concrete rules for the implementation of those principles. Furthermore, to strengthen prudential supervision, China needs to improve the current early warning system, enabling it more effectively to predict insurers' solvency problems. Another important issue that needs to be addressed is the establishment of a clear market exit system, which at present, China still lacks. It is suggested that China needs to set out

[71] It was reported that the CIRC is considering to draft "Regulations for premium rates", see *supra note* "Wu DingFu speaking on the new Insurance Law" at <http://www.chinainsurance.com> October 30, 2002.

clear rules and procedures for dealing with insolvent insurers. One urgent issue on this matter is that, to protect policyholders from losses resulting from insurers' insolvency, China needs to establish insurance guarantee funds and special bodies responsible for managing these funds.

g. Other important issues to be addressed

The new law has left some important issues relating to the development of insurance business to be addressed. In the revision process, both the CIRC and legislators agreed to shelve revising provisions of contracts because of the complexity of the subject. They envisaged to solve the problem through publication of judicial interpretations which seems not a appropriate way given the need for amendments rather than for just interpretations.[72] Besides the contract issue, in the author's opinion, the following four issues are also yet to be addressed.

Firstly, some competition issues arising in the insurance industry need to be addressed. With the development of the insurance market, different kinds of co-operation between insurers are emerging, such as the sharing of information on losses, jointly insuring large risks, agreements on standardised policy terms and conditions, and jointly setting premiums rates and commissions. For example, in 2000, five insurers in Guangzhou signed an agreement to work together to offer insurance against accidents to flight passengers,[73] and also in Guangzhou, major non-life insurers colluded their auto insurance commissions to avoid price-cutting wars in 2001.[74]

In developed countries, some kinds of co-operation between insurers are considered to be pro-competitive. For example, the sharing of loss statistics is justified because this collective measure can avoid individual insurers being short of loss statistics necessary for the proper rating of risks. It makes reserve calculations possible and helps reduce the risk of insolvency.[75] However, such co-operation may also help unfair competition if the loss statistics are not available on fair, reasonable and non-discriminatory terms to all existing and potential insurers. Jointly insuring large risks

[72] See "New Insurance Law reveals some vacuums" *Guoji Jinrong Bao (International Finance)* Oct. 31, 2002.

[73] See "Five insurance companies unite in offering accident insurance" *China Daily* November 26, 2000.

[74] See "Opening auto premiums in Guangdong insurance market entering into war era" *Jinji CanKao (Economic Reference)* December 25, 2001.

[75] "Competition and related regulation issues in the insurance industry" OECD, DAFFE/CLP(98)20 p21-54

may enable insurers to sufficiently diversify risks, but it may purposely limit new entrants. Both agreements on standardised policy terms and conditions and jointly setting premiums rates and commissions may involve in con-competitive transactions.

China promulgated the *Countering Unfair Competition Law* in September 1993, and is intensely drafting on antimonopoly law at present. However, there exist, to a certain extent, some weaknesses in the *Countering Unfair Competition Law.* For example, anti-competitive transactions, which could happen in insurers' co-operation, are hardly covered by both the Law and the new *Insurance Law.* It remains to see whether the government addresses these issues when drafting new stipulations.

Secondly, overlapping regulatory duties need to be addressed. Normally, though each government department has specific administrative duties, some departments may have duties that overlap with other departments. Sometimes, these overlapping areas may create loopholes in regulation and supervision. Regarding insurance regulation, the Industrial and Commercial Administrations (ICA) of PRC and the CIRC often get confused about such overlapping duties as the market performance regulation of insurers and insurance intermediaries, and anti-trust behaviour. For example, officials from the ICA often view auto insurers' designation of automobile repairers as a kind of unfair competition. Sometimes this confusion even leads to disputes between officials of the two departments.[76] It predicts that the CIRC will run into even bigger confusion when insurers' market performance comes to be tightly monitored.

Thirdly, there is a need to allow mutual insurance to provide coverage for those risks that existing insurers are unwilling to insure. Mutual insurance is a common organisational form seen widely in insurance markets around the world. According to Swiss Re., mutuals are on average more cost-efficient than stock companies in the non-life industry.[77] One main advantage of mutuals is that mutuality merges the functions of customer and owner, eliminating the need for stockholders whose priorities sometimes conflict with those of policyholders. Although there has been a trend towards life insurance demutualisation in developed countries in recent years, mutual ownership still plays a prominent role in insurance industries. Of the world's 50 largest insurers, as

[76] See *Beijing Gongshang Guanli (Beijing Industrial and Commercial Administration)* 2001, No.5., also "Insurance regulation should follow the preference of specific laws" <http://www.chinainsurnace.com> May 24, 2001.

[77] See Swiss Re. *Sigma* No. 4/1999.

measured by assets, 21 were mutuals; and they wrote an estimated two-fifths of world-wide premiums in 1997.[78]

Although mutuals were not permitted in the *1995 Insurance Law*, and nor under the new Law, some mutual insurance schemes do already exist in China. For instance, roughly Rmb4bn of employees' mutual assistance fund is held by the All-China Trade Union, and more than Rmb2bn of security insurance fund by PetroChina, but none of these funds is under the supervision of the CIRC. These facts showed that not only there is a *de facto* need for mutuals but also blurring supervisory duties of the two mutuals exist between the CIRC and the actual administrators.

Fourthly, the new law omitted to deal with the issue of self-regulation by both insurers and the insurance industry. In developed countries where there is a tendency towards liberalisation in the insurance markets, regulatory frameworks are developing towards comprising not just governmental macro-control but also industry self-regulation, firms' micro-self-control and public monitoring. The IAIS, Basel Committee on Banking Supervision (BCBS), and the International Organisation of Securities Commissions (IOSCO) recommend marrying the micro- and macro-prudential aspects of financial supervision.[79]

The quality of both firms and industry associations is a key element of an effective market economy. China's insurers currently lag behind their international counterparts in terms of the quality of risk management, business skills and the quality of services. The insurance industry's role of self-regulation is far from decisive. However, the new law missed out these essential problems. It suggests that China take solid measures to speed up the construction of a modern enterprise system, and in particular to promote the shareholder restructuring of state-owned insurance companies. Meanwhile insurers' internal control systems, including internal audit systems, need to be improved. China also needs to draw on the experiences of industry self-regulation in developed countries, such as the UK, to enforce self-regulation of the insurance industry as an important complement to government regulation. In addition, mass media monitoring also merits regulators' attention.

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[78] *Id.*

[79] See Principle 3, "Corporate Governance and Internal Control" in "Insurance Core Principles Methodology", IAIS, Oct. 2000. The similar principles also can be seen in *Core Principles for Effective Banking Supervision* BCBS, and *Objectives and Principles of Securities Regulation* IOSCO.

1.6 Concluding remarks

Over the last half-century, China's insurance industry and insurance regulatory and supervisory systems had undergone a long and tortuous process. During the period of the first thirty years, the industry and systems struggled with ups and downs, while they developed vigorously in the last two decades and now enjoy healthy prospects.

The Chinese insurance industry is playing an increasingly important role in the national economy and demonstrating huge potentials. The future development of the industry will largely depend on the ability of insurance firms to ever strengthen their competitive power, in the face of many challenges (*e.g.* technical advances, competition from other financial institutions and overseas insurance firms, more informed consumers) and the changing socio-economic environment. To build an effective, efficient and stable insurance sector that supports the needs of the country's socio-economic development, China must improve its insurance regulatory and supervisory systems. The strategies for the short-term and medium-term actions should aim to achieve the following objectives: protecting insurance entities' (especially policyholders) legitimate rights and benefits in the market; strengthening the financial resilience of insurers and safeguarding the stability of the market; increasing the industry's overall competitive ability in the post-WTO environment; combining market disciplines with government regulation and supervision, and balancing the fairness and efficiency of the market. To better integrate into the global market, China needs to actively adopt best practice in the world, especially the IAIS's principles, standards and guidance, by taking into account China's realities. In addition, China needs to adapt the systems to changing conditions.

Considering that the new *Insurance Law* only set out principles on many aspects of regulation and supervision, and left many issues to addressed, it suggests that China set out detailed rules to implement the principles and carry out researches on those not (or not fully) covered issues. The following five chapters will respectively address issues in the five selected aspects which appear urgent in the improvement of regulation and supervision of insurance in China.

Chapter 2
China's insurance sector: issues on opening up and liberalisation

2.1 Introduction

China's entry into the WTO is a tremendous event for insurance industries. The *General Agreement on Trade in Services* (GATS), a main WTO multilateral agreement in the services sector, covers insurance services.[1] The WTO accession, which provides blueprints for further opening up of the Chinese insurance market, means China must follow common international rules and fulfil certain stipulated obligations. Meanwhile it also brings China corresponding rights and interests. Although market access liberalisation is inevitable, obstacles still exist. Nevertheless, the essential issue to be addressed for China to date is no longer whether or not to open its insurance market, but how to deal with the liberalisation, especially, how to create a legal environment which enables China to promote the beneficial and abolish the harmful regarding the liberalisation while honouring its commitments to the WTO. Furthermore, a bigger issue, which is far beyond the issue of market access liberalisation, is how to deal with whole range liberalisation of the insurance sector.

This Chapter critically examines the liberalisation process, competition issues and relevant legal framework in China's insurance sector in the context of the WTO accession and the international convergence of regulatory standards and practices. The main points are: as a member of the WTO with an aspiration to develop a modern and viable insurance sector, China has to liberalise its insurance market and build a suitable legal infrastructure consistent with emerging international regulatory

[1] The *Annex on Financial Services to the GATS* defines insurance and insurance-related services, including: direct insurance, both life and non-life; reinsurance and retrocession; insurance intermediation, such as brokerage and agency; and services auxiliary to insurance, such as consultancy, actuarial risk assessment and claim settlement services.

standards and WTO requirements. Meanwhile, as a transition economy, China needs to deal with the liberalisation in a cautious manner, given a primary development stage of the insurance industry.

Section 2.2 of the chapter reviews the efforts to define the liberalisation in the insurance markets, and then focuses on market access liberalisation by reviewing literature and practice thereof. These are followed by discussions on their implications for China. Section 2.3 focuses on insurance market opening up and liberalisation in China. It reviews the process of opening up, and outlines the provisions concerning insurance in GATS as well as China's commitments. It then discusses the *2001 FFIC Regulations*, a specific regulation concerning foreign direct investment (FDI) in the insurance sector. This is followed by analyses of the combined policies of opening up and local protection adopted by China. Section 2.4 observes the situation of unhealthy competition seen in the market, the underlying factors, and counteractions taken by the regulator. The basic message is that the regulator needs to take a solid and systematic approach to whole range liberalisation of the Chinese insurance sector in order to cultivate a competitive and efficient market. The chapter ends with addressing the issue of making regulatory arrangements to properly balance local protection, liberalisation, competition, and regulation.

2.2 Liberalisation in insurance markets

2.2.1 Defining the term "insurance liberalisation"

The term "insurance liberalisation" covers two concepts. The first concept mainly refers to *market access liberalisation*, *i.e.* the removal of restrictions on insurance market entry for foreign providers. Some analysts applied this notion. For example, Cloney Gordon categorised five kinds of markets when characterising international insurance market trends in the decade before the mid-1990s. They included socialised markets, nationalistic markets, protected markets, transitional markets, and liberal

markets.[2] A liberal market is characterised by non-discrimination, market access, national treatment, and transparency. Gerry Dickinson noted that "insurance market liberalisation means allowing a greater internationalisation of the national insurance market by allowing foreign-owned enterprises greater access to the national insurance market through establishment or acquisition of a local operation and gradually selling cross-border, and by allowing local consumers (companies or individuals) to buy insurance in markets overseas."[3]

The second notion, more fundamental in nature, relates to pro-competitive reform (or more commonly known as the process of deregulation) which denotes the lessening of domestic regulation. Skipper *et al* suggests that "a liberal insurance market is one in which the market, subject only to economically justifiable government restrictions, determines the eligibility of insurers, products, premiums, and sale manners."[4] This notion emphasises that insurance market liberalisation should be directed towards market-oriented disciplines, which means reducing unnecessary government interventions. The OECD holds a similar opinion.[5] It states that the liberalisation requires:

> "(1) genuine market access; (2) adherence to the concept of national and non-discriminatory treatments; (3) a suitable regulatory framework and adequate prudential rules; (4) open and ongoing dialogue among regulators and all market participants, transparent markets, and (5) a transparent regulatory and supervisory process; and fair competition and de-monopolisation."

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[2] Cloney Gordon "US insurance experience with emerging markets" Comments presented in New Delhi, January 30, 1995. According to him, a socialised market has no private insurers, while a nationalistic market has no foreign insurers. A protected market allows some degree of foreign involvement. However, there are market access restrictions, national treatment inconsistencies and a lack of transparency, for example, restrictions as to the percentage of foreign ownership of an insurer. In a transitional market, the government makes efforts to render the market more competitive, but still faces the problems seen in protected markets.

[3] Gerry Dickinson (2001) "Overview of the Chinese insurance market and its challenges" *2nd Experts Meeting on Insurance Regulation and Supervision* organised by the CIRC and OECD, 2001.

[4] See Harold D. Skipper, Jr., C.V. Starr, and J. Mack Robinson (2000) "Liberalisation of insurance markets: issues and concerns" *Insurance and private pensions compendium for emerging economies OECD* Book 1, 1: 6)b

[5] To facilitate and guide actions of member countries and non-member countries, it sets out five principles for the liberalisation of insurance markets. See "Framework for insurance market liberalisation" Insurance Committee Secretariat OECD 1999.

However, it is still unclear what constitute a "liberal insurance market", and so are the scope and procedure of the insurance liberalisation, although in practice the liberalisation has been going on world-wide for many years. One underlying factor behind this is further insurance market liberalisation, a part of the liberalisation of trade in services, remains a sensitive issue in the *GATS 2000 round* negotiations. The purpose of GATS is liberalisation, aiming at increasing international trade in services including insurance by removing unnecessary restrictions and internal government regulations that are barriers to trade between countries.[6] The experience of insurance negotiations at the WTO, however, would suggest that many developing countries appear reluctant to liberalise their insurance sectors in a radical way.[7] Various political, social, and economical reasons are behind this, which include most notably infant-industry protection, inefficient prudential regulation, the costs of adjustment, and national security considerations. Furthermore, even 'liberalised countries" have difficulties on how to decidedly liberalise their insurance markets further. For example, insurance in the USA is regulated at the state level, resulting in a patchwork of regulation which is difficult and costly to penetrate from outside.[8]

Some non-government organisations (NGOs) proposed frameworks for the liberalisation. One important is the Working Document on "Pro-competitive Regulatory Principles for Insurance" drafted and adopted by the Financial Leaders Working Group-Insurance Evaluation Team in July 1999 to contribute to setting the agenda for the *GATS 2000 round* negotiations. The proposal underlines the strong feeling in both the European and the US insurance industry that an essential element of insurance market liberalisation must be "the development of pro-competitive

[6] Art. XIX, GATS commits governments to "achieving a progressively higher level of liberalisation...[and] increasing the general level of specific commitments undertaken by Members." See <http://www.wto.org> for more details.

[7] For example, Chile, Colombia, Egypt and Venezuela restrict the right of establishment by an economic needs test. Access is also restricted in many countries by the imposition of limitations on foreign equity holdings. This applies, among others, to Malaysia, Mexico, Pakistan, Singapore, Thailand and the Philippines. For details, see Hisaya Ishii (1999) "Liberalisation of international insurance operations: comparative tables" OECD.

[8] See Susan Randall (1999) "Insurance regulation in the United States: regulatory federalism and the National Association of Insurance Commissioners" *Florida State University Law Review* Spring, 1999. Also see "Regulatory Initiatives of the National Association of Insurance Commissioners" *United States General Accounting Office* Washington, DC 20548, July 6, 2001.

regulatory principles".[9] It recognises the role of regulation, but stresses the important features of pro-competitive regulation, which cover such areas as regulatory transparency, solvency and prudential questions, insurance monopolies and fair market practice, and the importance of independent regulatory authorities.

The proposal claims that, regarding transparency, regulations should be publicly available, and changes in them be the subject of prior consultation. Regulatory decisions should be explained and should be justifiable, and the regulators taking them should be free of arbitrary or non-transparent political control. It also suggests that prudential regulation focus on the soundness of insurance companies and their directors and controllers. Product and price approval should be avoided, as these tend to favour existing patterns of trading and may restrict a new comer's ability to compete on product-specification or price. In particular, the proposal suggests that market access and the right of establishment allow freedom in the forms of commercial presence (branch, subsidiary, and JV). Majority shareholdings in joint ventures (with the prospect of 100% holdings) must be allowed. National treatment must allow genuine freedom for foreign insurers to compete for the same business on the same basis, and with the same privileges, as long-established domestic companies.[10]

The International Chamber of Commerce (ICC) advocates these opinions. It asserts that "regulators should focus on solvency and prudential requirements to ensure a stable market while, in most cases, allowing competition to determine the most effective products and price. Transparency and fair enforcement of regulations are also important aspects of a pro-competitive regulatory framework that is conducive to equal competition amongst foreign and local firms."[11]

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[9] "Pro-competitive Regulatory Principles for Insurance" p2. A similar proposal, the "Insurance-Proposed model schedule & best practices"(October 2001), was raised by the Association of British Insurers (ABI) as part of a private sector initiative. See <http://www.abi.org>. This proposal was supported by the insurance trade associations in EU, US, Japan, and Canada. It provides a proposed text for the use of WTO Members in scheduling commitments under the framework of the GATS, and lists obligations that WTO members should undertake in relation to their insurance markets as well as best practices in insurance supervision.

[10] For details, see Annex of the "Pro-competitive Regulatory Principles for Insurance"

[11] "The liberalisation of trade in insurance services" ICC, 2000.

2.2.2 Review of liberalisation of insurance market access

Liberalisation of access to the services (including insurance market) is generally considered to have many benefits. According to the WTO, services liberalisation demonstrates its rationale by having six benefits. Firstly, it can spur competition and hence raise economic performance. Secondly, it helps exporters and producers in developing countries capitalise their competitive strength through providing access to world-class services. Thirdly, liberalisation leads to lower prices, better quality, and wider choice for consumers, which all lead to consumer savings. Fourthly, liberalised services markets have seen greater product innovation. Fifthly, liberalisation leads to greater transparency and predictability. Finally, FDI, encouraged by liberalisation, facilitates technology transfer.[12]

There are a number of theoretical studies on the rationale and phase of liberalising insurance market access. For example, Skipper argues that greater foreign insurer participation in emerging markets can bring the markets many benefits, including improvements in customer service and value, increased domestic savings, and transfers of technological and managerial know-how. It also can result in additional external financial capital, improvements in the quality of domestic insurance regulation, and the creation of beneficial domestic spillover, *e.g.* additional employment.[13] Gerry Dickinson summarises the scheduling of the market access liberalisation. It normally moves through the following stages: removal of obligatory cessions to state-run reinsurers/pool, freedom of cross-border reinsurance business, acquisition of minority holdings in the form of joint ventures, acquisition of majority holdings, establishing local subsidiaries, establishing branch offices/agencies, and cross-border sale of insurance products. Individual countries may undergo these

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[12] "GATS - fact and fiction", also see "The WTO in Brief, 10 Benefits of the WTO Trading System and 10 Common Misunderstandings about the WTO" The WTO, 2001.at <http://www.wto.org>

[13] Harold D. Skipper "Foreign insurers in emerging markets: issues and concerns" Centre for Risk Management and Insurance, Georgia State University, Occasional paper 97-2. Also see Harold D. Skipper (2001) "Insurance in the General Agreement on Trade in Services" The AEI Press, Publisher for the American Enterprise Institute, Washington, D.C., "Emerging markets: the insurance industry in the face of globalisation" Swiss Re. *Sigma* No.4/2000, "Insurance in Latin America: growth opportunities and the challenge to increase profitability" Swiss Re. *Sigma* No. 2/2002.

various stages in different sequence and timing.[14]

However, so far, there has been no thorough and independent assessment of the exact impact of GATS on services carried out by a respected body.[15] Empirical evidence about the practical effects of insurance liberalisation, especially within emerging markets, is also scant. In practice, liberalisation process, the reasons for it, and the consequences of it differ from region to region and country to country. Meanwhile, clearly, there are problems and concerns about liberalisation of insurance market access in both developed and developing countries.

a. Liberalisation in developed countries: experience from the EU

In the EU, the main objective of liberalisation is to create a single insurance market (SIM) for the whole of the EU, thereby to achieve a greater choice of products for customer who can then buy the most suitable insurance contract, and more competition between insurers.[16] Many forces driving this change are common to the insurance industry globally, *viz.* globalisation of markets, technical advances, and GATS/WTO Negotiations on Services.[17] Besides these, two distinctively European forces have been the EU initiatives to create the Single Market and the single currency (*Euro*) for European Monetary Union (EMU) countries, which have acted as a major

[14] Gerry Dickinson's presentation to the UNCTAD conference - "Emerging markets in globalising economy" Malaysia, 1999.

[15] Ten developing countries appealed for proper assessment on Trade in Services. They argued that assessment is particularly important given both the failure of developed countries to open their service sectors in areas of interest to developing countries and the threat posed to developing country service suppliers from foreign competition. WTO (2001) Assessment of trade in services - communication from Cuba, Dominican Republic, Haiti, India, Kenya, Pakistan, Peru, Uganda, Venezuela and Zimbabwe (Document code: S/CSS/WI14)

[16] "Liberalisation of insurance in the single market- an update (October 12, 1997) The EU, at <http://europa.eu.int/comm/internal_market/en/finances/insur/>

[17] "Liberalisation and competition in the service sector: Experiences from Europe and Asia" Joint analytical report The Asian Development Bank (ADB) and the *OECD Development Centre* June 2002.

catalysts for further restructuring of the EU.[18] Three generations of Insurance Directives have formally set up the freedoms of the establishment, and free movement, of insurance services. However, the consequences of liberalisation are largely discouraging although satisfactory in some Member States.[19] The Single Market Review[20] identified that there were substantial regulatory/technical barriers to the effectiveness of SIM in the area of personal or mass risks, in particular concerning cross-border restrictions on the marketing of financial services, and of conditions for sales. Rees, Kessner, and Klemperer reached their conclusions that, although EU policy towards SIM had been set out, there has been no sign of the growth of a single market in insurance products, and they did not expect there to be.[21] Bechmann, *et al.* reached similar conclusions in a recent study.[22] According to Bechmann, *et al.*, a survey[23] among a few leading players in the European insurance market identifies two groups of obstacles to the integration of SIM: policy induced obstacles and natural obstacles.

The EU experiences indicate some important lessons. Firstly, liberalisation has not been conducted with a concerted focus on competition. The Single Market has

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[18] "Euro 1999 Report on progress towards convergence and the recommendation with a view to the transition to the third stage of economic and monetary union" *European Commission* March 1998, also Andrew Crockett "Managing change in the European financial system: lessons from experience" *Joint Bundesbank/BIS conference on recent developments in financial systems and the challenges for economic policy* Frankfurt Septem 2000.

[19] For example, Cummins and Rubio-Misas observed the restructuring and performance of the Spanish insurance industry during the period 1989-1998. They concluded that there is substantial evidence to show that deregulation and consolidation have had beneficial effects on efficiency in the industry through the merger & acquisition (M&A) and the exit of inefficient firms. "Deregulation, consolidation and efficiency: evidence from the Spanish insurance industry" Working paper 02-01 Financial Institutions Center Wharton (2001)

[20] *The single market review series Sub-series II- Impact on services Volume I: Insurance* European Commission (EC) 1998.

[21] Rees R, Kessner E, Klemperer P, *et al.* (1999) "Regulation and efficiency in European insurance markets" *Economic Policy* (29), October 1999. On examination of the British and German markets, they concluded that there had not been any growth in "cross-border" trade and neither had there been an influx of new entries from abroad into the profitable German market.

[22] Rainer Bechmann, Carsten Eppendorfer & Markus Neimke (2002) "Financial integration within the European Union: towards a single market for insurance" Ruhr-University, Bochum.

[23] Conducted by the Centre for European Economic Research in 2001 (ZEW, Mannheim, Germany). See *id.*

arguably been more an exercise in harmonisation than in market access, thus not substantially increasing competition. Therefore, it is important to give EC competition laws a wide scope of application as a strong impetus towards the liberalisation process.[24] A second lesson is that the EU's gradualist approach to insurance liberalisation has both advantages and disadvantages. The approach makes the transition period less painful by providing a breathing space for adjustment and allows Member States to accommodate differences in the liberalisation process to ensure their participation. However, it is considered to be hazardous, costly, and inconclusive in bringing the full results of liberalisation, which may impair the process and make it more susceptible to political "hijacking".[25]

b. Liberalisation in emerging economies

The first phenomenon observed is that few empirical studies on the exact benefits of liberalisation for emerging economies are available to date. The main reason may be the short period of liberalisation so far. For example, the markets in China and India remained largely untapped until the end of last century. This may result in the absence of sufficient and representative data. Meanwhile, it is difficult to individualise the benefits of liberalisation because liberalisation usually exert its influence together with other important factors, *e.g.* globalisation, insurance innovation, technical changes, and economic cycle. This makes an assessment a complex work.

The second phenomenon is that, for developing/transition countries, liberalisation of insurance market access often has its impetus largely from external pressures, especially the pressure of major international insurers who actively push the liberalisation forward through GATS, rather than from internal needs. This is mainly because developing countries are not major exporters, but the main importers, of insurance service. They have many concerns about the impact of liberalisation. For example, in Russia, policymakers and insurance industry representatives expressed their concerns over greater access to the insurance market for foreign entities. These concerns are the "threat of a potential 'domination' of the national market by foreign insurance companies, insufficient contributions to the local insurance industry and the economy as a whole, outflows of capital, and only minor transfers of technological

[24] See "European Commission" Part I "Competition Law and enforcement issues", and Part II "Implementation of the single market programme in the insurance sector" *in Competition and related regulation issues in the insurance industry* OECD Dec. 1998 DAFFE/CLP(98)20 p189-200.

and managerial know-how."[26] Some concerns are realistic. For instance, in Hungary and Poland, which are deemed to have reached the highest level of EU compliance in the insurance industry,[27] the foreign insurers' market share amounted to 90% of the insurance markets[28] In Thailand, foreign insurers controlled nearly half of the total direct premiums in the life insurance sector by mid 2001. The Thai authority therefore delayed bills that would allow foreigners to increase their stakes in insurance companies to 49% from 25%, because small local insurers complained that they could not cope with fully free competition in short term.[29]

The third phenomenon is that major international insurers are profit-seeking organisations, and therefore act in their own interests. It would be naïve to think that their impetus of accession to developing /transition markets has been driven by anything but self-interest. Generally, their expansion to developing/transition countries serves several basic aims. Firstly, major North American and European insurers have very high levels of capitalisation[30] while the competitive nature in their local markets has left only a little more space for them to make profits. Naturally, they expand into many under-served markets in developing countries in order to make more efficient

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[25] *Supra note* 17.

[26] "Summary record" of *Roundtable on insurance in Russia Moscow* May 2000, OECD. In addition, Harold D. Skipper discussed in details the issue of concerns over liberalisation of insurance market access, see "Foreign insurers in emerging markets: issues and concerns" Certer for Risk Management and Insurance, Georgia State University, Occasional paper 97-2.

[27] According to *Swiss Re. Sigma* No. 1/2001, countries in central and eastern Europe (Bulgaria, Czech republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, Slovenia, and Romania) applying for EU membership provide free market access for foreign investors who can acquire majority stakes in local insurance companies or set up their own subsidiaries, but none of them allows foreign insurers to sell policies via branch offices. These countries have introduced EU capital adequacy standards, and made great efforts to comply with the three sets of EU Directives.

[28] Esther Baur, Ulrike Birkmaier and Marco Rustmann (2001) "The economic importance of insurance in Central and Eastern Europe and the impact of globalisation and e-business" Economic and Social Council, United Nations, TRADE/2001/15.

[29] "Free-market drive faces setbacks" <http://www.siamfuture.com/ThaiNews> March 26, 2001. Thailand committed to the WTO to carry out a three-phase liberalisation. The first stage was the granting of new licences with foreign equity participation up to 25% in 1997. 16 non-life and 12 life insurance licences were issued. In the next two stages, the foreign ownership ceiling were increased to 49% and then 100%.

[30] See Swiss Re. Sigma No. 1/2000 "Solvency of non-life insurers: balancing security and profitability expectations"

use of capital. Secondly, insurance is based on the spread of risks; major foreign insurers can significantly diversify their risk base by expanding into markets in developing economies. Thirdly, along with their existing international customers operating in developing/transitional countries, major foreign insurers necessarily extend their services to these countries. However, the basic motivation for their expansion into, for example, India and China, is to seize the sizeable potential of the markets. This will logically drive them to vie for market share with local insurers, and sometimes to insure selectively for those risks which are lucrative rather than for the public benefit.

The fourth phenomenon is that, while the assumed benefits to emerging insurance markets have not been well demonstrated or documented yet, a large number of studies show that some countries experienced significant problems with inappropriately designed liberalisation in other financial areas. For example, Chile liberalised the capital account for domestic banks in 1980, after its reform of the domestic financial market in 1975-77. Debates on its subsequent financial crisis pointed emphatically to the factors, such as capital account liberalisation, the lack of a prudent regulatory framework for domestic banks, lack of macroeconomic prudence, and over-enthusiastic lending by foreign banks.[31] Regarding the South Korean financial crisis in 1997, a survey by IMF/World Bank and South Korean experts reveals that financial liberalisation in South Korea widened risk-taking opportunities by allowing Korean financial institutions to both borrow from and lend to institutions outside Korea. The liberalisation also created additional disincentives for managing risk by intensifying competition and eroding bank franchise values. Furthermore, weak prudential regulation allowed bank portfolios to become riskier, especially in terms of increased liquidity risk, reflecting maturity mismatches between dollar-denominated assets and liabilities. The liquidity crisis, which followed the reassessment of the South Korean economy by international lenders in late 1997, triggered a full-blown financial crisis because of the absence of an effective international lender of last resort.[32]

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[31] Gerard Caprio Jr., Isak Atiyas and James Harrison (1996) *Financial Reform - Theory and Experience* (1st ed.) Cambridge University Press

[32] Kevin Amess and Panicos O. Demetriades "The South Korean Financial crisis: lessons for financial liberalisation" Department of Economics, University of Leicester.

2.2.3 Implications for China

From the preceding discussion, we can see that no formal definition of insurance market liberalisation exists so far, even within the scope of GATS. One implication of these is that there is no general prescription as to how to initiate a process of insurance liberalisation. The situation varies from country to country, and it is difficult to generalise the best practice. Different countries had different satisfactory solutions to regulation and supervision. Insurance liberalisation is not a one-off action but a gradual process,[33] and it is perhaps always carried out with recognition of national self-interest, not at the behest of foreigners. Emerging market economies need special consideration for pace of liberalisation due to their particular economic and financial situation.[34] Insurance regulatory and supervisory systems of a particular country have to be tailored to local condition, economic needs, political and management cultures, and the outlook prevailing in the country. Furthermore, the systems need to be adapted to changing conditions.

Another implication is that, if liberalisation of insurance service is to have its desired impact on the developing countries, it must be accompanied by adequate prudential regulation and supervision. Liberalisation for its own sake does not necessarily produce the desired results. This was clearly illustrated by the disastrous financial liberalisation experiments carried out by some countries, *e.g.* Chile and South Korea. The importance of prudential regulation is also acknowledged in a number of important documents. For example, the GATS explicitly recognises "the right of Members to regulate, and to introduce new regulations on the supply of a services within their territories in order to meet national policy objectives, and given asymmetries existing with respect to the degree of development of services regulations in different countries, the particular need of developing countries to exercise this right."[35] The *OECD Codes of Liberalisation*, which establish rules of liberalisation for the governments of its Member countries, set out exceptions (to liberalisation) for reasons of public order and security.[36]

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[33] A number of governments in both developed and developing countries, *e.g.* the EU Member States and Thailand, Malaysia, adopted a gradualist approach to insurance market liberalisation.

[34] "Guidance on insurance regulation and supervision for emerging market economies" IAIS 1997.

[35] "Preamble", GATS.

[36] "Overview to the OECD Codes of Liberalisation" OECD June 2002.

Emerging economies, *e.g.* China, particularly need to highlight prudential regulation and supervision in their process of liberalisation, because they are normally less prepared than the developed countries to tackle the complicated issues of international finance.[37] Risks connected with operations in an emerging country are therefore normally higher; hence, prudential requirements are needed to be increased. As recent experience in emerging economies has demonstrated, liberalisation can have dramatic effects on the developments of domestic financial markets. Without the support of a prudential regulatory and supervisory framework, any disturbance in the process of insurance liberalisation could be amplified, lead to insurers' collapse, and eventually trigger the instability of financial system.

2.3 Insurance market access liberalisation in China

WTO and GATS principles and rules aim to encourage market economy, free trade and the reduction as much as possible of the government's interference in economic activities. In this sense, the WTO accession will be a great force driving China to further open and liberalise its insurance market. This section reviews the process of opening up the insurance market, outlines the provisions concerning insurance in GATS as well as China's commitments. It then provides comments on the *2001 FFIC Regulations*, and analyses of combined policies of opening up and protectionism adopted by China.

2.3.1 Observations on the market access liberalisation process before WTO accession

a. Gradually opening up

Like those of other economic sectors, the basic objectives of opening up China's insurance market are to maximise China's benefits and facilitate China's long-term economic growth. Given once the extremely underdeveloped nature of China's insurance industry, the Chinese authority adopted a gradualist approach to

[37] Goldstein, M., *et al.* (1997) "The case for an international banking standard" *Washington: Institute for International Economics.* Also see Goldstein, M. and P. Turner (1996) "Banking crisis in emerging economies: origins and policy options" Bank for International Settlements (BIS) Economic Papers No. 46, and Hellmann T., K. Murdock and J. Stiglitz (2000) "Liberalisation, moral hazard in banking and prudential regulation: are capital requirements enough?" *American Economic Review* Vol. 90, No.1 p147-165.

liberalisation of insurance market access, ensuring that the level of foreign participation matches the step of growth of the industry. The first overseas insurer entering into the market in 1982 was Ming An, a Hong Kong based Property insurer, who was permitted to operate in Hainan and ShenZhen. It was until ten years later that the first foreign insurer, the US American International Group (AIG), which was initially founded in Shanghai in the early 20th century, was granted to establish operations in China. By the end of 1999, only 17 licenses were granted to foreign insurers (see Table 1.6).

b. Stringent restrictions on market access

Subject to the gradualist strategy, the Chinese authority established a number of stringent requirements on foreign insurers' accession. Foreign insurers must abide by both general requirements for all FDI (*e.g.* feasibility studies, market research, official assessment and approval, and foreign exchange control, etc.), and requirements for all insurers operating in China (set out in the *Insurance Law* and associated regulations[38]). In addition to these, they were also subject to both explicitly and implicitly specific requirements. For example, the *1992 Shanghai Measures* set out that a foreign insurer can apply for a license to conduct business in Shanghai if it has: engaged in insurance business for over 30 years; a representative office in China for minimum two consecutive years;[39] and total assets in excess of US$5bn.[40] Foreign insurers were also subject to restrictions on business organisations, locations and business scopes. Foreign insurers (except AIG) wishing to sell life insurance must form a JV with a government-approved Chinese partner, with share not exceeding 50% of the JV. They used to be restricted to operating in Shanghai or Guangzhou both designated by the authority as experimental areas for the opening up. They were further restricted to specific business scope. For example, non-life insurers can only serve customers who were foreign-invested companies, and life insurer were not allowed to sell group policies which constituted a major portion of life business. Further, both life and non-life insurers were not allowed to conduct reinsurance business. All foreign insurers

[38] For example, provisions on assets and liabilities, solvency, investment.

[39] The establishment of representative offices by foreign insurers was governed by the *1996 Measures for the Administration of Resident Representative Offices in China of Foreign Institutions*, which was replaced by the *1999 Measures for the Administration of Representative Offices in China of Foreign insurance Institutions* (CIRC).

[40] The *1992 Shanghai Measures*, Art.5.

were also required to cede 30 % of premiums to China Re., while only 20% required for domestic insurers.

Regarding implicit requirements, the Chinese authority highlighted applicants' images and records of commitments to China. Recognising the importance of building up their images and relationships ("guan xi") with the Chinese government, foreign insurers trying to gain a license in China one after another made insurance-related or unrelated contributions to China to smooth their way into the Chinese market. For example, they provided Chinese insurers with personnel training and education, organised seminars, and donated to universities and museums, etc. In addition, the Chinese government also appeared to use licensing as a means to gain political advantages. For example, AXA-UAP was granted approval to establish a JV in Shanghai in May 1996 following French President Jacques Chirac's official visit to China.

c. *Speeding up the liberalisation*

The requirements of the WTO negotiations and pressure from the international insurance community drove China's government to expedite the pace of opening up. Since November 1999 when the Sino-US WTO deal was made, China has speeded up the licensing of foreign firms, and gradually loosened geographic and operational restrictions, thereby allowing foreign firms more access to the market. By the end of 2001, 38 licenses had been issued to insurers in 11 different countries (including 9 branch licenses for AIG, and 2 branch licenses each for Royal & Sun based in the UK, and AXA in France). Of the 38 licenses, 12 are for property and casualty insurers and 26 for life insurers. Most of them had already started to do business in China, primarily in Shanghai, while the remaining licensees are preparing for starting operation (see Table 1.6 and Table 2.1). The Chinese government added Shenzhen and Foshan in 1999, Tianjin and Dalian in 2000, Beijin, Dongguan, Suzhou and Jiangmen in 2001, to the list of opening areas.

Table 2.1 The number of licenses granted to foreign insurers during 1992-2001

1992	1994	1995	1996	1997	1998	1999	2000	2001
2	1	2	2	3	2	3	8	15

2.3.2 China's obligations and commitments regarding insurance

As a member of the WTO, China has to keep its commitments and fulfil its obligations laid down by the WTO.[41] China's basic obligations include: not to discriminate amongst different foreign insurance providers (MFN)[42] or amongst foreign and domestic insurance providers (National Treatment);[43] and to ensure regulatory transparency.[44]

Under the *Final Schedule of Services Commitments*, the Chinese government has

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[41] Concerning the main responsibilities that the members should observe in their insurance industry, the GATS (1994) and the *Results of the Financial Services Negotiations under the GATS* (1997) set out the following principles: *Market access, National Treatment, Transparency, and Most Favoured Nation Treatment* (MFN).

China's WTO commitments are documented in its (1) *Protocol on the Accession of the People's Republic of China* (*Protocol*), which contains the terms of membership that China negotiated and affirms China's adherence to the WTO agreements; (2) the *Report of the Working Party on the Accession of China* (*Working Party Report*), which contains additional commitments and provides a narrative on the results of China's negotiations; and (3) annexes containing market access commitments, which primarily cover individual tariff lines for goods and schedules for various service sectors.

[42] The GATS generally provides for MFN treatment in trade in services. It requires signatory members to avoid discrimination among trading partners. As most countries, especially developing countries, insist on conditional MFN treatment commensurate with their different insurance development levels, along with the economic development goals and opening modes, the GATS allows for a ten year exemption subject to conditions. The exemptions are subject to negotiation. The ten-year exemptions further contains a transparency requirement that calls for the publication of all relevant statutes and regulations, and are normally required to be reviewed after five years.

[43] This provision contains the obligation to treat foreign insurance firms and their domestic counterparts in the same manner. This obligation is limited to the member's schedule of commitments. In addition, the GATS also provide the possibility of different treatment being accorded as long as the conditions of competition are not modified in favour of the domestic insurance firms. Art. XVII, the GATS.

[44] *Id.* Art. III, and see "Concluding remarks" of the chapter.

made a wide range of commitments with respect to market access;[45] most of them concern GATS mode 3 ("commercial presence" in China).[46] Regarding cross-border supply, except for international marine, aviation and cargo insurance, reinsurance, large commercial insurance, and reinsurance brokerage, China has made no pledges. Regarding consumption abroad, China has pledged no limitation except for insurance brokerage. Regarding the presence of natural persons, China has made no pledges except for the trans-sector horizontal commitment (*i.e.* general pledge for sectors including insurance).

Regarding commercial presence, China's commitments are wide-ranging and very significant. Firstly, China has accepted that licences are awarded only based on prudential criteria[47] without "economic needs" test or quantitative limits on licenses. Secondly, it agrees to phase out existing geographic restrictions on all types of

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[45] The intention of the market access provisions in WTO is to progressively eliminate various types of measures that restrict foreign service suppliers' access to domestic market. The GATS prohibits limitations on: the number of suppliers; the total value of service transactions or assets, including economic-needs tests; the total number of service operations or the total quantity of service output, including economic-needs tests; the total number of naturalised persons who may be employed; the types of legal entities through which a service supplier may supply a service; and participation of foreign capital. This list is not exhaustive. *See* Art. XVI, the GATS.

The obligations regarding market access to certain service sector are listed in the member's schedule of commitments. For detailed commitments of each member, see Hisaya Ishii (1999) "Liberalisation of international insurance operations: comparative tables" OECD.

[46] Instead of a definition of a service, the GATS defines trade in services according to the mode of supply of an international service. There are altogether four modes, including: services supplied from one country to another ("cross-border supply" - mode 1); consumers or firms making use of a service in another country ("consumption abroad" - mode 2); foreign companies setting up a commercial presence to provide services in another country ("commercial presence" - mode 3); and individuals travelling from their own country to supply services in another ("presence of natural persons" - mode 4).

[47] In order to qualify a license, an foreign insurer must meet three conditions: (1) more than 30 years of experience in a WTO member economy; (2) a representative office for two consecutive years in China; (3) Third, total assets at the end of the previous year should be no less than US$5bn. Regarding qualifications for insurance brokerage houses, in addition to the aforementioned requirements for 30-year operation and two consecutive years of a representative office, the applicant should have more than US$500 million of assets at China's WTO entry, US$400mn in the first year after the entry, US$300mn in the second year, and US$200mn beginning from the fourth year.

insurance operations during the first three years after accession.[48] Thirdly, upon accession, foreign life insurers are permitted to hold 50% equity share in a JV. At WTO entry, foreign non-life can hold a maximum 51% ownership of a JV, and can establish a wholly owned subsidiary within two years after accession. Foreign insurance brokers can reach 50% equity share in a JV brokerage upon accession, and should be able to establish proprietary subsidiaries by December 2006. At WTO entry, foreign insurance/reinsurance companies are allowed to provide reinsurance services with no geographical restrictions in non-life and life insurance in the form of branch, JV or proprietary subsidiary. Fourthly, regarding the expansion of business scope, at WTO entry, foreign non-life insurers are able to provide master policies and insurance of large commercial risks[49] without geographical restrictions, and to provide all-round coverage to indigenous Chinese entities within two years. Foreign life insurers are allowed to provide individual (non-group) life coverage upon accession, and to provide health insurance, group insurance and pension/annuity insurance services three years after accession. Fifthly, the 20% cession of Chinese and foreign direct insurance companies to Chinese reinsurance companies phases out by a quarter annually beginning from the first year after WTO entry. However, foreign insurers insurance companies are not allowed to engage in third party liability insurance and public transport vehicle and commercial vehicle driver's/carrier's liability insurance.

2.3.3 Post-WTO market access liberalisation

[48] At WTO entry, Shanghai, Guangzhou, Dalian, Shenzhen and Foshan are opened to foreign entrants. In the second year after WTO entry, the opened cities extend to Beijing, Chengdu, Chongqing, Fuzhou, Suzhou, Xiamen, Ningbo, Shenyang, Wuhan and Tianjin. In the third year, China will totally lift geographical restrictions.

[49] Insurance of large commercial risks is defined as the coverage of large industrial and commercial enterprises. The coverage will be treated as large commercial insurance, if: (1) at China's WTO entry, annual premium from the enterprise exceeds Rmb800,000 and the amount of investment surpasses Rmb200mn; (2) in the first year after WTO entry, the annual premium exceed Rmb600,000 and the amount of investment surpasses Rmb180mn; and (3) in the second year, annual premium should exceed

Since the WTO accession, China has made substantial efforts to deliver its commitments required of a WTO-member. Assessment reports by some entrusted bodies such as the Office of the US Trade Representative and the US Chamber of Commerce made generally positive comments on China's implementation of its WTO commitments. They also made recommendations about further steps that China needs to take to fully comply with its WTO commitments.[50]

In insurance area, China also made great efforts to improve its regulatory and supervisory system, amending or abolishing law and regulations that are not compatible with or contradict the basic principles of the WTO and the commitments made by China. It revised the *1995 Insurance Law* mainly for the WTO consistency (see Chapter 1 for detailed discussions), and issued several new regulations and rules. For example, on September 17, 2002, the CIRC promulgated the *Administrative Rules on Business Scope and Operational Capital Required to Establish Reinsurance Companies*, which directs to honour its promise of opening the reinsurance market up to domestic and foreign competition immediately upon its accession to the WTO (See note 66, Chapter 1). As part of the continuing efforts to liberalise and streamline its supervision of the growing industry, in the late 2002 the CIRC scrapped 58 administrative approvals which were introduced in recent years as part of various regulations. This move was followed by a scrapping 28 other approval requirements months later. In the first year after the WTO accession, six foreign insurers were approved to enter China, and 16 foreign insurance institutions started operation. To promote competition, auto insurance and aviation accidental insurance began to apply file-and-use rate and term regulation.

2.3.4 FFIC Regulations

Promulgated in the wake of the China's insurance service commitments made during its accession to WTO, the long waited *FFIC Regulations* is apparently to fulfil the commitments. The regulation covers the procedures and requirements regarding registration, supervision, liquidation and liability, as well as business scope, for

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Rmb400,000 and the amount of investment surpasses Rmb150mn.

[50] See "First step: A U.S. Chamber report on China's WTO progress" U.S. Chamber September 2002, <http://www.amcham-china.org.cn> and "2002 report to Congress on China's WTO compliance" *The Office of the U.S. Trade Representative* November 2002. <http://www.ustr.gov>

FFIC.[51] It in fact superseded the *1992 Shanghai Measures* which had governed the activities of foreign insurers in China since 1992. Compared with the *1992 Shanghai Measures*, the *FFIC Regulations* made various issues regarding the application procedures clearer.

Firstly, the regulation reaffirms criteria for obtaining licenses,[52] which are consistent with the WTO commitments and the criteria in the *1992 Shanghai Measures*.[53]

Secondly, the application procedures are simplified. Foreign insurers are no longer required to be invited to apply by the CIRC. This is a major improvement over the licensing system that had existed in China for the previous decade. The licensing process, which is the same for all three FFIC forms, can be divided into three consecutive steps: (1) the filing of pre-licensing information called an "initial application",[54] and then, if accepted (the CIRC shall decide whether to accept or deny within six months); (2) the filing of an official application,[55] and then, if approved (the CIRC shall approve or deny within sixty days); (3) registration of the CIRC approved entity with the *State Administration of Industry and Commerce*. The establishment of explicit time limits for reviewing the application is another improvement over the previous, sometimes arbitrary, review process.

Thirdly, subject to CIRC approval, a FFIC may be licensed to engage in property insurance such as casualty, liability and credit insurance, or in life insurance such as life, health, accidental death and dismemberment insurance. Within the verified scope, a FFIC may also engage in insurance of large commercial risks and issue master policies. While one FFIC is not allowed to engage in both property insurance and life

[51] *FFIC* are defined to include JVs, wholly foreign-owned enterprises, as well as PRC branches of foreign insurance companies. Art.2, the *2001 FFIC Regulations*.

[52] Art.8, the *2001 FFIC Regulations*.

[53] *Supra note* 40.

[54] The initial application requires submission of basic corporate information as well as information on the Chinese JV partner, if one is required. Foreign insurers are also required to submit a "feasibility study" for the proposed insurer.

[55] Once the CIRC accepts the initial application, a company has up to one year (with a maximum extension of three months) to form the proposed foreign-funded insurer. Upon completion of the formation, the company is required to submit an official application which includes extensive information about the new entity. Some of the information required include: a list of investors and respective contributions, a capital verification certified by a designated Chinese auditor, a three year business plan and reinsurance program, and premium rates and contract forms.

insurance business simultaneously, they may engage in reinsurance of risks that they are authorised to insure. Life insurance, however, can only be written through a JV.

While the promulgation of the *FFIC Regulations* is an active step forward in clarifying the licensing process, some articles of it drew complaints from foreign insurers. For example, the registered capital threshold of Rmb200mn (US$24mn) for an foreign insurer's mainland branch is claimed too high, placing an excessively heavy burden on foreign insurers.[56] In addition, the regulation leaves the CIRC the discretion to increase capital requirements. Moreover, an applicant needs to show that regulatory authorities in its home jurisdiction have consented to the application to establish an insurance company in China. This requirement seems questionable as obtaining such a consent would be likely difficult in most jurisdictions.[57] Furthermore, the regulation prohibits composite insurers, a market access limitation that does not appear in the WTO guidelines.

There are other questionable or vague issues. One important is that such licensing items as business scopes, customer scopes, and foreign investment percentages, have to "be approved by the CIRC in accordance with the relevant regulations". However, there is no indication in the regulation to what these regulations are. It would be problematic for foreign insurers to identify which of the relevant regulations are in the existing *Insurance Law* and its supplementing regulations, or regulations yet-to-be issued. Another issue is that the regulation requires a notice in writing with reasons of stipulated decision to be issued by the CIRC upon denial in licensing process. This appears in violation of the WTO obligation to provide tribunals or procedures to review such a type of decisions. Regarding whether foreign brokers, agents and actuaries can establish themselves in China, the regulation is silent, although China's WTO commitments open the brokerage business to 50:50 joint ventures without a mention regarding agencies or actuaries. The *2001 Brokerage Regulations* are also silent on foreign brokerage access, except saying that if any laws, treaties or administrative regulations to which China is a party specify differently, then those laws, treaties or administrative regulations shall govern. These leave the licensing procedures of brokerages unclear.[58] A similar situation exists for actuaries. By contrast, the *2001 Agency Regulations* specifies that they are applicable to foreign

[56] "Another progressive move" Chang Tianle *Shanghai Star*, July 2, 2002.

[57] Andreas Lauffs and Jeffrey Wilson (2002) "China moves forward on foreign investment in insurance" Baker & Mckenzie (China)

funded insurance agency institutions. In summary, the above questionable and vague rules need to be revised in the future.

2.3.5 The combination of policies: opening up and protectionism

Although greater freedom for foreign insurers has been enshrined in principle, in practice, protectionism is still manifested in many ways. For instance, the CIRC has open-ended discretion on any approvals; the complicated licensing process remains in effect. Foreign insurers have to apply for separate permits to set up branches in different cities. Capitalisation requirements are high. With few Chinese companies able to tie up that much capital, foreign insurers simply cannot enter the marketplace in terms of setting up a 50-50 JV with a Chinese company. Some foreign insurers have sought to tap the market not by starting a JV or waiting for a licence, but by buying into domestic insurers.[59] However, foreign stakes in domestic insurers are limits to 25 % of total shares with each individual foreign insurer restricted to a maximum 10% of total shares, caps that were in effect before WTO membership and are not scheduled to change.

In fact, China has chosen combined policies - allowing foreign access while purposely controlling new entry and liberalising in a gradualist manner. An ostensive reason is that China would like highly competitive foreign insurers to help strengthen the weak domestic insurance rather than to drive their domestic rivals out of business. Furthermore, in deeper analyses, the possible reasons could range from the objectives of opening up, infant industry argument, concerns about both financial stability and the important position of the insurance industry in the economy, to the inadequacies of domestic regulation.

Firstly, it is necessary to understand the purposes of opening up the insurance market and the forces driving insurance liberalisation. China's goal in pursuing trade

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[58] For example, there is not a single license issued to foreign insurance broker in China yet.

[59] The New China Life Insurance Co Ltd became the country's first insurer to sell shares to foreign enterprises. Five foreign institutions, including International Finance Corp, Zurich Financial Services Group and MeiJi Life Insurance Corp, bought a 24.9% stake in New China. Consequently, New China's net assets increased from US$75.9mn to more than US$192.8mn. The insurer is also said to have received advanced technology and management know-how from the five foreign shareholders who were given a chance to enter the relatively closed Chinese market at a reasonable price. *China Daily*, August 31, 2000

liberalisation is to transform its domestic economy; joining WTO builds on China's two-decade reforms rather than for membership's sake only. China's leaders believe foreign competition is essential to encouraging economic rationalisation and faster productivity growth. The insurance sector is sharing similar views. China would like foreign capital to help strengthen its weak domestic insurers. Foreign insurers may serve as a vehicle for capital inflow, transferring technology and know-how,[60] as well as higher standards of transparency and self-regulation. However, China's authority is sensitive to the impact of foreign competition on China's domestic insurers, financial stability and the economy. Choosing the combined policies reflects the government's attempt to strike a balance between the benefits and costs of foreign access in the market.

Secondly, there is a perceived need for the government to protect the domestic insurers from immediate fiercer competition because of the infant industry argument. Despite the impressive growth, China's insurance market still has many features of a under-developed market. Tables 2.2-2.6 demonstrate the gap between China and certain countries. China ranked 16th (17th in 1998) in the world when measured by 2000 premium dollars (non-life 15th and life 18th), 73th (78th in 1998) measured by 2000 insurance density, and 61th (66th in 1998) measured by 2000 insurance penetration.

Table 2.2 Total premium volumes in US$ 2000

country	Ranking	Premiums(US$ m)	Real growth 1999/2000 (%)	Share of world market (%)
US	1	865,327	3.5	36.41
Japan	2	504,005	0.2	20.62
UK	3	236,960	-14.5	9.70
China	16	19,278	0.79	0.4
India	23	9,933	0.41	-2.6

Source: Swiss Re, Sigma No. 6/2001

[60] One notable benefit concerning technology transfer is operational transformation in the life insurance business. Chinese domestic insurers used to focus on corporate business through sales staff. The personal sales agent system of AIG introduced a new distribution approach to the domestic insurers. This facilitated the domestic insurers' transformation of limited operational targets to the simultaneous development of both group and personal business through personal sales agents. Another obvious benefit relating to indirect technology transfer is, through foreign insurers' contributions and the introduction of foreign qualification examinations (*e.g. Loma, CPCU*), the quality of insurance professional training and education in China has been improved. Except for these, other benefits of technology transfer appear uneasily identifiable.

Table 2.3 Life insurance premium volumes in US$ 2000

country	Ranking	Premiums(US$ m)	Real growth 1999/2000 (%)	Share of world market (%)
US	1	442,373	3.7	29.08
Japan	2	402,484	0.1	26.39
UK	3	179,742	-4.7	11.82
China	18	12,049	0.4	0.79
India	20	7,595	-2.7	0.5

Source: Swiss Re, Sigma No. 6/2001

Table 2.4 Non-life insurance premium volumes in US$ 2000

country	Ranking	Premiums(US$ m)	Real growth 1999/2000 (%)	Share of world market (%)
US	1	422,954	4.5	46.85
Japan	2	102,521	0.2	11.11
Germany	3	67,465	-11.9	7.31
China	15	7,228	0.4	0.78
India	29	2,338	-2.3	0.25

Source: Swiss Re, Sigma No. 6/2001

Table 2.5 Insurance density: Premiums per capita in US$ 2000

Country	Ranking	Total business	Life	Non-life
Switzerland	1	4,153.9	2,583.3	1,570.6
Japan	2	3,973.3	3,165.1	808.2
UK	3	3,759.2	3,028.5	730.7
China	73	15.2	9.5	5.7
India	78	9.9	7.6	2.3

Source: Swiss Re, Sigma No. 6/2001

Table 2.6 Insurance penetration: Premiums in % of GDP 2000

Country	Ranking	Total business	Non-life	Life
South Africa	1	16.86	14.04	2.83
UK	2	16.78	12.71	3.07
South Korea	3	13.05	9.89	3.16
India	52	2.32	1.77	0.55
China	61	1.79	1.12	0.67

Source: Swiss Re, Sigma No. 6/2001

The insurance market is small, mainly due to both the low per capita GDP and the lack of public awareness. While considerable advances have been made in the development of human resources, the market still lacks qualified personnel with technical and specialised skills and robust risk management. Local insurers are often undercapitalised. In comparison, any one of the foreign-funded companies approved to enter China has high-quality staff with a hefty amount of capital, rich experiences, and effective management system. All these advantages enable them to challenge local insurers in product development, sales, client services, and enlisting talents. It fears that without barriers and tariffs, inefficient and under-developed local firms are

inferior to immediate competition from foreign rivals.[61]

Thirdly, the China's view of insurance development is driven by strategic considerations, not just adherence to liberal economic values. It is frequently argued that as finance including insurance industry provides important services to an economy, it is therefore best owned and controlled by domestic interests. More sophisticated foreign entrants, pursuing different objectives, could come to dominate the industry to the detriment of national objectives. Furthermore, China's domestic insurers do have their incomparable advantages in scale of service network and understanding of market situation; there has to be a process for foreign insurers to adapt to the Chinese market. Given these factors, Chinese insurers are expected by the government to restructure or learn-by-doing, eventually become internationally competitive, and take a lion's share of the market unpredictable potential, if provided with protected markets. In fact, the combined policies are considered as one of the successful factors for the rapid development of local firms in the last two decades.

Fourthly, with the shift from once a closed and monopolistic market to an opening and competitive market, China needs to adapt its regulatory framework to new environment, and improve its monitoring and supervisory capacity. Among the areas for prior actions, issues of prudential regulation and insurers' corporate governance are acquiring significance (See Chapter 3, 4).

2.4. Competition issues in the Chinese insurance market

China's insurance market is suffering from the lack of sufficient, effective and orderly competition. This section observes the situation of unhealthy competition (for the insufficient competition of the market, see Section 1.3.3, Chapter 1) seen in the market, and counteractions taken by the regulator. It also analyses the underlying factors of the incomplete and unhealthy competition.

2.4.1 Rampant unhealthy competition and crackdowns

[61] A survey conducted by Horizon Research in the late 2000 showed that 51 percent of the respondents in the main large cities of China favoured foreign insurers over native Chinese insurers although most of them had had little experience with foreign insurers. The reason for this appeared to be mistrust and specifically a fear that Chinese insurers might defraud them. It fears that the biggest challenge to Chinese insurers posed by the increasing presence of foreign insurers is in winning sufficient consumer confidence ultimately to gain business.

As we discussed in Chapter 1, China's insurance market is highly concentrated. However, incomplete competition does not necessarily mean a lack of fierce and unhealthy competition. In fact, the rapid growth in recent years has been accompanied by a surge in regulatory problems, requiring successive overhauls by the government. The unhealthy competition witnessed in the market shows the following common types:

Some insurers and intermediaries operate illegally, *i.e.* without official approvals, and abuse the legal system by illegally setting up branches and shops, appointing senior management staff without approvals, and "fronting" for foreign firms.[62]

Some firms use administrative means to prevent fair competition and monopolise the market, which is strictly prohibited. For example, some insurance institutions joined with local government departments to designated insurers to monopolise *students' and children's safety insurance* (SCSI) and prevent fair competition. Some insurance institutions even through the departments forced customers to buy SCSI or other insurance products.[63]

Some firms' sales personnel promote products untruthfully and vaguely, misleading consumers. For example, they bragged about insurance coverage and functions rather than giving an honest description about the insurance. Some offered low premiums but

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[62] Fronting occurs when a foreign firm lacks a license to do business in China and forms an alliance with a domestic firm. The foreign firm is then able to offer insurance policies in the name of the domestic firm, and receives a portion of the premium. It was reported that by the end of 2000, among the 10,000 senior management staff in various insurance institutions, 20 percent were appointed without approvals. At the same time, of 10,000 insurance institutions registered in China, 4 percent, namely 400 institutions, were set up in breach of regulations. "China Rectifies Insurance Market" *Renmin Ribao (People's Daily)* July 20, 2001. In 1999, the CIRC overhauled illegal foreign-funded insurance intermediate activities. Sedgwick Insurance & Risk Management Consultants (China) Ltd. was suspended from trading for operating unlicensed businesses among other things. The suspension was lifted in October 1999. In Septem 1999, Jardine Insurance Brokers Ltd.'s Beijing representative office was ordered to close for allegedly transacting unauthorised insurance business. See *Business Insurance* Crain Communications, Inc. October 25, 1999. It was also reported that some Hong Kong based agents were penalised for selling policies in the mainland, which was forbidden. *South China Morning Post* October 5, 2000.

[63] The CIRC, therefore, warned that it would severely punish those who continued to engage in such improper competition. See "Announcement on Rectifying and Standardising Students' and Children's Safety Insurance Business" The CIRC 2000, and "China - CIRC prohibits students', children's insurance monopolies" *Zhongguo Gaige Bao (China Reform News).* August 15, 2000.

hollowed out coverage by vague language. Some overstated the investment potential of insurance products. To lure customers to purchase policies, some concealed parts of obligations that buyers had to perform, or purposely glossed over the possible defects with an ingratiating attitude.[64]

Some insurance lines are plagued by various irregular activities. For example, to secure a larger market share in the auto insurance market, some firms engaged in such malpractice as offering excessively high commissions to agents, providing customers with high interest kickbacks by means of refunds or gifts, or illicitly granting no-accident discounts. They also competed with rivals by offering rock-bottom premiums, or providing exorbitantly high returns to policy buyers.[65] To obtain large amount transactions such as blanket contracts and construction insurance, some companies decreased their bidding premiums below approved scopes, or provided coverage extensions that exceed approved terms. These resulted in the firms' inability to make repayments when policies matured. In the group insurance market, some firms provided high returns and high commissions, expanded their scopes of coverage, and assisted consumer companies in raising funds in an effort to attract as many clients as possible. Some sales personnel illicitly individualised group insurance contracts in order to get higher commissions than they can get from the group contracts.[66]

In recent years, the CIRC has made great efforts to tackle the rampant unhealthy competition.[67] However, these efforts have not turned out to be fully effective. Market chaos resulted from unhealthy competition became a chronic and stubborn "disease".

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[64] *Renmin Ribao* (*People's Daily*) March 16, 2001

[65] According to the *China's Insurance Association* (CIA).

[66] <http://www.chinainsurance.com > May 25,2001

[67] For example, in January 1999, the newly established CIRC launched an overhaul on the aviation personal accident insurance market, requiring insurers to use standardised policies printed by the CIRC. Later that year, the CIRC carried out a series of overhauls on the motor vehicle insurance market, group business, part-time agents, and illegal foreign-funded insurance intermediate activities. The CIRC comprehensively cleared and standardised insurance clauses, putting over 2,000 effective clauses on file, and abolishing 151 clauses; renewed the licences of 244 insurance companies and their branches; and examined 2,030 high-level managerial personnel of insurance companies. In 2000, the CIRC took up a sharp crackdown on illicit market activity, mainly targeting fake insurance policies circulating in parts of the country and sharp discounts on policies sold by insurance agents. See Karby Leggett "China launches insurance sector crackdown before WTO entry" *Dow Jones International News* April 28, 2000. In 2001, the CIRC launched another nation-wide clean-up campaign in China's insurance market. For details, see *China Daily* July 15, 2001.

Experience showed that tightening the regulations of market performance was not enough to restrain the chaos, and restricting market access to avoid presumed excessive competition did not provide a proper remedy for the "disease". Solutions that deal with the root causes of the problems should be developed.

2.4.2 Regulatory controls on the Chinese insurance market

China imposes many restrictions on the insurance business; some of them do not help create a competitive and effective market. This section presents some of characteristics of the Chinese insurance regulatory framework.

a. Control of ownership and forms of business

The *2002 Insurance Law* provides for only two types of insurance companies: companies limited by shares (joint-stock companies) and wholly state-owned companies.[68] The provisions of corporate structure set out in the *Company Law* also apply to insurance companies.[69] The *2002 Insurance Law* also indicates the possibility of other investment forms, such as mutual insurers, but only in the future[70]. There are four vehicles for foreign investment: JV, joint-stock limited companies, subsidiaries and branches of foreign insurance companies.[71] The existing system also lays down explicit requirements relating to change of control. For example, a change of shareholders involving more than 10% of voting shares must be approved.[72]

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[68] See the *2002 Insurance Law*, Art. 70.

[69] The *Company Law* (1994) provides for the establishment of limited liability companies and joint-stock companies. A wholly state-owned company is a form of limited liability company established by a single investment from a state-authorised investment organisation or state-authorised departments.

[70] The *2002 Insurance Law*, Art. 156.

[71] *Supra note* 51. The primary laws and regulations that provide for JVs and branch offices are respectively: the *Law on Sino-Foreign Equity Joint Ventures* (July 1979, 3rd revision in March 2001) and its relevant implementing regulations, and the *Foreign Investment Enterprise Law* (April 1986, 2nd revision in November 2000). The *Provisional Regulations on Several Issues Concerning the Establishment of Joint stock Limited Companies with Foreign Investment* (*Foreign-invested Joint Stock Regulations*, January 1995) regulate joint-stock investment.

[72] The *2002 Insurance Law*, Art. 82. It also lists other changes that must be approved or examined by the authority.

China prohibits insurers from operating also in other business areas, and bans an insurer from offering both life and non-life insurance policies at the same time.[73] Insurers are further restricted by law from operating outside the scopes and territories of business approved by the CIRC.[74] The permitted scope of reinsurance business is the same as for primary insurers, in other words, reinsurance in both property and life insurance at the same time is not permitted. When approved, insurers may reinsure out to other insurers, and accept risks from other insurers (but not to/ from related parties).

b. Barriers to entry

The existing legal system has explicit requirements for the establishment of insurance companies and branches in the process of licensing. For the setting up of a company, it requires minimum registered capital,[75] special expertise, suitability of owners, reliable management, elaborate business strategies, and a business site and facilities.[76] To establish a new branch, or a sub-branch, or upgrade a sub-branch to a branch, an insurance company needs to meet the precondition that its premium income growth reaches certain amounts,[77] and get an approval from the CIRC. In fact, China executed a strict licensing system based on the *economic needs test*,[78] and stringently restricted both domestic and foreign investors from entry into the market. At present, the CIRC bars the door with a strict approach of case-by-case approval.

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[73] This restriction has been circumvented by establishing two separate insurance companies, with one for life insurance and one for property insurance. For instance, Ping An has set up a holding company to possess subsidiaries engaging in life insurance and property insurance, respectively. AIG is presently the only foreign insurance company that has different arms engaging in life insurance and property insurance under different subsidiaries in China.

[74] The *2002 Insurance Law*, Art. 92.

[75] Art. 73 of the *1995 Insurance Law* provides for a minimum registered capital of Rmb200mn that must be fully paid up. Later, the *1996 Administration Regulations* increase the minimum registered capital. It provides for no less than Rmb500mn paid-in capital for an insurance company that carries on insurance business on a nation-wide basis. For an insurance company including a branch of a foreign insurer that carries on insurance business within a designated territory, its registered capital is no less than Rmb200mn (Art.7, the *2001 FIIC Regulations*).

[76] See the *2002 Insurance Law*, Art. 72-75; the *1996 Administration Regulations*, Art. 5, 13-17; the *2000 Insurance Company Regulations*, Art. 6-16; and the *Provisional Regulations on Eligibility of Senior Management in Insurance Institutions* 1999, the CIRC.

[77] See the *1996 Administration Provisions*, Art. 5-10.

[78] The *1995 Insurance Law*, Art. 71, and the *1996 Administration Regulations*, Art. 4.

c. Barriers to exit

The main legal basis for sorting out firm exit is the *Bankruptcy Law 1986* for general enterprises and several judicial annotations. The *Insurance Law, the Company Law,* the *Civil Procedure Law* and several insurance regulations also provide scattered rules for handling insolvency and liquidation. Under the *2002 Insurance Law,* an insurance company may merge, or de-merge, or dissolve as specified in its articles of association, if approved by the CIRC. A life insurer is not allowed to exit by dissolution. An insurer must go through mandatory liquidation when it is divided, merged, dissolved, or deprived of its license, or becomes insolvent. There are sets of specific substantive and procedural provisions for liquidation designed to protect the interests of policyholders. Firstly, a life insurer has to transfer its existing business together with the portfolio reserves to another life insurer before being able to exit the industry. The CIRC may order a selected life insurer to accept the transfer if the deal can not be reached voluntarily between the insurers.[79] Secondly, assets cannot be repatriated until all continuing insured risks are provided for.

However, the insolvency system in China is underdeveloped, especially in the regime of SOEs. In fact, most insolvent SOEs have been dissolved or merged into other SOEs under administrative arrangements since China first passed the *Enterprises Bankruptcy Law* in 1986. This was mainly due to the government concern over social stability and employees' benefits. Moreover, concerning insurance company insolvency, China has not yet passed the secondary legislation of the special insolvency procedure for insurance companies as specified in the *2000 Insurance Company Regulations* (Although, there has been so far no report of insurance company failure). Additionally, China has not established insurance guarantee funds as countries such as the UK and the US (most states) have done (see Chapter 4).

d. Control of price and products

China had long implemented unified tariff system for major risks, especially in non-life insurance. Under the *1995 Insurance Law,* premium rates and the basic insurance clauses for the principal types of commercial insurance risk must be set by the "insurance authority". Premium rates and basic clauses for other types of risk, although left to the discretion of insurers, need to be reported to the "insurance

[79] The *2002 Insurance Law,* Art. 88.

authority" together with the required documents for the record.[80] Under the *2000 Insurance Company Regulations*, the CIRC is given a wide range of powers for regulating policy provisions and rates.[81]

The stringent control on products and prices is a "double-edged sword": while assumedly promoting the fair and safe development of the insurance business, it results in stagnation in the innovation of insurance products and services. This leads to the unwelcome phenomenon of "cloning". To achieve a functional transition for the regulator from a controller to a supervisor and reduce the government interference with insurers' operations, the *2002 Insurance Law* establishes *prior approval* and *file-and-use* systems. However, regulations for implementing the new systems still need to be formulated.

e. Control of marketing and distribution

The existing system lays down a number of stipulations on fair competition and how insurers are to conduct their business. For example, insurers may not appoint insurance agents to develop business on its behalf unless the agents have been approved by the CIRC. Neither may they accept insurance business introduced by insurance brokers that have not been approved by the CIRC. Insurers are prohibited from engaging in unfair competition including vicious pricing, and illegal advertising. It is also illegal to fabricate and disseminate false information to harm competitors, or to use judicial or administrative powers to pursue a monopoly or obtain commercial advantages. However, there are no detailed provisions that oblige insurers and their staff to properly disclose important information when they are doing insurance business with clients.

The *1995 Insurance Law* sets out a general framework for regulating insurance agents and brokers (remains unchanged in the 2002 revision), which is supplemented by the *2001 Agency Regulations*[82] and *2001 Brokerage Regulations*[83]. Generally,

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[80] The *1995 Insurance Law*, Art. 106, the *1996 Administration Regulations*, Art. 43,44, and the *2000 Insurance Company Regulations*, Art. 69-75.

[81] See section 6.3.1, Chapter 6.

[82] The Regulations repealed the *Interim Regulations for the Administration of Insurance Agents* (by PBOC, Nov.30, 1997) which repealed the *Provisional Regulations for the Administration of Insurance Agents* (by PBOC, Feb. 2, 1996).

[83] It repealed the *Regulations on the Administration of Insurance Brokers* (by PBOC, Feb. 16,1997).

brokers, agents and loss adjusters[84] are required to be licensed and registered with the authorities. They are also required to have professional certifications, to deposit guarantee funds with the authorities, and to insure against professional liability risks.

f. Control of fund investment

Insurers' investment is restricted to fixed deposits with banks, the purchase of government, financial or state-level corporate bonds, and other forms of investment prescribed by the State Council. They can only indirectly invest in the stock markets via mutual funds (see Chapter 5).

2.4.3 Impairment of incomplete and unhealthy competition

Incomplete and unhealthy competition adversely affects market performance in many ways. Firstly, it disturbs the market order and damages the competition environment. As we saw in the auto insurance market of China, tight rate and term controls caused incomplete competition between insurance firms. Under the umbrella of extra profits derived from rate regulation, many insurers spared no expenses to compete for market share. As a result, the market was flooded with various irregular activities, *e.g.* illegitimately refusing to fulfil contractual obligations, unsustainable low price wars between insurance firms.

Secondly, it tarnishes insurance firms' reputations and reduces their credibility. Over the past years, China's mass media repeatedly reported complaints about insurance.[85] Many of the reported cases revealed that insurers refused to fulfil their contractual obligations in order to keep low compensation ratios. This directly damaged their images. A survey organised by the DRC in 2002 showed that about 40% of the respondents in China's fifty main cities expressed their dissatisfaction with, or lack of trust in, domestic insurance companies, based on their own experience or opinions.[86] Cases also disclosed the fact that some insurers lacked creditability because of paying unreasonably high commissions, sometimes above 50% of first year received premiums in life insurance.

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[84] The *2001 Administrative Rules on Insurance Appraisal Institutions* CIRC.

[85] For example, in 2000, insurance disputes listed among the top ten complaints recorded by the China Consumers Association. See *Renmin Ribao (People's Daily)* March 16, 2001.

[86] Note 48, Chapter 1

Thirdly, blind competition certainly increases costs and erodes insurers' profits and solvency, consequently increasing risks in the insurance industry. That is mainly because most kinds of blind competition involved in low price wars which increased companies' cost (see Chapter 6). Additionally, that consumers lost their trust in insurance industry due to unhealthy competition makes them resort to insurance less than when they have a strong confidence.

Fourthly, it restrains the industry's incentive for innovation. Unhealthy competition on the one hand drew insurers' attentions and absorbed their main resources from carrying out healthy competition; on the other hand, activities such as infringing upon copyrights of insurance products dampened owner insurers' enthusiasm of innovation. In addition, insurers' decreased efficiency curbed their ability to promote innovations in products and services.

Fifthly, it increases regulatory costs. Since insurers do not have incentives to comply with laws and regulations, regulatory authorities at all levels have to take much time, energy and resources in supervising every market action of insurers. n summary, all above harmful effects act negatively on the long-term development of the industry.

2.4.4 Roots of incomplete and unhealthy competition

The incomplete and unhealthy competition in China's insurance may be attributed to many factors, among which, four stand out: regulatory restrictions on complete competition, the homogeneity of products and services, the quality of insurance companies' management, and underdeveloped supervision on destructive competition.

Firstly, it is rooted in the market itself that is dominated by oligopoly and lacks complete competition. The fundamental characteristics of this market are a lack of sufficient competitors, a lack of market access and exit mechanisms, and many controls on price, products and investment. On the one hand, tight government control of market access works as an invisible umbrella that protects suppliers (most of them are state-owned insurers or insurers with state-owned companies as majority shareholders) from a complete and effective competition. On the other hand, since the exit mechanism is not well established, insurance companies naturally do not feel the pressure of free market competition. This has led to the proliferation of high-risk insurance policies. Tight control of both price and term tempts twisted and covert

price competition between the insurers seeking for a larger market share. Investment control drives insurers to exploit extra profits through keeping compensation ratios lower. The basic massage from all these is that the regulator needs to take solid and step-by-step approaches to liberalisation in order to cultivate an competitive and efficient market.

Secondly, the deficiency of providing competitive products and services attracts insurers to launch irregular price competition. By their very nature, insurance products are largely homogeneous. In addition, most domestic insurers in China are short of skilled staff (for example, there were only 80 actuaries in China by 2000), and therefore, they have limited capacity for designing new types of products to satisfy the preferences of customers. This results in a proliferation of offering similar products and services by insurers. Before 1998, products provided by the former PICC had dominated the market for more than a decade. Other insurers provided similar products which copied the premium rates, coverage, and terms, of the former PICC's products. In recent years, "product copy" prevailed in the market, although innovative products emerged periodically. According to the statistics, in 2000, the similarities between products and services were as much as 90% amongst more than 2000 products in the market.[87] Those insurers that are unable to design successful new products are easily attracted to irregular price competition.

Thirdly, due to underdeveloped risk management (see chapter 3), some insurers tend to seek immediate successes and short-term profits. They usually pursue a single-minded strategy that accentuates a high percent of premium growth and neglects excessive growth risks.

Finally but not least, the CIRC needs to build its capacity to more effectively crackdown unhealthy or destructive competition. Compared with the other two financial regulators, viz. PBOC and CSRC, the CIRC has shorter history, not having established its nation-wide network until 2001. It is still building its capacity including a reliable and stable source of funding and skilled personnel to safeguard its effectiveness. Furthermore, as most of the CIRC staff are from the former PICC, regulatory neutrality is a crucial issue facing the CIRC. Eventually, the guarantors of the stability of the insurance sector must be sound prudential regulation and supervision rather than costly restraints on competition.

[87] See CIRC *China Insurance Almanac 2001*

2.5 Concluding remarks

In this chapter, we provided a review of insurance liberalisation which basically has two conceptual meanings. By observing practices in the world, there is no general prescription as to how to initiate a process of insurance liberalisation. Insurance liberalisation is perhaps always carried out in a gradualist manner with recognition of national self-interest, and adapted to their particular conditions, perceptions, economic needs, and changes thereof. Furthermore, to have its desired impact on the developing countries, it must be accompanied by adequate prudential regulation and supervision.

China adopted a gradualist approach to liberalisation of insurance market access in the last decade, and is carrying out policies combined opening up and protectionism. These are seemingly driven by objectives of opening up, infant industry argument, concerns about both financial stability and the important position of the insurance industry in the economy, and the inadequacies of domestic regulation. On the other hand, the Chinese insurance market suffers from incomplete and unhealthy competition which not only coexists with the infancy of the market but also hinders the development of the market. The problems are partly blamed to both unnecessary and underdeveloped regulation. To develop a modern and viable insurance sector, China has to liberalise its insurance market and build a suitable legal infrastructure consistent with emerging international regulatory standards and WTO requirements. Meanwhile, given a primary development stage of the insurance industry, China needs to deal with the liberalisation in a cautious manner and make appropriate regulatory arrangements to properly balance local protection, liberalisation, competition and regulation.

In this concluding section, it is worth examining some of the major regulatory issues related to the arrangements in the transition to market-based insurance regulation, including honouring WTO accession commitments, improving regulatory transparency, gradually liberalising the market to nurture competition, strengthening regulation, and actively participating in WTO negotiations.

a. *Honouring WTO accession commitments*

It is obvious that China will make full use of the exemptions in GATS and constraints beyond the scope of China's WTO agreement to nurture the country's

fledgling insurance industry and protect its state interests.[88] There had been some disagreements in China over the liberalisation of the insurance sector during the multilateral negotiations between China and WTO members on China's WTO accession. Debates both inside and outside China still rage over whether China will honour its commitments after WTO entry, as domestic protectionists exert their pressures. Although China's insurance sector is undergoing ambitious liberalisation as a result of internal reforms and WTO consistency, the pace and scope of liberalisation will depend on both cautious regulation and commercial realities.

As a member of the WTO, China has to keep its commitments and fulfil its obligations. Further opening up will challenge the various limitations on foreign firms, thus sparking the conflict with local protective policies. Therefore, China must correct any over-protective measures. Backsliding is unwise and could be costly. According to GATS, failure to honour a commitment could lead a country to being challenged by another WTO member. It will then be up to the WTO dispute settlement proceeding, and ultimately, face sanctions taken by the WTO. It may also invoke trading partners' retaliatory actions and lose the trust of other members. In addition, long term highly protective strategies for domestic insurers will discourage them from increasing efficiency, lowering costs, and promoting innovation, and lead them to losing competitive edge. Further, as China is aiming at building Shanghai a financial centre in Asia, China can promote and consolidate its insurance regulatory reform efforts in the process of WTO compliance. In the long-term, the adoption of best regulatory practices or adhesion to international standards may help China overcome regulatory hurdles in foreign markets.

b. Improving regulatory transparency

One important commitment that China made is *regulatory transparency*, a notable issue on the potential changes in China's insurance regulation. Transparency, set forth in the WTO and GATS as one of the basic criteria governing the trading system, requires Members to publish both legislative and subordinate measures before they are enforced. In addition, GATS requires an annual notification of new or changed

[88] For example, foreign life insurers keen on entering China's health insurance market had been excluded from the national health insurance scheme unveiled in 2000. Their opportunities over the next five years will be limited largely to individual life insurance policies and extra benefits or special features that are added to a basic policy to meet a client's specific needs. See "China: no room to grow?" *Business China* The Economist Unit Ltd. June 19, 2000.

measures. For administrative decisions, WTO agreements require uniform, impartial and reasonable administration, as well as a review mechanism and an opportunity to appeal.

The WTO's transparency requirements focus on "publication and administration" which seem narrow in scope.[89] In comparison, in the view of some academics,[90] governmental proposals,[91] and international organisations' documents, transparency apparently exceeds the WTO's requirements. The International Monetary Funds (IMF)'s *Code of Good Practices on Transparency in Monetary and Financial Policies*[92] (the IMF's Code) provides governments with useful guidelines. As defined by the IMF, transparency in monetary and financial policies "refers to an environment in which the objectives of policy, its legal, institutional, and economic framework, policy decisions and their rationale, data and information related to monetary and financial policies, and the terms of agencies' accountability, are provided to the public in a comprehensible, accessible, and timely manner."[93]

Transparency has become a main target of regulatory reforms that many governments are undertaking in pursuit of effective and efficient regulations. The main philosophy of transparency is that it promotes understanding of decisions and actions when they are made accessible and visible, as the reasoning behind the decisions

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[89] In addition, the WTO is criticised for a lack of transparency in its negotiations and decision-making. For example, the critics claim that its major decisions are formulated in informal, small group meetings which are dominated by the U.S. and EU whose negotiating proposals are not publicly available. See *GATS campaign update* May 2002, World Development Movement.

[90] For example, in the view of Charles R. Irish (2001), transparency also includes concern for the quantity and quality of information about business and financial activities. "Transparency, the WTO, and China: a special presentation at the China Economic Forum" University of Wisconsin Madison, Wisconsin, USA. (November 2001).

[91] For example, "Principles of good regulation" *Better Regulation Task Force, The Cabinet Office Publications & Publicity Team. UK* October 2000 asserts that to be a transparent regulation, the following criteria should be met. "The case for a regulation should be clearly made and the purpose clearly communicated; proper consultation should take place before creating and implementing a regulation; penalties for non-compliance should be clearly spelt out; regulations should be simple and clear, and come with guidance in plain English; and those being regulated should be made aware of their obligations and given support and time to comply by the enforcing authorities with examples of methods of compliance."

[92] Available on the IMF web site at <http://www.imf.org/external/np/mae/mft/code/index.htm>

[93] Supporting Document to Code of Good Practices on Transparency in Monetary and Financial Policies Part 1, Appendix III "Glossary of Key Terms" IMF 2000.

becomes known. In turn, it makes decision-makers and executives accountable for their actions and decisions. As part of the development of internationalisation in insurance regulation, insurance regulators are increasingly urged to adopt "a transparent regulatory and supervisory process",[94] with transparent regulatory structures. On regulatory transparency, China has made a series of commitments which also govern the insurance sector.[95] Many observers view the WTO accession as a further impetus to increasing regulatory transparency in China.[96]

It is crucial that China's insurance regulation catches up with the global trend towards increasing transparency. However, achieving this is perhaps unlikely in the short term in the light of the difficulties facing China's legal reforms. The current regulatory system of China mainly depends on administrative actions. Both the transparency and fairness of administrative decision-making, and judiciary independence (in matters such as judicial procedures, adjudication and enforcement of decisions on cases by local courts or arbitrators) have long been criticised. Regarding the insurance regime, regulations permit considerable bureaucratic discretion. The regulator used to take a domestic-supplier-biased stand partly due to the regulatory

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[94] "Principle one", *The Core Principles* IAIS (1999)

[95] China's transparency commitments mainly appear in *Paragraph 2, Protocol* and *Working Party Report.* Firstly, before implementation and enforcement, laws, regulations and other measures pertaining to or affecting insurance should be published and readily available to other WTO Members, individuals and enterprises, upon request. In emergent situations, laws, regulations and other measures shall be made available at the latest when they are implemented or enforced (Protocol paragraph 2.C.1.). Secondly, China agreed to implement a variety of "transparency and prior notification and comment" measures at the national and sub-national level regarding insurance-related laws, regulations, and measures (Protocol paragraph 2.C.2.). Thirdly, China agreed to apply and administer "in a uniform, impartial and reasonable manner" all its insurance-related laws, regulations and other measures applied or administered by both the central government and the governments at the sub-national levels (Protocol paragraph 2.A.a.). Fourthly, China agreed to establish or designate and maintain tribunals, contact points and procedures for the prompt review of administrative actions related to trade laws, regulations, and measures (Protocol paragraph 2.D.1.). China also agreed to ensure such judicial review should be "impartial and independent" of any agency entrusted with administrative enforcement. Finally, China will publish in the official journal, by appropriate classification and by service where relevant, a list of all organisations that are responsible for authorising, approving or regulating services activities whether through grant of license or other system of approval, including organisations to whom the national authorities delegate such authority (Working Party Report paragraph 332.).

[96] See Biddulph, Sarah (2001). "Through a glass darkly: China, transparency and the WTO" *Australian Journal of Asian Law*, 3(1).

personnel who are mainly from the former PICC and other financial institutions. Administrative orders, which are not fully publicised, usually substituted for regulatory and supervisory rules.[97] Public consultation on new regulations is not often appropriate. For instance, either short comment periods or limited and unequal commentators often hinder the consultation. Procedures for applying regulations are not always straightforward and non-discriminatory. Overlapping responsibilities exist among regulatory authorities.

Having committed to abide by the WTO principle of transparency with accession, the regulator needs a shift from a local-supplier-biased stand to a more neutral stand. This requires China to further clarify the CIRC's roles, responsibilities, objectives and procedures of formulating and implementing regulation and supervision, as well as public availability of information on CIRC's regulatory and supervisory activities. It is also essential to systemise both the assurance of the integrity by the CIRC and its accountability.

c. *Gradually liberalising the market to nurture competition*

In China today, the question about insurance liberalisation is rather how best to design liberalisation strategies for succeeding under new environment than whether or not to liberalise. This involves the contents, sequence and speed of liberalisation.

In the past years, the CIRC encouraged domestic insurers to open more branches, granted a number of licenses to domestic companies and intermediaries, and allowed certain domestic insurers to operate outside their designated geographical areas.[98] It also encouraged state-owned insurers to go through diversifying their ownership by accepting foreign shareholders or becoming listed firms. All these measures contribute to fostering competition, although some seem to encourage the preoccupation of domestic firms. On the other hand, some approaches to liberalisation seem rather radical and unbalanced. For example, in an effort to address shortfalls of rate regulation in auto insurance sector, the CIRC swiftly replaced statutory rates with *file-and-use* rates. However, the market is still far from maturity and lacks complete competition. Both rate regulation and related systems, *e.g.* prudential regulation and market performance regulation, are not well constructed. Under such conditions, the

[97] For example, the CIRC only posted very limited regulatory texts on its website.

[98] For example, "China eases restriction on project insurance" Dow Jones International News March 3, 2000.

initiation of the rate deregulation in the auto insurance market inevitably led to irrational price wars and collusion between insurers (see Chapter 6). On the contrary, the efforts of liberalising investment are too cautious to meet the urgent needs for broadening investment channels (see Chapter 5).

Generally, insurance liberalisation needs to take into account the state of the market development, conditions of insurance institutions, supervisory capabilities, the financial system as a whole, and the outlook prevailing in the country. Given the fledgling stage of China's insurance industry, the infrastructures of liberalised markets taken for granted in developed countries can not necessarily be expected ready immediately in China. Therefore, China should carry out liberalisation gradually to ensure a smooth transition to a liberalised environment. In the short term, China needs to further the market access liberalisation and the ownership reform, while urging insurers to strengthen corporate governance and improve internal risk control. Investment channels need to be greatly broadened, and meanwhile, it is desirable for China to adopt a rather strict and detailed investment regulation to protect policyholders against the investment risks facing insurers. To succeed the current rate deregulation, required conditions need to be created.

d.. Strengthening regulation and prudential carve-out

The strengthening of the regulation and supervision in parallel with a gradual liberalisation is essential for improving the efficiency of China's insurance market. Liberalisation without attendant regulations and supervisory measures merely fosters a chaotic market.[99] After the WTO accession, growing domestic and international pressures require the regulatory environment to be further developed towards internal consistency, completeness, transparency, and fairness. Especially, liberalisation of market access, rate setting and investment implies increased prudential regulation requirements. This also raises the issue of how properly to deal with the interrelation between liberalisation and prudential regulation, or in other words, how sensibly to use the principle of *prudential carve-out.*

Prudential carve-out is one of the most sensitive issues under the GATS. The principle allows a member to take prudential measures "for protection of investors, depositors, policyholders or persons to whom a fiduciary duty is owed by a financial

[99] "Guidance on insurance regulation and supervision for emerging market economies" IAIS, 1997.

service supplier, or to ensure the integrity of the financial system"[100] regardless of any other provision of the GATS. As a compromise of reaching the GATS, the *prudential carve-out* is broadly worded, and neither a definition nor an example of it is provided in the Annexes on Financial Services of GATS.

Prudential carve-out is particularly important for China because of both the weaker risk management within local insurers and its lower quality of prudential regulation than those in developed countries. However, China should avoid abuse of the principle, *e.g.*, using it to screen protective measures. Abusive applications are subject to WTO dispute settlement procedures and thus potentially to a decision by a dispute settlement panel of WTO. In addition, abusive behaviours can stain China's determination to honour WTO commitments and to build a modern insurance system. Therefore, actively adapting China's domestic regulatory and supervisory systems to both international standards and best practice in the world is a recommendable strategy.

e. Actively participating in the WTO negotiations

The structure adopted by GATS and the principle of more participation of developing countries mean that future GATS negotiations would surely be influenced by China's accession. In the past, China had always insisted on the balance of rights and obligations on the issue of acceding to the WTO. A new round of financial services negotiations initiated in 2000, which probably leads to further insurance market liberalisation. As a WTO member, China is taking part in the negotiations, and has raised its proposals that stress the interest of the developing countries.[101] As a powerful voice in the international community, China could join the power of developing countries to address their desires more effectively in the future.

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[100] Art. XXIX, the GATS Annexes.

[101] The proposals were put forward at the third ministerial meeting of the WTO in December 2, 1999. See "China raises five proposals for next round trade talks" <http://www.chinaonline.com> December 2, 1999.

Chapter 3
Effective and efficient insurance regulation and industry perspectives

3.1. Introduction

Effective and efficient insurance regulation can hardly be realised without the co-ordination of both insurers and insurance industries with regulatory authorities. The financial crisis that hit the East Asian economies in 1997 highlighted the significance of good corporate governance and best business practices to many countries in the world. The significance was further evinced by the tragedy of corporate governance in the US in the recent years.[1] There is a growing recognition around the world that insurers' good corporate governance and transparency and active self-regulation within insurance industries are crucial to effective and efficient regulation and supervision.

This chapter probes how China's insurance regulation and supervision can be improved by the implementation of greater corporate governance, information disclosure by insurers and self-regulation by the insurance industry. It draws on concepts from some developed countries and international practices where have seen a major shift in this direction. The structure of the rest of the chapter is as follows. Section 3.2 deals with corporate governance of state-owned insurers in China. It begins with a review of the conceptual framework and importance of corporate governance, followed by descriptive analyses of major shortcomings of the insurers' corporate governance. It then examines two current reforms to transform China's outdated and state-owned insurers into credible firms, shareholding restructuring with private and foreign participation, and listing. Finally, it presents some recommendations on the improvement of corporate governance. Section 3.3 deals with how to further improve information disclosure by insurers, and section 3.4 describes the current situation of self-regulation in the Chinese insurance industry and discusses measures to enhance the

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[1] Starting from 2001, a series of well-known US companies exposed serious problems, resulting in crises in the US securities markets. For example, Enron which went into insolvency involved in manipulating energy market and creating complex outside partnerships that kept billions in losses of balance sheet. While Andersen engaged in lax oversight of client books and criminally shredding of legal documents, Worldcom inappropriately accounted for US$ billion in expenses and inflated profits. See "How corrupt is it?" *Business Week* May 13, 2002 and "The wickedness of Wall St" *The Economist* June 8, 2002.

importance of industry associations' roles in the whole framework of insurance regulation.

3.2. Corporate governance of state-owned insurers and effective and efficient insurance regulation

3.2.1 Corporate governance: the conceptual framework

Corporate governance is of universal concern nowadays and has caused many debates.[2] As proposed in the OECD "Principles of Corporate Governance", corporate governance refers to the relationship between the management, board of directors, and shareholders as well as other interested parties.[3] The IAIS in its "Insurance Core Principles Methodology" provides insurance regulators with essential criteria for assessing the corporate governance of insurance companies, together with their regulatory framework.[4] Corporate governance mechanisms may be broadly classified as internal and external mechanisms. The former refers to relationships between directors, supervisors, managers and sometimes employees; the latter, the main mechanism, chiefly refers to relationships between the firm and shareholders, creditors and government. For a commercial insurance company, corporate governance relates to the mechanism by which the owner as well as creditors and the government exert control over the company. It is the combination of any correlation of functions between various subjects such as decision-makers, insider shareholding, board membership and characteristics such as size of the board, the number of external independent directors, audit committees, audit quality, chief executive officer (CEO) tenure, and remuneration

[2] Corporate governance is a topic of debates; there are many examples of corporate governance codes, guidelines and commentaries. Some of the known examples are: *Cadbury Report* in the UK, *Dey Report* in Canada, *General Motors Board of Directors Guidelines* in the US, *Australian Stock Exchange Listing Rules*, *Code of Best Practice* (Hong Kong Stock Exchange), and *Practice for Corporate Governance* (Korea), etc.

[3] According to *1999 OECD Principles of Corporate Governance*, "Corporate governance is the system by which a corporation is directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the company, such as, the board, management, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance."

[4] See *IAIS Core Principles Methodology* (2000) p20-22.

committees. It also involves in the separation of these functions, which requires to clearly define accountability and responsibilities of the subjects, and put checks and balances on the firm from both outside and inside.

3.2.2 Why does corporate governance matter in insurance regulation?

Corporate governance is being increasingly recognised world-wide as a key to establish a healthy corporation capable of exercising effective internal control and risk management and coping with radical competition and rapidly changing markets and technology. Likewise, good corporate governance of insurance firms is considered by insurance regulators as one of the preconditions for effective and efficient insurance regulation.[5] There are several factors bringing corporate governance to the forefront of insurance regulators' concerns today.

a. *Increasing focus on good corporate governance of firms*

Diversification is vital to the survival of corporations in today's business environment. Unlike corporations in the early 1900's, most of which were family-owned businesses with limited diversification and therefore vulnerable to competition, modern corporations require separation of ownership and management because of diversification and expansion. Diversification has brought professionals onto the management board, and required outside capital which has hastened the need for good corporate governance as outside investors demand openness and transparency in corporations' operations. More importantly, massive changes, especially in technology and modernisation, have spurred the need for outside capital and the use of professionals as management. The development of capital markets, which has provided a means for obtaining outside capital and created public minority shareholders, also increases the involvement of investors in the ownership of corporations.

b. *The characteristics of insurance companies*

Firstly, insurance inherently involves the taking of risks, and insurers are exposed to various risks. Risk management involving assessment, measurement and active management of risks must be the primary responsibility of an insurer. This highlights the importance of insurers' internal control and risk management. Experience suggests

[5] IAIS *Core Principles Methodology* (2000) p48

that good corporate governance could help improve the prudential management of insurers, and sometimes even constitute a precondition for effective internal control and risk management in insurers. Secondly, the nature of the insurance business gives rise to significant information asymmetry that underpins governance problems. Thirdly, as important institutional investors, insurers play an important role in the governance of other institutions. Insurers may act as holders of equity stakes with voting rights to influence the strategy of the institutions in which they have invested, and monitor their performance.

c. *Management risks in insurance companies*

We have seen from experiences in the past decades that many insurance companies failed due to the lack of sound risk control and adequate risk management practice.[6] Some cases showed that the risk of collapse was heightened where poor corporate governance practices prevailed.[7] Perhaps the majority of insurance failures have been due to lapses in corporate governance.[8] Moreover, evidences suggest that excellent corporate governance practices enhance the individual insurers' performance and improve their ability to access capital. This is generally because the framework established focuses the board and management on the insurers' objectives and keeps them accountable for their actions.

d. Deregulation

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[6] David F. Babbel and Anthony M. Santomero examined ostensible causes of insolvent insurers in the US in the decade leading up to the mid 90's, and suggested that inadequate risk management practices is the underlying factor in all of these insolvencies, despite the numerous and disparate causes. see "Risk management by insurers: an analysis of the process" *Financial Institutions Centre, Wharton* 96-16

[7] For example, in the UK, the management and sales forces, including Equitable Life, systematically mis-sold personal pensions (many of them with with-profits products) for many years, creating misery for many savers, and the regulatory response was clearly too slow. The authority estimated through the *pensions review* that around 1½ million investors would, in due course, receive somewhere around £12 billion in compensation for the mis-selling. The case raises serious concerns over the breadth of discretion retained by insurers, the lack of transparency over the exercise of that discretion and the potential for conflicts of interest. John Tiner, FSA managing director, said: "Governance is at the heart of many of the concerns about consumer detriment in with-profits products, as we have seen in the case of Equitable Life." See *Issues paper 5*: "Governance of with-profits funds and the future role of the appointed actuary"

[8] Catherine Prime "The actuary and insurance regulation" *The 2nd Global Conference of Actuaries Delhi*, February, 2000.

A deregulated environment normally gives rise to greater potential for risks by the removal of constraints on management, and provides incentives for insurers to undertake new activities. This could have given insurers an incentive to increase their risk-taking. On the other hand, deregulation does not simultaneously provide for enhanced corporate governance mechanisms in the newly deregulated environment. Therefore, to avoid the replacement of old regulation with new regulation, both regulators and other stakeholders of insurers have to rely on reliable corporate governance, as they may have little experience of how to assess performance in the new environment. This raises higher requirements for insurers to adopt good practice of corporate governance.

e. *Transition of insurance regulation mode*

During the 1990s, prudential regulation for insurance industries appeared gradually to gain universal acceptance. Prudential regulation, however, is hardly adequate or even effective, without importance accorded to good corporate governance and the monitoring of the governance. Appropriate regulation should provide a relaxed and level playing field for an insurance industry and focus on ensuring that insurers are able to demonstrate that they run a strong corporate governance regime. Under this regime, insurers manage operational risks well and conduct their affairs in such a way as to be prudent risk managers.

Efficiency in governments and regulators, ensuring that individual insurers are adopting excellent corporate governance practice, has a number of attractions. Many regulators came to realise that maintaining market confidence does not imply zero failure which could use up an excessive proportion of regulatory resources. They aim at ensuring an incidence of failure of regulated firms and market is as low as consistent with maintenance of competition and innovation in the market.[9] Corporate governance is therefore increasingly seen as a mechanism which supports the objectives of the regulators responsible for protecting the confidence in insurance market, encourages insurance innovation, and enhances overall industry performance.

[9] See "A New Regulator for the New Millennium" *Financial Service Authority U.K.* January 2000. p5-11.

3.3.3 Corporate governance in China's state-owned insurers

By 2001, there were 25 state-owned insurance companies in China, with 5 solely state-owned companies and 20 shareholding state-owned companies in which majority ownership is in the hands of a few state investors (see Table 1.5).

a. Reforms on state-owned insurers' restructuring

In the last two decades, state-owned insurers were through continuous restructuring. During 1980-1993, China's economic reform focused on removing the impact of the traditional planned economy on enterprises, which was achieved by increasing the role of the market and granting enterprises more autonomy in doing business independently. As a state-owned monopolistic enterprise, the former PICC underwent a series of reforms such as delegation of enterprise authority, allowing to retain profits earned over the pre-set targets, substituting taxation for profit turning in, and performance contracting. All these increased both the insurer's decision-making autonomy and economic incentives. However, problems such as the ambiguity of property rights inherent in state ownership, politically appointed management and soft budget constraints still remained.

Since 1993, the Chinese government has focused its efforts on introducing a modern enterprise system[10] into state-owned enterprises (SOEs) by implementing the *1994 Company Law.* Under the Law, a company must adopt a corporate governance structure, comprising a shareholders' general meeting, a board of directors and a board of supervisors, and the manager. A company's investors constitute the shareholders' general meeting, the power organ of the company, which appoints the board of directors as the primary source of direction of management and the board of supervisors for internal corporate monitoring of directors and senior officers. The board of directors appoints the manager who is responsible for day-to-day operation.[11]

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[10] Firstly adopted by the *Decisions on Some Issues in Establishing the Socialist Market Economic System,* Third Plenum of the Fourteenth Congress of the Chinese Communist Party (CCCP), November 1993, a modern enterprise system was defined as one characterised by clearly clarified property rights, designated authorities and responsibilities, separated functions between government and enterprise, and scientific management. The concept was reaffirmed by *Some Important Decisions on the Reform and Development of State Owned Enterprises,* Fourth Plenum of the Fifteenth CCCP, September 1999.

[11] Art. 102,112, 126, and 119 of the *1994 Company Law.*

The modern enterprise system reform spread into the insurance industry as well, with newly established insurers overwhelmingly adopting the shareholding structure, which remain under majority state ownership and control.[12] The solely state-owned insurers including the former PICC, meanwhile, went through a corporatisation process with aims to further separate government administration from business management and plant sound corporate management within the insurers.[13]

Required by the CIRC, every insurer, according to *the Principles Guiding the Construction of Insurance Companies' Internal Control System* issued by the CIRC in 1999, worked out or completed its internal control system fitting for its own features. This reform brought some changes to once *three no states*: no specific rule of internal control for insurers to comply with, no active compliance with existing laws and regulations by insurers, and no serious redress for rule-breaking conducts.[14]

b. Major shortcomings of state-owned insurers' corporate governance

Despite fairly stringent legal requirements for building a modern enterprise system, major shortcomings in corporate governance in the state-owned insurers can be identified in practice. Firstly, both solely state-owned insurers and state-owned shareholding insurers still see the pervasive government control and interference which mainly take the forms of ownership control and management appointment together with party control. These insurers are either directly owned by the government or owned by government controlled entities. Many senior managers, appointed by the government, look for promotions in the government hierarchy as their ultimate career goals.

Secondly, while failing to solve ambiguities of property rights, the corporatisation creates an agency problem.[15] The government ownership results in the absence of real shareholder interest in the insurers. The exercise of the state ownership, vested in

[12] For example, the Shanghai Municipal government is the major owner of China Pacific Insurance.

[13] See Ma Yongwei "A review of the insurance market in China in 1998" China Insurance Almanac 1999.

[14] See Ma Yongwei "A review of the Insurance Market in China in 1999" China Insurance Almanac 2000.

[15] According to *principal-agent* theory, conflicts can occur when a "principal" has difficulty in monitoring and controlling the behaviour of his/her "agent" and the agent's interests differ from those of the principal.

departments of the central government or local governments (Tiaokuai),[16] often appears to be ineffectual and in a dysfunctional manner due to increasing management autonomy and ambiguous residual risk bearing.

Thirdly, the insurers maintain weak economic incentives due to the lack of the power to compensate their staff independently, which exacerbates the agency problem. The determinants of senior officers' money incomes are usually connected with their relative administrative positions, and the insurers' geographic location and ownership characteristics.

Fourthly, the phenomenon of "insider control" exists in many insurers, preventing them from making significant improvement on internal control and risk management. The chairman of the board of directors and CEO are usually appointed by the controlling shareholder (one of the state agents), notified to other shareholders. Other board members are appointed by other major shareholders in proportion to their shareholding, but discussed beforehand with the controlling shareholder. The shareholders' general meeting and the board of directors normally represent the same side when an insurer is controlled by one or two major shareholders, and, even worse, the two bodies in some cases are mainly composed of the same people. CEO is usually free from the supervision by the board of directors. The board of supervisors is generally weaker than the board of directors. Although the board of supervisors has the power to supervise actions of directors and officers, it has no power to stop or correct such actions directly. Instead, it can only report to the shareholders' general meeting. In particular, the interests of stakeholders are not adequately protected because of the lack of effective mechanisms that could provide checks and balances such as independent supervisors and independent subcommittees for regulatory compliance, auditing, remuneration and nomination.

Fifthly, the standards of transparency and disclosure are low, making the monitoring and control by outsiders and minority shareholders difficult (See section 3.3).

[16] Previously, the management appointment power in the branches of the former PICC was shared between central and provincial governments. The provincial governments were stripped of the power through corporatisation, thus reducing provincial governments' meddling in the decision-makings of the insurer.

Sixthly, incompetent and improper risk management has been a major problem facing most Chinese insurers. In the last decade, it was not rare for most insurers to stop at nothing in order to increase their premium income and promote their market share. They usually relied on extensive expansion through illegal competition, *e.g.* cutting-price wars, recruiting unqualified personnel, sales of insurance policies with high interest 'kickbacks', instead of internal risk management and good co-ordinated development with their fast growth. Low level of risk management is the part of sources that led to weak profitability and low efficiency seen in the Chinese insurance industry, and remains the most important issue on prudential regulation.

Seventhly, the insurers' corporate governance was further weakened by inadequate external disciplines. For example, under the CIRC's strict licensing system in the past, insurers with primarily private investment were rarely approved[17] while insurers with foreign investment were under tight controls. This resulted in insufficient competition from foreign and private insurers, eroding the stimulus to state-owned insurers' improvement on corporate governance.

Although state-owned insurers have been through continuous change, we still see in most of these insurers well-known weaknesses that are symptomatic of defective corporate governance. These weaknesses are evidenced mainly by the high operation costs, low profitability, low capital adequacy ratios, some malpractice at all different managerial levels due to lax internal risk control, large amount of negative interest driven losses and non-performance loans. The regulator thus has taken a number of initiatives to deal with these problems. Currently, there are two broad approaches to state-owned insurers' restructuring: shareholding reform with private or foreign

[17] China Minsheng Insurance Co., the first private insurance insurers, led by the All China Federation of Industry and Commerce (ACFIC), established in 2002. The company is primarily funded by private companies which make up 90 percent of its 21 shareholders. *Zhongguo Jingji Shibao (China Economic Times)*, April 22, 2002.

participation,[18] and listing.[19] Both focuses on ownership restructuring or divestiture, aiming at improving the insurers' corporate governance by diversifying shareholders, introducing advanced technology and management, and increasing capital bases.

c. Advantages and shortcomings of current initiatives

Ownership restructuring is particularly crucial in the case of China where state-owned insurers are significantly less capitalised than required by their rapid growth, as listing enables the public financing while shareholding attracts extra capital from investors. The potential gains from public listing are large as a lot of the costly monitoring arrangements to ensure good corporate governance can be "delegated" to securities markets. The listing imposes a set of standardised disclosures that help mitigate information asymmetries, hence facilitating monitoring. It links managerial performance with incentives (*e.g.* via stock options) thus creating better management motivations. Empowering employees through ownership helps align their interests with management and shareholders. For the shareholding reform, introducing apolitical shareholders (either foreign or private) with board representation that seeks to maximise firm values could possibly improve corporate governance.

Without addressing the imbedded problems of the state majority and government intervention, ownership restructuring alone could be just a means of procuring capital and not sufficient to create efficient insurers. According to the existing reforms, the State retains its majority, whatever restructuring modes are. Regarding the listing reform, broadly two modes are initiated: partly listing and fully listing. For the former, as the cases of PICC and China Life show, a state-owned insurer sets up a new stock company limited by transferring a portion of the insurer's assets and liabilities to this new company, and then lists it. As a result, the majority of this subsidiary is still held by the parent insurer (holding company), which could become the breeding ground

[18] See note 59, Chapter 2.

[19] For example, the State Council was reported to had already approved reform plans for PICC and China Life who wanted to restructure by spinning off their key portions into international subsidiaries designed to sell stock. Both insurers expected that overseas flotation would fund their expansion and allow them to introduce better management. See "Insurance giants step up shareholding reforms" *China Daily* November 11, 2002.

for opaque corporate governance.[20] For the latter, showed in the case of Dazhong Insurance Co Ltd,[21] a state-owned shareholding insurer is fully listed but the majority of the listing company is still in the hands of the state shareholders. Regarding the shareholding reform, the case of New China Life showed that the state-controlled holders retained their majority, as foreign shares are restricted to 25% of total shares. All these kinds of ownership structure appear to be ways of keeping the state majority and avoiding full privatisation.

d. Recommendations for strengthening corporate governance

Experiences show that ownership restructuring or divestiture alone is seldom enough for performance improvement,[22] although it is a necessary step in the process of state-owned insurers' restructuring. Developing corporate governance arrangements needs a comprehensive approach to dealing with the existing shortcomings and the requirements for improving insurers' conducts and strengthening public confidence in the insurance industry. The main objectives of the arrangements are to nurture the development of insurers who seek maximising value subject to meeting their financial and other legal and contractual obligations, to ensure the insurers' accountability, and to strengthen insurers' regulatory compliance and their co-operation with the regulator, thus reducing regulatory costs. To these ends, the CIRC needs to set out basic principles and guidelines of good corporate governance, and monitor the design and implementation in individual insurers. Drawing upon international and domestic practices appropriate to China's economic and social conditions and insurance

[20] For example, as Zhang and Stoyan suggest that in China's securities markets, the relationship between listed subsidiaries and parent companies are fraught with governance problems (e.g. connected-party transactions, loans from listed companies to their state-owned parents, and finagling the financial figures by, for example, juggling profits between the two operations) and pose a major hurdle to better performance. See Zhang Chunlin and Stoyan Tenev (2002) "Corporate governance and enterprise reform in China: building the institutions of modern markets" The World Bank, April.

[21] "Insurance companies run for leading listing" <http://www.chinadaily.com.cn July 30, 2001.

[22] See Chapter 3, *Bureaucrats in Business: The Economics and Politics of Government Ownership* A World Bank Policy Research Report, September 1995.

market realities can help do these.[23] Here, we select several issues acquiring the CIRC's special attention. (1) ownership and corporate independence; (2) responsibilities and accountability; (3) internal control and risk management; (4) disclosure and transparency (see section 3.3); and (5) the neutrality of the regulator.

Ownership and corporate independence

Diversification of state-owned insurers' capital structures is a central element of the current strategy towards the creation of a modern enterprise system. However, ownership reforms could be politically sensitive and controversial. Theoretically, whoever owns, private or the State, the structure of large or majority shareholder (with the state majority shareholder as a typical case) itself is not necessarily negative to governance.[24] The successes and failures seen in both private majority companies and state-owned companies evince this. Furthermore, it was not rare that individual cases of corporate privatisation failure occurred in both transitional countries[25] and developed countries. In addition, it can hardly be expected that in the near future, the Chinese authority will relinquish its majority ownership in the major national insurers, although it may gradually reduce its ownership. Therefore, the CIRC will have to develop a good corporate governance system within the current state-dominated domain. To these ends,

[23] For example, in January 2002, the CSRC and the State Economic and Trade commission (SETC) jointly released the *Rules for Corporate Governance of Public Companies*. The rules reflect international practices and address such issues as shareholder rights, procedural requirements of shareholders' meetings, related transactions, conduct of controlling shareholders and independence of the company from them, election, duties, and meetings of the directors and structure of the board, independent directors, specialised committees of the board, board of supervisors, assessment and incentives, hiring and compensation of senior management, interested parties and duties of disclosure. Significantly, the rules confirm that shareholders may bring civil lawsuits to protect their lawful interests. Another document available for reference is *the Guidelines for Corporate Governance of Commercial Banks* (for comments), released by the PBOC in 2002.

[24] It is widely agreed that the multitude of stakeholders either internal or external influences the operations of firms, while it is highly debated which influence affects negatively or positively. Therefore, shareholder structure may not be the key issue of corporate governance which "is the process by which corporations are made responsive to the rights and wishes of stakeholders" Demb A. and Neubauer F.F. (1992) "The corporate board: confronting the paradoxes" Long Range Planning, Vol.25, No3, p9-20.

[25] See John Nellis "The World Bank, privatisation and enterprise reform in transition economies: a retrospective analysis" OED Background paper, Centre for Global Development, The World Bank, Washington, D. C.

three major points are maintaining an adequate independence of state-owned insurers; balancing interests between powerful state majority and minority investors; and appropriate managerial incentives.

Firstly, the insurers' fiduciary duties demand them to operate with an adequate degree of corporate independence from their related parties. Meanwhile, there must be an effectual and functional expression of the State's legitimate interest in the corporate governance of insurers in which it holds an ownership stake. To ensure the corporate independence, government interference in the insurers must be further reduced with a compromise between the principle of party control and the necessity of allowing the insurers to exercise their enterprise autonomy. The State interest is preferably pursued in a manner that is compatible with the development of competitive insurance market and not at the expense of other forms of insurers. It is necessary to address the risks associated with overlapping interests under complicated group structures (including state holding companies), related-party transactions, and the effects of multiple gearing on the financial strength of insurers. Secondly, focus should be on ensuring the equitable treatment of all shareholders including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights.[26] Thirdly, state-owned insurers need to be empowered an incentive mechanism that ties the management's performance to its compensation.

Responsibilities and accountability

The government needs to strengthen regulations of the responsibilities and accountability of both the boards and the senior management, especially in the presence of state majority. In addition to the current corporate governance framework laid down by the *1994 Company Law, 2002 Insurance Law* and other related laws and regulations, the important elements of the new regulations include the follows:

A clear specification of the fiduciary duties of directors needs to mandate, together with corresponding penalties for any violation of these duties. This is a necessary provision to provide a sound basis for the enforcement of prudential requirements on insurers and to support shareholder activism. It also needs to mandate the monitoring of management by the board of directors, and place the responsibility for the prudential operation of each insurer on its directors and management with penalties and financial liabilities for false statements.

[26] See (ii) Equitable treatment of shareholders, the OECD "Principles of Corporate Governance"

The board of directors in each insurer establishes independent board committees to exercise governance over certain activities.[27] Typically, the committees may include audit, investment, prudential regulation compliance, reinsurance, nominations, and remuneration committees, whose members are appointed by the board. To strengthen the independence of the audit, nominations, and remuneration committees, the members of these committees should comprise independent non-executive directors.

To ensure the equitable treatment of minority shareholders, it is necessary to mandate appointments of independent directors, maximum limits of directorships and penalties for non-compliance. In addition, allowing cumulative voting directors is worth being implemented.

The *2002 Insurance Law* (Art. 85) requires that "a solely state-owned insurer shall have a board of supervisors, which comprises representatives from the (CIRC) relevant experts, and employees of the insurer. Said board of supervisors shall exercise supervision with respect to solvency." To strengthen the roles of the board of supervisors, this provision could extend to all insurers with state majority. It must ensure that the board of supervisors has the power to investigate independently the events in which directors and managers possibly harm the insurer's interests, and to decide the external auditor to audit the insurer's accounts.

Insurers' fiduciary duties and public duty of trust owned to policyholders require adequate safeguards against unfair practices by the insurers. Therefore, good corporate governance should contain provisions for fair trade practices and conducts.

Internal control and risk management

Recent corporate governance reform initiatives in the UK and elsewhere have begun to turn corporate governance requirements into risk management controls that are deeply rooted within firms. Boards and senior executives have been made responsible for poor risk management.[28] Meanwhile, the regulation of financial firms, and especially of banks, has evolved to put new emphasis on formal risk management as a

[27] See Corporate Governance: essential and additional criteria. IAIS "Insurance Core Principles Methodology".

[28] For example, "Internal control: guidance for directors on the Combined Code" (the Institute of Chartered Accountants in England and Wales, April 1999) provided guidance of internal control for listed companies.

regulatory requirement, ensuring the standardisation of risk assessment and reporting and that all kinds of risks are managed right across a firm.[29]

The adequacy of internal control and risk management systems is an essential part of good corporate governance in insurers whose business is fundamentally about managing risks. This importance is recognised by the CIRC. Its Principles Guiding the Construction of Insurance Companies' Internal Control System sets out principles which reinforce internal control by integrating multifaceted and multi-level control activities that form an inherent part of an insurer's daily operations.[30] However, it does not emphases risk management given that the link between internal control and risk management is not clearly drawn. Therefore, it is necessary to complement the Principles, ensuring that insurers establish risk management systems together with internal control that are able to detect and continually assess risks that could materially impair the insurer's ability to meet its corporate objectives and responsibilities. The focal point of the replenishment is to mandate board of directors' responsibilities of ensuring that principal risks are identified and appropriately managed. It is also desirable to set up a functional unit within an insurer with the responsibility of implementing risk management systems. Its tasks may include identification of risks, development of measurement systems of risks, establishment of policies and procedures to manage risks, and reporting of results of risk monitoring to both senior management and the board. These tasks can be carried out by integrating into the insurer's solvency regulatory compliance.

Neutrality of the regulator

While strengthening co-operation with the regulated, the CIRC needs to avoid either a state-owned insurer favoured or an industry-bias stand. Capture theory suggests that regulation may be affected by the interests of the regulated industry, and, what is worse, be captured for the industry's private interests rather than for promoting public interests.[31] One of the CIRC's important policy objectives is to promote market efficiency and innovation, thereby hastening the rapid growth of the insurance market.

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[29] This trend can be seen in the original Basle Capital Accord of 1988 and in the latest Basle II proposals that offer an explicit capital charge for bank operational risks such as fraud and system failures.

[30] For example, proper segregation of duties in critical operational areas, application controls over management information systems, an effective accounting function, and rectification of internal control deficiencies, etc.

[31] See A.I. Ogus (1994) *Regulation: Legal Form and Economic Theory*, Oxford University Press, p57.

This objective could be compromised, if regulation or deregulation is prone to certain insurers' capturing requirements, which could also impair consumer protection.

3.3 Transparency and information disclosure by insurers

Insurer's transparency and disclosure of information involve the timely disclosure of adequate information concerning an insurer's financial and operating performance and its corporate governance practices. High standards of disclosure and transparency enable stakeholders to effectively monitor the insurer's operating and financial performance and management, thus facilitating effective and efficient regulation and supervision. This section addresses the significance of transparency and information disclosure, the present status in the Chinese insurance industry and some measures necessary for improvement.

3.3.1 Significance of transparency

Transparency aims to protect stakeholders, especially consumers, by redressing the market imperfections that arise from asymmetrical and complex information as well as the market power of insurers. It facilitates a clear understanding of insurers' true underlying financial condition and management, and especially assists consumers in making a well-informed purchase based on a proper assessment of both the quality and relative prices of diverse and often complex insurance products and services, and the risks that insurers entail.

a. Information asymmetry

The information asymmetry prevents the market economy from functioning effectively, which means that public disclosure rules, as parts of regulation, are essential. This problem is particularly acute in insurance markets where there are two basic kinds of information asymmetry. One is that policyholders (the "agents") have hidden personal information about their own level of risks, which insurers (the "principals") can not completely grasp. This kind of information asymmetry usually

results in adverse selection[32] and moral hazard.[33] Insurers generally solve this type of problem by devising sets of contracts in a manner that obliges the agents indirectly to impart their risk level, thereby capacitating the insurers to treat the different risk groups independently.[34] Another kind of information asymmetry relates to insurers who have their own information which is not directly discernible to the insured or other stakeholders. Unlike durable commodity transactions, *e.g.* buying a car, or a property, a risk assessment of an insurer is a critical element in the decision to purchase insurance products. This is because consumers essentially buy 'promises' and therefore need assurance that the promises can and will be fulfilled in the future. Other important information influencing policyholders' purchasing decisions includes information about products, *e.g.* product pricing, coverage, exclusions, and information about compensation. Policyholders are at a disadvantage, as against insurers, regarding this information. The main goal of information disclosure by insurers is to solve this second type of problem.

b. Complexity of information

Insurance is a complex business, and so it is difficult for consumers, especially retail consumers, to make informed purchase decisions.[35] On the one hand, insurance products are complex in terms of their risk/return profile, premiums and benefit structures, early exit penalties and taxation consequences. Moreover, the structure, size

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[32] *Adverse selection* occurs when high-risk individuals are more likely to purchase insurance than low-risk individuals. In a seminal article, co-authored with Michael Rothschild, Stiglitz observes that if insurance buyers know more about their own health than do insurers, then buyers who know their risks are greater than average will purchase more insurance when its price is based on average risk. Buyers who know their risks are less than average will purchase less insurance. This sequence of events is termed "adverse selection." See Rotschild M. and J. Stiglitz (1976): "Equilibrium in Competitive Insurance Markets: An Essay on the Economics of Imperfect Information," *Quarterly Journal of Economics*, 90, 629–649.

[33] *Moral hazard* occurs when having an insurance policy causes the insured to expend less effort to avoid losses and, under certain circumstances, intentionally cause losses. For example, this could happen if a homeowner could insure a home for more than its market value and gain financially from its loss.

[34] For example, Insurers seek to avoid adverse selection through accurate risk classification and pricing, and decline to sell insurance to risks for which they cannot determine or charge an adequate premium.

[35] Retail consumers of insurance services often lack sufficient knowledge, experience or judgement to decide what information they need. They also require greater protection than do other users of insurance services. Conversely, financially sophisticated participants in wholesale markets can reasonably be expected to apprehend their own informational needs.

and complexity of an insurance industry make it impossible for most consumers to adequately assess the 'institutional risk' of insurers. On the other hand, retail policyholders do not always have the ability or resources to assess insurers' financial stability and to understand the information disclosed by insurers.

c. Bargaining power and malpractice

The superior bargaining power of insurers, who are naturally in a position to exploit (their) vulnerable customers, can prejudice the interests of consumers. For example, the unsophisticated consumers can be victims of misrepresentation or fraud. They may also suffer from bad advice due to either inadequate staff training within insurers or to undeclared conflicts of interest on the part of persons selling a product or service. Even after a purchase, policyholders may still entail increased risks caused by insurers' malpractice. It is difficult and costly for consumers to properly assess an insurer's financial strength in relation to its prices and quality of service. Information asymmetry and imperfect control mechanisms could cause some insurers to incur greater financial risks than would be optimal for policyholders and society.

d. Corporate governance

Disclosure and transparency are among the fundamental principles of good corporate governance. The OECD principles prescribe that "the corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company".[36] For a well-governed insurer, good transparency enables stakeholders effectively to monitor its financial situation and management.

e. Market-oriented regulatory mode

Market-oriented regulatory mode needs market disciplines which further require an appropriate balance of information between participants. Ill-informed markets do not generally produce optimal outcomes. Conversely, appropriate information which allows stakeholders to assess insurers' activities and the risks inherent in those activities help improve market efficiency. The objectives of insurance regulation are to ensure that markets are sound, orderly and transparent; users are treated fairly; the price formation process is reliable; and markets are free from misleading, manipulative or

[36] Section IV. Disclosure and Transparency, *supra note* 3.

abusive conduct.[37] To address potential market failure arising from inadequate disclosure of information, regulators must ensure that insurers make effective disclosure thereby facilitating informed choices, effective competition, and efficient and effective regulation.

3.3.2 The present situation of disclosure practices

Interests in the public disclosure of information by insurers and intermediaries, which have reached an unprecedented level in China, stem mainly from the emergence of innovative life insurance products and the enthusiasm of insurers for listing. First, in recent years, insurers launched some innovative products characterised by investment features, and, naturally, consumers were attracted by the returns available on the investments. However, by taking advantage of imperfect and non-standardised information disclosure, some insurers and intermediaries mislead their consumers.[38] This triggered the CIRC's promulgation of a set of rules, including the *Tentative Rules on Investment-linked Insurance Management*, the *Tentative Rules on Information Disclosure Management of New Life Insurance Products*, and the *Announcements of Certain Items of New Life Insurance Products*. These Rules mandate the disclosure for "new life products" (profit-sharing policies, universal policies, and packaged investment policies including unit-linked life products and with-profits life products), aiming to provide meaningful information to consumers by effective means.[39]

The second cause, that insurers are increasingly keen to be listed on the stock exchanges, means there must be more transparency in insurers' activities than that they remain non-public insurance companies. This lead to the CSRC's issuance of two specific regulations related to public disclosure by listed insurers, the *2001 Special Rules on Contents and Forms of Prospectus by Insurance Companies*, and the *2001 Special Rules on Notes of Financial Statements of Listed Insurance Companies*. These

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[37] Supra note 5.

[38] See "On establishing insurance information disclosure system" *Zhongguo Baoxian (China Insurance)* No.6, 2001.

[39] According to these rules, life insurers are liable for ensuring the objectiveness, truthfulness and non-material omissions in their product disclosure. The main component of the disclosure is the required product prospectus containing mandatory contents (material information) provided to consumers. For investment-linked products, insurers also must monthly publish the unit value of a policyholder's investment account, in addition to providing the prospectus.

two stipulations set out financial information and business risks which listed insurers have to disclose.

China recognises two systems of disclosure: voluntary disclosure and compulsory disclosure. Disclosure by insurers is primarily made through the voluntary efforts of insurers who disclose basic information through their sales representatives, agents, product pamphlets and websites. To promote accurate and voluntary disclosure, the Chinese insurance association (CIA) and some regional associations issued codes of conduct including disclosure standards. Compulsory disclosures, like those in the developed countries, are divided into public disclosure and non-public disclosure. Public disclosure involves listed insurers' obligations to disclose information (annual and quarterly reports, prospectuses and *ad hoc* information) required by the CSRC's two specific rules for listed insurers who may emerge soon. Non-public disclosure refers to non-listed insurers' disclosure obligations, which constitutes the main body of the current regulatory framework of disclosure.

At present, China lacks an integrated and comprehensive legal framework of insurers' disclosure.[40] In addition to the above-mentioned three regulations issued by the CIRC, the *2002 Insurance Law*, which leaves the disclosure provisions in the old version untouched, addresses insurers' disclosure. It only sets out two kinds of obligations. One is the disclosure of terms and conditions of insurance policies. Art.17 of the Law prescribes that an insurer shall explain the details of the terms and conditions of the insurance contract to a proposer. However, there is no stipulation of legal penalties for non-compliance with the provision, leaving a loophole for disputes between contractual parties.[41] Art.18 states that terms and conditions concerning exclusion of an insurer' liabilities shall not be effective until being clearly explained by the insurer. Another is the reporting duty of insurers (see "reporting system" in Chapter 4), which requires insurers to file financial reports among others with the regulator.[42] However, there is no mandatory public disclosure for the reports. In the past, the CIRC published abstracts of the reports in its almanacs which are accessible to consumers

[40] The sketchy disclosure system derived from the era of the planned economy. During the former PICC monopolistic times, disclosure as an administrative conduct was largely unregulated.

[41] This is a controversial issue. In the UK, the requirement of utmost good faith has long been said to apply to both parties to the insurance contract, which requires disclosure, but burdens on insurers seem not significant in practice. For detailed discussion, see John Birds "Chapter 6", *Modern Insurance Law* (5th ed.) Sweet & Maxwell 2001.

[42] Insurance intermediaries have a similar duty required by relevant regulations.

through a purchase. However, information disclosed through this way does not appear comprehensive, timely and affordable for individual consumers. In summary, so far, except those for "new life products", there are few explicit requirements concerning the contents and means of insurers' public disclosure of insurance products and prices as well as insurers' financial and operational conditions.

The weak disclosure system promoted an opaque market difficult for stakeholders' monitoring, and resulted in practical drawbacks. For example, the large amounts of negative interest margin loss and non-performing loans incurred to insurers are an "open secret", leaving to observers' wild estimates due to the lack of transparency. Inaccurate and intentionally deceptive product and price information is a material factor of unhealthy competition (see Section 2.4, Chapter 2).[43]

The reliability of insurers' information is frequently distorted due to accounting and auditing malpractice. For example, the role and effectiveness of internal audits and financial officers in practice are often circumscribed by the excessive powers of CEO who has the authority and means to influence the reports of accountants and internal auditors. In addition, as in western countries, external auditors "qualify" their audits[44] and perform audits largely on the basis of information provided by their clients who could mislead or cheat, leaving external auditing under such circumstances meaningless. What is worse, false auditing conducted by certified public accountants is frequently reported in recent years.

In addition, despite the regulatory efforts on disclosure, the utility of the disclosure is in question due to many factors that make it difficult for consumers to understand disclosed information. Firstly, the Chinese insurance market, being in a primary stage of development, largely comprises non-professional consumers. They tend to have relatively little knowledge and prior experience with insurance products. Secondly, insurance information remains uneasily accessible for most of ordinary consumers due to scarce amounts and complexity of information. Sometimes, only experts can decipher the information disclosed by insurers to assess the insurers' financial and operational condition accurately. Thirdly, insurance intermediaries who are still lag

[43] According to a survey of insurance markets in 50 China's cities, 26.2% of respondents repressed their dissatisfaction with sales representatives' explanations of prices and terms of insurance contracts. Note 48, Chapter 1

[44] Certified public accountants (CPAs) are obliged under the "Independent Auditing Standards for Certified Public Accountants" (issued by the Chinese Association of Certified Public Accountants) to express an opinion based on their audits.

behind the rapid development of the insurance market rarely provide public professional assessments on insurers' financial strength, management quality, products, and prices. Especially, no formal insurance rating institution so far exists in China; few law firms and public accountants provide the services concerning insurance regulation compliance. Fourthly, regulatory requirements sometimes appear not specifically relevant to the essential points of effective disclosure. For example, the comprehension of comparative price and term information tends to be decisive to a consumer's purchase,[45] but few of such effective ways are required by the regulator.

3.3.3 Suggestions for improving transparency and information disclosure

Compulsory disclosure subjecting insurers to public scrutiny, which is necessary to guarantee stakeholders/policyholders' right to know the quality of the insurers, will serve as a binding force pushing insurers towards more standardised and efficient management. To strengthen insurer transparency and corporate governance, the CIRC needs to draw up the *Provisional Rules on Information Disclosure by Insurers* to provide an integrated and comprehensive regulation for standardised information disclosure by insurers.[46]

Several selected issues regarding the proposed regulation are pointed out. Firstly, in line with international practice, the quality of disclosure by insurers should be measured by a set of standards, including relevance, timeliness, accessibility, comprehensiveness, reliability, comparability, utility, and consistency.[47] Secondly, regarding the contents of disclosure, it is essential to focus on two categories of information: product information and solvency information.[48] The relevant suggestions

[45] "Informed consumers: a review of product information at the point of sale" (FSA November 2000) Suggests that "comparative information tables" provided by insurers could be an effective way of disclosure.

[46] By comparison, as a substantial step towards improvement of corporate governance, the PBOC released the *Provisional Regulation for Information Disclosure by Commercial Banks* in May 2002, which can be drawn on by the CIRC.

[47] See IAIS "Guidance paper on public disclosure by insurers" 2001.

[48] At present, consumers are showing their focal interests on product information and insurers' claim handling performance because of their perceived importance of such information. *Supra note* 43.

in the IAIS guidance on this respect can be used as a reference.[49] Thirdly, improving the utility/effectiveness of product disclosure is important, otherwise the disclosure can hardly be cost-effective. To this end, it is essential to obtain baseline data about policyholders' exposure to and awareness of the disclosure, comprehension of important information, and their ability to use the disclosure correctly. This facilitates examining effectiveness of the existing measures (*e.g.* the effectiveness of prospectus[50]), and finding the ways to increase the relevance of disclosure.

In practice, consumers' financial knowledge and ability to bear costs are very limited. Considering the current situation that the increasing complexity of insurance products has created a need for consumer protection measures based on consumers' limitations, it is constructive to introduce CAT system implemented in the UK.[51] CAT is an acronym for the three aspects of financial product standards: charges, access (minimum transaction unit and other conditions of use), and terms (interest rate and other contract terms). If required standards are met (or exceeded in the consumer's favour), products are given the CAT stamps. CAT standards are intended to promote fair and suitable product purchases, and not to ensure optimal product purchases. The introduction of CAT into China would enable consumers to purchase insurance products with reasonable confidence.

Making the full use of intermediaries' positive roles is vital for improving the effectiveness of disclosure by insurers. Experiences from developed countries show that credit rating business is a major contributor to insurance market efficiency, bringing about important reductions in information costs and providing the basis for returns by the intermediaries and end-users.[52] Other intermediaries such as insurance

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[49] Briefly, insurers should disclose the information about their financial position, financial performance, risk exposure and how they are managed, how information is prepared, and basic business, management and corporate governance information. *Supra note* 47.

[50] In the UK, a research shows that most consumers do not use a Key Features Document (KFD) for shopping around, or only skim them; and those who do read KFDs often have difficulty understanding the material and in some cases misunderstand it. See "Informed decisions? how consumers use Key Features: a synthesis of research on the use of product information at the point of sale" FSA, November 2000.

[51] In December 1998, the UK Treasury established the CAT standards, a governmental seal of approval, which were first applied to a new savings plan introduced in April 1999 called Individual Savings Accounts (ISA). Paul Johnson "CAT standards and stakeholders - their role in financial regulation" Occasional Paper Series 11, FSA of the UK, September 2000.

[52] "Credit Ratings and Complementary Sources of Credit Quality Information" (Basel: BIS, 2000).

brokers, law firms and certified public accountants are playing a growing role in analysing the condition of insurers and providing useful information to the public/consumers choosing an insurer. However, in this area China lags far behind the US where insurers are rated by not only general rating agencies (*e.g.* Moody's, and Standard & Poors) but also rating agencies that specialise in specific insurance businesses (*e.g.* A.M. Best).[53] The CIRC needs to encourage reliable activities of both rating institutions[54] and brokers (either foreign or domestic) and regulation compliance services provided by law firms and other institutions.

Educating consumers is conductive to improving their abilities of understanding of risks, assessing and assuming risks, thus lifting the effectiveness of disclosure. It is crucial that consumers be educated insurance knowledge on every opportunity from the universal education all the way to various kinds of knowledge dissemination made by the regulator and the insurance industry.

3.4 Self-regulation of insurance industry

As part of its policy commitment to rectify and regulate the order of the market economy, the Chinese government affirms to "give full play to the role of industry associations" and encourages the improvement of industrial self-regulation approaches.[55] According to the CIRC, "a combination of government regulation, industrial self-regulation and internal control of firms marks a modern insurance regulatory system."[56] This section tries to probe how the insurance industry's self-regulation, which is still in its primary stage of the development, can be improved to be a useful means of effective and efficient insurance regulation and supervision. This

[53] A.M. Best (www.ambest.com) is a global specialist covering the insurance sector, while the top three of the global rating agency industry, Moody's (www.moodys.com), Standard & Poors (www.standard&poors.com), and Fitch IBCA (www.dcrco.com), also provide rating information of insurance industry.

[54] As profit-making entities with inherent conflicts of interest (that derive from raising income by charging clients on whom they rate), rating firms are reasonably subject to regulation.

[55] Premier Rongji Zhu "Review of Domestic Work in 2001"

[56] " Insurance Association of China set up" *People's Daily* November 16, 2000,

issue is addressed by mainly referring to the analyses from the "Industry Self-Regulation in Consumer Markets"(hereinafter "Self-regulation report").[57]

3.4.1 Basic issues on self-regulation

"Self-regulation occurs when those regulated design and enforce the rules themselves."[58] However, there is no consensus on the definition that entirely covers the terms and instruments referred to as self-regulation.[59] While it can be narrowly understood as law formulated by private agencies to govern professional and trading activities,[60] many forms of self-regulation have involved the State with various functions.[61] Based on whether a public body involves or not, self-regulation can be divided into two categories: spontaneous private self-regulation (without governmental involvement) and self-regulation as a delegation of a State. As Julia Black argues, a definition of self-regulation needs to address primarily three issues: the notion of "self", "regulation" and role of the state.[62] The term "self" can be used to refer to an individual or as a collective.[63] It can include professional groupings, occupational groupings, industry groupings, business communities or a combination of different groupings

[57] In 2000, the Minister for Financial Services & Regulation, Commonwealth of Australia released the "Industry Self-Regulation in Consumer Markets" which analyses the market circumstances where industry self-regulation is likely to be most and least effective.

[58] Haufler, Virginia. (2001) "A public role for the private sector: industry self-regulation in a global economy" Carnegie Endowment for International Peace: Washington, D.C. pg.8

[59] The term self-regulation covers a wide variety of schemes. For example, the UK National Consumer Council, quoted in the Better Regulation Task Force report (2000), identifies eight different categories: unilateral codes of conduct; customer charters; unilateral sector codes; negotiated codes; trade association codes approved by the Office of Fair Trading; recognised codes; official codes and guidance; and legal codes.

[60] See Anthony Ogus (1997) "Self-regulation", Encyclopaedia of Law and Economies: Literature Review 9400.

[61] Maxwell, John W., Thomas P. Lyon and Steven C. Hackett. *Self-regulation and social welfare: the political economy of corporate environmentalism* The Journal of Law and Economics Vol.43 (Issue 2) 2000, p584.

[62] Black, Julia (1996) "Constitutionalising self-regulation" *The Modern Law Review* Vol. 59 (Issue 1) 1996, p.26

[63] *Id.*

involved in a common activity bridging their differences.[64] According to "Self-regulation report", the term "regulation" can be an array of options to address specific problems and objectives, including codes of conduct, industry service charters, guideline and standards, industry-based accreditation, and complaint handling schemes. It also comprises enforcement including imposing an appropriate sanction on violators. The state's role can vary from as an outsider to a participant.[65]

As identified in "Self-regulation report", the need to stay competitive within the domestic and international marketplace has seen the momentum shift towards implementing alternatives to formal government regulation and legislation. Industry self-regulation is acknowledged as one of the most effective alternatives.[66] Effective self-regulation tends to promote good practice and target specific problems within industries, impose lower compliance costs, and offer a quick and low cost mechanism of dispute resolution. It can also avoid often overly prescriptive regulation and allow industries quickly to adapt to changes in the market, technologies and consumer expectations.

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[64] Gunningham, Neil and Joseph Rees. "Industry self-regulation: an Institutional Perspective" *Law and Policy* Vol. 19 (Issue 4) 1997 p370-380

[65] In the "Study to identify best practice in the use of soft law and to analyse how this best practice can be made to work for consumers in the European Union", experts from the EU suggest that, to encourage and support process of soft law (including self-regulation) application, the EU could exercise one of the following functions: *catalyser* (impetus, launching of initiatives); *facilitator* (provision of equipment, moderator of discussions); *supporter* (moral support, labels, approval of projects); *organiser* (establishment of permanent structures for meetings, assistance to consumers' organisations, reform of the method of representation); *negotiator* (participation as party to European agreements); and *legislator* (establishment of frameworks for European soft law).

[66] See Appendix D "International policy on industry self-regulation" to the "Self-regulation report"

3.4.2 Improving self-regulation by the insurance industry

The first insurance industry association in China emerged in Shanghai in February 1994, which was formed by the Shanghai branches of the former PICC, Ping An, China Pacific and AIG, to co-ordinate and self-regulate the market. Later, this practice spread over the country with local insurance industry associations seen in 32 cities and provinces by 1999. The Insurance Association of China (IAC), a national organisation, made its debut in November 2000.

Almost all insurance associations share the following common characteristics. In nature, an association is normally a spontaneous private self-regulation and non-profit *society legal person* registered with a pertinent Civil Services Department[67] under the *Regulations for the Management of Societies Registration.* It is subject to both the regulation and supervision of Civil Services Departments and business guidance of the CIRC. The main objectives of the associations are to abide by laws, regulations and insurance policies, observe social moralities, maintain the insurance market order, promote a healthy and stable development of the insurance market, and serve for the economic prosperity and the stability of people's livings.[68] They are funded by the subscriptions of members. The organisational structures vary among the associations.[69] The main difference between various associations is the status of their members. The members of a local association are usually local branches of insurers or insurance intermediaries, while those of the IAC are usually corporate level insurers and insurance intermediaries as well as local insurance associations as collective members.

During the past years, the associations have worked under their guidelines for strengthened self-discipline and for close exchanges and co-operation among members, thereby enhancing the public understanding of and trust in the insurance sector and improving management within the sector. Their missions carried out include[70]:

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[67] For example, the IAC registered with the Civil Services Department of the PRC, while the Shanghai insurance association, as a provincial level association, registered with the Civil Services Department of Shanghai municipal government.

[68] Art.1, Articles of Association, Sichuan Insurance Association,1999.

[69] For example, the IAC is organised around four main policy committees, including non-life, life, intermediaries, and actuary committees, together with a secretary department of the association. Articles of Association, IAC.

[70] "The general secretary of the IAC addressing the issue on misleading sales" *Zhongguo Baoxian Bao (China Insurance News)* April 25, 2002.

(1) formulating self-discipline covenants, guild standards, and disciplines, for implementing the CIRC's regulations and rules;
(2) implementing laws, regulations and rules related to insurance business, standardising market conducts of firms in accordance with law and self-regulation agreements and guidelines, and keeping the market order;
(3) mitigating and handling disputes between either members or insurance contractual parties, and disciplining defaults of members;
(4) providing a kind of protection to members and policyholders, and representing the collective interests of the insurance industry to speak out on issues of common interest and to inform and suggest the regulatory authorities on public policy issues;
(5) facilitating closer exchanges and communication among members, strengthening the industry's solidarity and the co-ordination among the members, and promoting exchanges between Chinese insurers and their foreign counterparts so that its members can learn from the advanced technologies and management expertise of foreign firms and take a more active role in international competition;
(6) conducting market surveys, disseminating insurance knowledge among consumers, publishing circulars and booklets, organising conferences and seminars among members, and enhancing professionalism of staff through training and education;
(7) carrying out designated activities of insurance agent supervision, including accreditation, operation monitoring and taking disciplinary actions; and
(8) appraising and rewarding advanced staff.

Despite these efforts, the development of the insurance associations is still in its initial stage. The following are some priorities for further display of their functions as self-regulation bodies. Firstly, according to the "Self-regulation report", consumer groups play an important role in developing and maintaining the relevance of self-regulation. Experience shows that self-regulation organisations may use their powers to benefit their members in ways which are not consistent with the public interest, for example, impeding competition on the supply side of the market.[71] It requires institutional structures capable of controlling this phenomenon. So far, the associations only have firms (or local insurance associations) in the membership which is not linked to the importance of consumers' attachment. Therefore, it suggests an increased consumer input by allowing consumer groups or representatives' membership as an instrumental factor in determining the priorities and work of the associations.

[71] For detailed discussion on disadvantages of self-regulation, see *supra note* 59.

Secondly, insurance firms' tariff transparency needs to be greatly increased. The tariff transparency is closely connected with the success of information disclosure and corporate governance. Although there are a few formal obligations relating to the tariff transparency, the associations could take active actions on the matter. For example, they can provide facilities (*e.g.* websites or publications) that enable consumers to know in advance prices and terms of insurance products and make tariff comparisons.

Thirdly, it is necessary to increase government involvement. In some countries, there are statutory requirements for certain insurance firms to be members of insurance associations.[72] Such an institutional arrangement could help strengthen the authority of an insurance association although rent-seeking may inhere in the delegated self-regulation regime. In practice, the voluntary membership of the insurance associations in China proved difficult for effective discipline on their members, needless to say on those non-members who are beyond the associations' authority. The regulators could consider providing the associations with certain regulatory incentives, for example, statutory memberships of the associations, promoting self-regulation through guidelines, directories and information disclosure via the Internet. The CIRC and the Civil Services Department also need to co-ordinate in guiding and monitoring insurance self-regulation.[73]

Fourthly, the dispute settlement function needs to be strengthened. Fairly, promptly and professionally handling consumers' complaints is a key influence of the effectiveness of self-regulation, because it help strengthen consumers' confidence in the industry.[74] China's existing legal framework regarding the settlement of contractual disputes has some drawbacks. First, the *Insurance Law* and the *Administration Regulation* set out time limits for settling claims. An insurer who fails to determine the amount of payment within 60 days of receipt of a claim must make an initial minimum payment based on available information, and pay the balance when the insurer make a

[72] For example, the Malaysian Insurance Act 1996 requires all life insurance/life reinsurance companies to be members of the Life Insurance Association of Malaysia (LIAM).

[73] For example, in Shanghai, the municipal government set up an insurance development and planning institute to help the industry grow smoothly and make the city a major financial centre in the Far East.

[74] "Self-regulation report" p71-78.

final determination.[75] However, there is no provision for penalty where an insurer takes a long time to make a final determination, or intentionally repudiates to fulfil obligations by not making a final determination.[76] Second, the disputes of insurance contracts are usually settled through courts or arbitration; the disputes between the insurance regulator (and its agents) and the regulated are dealt with through administrative procedures, and if it fails, then through administrative litigation procedures. Although there is a Division of Complaints in the CIRC, it only accepts administrative complaints from regulated firms or consumers other than controversies involving insurers and policyholders. Third, although the insurance associations accept consumers' complaints, they only discipline the default insurance firms by such measures as advising the involving firms, circulating a notice within the industry, or advising the regulator on necessary penalties. In summary, there is no proper process of contractual dispute settlement within the CIRC or the associations. Disputing parties have to resort to courts or arbitration.[77] Such a scenario sometimes proves time-consuming and costly for insured. The CIRC needs to build a streamlined, effective and user-friendly complaint handling and dispute-solving system. It may contain an internal complaint review process within insurance firms, and an insurance ombudsman (or it is

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[75] The *2002 Insurance Law*, Art. 24-26. The Law also stipulates that an insurer must reach a settlement agreement with the insured or beneficiary within 10 days or the time limit specified in contract if there is one. The insurer who fails to do so is obliged to pay compensation for any losses suffered by the insured or the beneficiary.

[76] By contrast, South Carolina in the U.S. has well established rules that punitive damage may be recovered for fraudulent breach of contract. For example, West v. Service Life & Health Insurance Co., 66 S.E. 2d 816 (S.C.1951), and Yarborough v. Bankers Life & Caas. Co., 81 S.E. 2d 359 (S.C.1954).

[77] To facilitate quickly solving contractual disputes of insurance, the CIRC decreed that an insurance policy must contain an arbitration clause. The *Notice of Drawing Arbitration Clauses in Insurance Policies*, the CIRC, August 1999.

advisable to set up a dispute resolution scheme in the associations[78]), supplemented by arbitration and court systems.

Fifthly, self-regulation could be extended beyond the association regime. The regulators can use mass media and consumer protection organisations as useful means to promote self-regulation by the insurance industry.

3.5 Concluding remarks

This chapter probed how China's insurance regulation and supervision can be efficiently and effectively improved by the implementation of market-based approaches that shift some of responsibilities for supervision to both insurers and the insurance industry and promote insurers' transparency. At present, many shortcomings are identified in the corporate governance of state-owned insurers, including the lack of adequate corporate independence, the agency problem, weak economic incentives, the "insider control" due to deficient governance structures, incompetence of risk management, and inadequate external disciplines. In addition, China lacks an integrated and comprehensive legal framework of insurers' disclosure. The reliability of insurers' information is frequently distorted by accounting and auditing malpractice. The utility of insurers' disclosure is in question due to many factors that make consumers difficult to understand disclosed information. The self-regulation by the insurance associations has a short history and is still in its primary stage. The suggestible measures, therefore, include better corporate governance within insurers, particularly through the current wave of listing and shareholding reforms on state-owned insurers, reinforced information disclosure by insurers, and enhanced self-regulation by the insurance industry with appropriate involvement of consumers and regulators.

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[78] A formal alternative dispute resolution (ADR) scheme administered by Insurance Enquiries & Complaints Ltd (IEC) in Australia is an example of the development of an approach to self regulation in the general insurance industry. The scheme is a national two-tiered dispute resolution service involving the provision of advice as well as the resolution of disputes. The first tier consists of an enquiry and advisory service undertaken by Consumer Consultants (CC) who receive calls from consumers and policyholders and liaise with insurers to resolve disputes. If a dispute is unresolved after review by the insurer through its internal dispute resolution process, it is referred by the policyholder to a second tier for determinations by the Claims Review Panel, Referee or Adjudicator. The determinations are binding on member firms but not on consumers, who have recourse to the legal system if they are dissatisfied with the determinations. See IEC Submission to Taskforce on Industry Self- Regulation, Australia. The Ombudsman Scheme in the UK shares some similarities with the ADR scheme.

Chapter 4
Some selected issues on prudential regulation in China

4.1 Introduction

Prudential regulation,[1] also referred to as *solvency regulation* or *financial regulation,* along with market regulation, traditionally constitutes one of the two most important areas of insurance regulation. The commonly applied model of prudential regulation is to establish certain financial prudential standards, monitor insurers' compliance, intervene in non-compliance, and provide remedies to certain policyholders from guarantee funds when insurer failure occurs. Generally, the solvency position of an insurer depends at least on sufficient technical provisions, sound investment assets corresponding to the technical provisions, and a satisfactory solvency margin. These elements are considerably intertwined. The important kinds of financial prudential standards usually consist of: (1) rules directing technical provisions including types of provisions and valuation methods, (2) rules governing asset diversification and valuation, and (3) capital regulation. Rules for reporting and on-site/off-site inspections, and the administering of guarantee funds are also major components of prudential regulation and supervision.

The rationale for prudential regulation generally derives from the anxiety that, due to running risk business, insurers have inherent difficulties of honouring their promises to policyholders, and, if they fail, the consequences can be severe. Meanwhile, consumers, especially individual consumers, face difficulties in assessing the financial condition or creditworthiness of the insurer they deal with. Prudential regulation as "one of the most important elements in the supervision of insurance companies" is "to maintain efficient, fair, safe and stable insurance markets for the benefit and protection of policyholders".[2] Moreover, some economic theories can be used to demonstrate the essentiality of prudential regulation. As the problem of information asymmetry exists in insurance transactions, it may benefit insured that governments use minimal regulation relying on

[1] For an explanation of the term, see "Financial (prudential) regulation" in *Glossary of Insurance Policy Terms* OECD 1999, p30-33.

[2] "Principles on capital adequacy and solvency" IAIS 2002. p1.

information disclosure by insurers[3] or private rating services[4] as a supplement or an alternative to regulation. Insured may be able to benefit from use of monitored conditions in contracts or through mutual insurance.[5] Majority of individuals, however, can hardly fully understand the complexity of the information released by insurers or rating services. In addition, insurers may use their market power to take advantage of insured's inferiority in contracting.[6] All these understandings further underpin the rationale for prudential regulation.

Generally, the greater the detail and degree of prudential regulation, the more secure the insurer, and thus the more stable the insurance industry. However, too stringent regulation or over-regulation is highly likely to stifle competition and insurers' innovation, thereby lowering consumer choice and value. Balancing these competing public interests has been proved very difficult, but regulators still need and have been striving to strike this balance by weighing these interests in certain economic and social circumstances.

Over the last decade, state insurance departments in the US, co-ordinated by the *National Association of Insurance Commissioners* (NAIC), directed their efforts at strengthening financial regulation by establishing higher capital standards, expanding financial reporting, improving monitoring tools, and accrediting insurance departments. However, within the recent years, there have been pressures to slow and even reverse some of these initiatives, to cater for deregulation appeals by insurers. In the EU, prudential provisions contained in *Directives* are expected to have a dramatic change under the *Solvency II project*. In the dimension of international co-operation, some international organisations, *e.g.* IAIS, OECD, are making their endeavours to provide blueprints and guidelines for harmonising nations' prudential regulation restructuring. All these regimes provide China with instructive experiences.

This chapter aims to examine some selected issues on the restructuring of China's prudential regulation and supervision by drawing experiences from the EU and other

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[3] In contrast to practice in continental countries of the EU, the UK regulators largely rely on information publicity to regulate insurance industry. Such an approach seems to expand gradually its adoption in the world.

[4] See Section 3.3.3, Chapter 3.

[5] See Mayers D. and Smith C.W. Jr (1981) "Contractual provisions, organisational structure, and conflict control in insurance markets" *Journal of Business* 54, p407-434.

[6] Robert W. Klein "Restructuring regulation for developing insurance markets" Centre for Risk Management and Insurance Research, Georgia State University, 1999. p3-4.

regimes. It initially presents observations on current trends of prudential regulations in some regimes. Section 4.3 examines the basic situations of solvency in the Chinese insurance industry, focusing on analyses of deficiencies existing in the industry. Section 4.4 then provides an overview of the framework of prudential regulation and supervision in China, and comments on the current system. Section 4.5 discusses the issues on *early warning system* and section 4.6 deals with the issues concerning the establishment of policyholder protection fund (PPF) system in China. The chapter concludes with some recommendations.

4.2 Some observations on prudential regulation in selected regimes

With ever increasing liberalisation and deregulation in both developed and developing countries in recent years, prudential regulation has become even more important world-wide, gradually turning into the core task of insurance regulation and supervision. In addition, with the development of insurance industries and the progress of information technology, prudential regulation has been endowed with some new concepts and new forms. Although regulatory models vary in different countries, prudential regulation around the world is undergoing a transition from material regulation mode into a solvency-oriented mode characterised by changes towards a risk-dealing, comprehensive, synergetic, jointly functioning, dynamic and internationally harmonised domain.

a. Risk-dealing approach

The first trend evident around the world is the incorporation of the various risks that insurers face into prudential regulation and supervision. The *risk-based capital* (RBC) and *Basel capital adequacy* model are two typical examples of this trend. RBC is a regulatory model developed as a tool for measuring the solvency and capital adequacy that a financial institute needs to support its overall business operations. The NAIC of the US formally adopted RBC model laws in December 1993 and has applied them to US insurers since 1995.[7] Its objective is to address the drawbacks of the fixed-ratio model by incorporating (at least what is considered to be) all of the risks confronting an

[7] Based on reviews performed as part of the *NAIC Accreditation Program*, 47 of the U.S. insurance jurisdictions have adopted substantially these laws in their state laws, regulations or bulletins. See "Risk-Based Capital general Overview" NAIC <http://www.naic.com>

insurer into solvency regulation,[8] rather than just a few risks which the EU model incorporates.[9] The NAIC RBC approach contains two main components: (1) a risk-based capital formula, which establishes a hypothetical minimum capital level that is compared to an insurer's actual capital level, and (2) a ratio of *total adjusted capital to authorised control level risk-based capital* and consequential action levels for regulators to correct insurers' impairment. The common risks identified in the NAIC models include *asset risk - affiliates, asset risk - other, credit risk, underwriting risk,* and *business risk.*[10] Separate RBC model laws apply to life insurers, property/casualty insurers and health insurers respectively, which reflect the differences in the risk profiles facing these different insurers.[11] Although both strengths and criticisms exist in the US RBC system,[12] the RBC concept has been gradually introduced into other countries where regulators and insurers adopted various RBC approaches into their solvency regulation and risk management.[13]

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[8] According to the NAIC, the stated objectives of the NAIC RBC requirements are to provide a standard of capital adequacy that: (1) is related to risk, (2) raises the safety net for insurers, (3) is uniform among states, and (4) provides authority for regulatory action when capital falls below the standard. See "NAIC Property-liability Risk-Based Capital Formula Exposure Draft"(1993) for details.

[9] For a comparative study of the NAIC RBC model and the EU fixed-rate solvency model, see Chapter 10, and Appendix 10.2 of the 2002 KPMG Solvency Study.

[10] For a detailed description of NAIC RBC system, see N.D. Hooker (1996) "Risk-based capital in general insurance" *B.A.J.* 2, II, 265–323, and Sholom Feldblum "NAIC Property/Casualty Insurance Company Risk-Based Capital Requirements" 1997 <http://www.actuaries.ca>

[11] For details, see "Comparison of the NAIC Life, P&C and MCO RBC Formulas summary of differences" *American Academy of Actuaries* Febuary 2002.

[12] See J. David Cummins Scott E. Harrington Robert Klein "Insolvency experience, risk-based capital and prompt corrective action in property-liability insurance" Wharton 95-06, "1995 RBC results - property/casualty" compiled by NAIC staff NAIC Quarterly April, 1996 - Volume II, Issue 2, "1997 P&C RBC industry results" by Mike Barth, NAIC Staff NAIC Quarterly April, 1998 - Volume IV, Issue 2, and J. David Cummins, Martin F. Grace, and Richard D. Phillips (1997) "Regulatory solvency prediction in property-liability insurance: risk-based capital, audit ratios, and cash flow simulation" Journal of Risk and Insurance 66: p417-458.

[13] For example, Japan introduced a solvency margin ratio that is similar to the US RBC formula to serve as an early warning system. See, "Fact book non-life insurance in Japan 1999-2000" *The Marine and Fire Insurance Association of Japan Inc.* In the UK, some insurers and Lloyds use RBC as a tool of risk management. In Belgium, some insurers calculate RBC as a base of the return on equity (ROE) calculation. Malaysia and Singapore are doing studies on the introduction of RBC system. See "Insurance regulation changes in Singapore" *Tillinghast-Tower Perrin* September 2001.

The new proposals of capital accord put forward by the Basel Committee of Banking Supervision, Bank of International Settlement ("Basel")[14] is expected to make a huge impact on insurance prudential regulation in the near future,[15] typically on the *Solvency II project* of the EU.[16] Based on three inter-reinforcing "pillars", "Basel" is seeking a more risk-sensitive, flexible approach to bank capital requirements than the approach of *1988 Capital Accord.* The first pillar develops and expands on the standardised 1988 rules of minimum capital requirements,[17] and allows banks to use their own internal risk management systems to determine the appropriate capital level if they meet certain qualifying standards. The second pillar is the supervisory review of capital adequacy which will seek to ensure that a bank's position is consistent with its overall risk profile and strategy, or will trigger an early supervisory intervention. The third pillar is the role of market discipline, including high disclosure standards and increased transparency, in promoting bank capital adequacy.

The basic objectives of *Solvency II project* which is in a process are "to try and better match solvency requirements to the true risk encountered by an insurance undertaking and also to encourage insurers to improve their measurement and monitoring of the

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[14] See "Overview of The New Basel Capital Accord" Consultative Document *Issued for comment by 31 May 2001 Basel Committee on Banking Supervision*

[15] See Alan McNee "The next generation of insurance regulation" *Erisk* August. 2001.

[16] In 1999, the EU Insurance Committee decided to adopt a two-stage approach to the issue of insurance capital adequacy. The first stage -*Solvency I project*- was to introduce some improvements to the existing solvency margin, which resulted in the adoption by the *Council of Ministers* of the EU in February 2002 of two Directives to amend the solvency margin requirements for life and non-life insurance undertakings (in Directives 73/239/EEC and 79/267/EEC). The second stage - *Solvency II project*- exercises a wide-ranging review of, among the other things, the rules governing the assets and liabilities of insurers, the matching of assets to liabilities, reinsurance arrangements, sophisticated approaches to solvency margins, and the implications of accounting and actuarial policies. The project will take several years, and at the end, the EU Commission will consider further improvements to insurance prudential regulation by introducing a new Directive.

[17] *International Convergence of Capital Measurement and Capital Standards* (1988) sets out the details of the risk-based capital framework. The document outlines how different asset classes (both on and off-balance sheet) are weighted according to their riskiness. There are five weights -0%, 10%, 20%, 50% and 100%. OECD-government debts or cash, for example, have a zero or low weight; loans by banks get 20% while loans fully secured by mortgages on residential property 50%. All claims on the private sector or on banks incorporated outside the OECD with a residual maturity of over one year are weighted 100%.

risks they incur".[18] These objectives parallel with those of the "Basel" new proposals of capital accord, indicating the EU's implementation of the "Basel" new proposal.[19] The EU Member States are planning their own implementation. For example, the FSA of the UK requires each financial company to establish risk management systems to carry out an internal assessment of the level of capital they require to meet their plan, taking account of the risks to which they are exposed.[20] Meanwhile, a supplementary capital assessment (SCA) is an additional tool that the FSA may require when it has specific concerns.[21] It seems possible that an insurer will have to demonstrate at all times that it has capital equal to the highest among: its own assessment results, the FSA's bespoke capital requirements in the supervision manual, and the EU's solvency margins.

b. A comprehensive approach

A second trend is to handle insurers' solvency in a comprehensive manner dealing with all the factors on which the overall financial position of an insurer depends. Jean-Louis Bellando[22] claims that a comprehensive regulatory and supervisory approach to solvency needs to consider four aspects: a solvency ratio, a triple test of balance sheet soundness,[23] operating conditions (which are essential to an insurer's prospective solvency), and outside forces affecting an insurer's financial health. The *Solvency II project* of the EU is undertaking extensive studies on many complex issues concerning insurance prudential regulation. The eight issues addressed in the EC commissioned study by KPMG in 2002 include: risks and risk models; technical liabilities; asset valuation; reinsurance; alternative risk transfer arrangement and advanced risk reduction techniques; the impact of future accounting changes; use of rating agencies

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[18] "Insurance solvency margin rules-frequently asked questions" at <http://europa.eu.int/comm/internal_market/en/finances/insur>

[19] See "Consideration on the design of a future prudential supervisory system" Paper for the Solvency Subcommittee, EC, 2002.

[20] "UK implementation of the new Basel and EU capital adequacy standards" 2002, and "Integrated prudential sourcebook" 2001, the FSA of the UK.

[21] Consultation Paper 136: "Individual Capital Adequacy Standards" the FSA of the UK. 2001.

[22] See Jean-Louis Bellando (2000) "Assessing the financial health of insurance undertakings to protect the insured from the risk to which these firms are exposed: solvency rules" OECD p7.

[23] The test checks that technical provisions are adequate, the provisions are covered by quality assets of at least equivalent value, and equity capital exceeds a minimum standard. *Id.*

and market mechanisms; and comparative analysis of solvency margin methodologies.[24]

c. A synergetic approach

A third trend in prudential regulation and supervision is that, instead of trying to do everything with their own staff and budgets, regulators use professionals (auditors, actuaries, rating agencies, etc.) to assist them in ensuring insurers' ongoing compliance with prudential standards. To safeguard and ensure the competence and reliability of these professionals, regulators enforce professional standards, monitor professional practice, and penalise malpractice in the professions. The existence of professional standards backed by an effective disciplinary regime allows regulators to rely on professionals to have an unbiased perspective on an insurer's prudential situation, and achieve their regulatory goals in an efficient way.

Many jurisdictions have long been requiring external or statutory auditors[25] to examine and certify insurers' published financial statements or even attest the truth of the statements.[26] The Australian solvency regime requires the independent auditor to attest the appropriateness of risk management procedures and statutory conduct compliance.[27] To ensure the reliability and integrity of auditors, which was highlighted by the collapse of Andersen (the US), many OECD member countries require auditors to produce the evidence of competence and reputability, being independent of insurers, and taking third party liability insurance.[28]

Actuaries are experts in valuation and management of financial risks, and have traditionally the role of unique discretion over liability calculation, reserving and profit

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[24] See "Study into the methodologies to assess the overall financial position of an insurance undertaking from the perspective of prudential supervision" *KPMG* (2002 KPMG Solvency Study) commissioned by EC, May 2002.

[25] In Singapore and Malaysia, auditors have to be appointed by the supervisory authority.

[26] For instance, the EU Directive 95/26/EC reinforces the obligations of statutory auditors by requiring them to rapidly advise the supervisory authorities of any factor, or decision concerning the undertaking that might constitute a breach of the regulations or jeopardise the continuity of the business.

[27] "Prudential Supervisory Requirements for General Insurers" implemented from July 2002, *The Australian Prudential regulatory Authority (APRA)*

[28] See "Insurance regulation and supervision in OECD countries, Asian economies and CEEC and NIS countries" OECD 1999. p24.

distribution.[29] As observed by Catherine Prime,[30] in many developed countries the role of Actuaries has changed to a membership of a synergetic team charged with compliance with prudential regulation requirements. The appointed actuary system, introduced in the UK in 1974, clearly expects actuaries to act as front-line controllers of prudential financial management.[31] Most OECD countries require by law that life insurers appoint actuaries, although in practice the tasks of an actuary vary. They mainly involve the oversight of actuarial aspects of the insurers' whole operation, and continuous responsibility for keeping within prudential requirements. Although such duties may be slightly adjusted in certain regimes in the future,[32] the issue of the reinforcement of actuaries' role within insurance prudential regulation brought attention to both insurance regulatory regimes[33] and actuary communities.[34]

Rating agencies[35] play an important role in the infrastructure of the modern financial system, and fit into the scheme of banking prudential supervision in a number of countries.[36] By providing professional analyses of and judgements on financial institutions' performance and solvency situations, they improve the effectiveness of

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[29] See Chris Daykin (1999) "The role of the actuary in the supervision of insurance" Part 1:3)b, Book 1 in *Insurance and private pensions compendium for emerging economies* OECD.

[30] Catherine Prime "The actuary and insurance regulation" presented to the 2nd Global Conference of Actuaries

Delhi, February 2000.

[31] See supra note 85 for a description of roles of *appointed actuaries.*

[32] According to "Future role of actuaries in the governance of life insurers" (the FSA of the UK, 2001), the FSA proposed to abolish the *appointed actuary* role for all companies that do not write with-profits business. For with-profits companies the role of the *appointed actuary* is to be restricted to one of advising the company on the use of its discretion with regard to with-profits business. A new position, head of the "actuarial function", is to be created to advise board of directors on actuarial matters. The board will take full responsibility for setting the mathematical reserves, which become subject to audit, and for the production of a financial condition report (FCR) which would be made available to the FSA.

[33] The IAIS in its "On solvency, solvency assessments and actuarial issues" (Mar.2000) suggests that actuaries can play a dominant role in a prudential regulatory framework stressing risk management systems of an insurer.

[34] Phillip Booth (2000) "Actuarial issues related to the regulation of pension schemes and life insurance" OECD.

[35] See Chapter 3, Note 52.

[36] In 2000, of the 12 Basel Committee on Banking Supervision countries, 11 used credit rating agency information in one way or another in the financial regulation activities. See "Credit Ratings and Complementary Sources of Credit Quality Information" Basel: *Bank for International Settlements* (BIS), 2000.

information disclosure and reduce information costs, thus enhancing market efficiency. With the influence of the Basel new capital accord, the role of rating agencies is expected to spread into the insurance prudential regulatory regime.

d. A joint approach

A fourth trend is the joining of efforts of both regulators and individual insurance firms. The IAIS explicitly points out that "a sound supervisory system has to combine capital adequacy and solvency regimes with requirements for risk management systems for risk reduction and mitigation".[37] The growing interest in the joint approach is due to the deregulation environment and the importance of enterprise risk management. One regulatory objective in deregulation environment is to optimise the balance between market efficiency and regulatory soundness, so that market forces become the main determinants of insurers' transactions. Meanwhile, insurers' risk management systems have been unfavourably highlighted by many studies on the causes of insurers' failures. For instance, one main identified cause of insurance insolvencies in the EU refers to "operational failure related to inexperienced or incompetent management"[38] To secure their financial stability, insurers must establish risk management systems that are comprehensive, cover all risks to which they are exposed, and are appropriate to the complexity, size and mix of the insurers' operations. Meanwhile, regulatory requirements should be seen as the lowest standards that they should follow in their efforts at risk management.

A regulatory framework supports the joint approach by both recognising and enforcing risk management system within individual insurers, and encouraging and mandating public transparency about insurers' operations. The second pillar of the *New Capital Accord* and the "Integrated prudential sourcebook" of the FSA, the UK, as mentioned before, both advocate the establishment of risk management systems within insurers with certain regulatory incentives and mandates. The Australian solvency regime requires directors and the management of all insurers to evidence the development and continued monitoring of internal risk management systems. In addition, the Australian actuaries association suggests the creation of a position of

[37] "Background" and "Principle 10" in "Principles on capital adequacy and solvency" The IAIS, 2002

[38] An EC Working Group publication on "Solvency of insurance undertakings" (The Muller Report) EC, 1997.

prudential risk manager with clear statutory roles within an insurer.[39] This could be a way to facilitate the joint approach whereby some of the responsibility for prudential regulation is transferred to the insurers, and to ensure insurers' fulfilment of their responsibilities of prudent operation. Further, the third pillar of the *New Capital Accord* stresses transparency and market discipline to bring the power of market discipline into play.

e. A dynamic approach

A fifth trend is timely supervision of insurers' financial positions. The potential consequences of failing to monitor risks in a timely manner, and therefore failing to act on early warning signals, has been highlighted by many cases, *e.g.* the failure of Barings.[40] The failure was identified as due to losses incurred by unauthorised and concealed trading activities and a serious failure of controls together with managerial confusion within Barings, that made early notice of the rogue trading unachievable. Therefore, a prudential regulation system must give sufficient warning of impending problems to allow timely intervention by regulators. Beginning in 1993 for life insurers and in 1999 for non-life insurers, the Canadian federal regulator has required the appointed actuary of an insurer to complete an annual Dynamic Capital Adequacy Testing (DCAT) report. The report is compiled by projecting financial results and capital adequacy on expected scenarios (including on the insurer's business plan, and various adverse scenarios) for a few years into the future so as to get a dynamic prediction of the insurer's future solvency.[41]

f. International harmonisation

The IAIS, although a relatively new organisation compared to "Basel" and the International Organisation of Securities Commissions (IOSCO) for securities supervision, has made great efforts to promote the harmonisation of insurance prudential regulation around the world. It issued several papers setting out principles,

[39] Kent Griffin (1999) "The continuing evolution of financial services regulation and the role of the actuarial profession" The *Prudential Regulation Taskforce* of the *Council of the Institute of Actuaries of Australia.*

[40] See David Llewellyn (1999) "Some lessons for regulation from recent bank crises" Institute for Development Policy and Management, University of Manchester.

[41] "Dynamic capital adequacy testing " Committee on solvency standards for financial institutions, Canadian Institute of Actuaries, December 1998.

standards and guidance notes relating to the prudential regulation and supervision of insurance.[42] The IAIS is seeking to extend its work on prudential issues, given the importance and complexity of this topic. The OECD has been working on efforts to compare solvency regulations across jurisdictions for the purpose of harmonisation.[43] The International Actuarial Association (IAA) and the International Accounting Standards Board (IASB) have also been closely involving in the development of rules relating to insurance capital adequacy. Furthermore, in preparation for the foreseeable greater convergence between financial institutions in the future, "Basel" and the IAIS are seeking to largely harmonise the prudential regulation for banking and insurance.

4.3 Prudential situation of China's insurance industry

The purpose of this section is to consider the prudential situation of China's insurance industry.[44] It presents the findings from financial tests plus some qualitative analyses that focus on the solvency margins and relevant elements of prudential conditions such as capitalisation, profitability, expense ratios and investment performance. While the analyses are basically concerned with the four major national insurers mainly based on their statutory financial filings during 1996-2000, the results may represent the generic nature of the industry in the same period.[45] The data, which has been used in this section, is mainly drawn from the *China Insurance Almanac 1998, 1999, 2000,* and *2001.*[46]

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[42] Formulating principles and standards on solvency is the domain and one of the greatest challenges of the IAIS. In 2002, it adopted *Principles on Capital Adequacy and Solvency,* viewed by the IAIS as "an essential building block in the development of more detailed standards relating to capital adequacy and solvency." It elaborates 14 principles for evaluating the solvency of life and non-life insurance undertakings. The paper is also relevant to reinsurers.

[43] For example, Viviane Leflaive (2001) "The supervision of insurance solvency: comparative analysis in OECD countries", and Jörg Vollbrecht (2000) "Insurance regulation and supervision in OECD countries" OECD

[44] The prudential situation here means circumstances relating to insurers' solvency, including capital adequacy and solvency margins, return on investment, underwriting profitability, etc.

[45] The four insurers are PICC, China Life, CPIC, and Ping An. During 1996-2000, they managed to maintain an average 95 percent of the market share in the whole industry in terms of premium income.

[46] These yearbooks have been compiled by the CIRC annually since 1998, which mainly contain the financial statements filed by all insurers in China to the CIRC.

4.3.1 The general situation

The main problem in the Chinese insurance industry is that, having experienced a high-speed development in the last two decades, the industry as a whole is revealing a state of insufficient solvency.[47] This has all along drawn the attention of regulators and experts.[48] The typical solvency margins of the four major insurers demonstrates this problem. It is also incidentally evidenced by these four oligopolies' features such as the low level of capitalisation and the low operation profitability in both underwriting and investment (Chapter 5). Moreover, life insurers especially suffered huge losses due to negative interest margins (Chapter 5); and insurers, especially state-owned insurers, usually have a low profile corporate governance and risk management (Chapter 3) which make up essential issues on prudential regulation.

4.3.2 The solvency situation

As Fang Huang and XiaoTang Yu calculated, in 1997 the industry had a 32.69% insolvency rate measured against the solvency margins required by the *1995 Insurance Law* and regulations.[49] Although this figure can not be verified in this paper due to the unavailability of the detailed data, the solvency problem can be partly demonstrated by an estimation of the weak solvency of PICC and China Life. For example, in 1999, PICC just met the solvency requirements, while China Life had a 141.37% insolvency ratio (see Table 4.1). This could suggest that the Chinese insurers, especially the major state-owned oligopolies, suffered from insufficient solvency.

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[47] Chengming Li (2002) "On fast growth risks and related management and regulation" *Zhongguo Baoxian Bao (China Insurance News)* May 20, 2002.

[48] "Worrying amid Fast Growth" *Zhongguo Baoxian Bao (China Insurance News)* November 20, 2001.

[49] Fang Huang and XiaoTang Yu (2001) "Realistic options of ways to substantiate capitals of the Chinese insurance companies" *Shanghai Baoxian (Shanghai Insurance)* No.2 2001, p9-11. The calculation is illustrated in the following table:

Items	Amounts (Rmb mn)
1. Total Assets	167,271.66
2. Deductibles	3,077.83
3. Admissible Assets(1-2)	164,193.83
4. Equity	18,418.94
5. Actual Liabilities (1-4)	148,852.72
6. Capital Adequacy (3-5)	15,341.11
7. Solvency Margin *	22,792.19
8. Insolvency	-7,451.08
9. Insolvency ratio	32.69%

*Calculated separately according to the prescriptions of the *Law* and the regulations.

Table 4.1 An estimation of solvency situations of PICC and China Life in 1999

Items	PICC (Rmb mn)	China Life (Rmb mn)
1. Total Assets	46,667	131,507.12
2. Admissible Assets (estimated)	43,123.3	125,853.94
3. Liabilities	37,361.3	127,243.16
4. Capital Adequacy (2-3)	5,762	-1,389.22
5. Solvency Margin	5,701.2	3,357.85
6. Actual Solvency	60.8	-4,747.07
7. Insolvency Ratio		141.37%

4.3.3 Low level of capitalisation

Firstly, the reported statutory equity funds of the four major insurers had experienced a continuing growth during 1996-2000 (see Chart 4.1), but it was realised wholly by the increase of paid-in capital rather than surplus from operation earnings. The aggregate equity rose from Rmb11,618.74mn by 1996 to Rmb23,486.21mn by 2000, or by 102.14% in nominal terms. The decisive component of this growth is that PICC and China Life supplemented their paid-in capitals by Rmb6,600mn and Rmb3,800mn respectively. Altogether, the paid-in capital of the four insurers increased by Rmb12,300mn, while the aggregate equity increased by just Rmb11,867.47mn, which means that the growth of the aggregate equity was entirely due to the increase of paid-in capital. Secondly, it notes that the capital base had increased less than the increase of

risk exposure (see Table 4.2), which could harden the poor solvency situation. Thirdly, the levels of capitalisation (equity in percentage of total assets) of the four insurers fluctuated slightly in the period (see Chart 4.2).

Table 4.2 Premium Increase vs. Equity Increase

Year	Net Written Premium Growth (%)	Capital growth (%)
2000	217.40	202.14
1999	199.09	184.81
1998	180.04	170.35
1997	146.05	122.03
1996 (Basic year)	100	100

Chart 4.2 Equity/total assets of the four major insurers 1996-2000

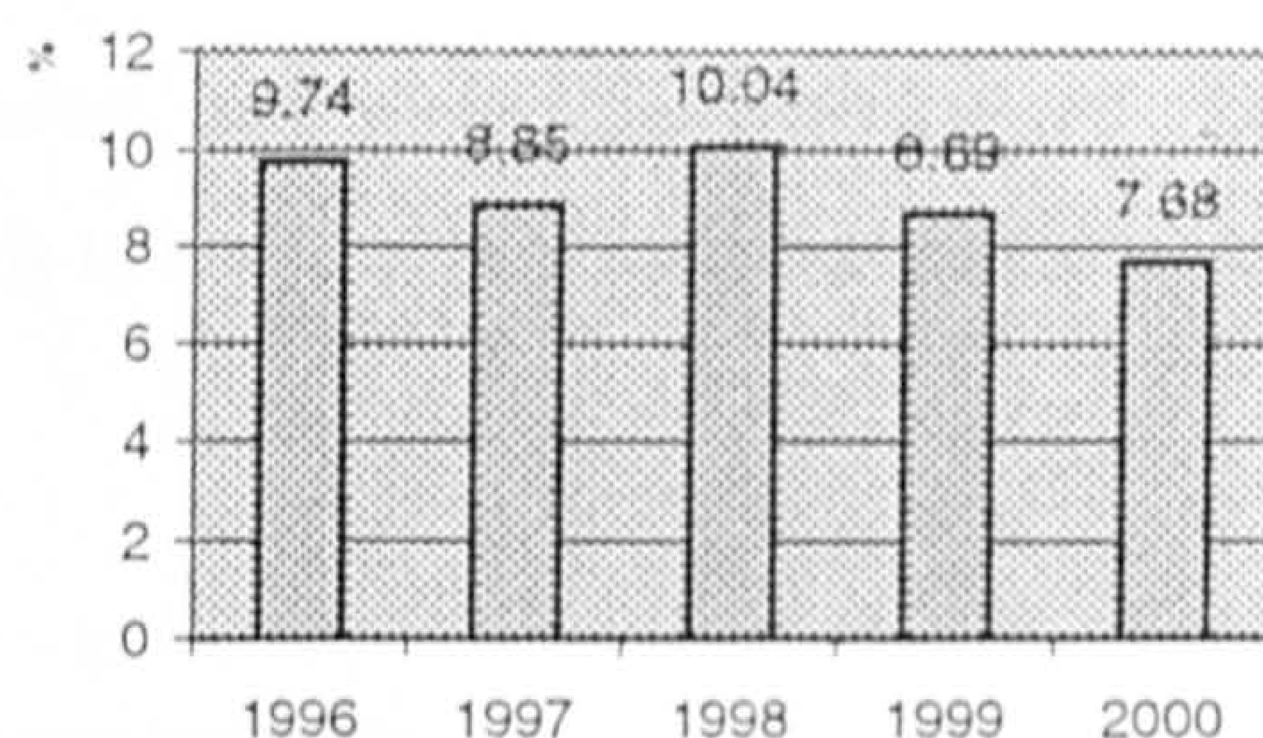


Chart 4.1 Equity growth of the four major insurers 1996-2000

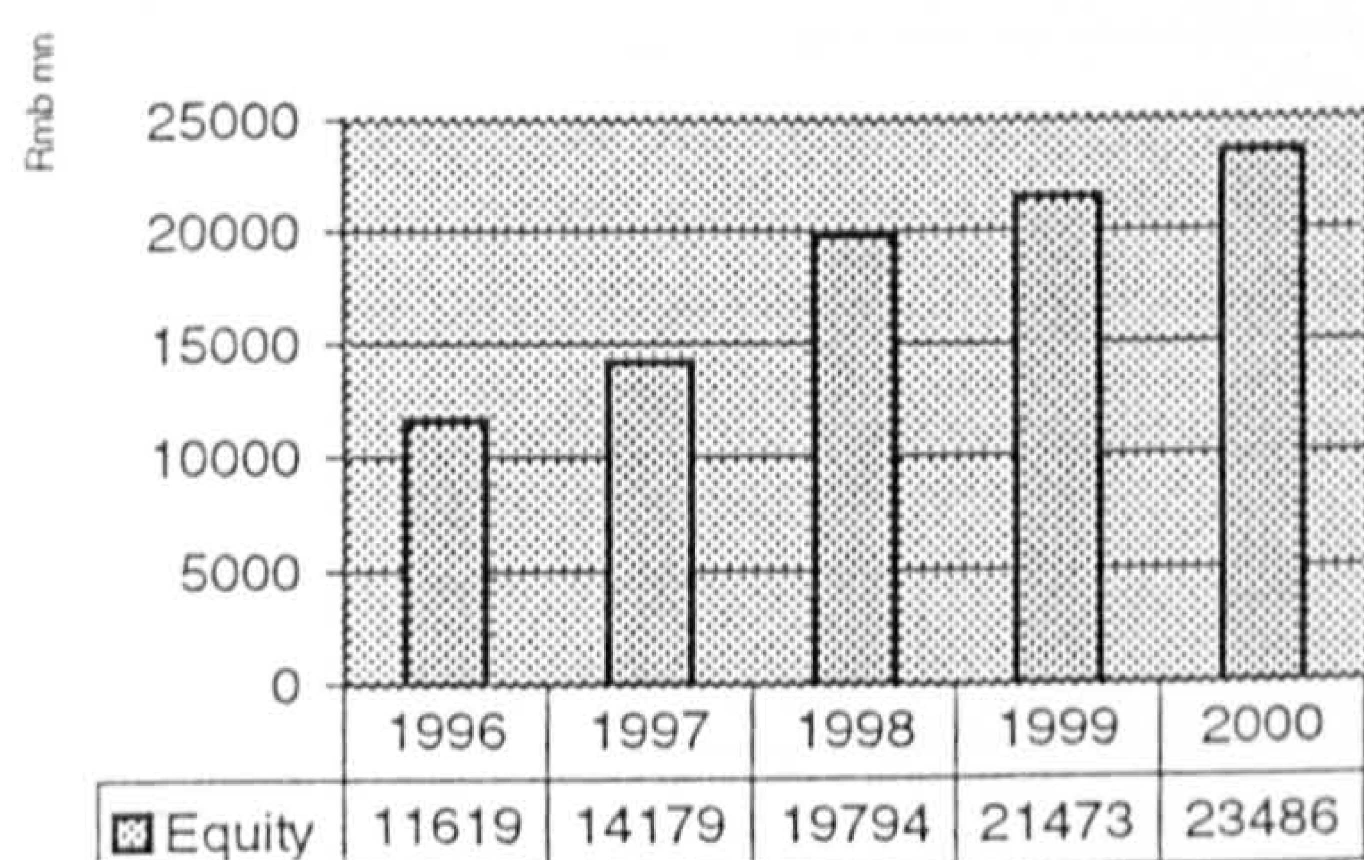
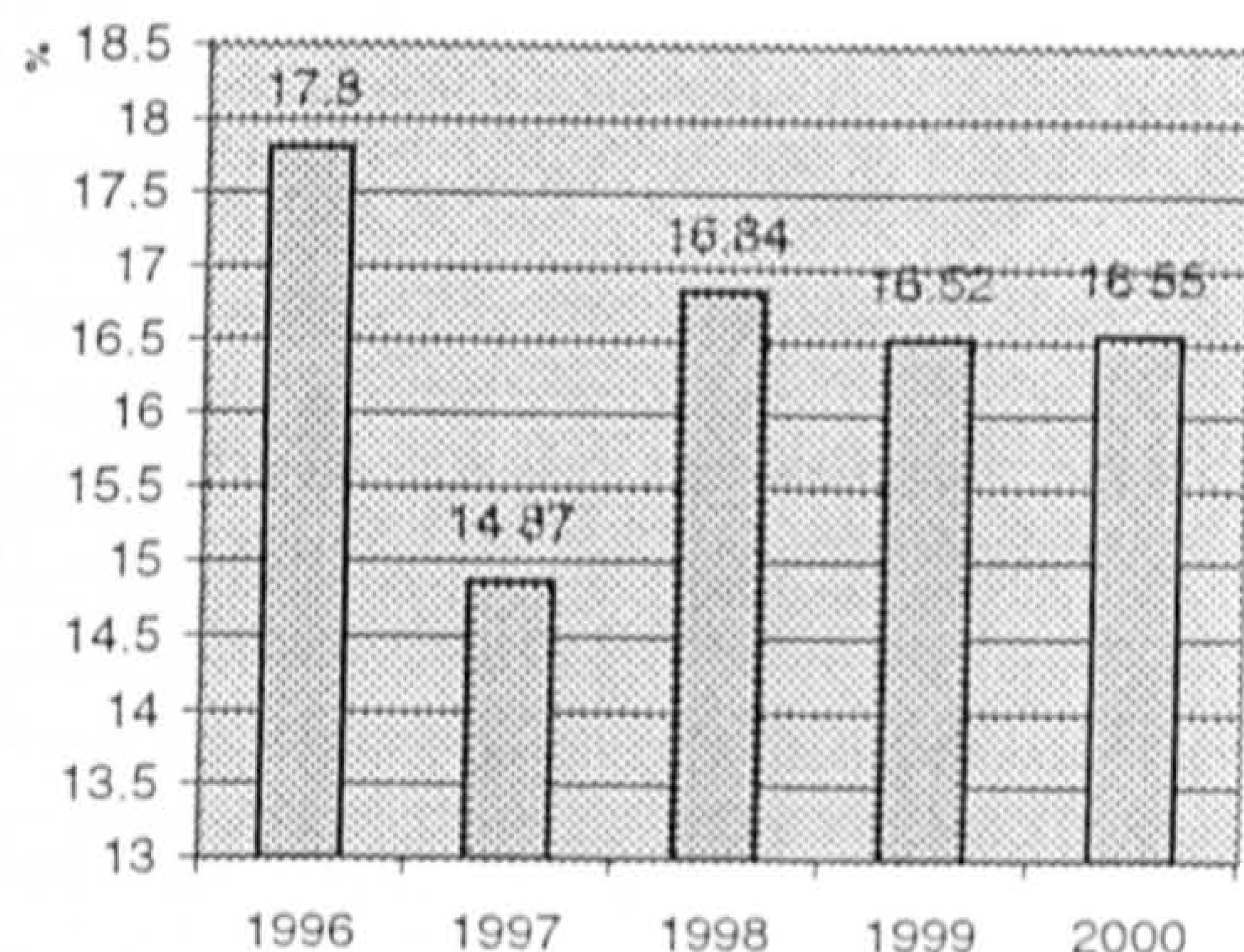


Chart 4.3 Solvency ratios of the four major insurers 1996-2000



The feature of low capitalisation can be further demonstrated by a comparison of the capitalisation between PICC (17.42% in 1998) and that of an average US non-life insurer (34.64% in 1998[50]). In addition, most global primary insurers that entered the Chinese market usually possess far more equity than that of the whole Chinese insurance industry. The low capitalisation suggests that the Chinese domestic insurers own insufficient financial resources to support effective competition with well-endowed foreign entrants. The genesis of this situation mainly goes back to the insurers' low level of initial capital, sustained neglect of capital supplement, and bad operation results.

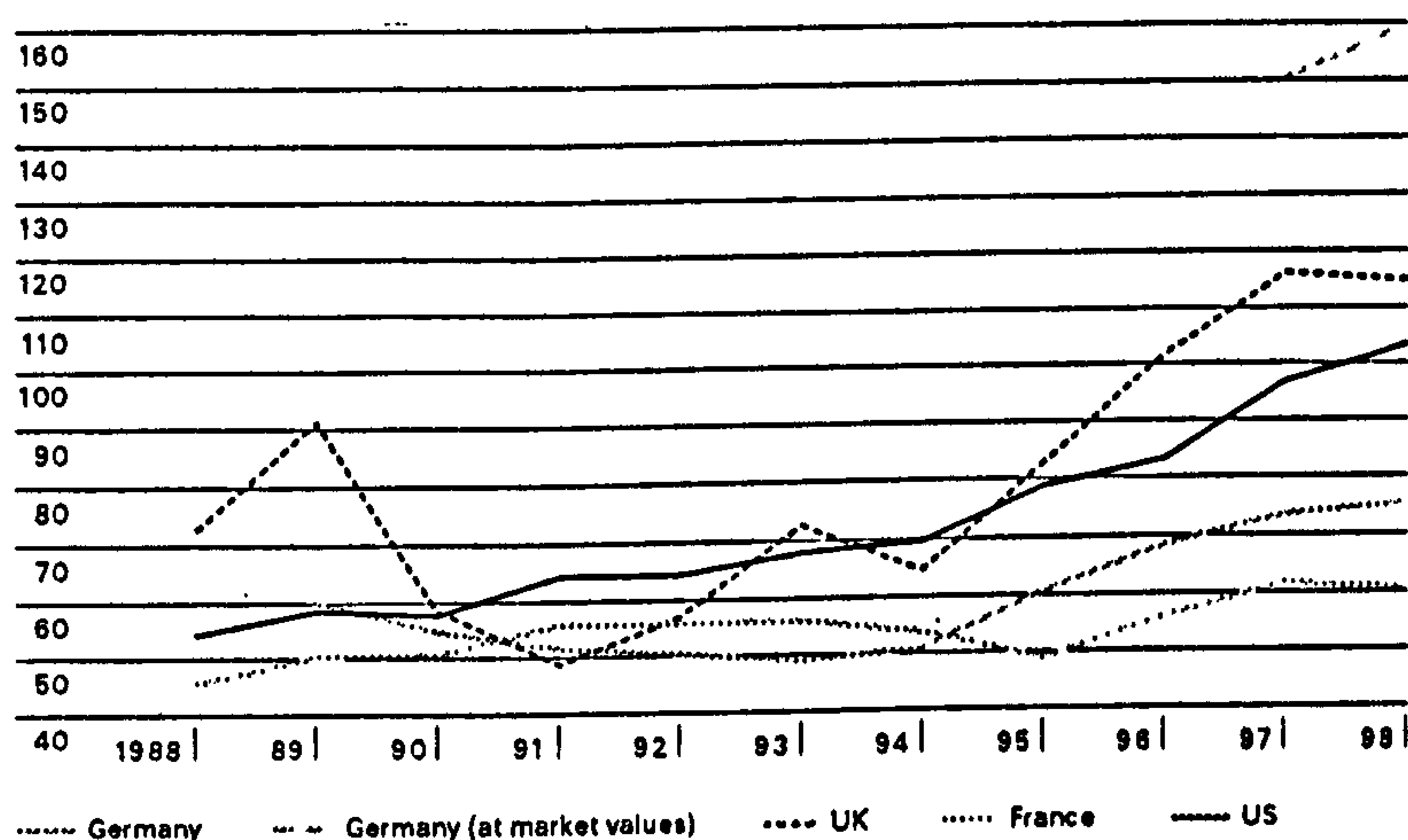
4.3.4 Low level of solvency ratios

As shown in Chart 4.3, the *solvency ratios* (equity funds expressed as a percentage of net premiums) of the four major insurers during 1996-2000 ranged from 14.87% to

[50] Sigma No1/2000

17.80%. These figures are below the average ratios of above 50% in the UK, the US, Germany, and France in 1996, and well below that of over 110% in the UK in 1998 (see Chart 4.4). While accurate comparisons between the countries may be impossible due to such incomparable elements as different accounting systems and regulations, there are clear gaps between the Chinese insurers and their counterparts in the developed countries in terms of solvency ratio. This to some extent evinces the Chinese insurers' insufficient solvency.

Chart 4.4 The average solvency ratio in some western countries



Sources: Swiss Re. Sigma No1/2000

4.3.5 Weak profitability

This is another main contributory factor to the insufficient solvency. The industry has in general a low-profile profitability. As shown in Table 4.3, the four major insurers' average profitability (net profit in a percentage of total assets) during 1996-2000 ranged from 1.48% at the highest to 0.96% at the lowest. Among the them, China Life is the worst performer with profitability rates never exceeding 0.57 % (in 2000) during the five years, showing very weak profitability. This is well below the average level of 2.1% for the life insurance industry in the world.[51] Clearly, as the Chinese insurance industry is unable to make encouraging profits, its solvency problems thus can not be solved by surplus generated from its profits. The fact that the four major

[51] "Accounting and financial reporting in life and health insurance companies" *Loma* 1999.

insurers increased their equity only by supplementing paid-in capital during the period highlights this problem.[52]

A high expense ratio, insignificant investment returns, and unfavourable taxation are among the main causes of weak profitability. As shown in Table 4.4, the average operating expense ratios of the four insurers ranged from 17.33% to 26.51%, with PICC exceeding 30% in 1997 and 2000. These figures are higher than figures in some countries. For instance, the operating expense ratios of 1999 in Korea were 8.65% for the life industry, and 14.85% for the non-life industry.[53] As labour costs in China are comparatively low, such levels of expense ratios could imply inefficiency on the part of the Chinese insurance industry.

Regarding operational performance, the four insurers maintained average positive profitability during 1996-2000 (see Table 4.3). However, they achieved this mainly through keeping low loss/payment ratios that ranged from 40.87% to 56.05%, which were considerably below those of western insurers, normally above 70%.[54] Low loss ratios do not necessarily mean a good operation because overpricing can also result in them. Conversely, as insurers' compensations or payments to policyholders typically display the functions of insurance business, low loss ratios may hint that policyholders are not fully compensated by insurers as prescribed in policies. If so, that will negatively affect insurers themselves. Actually, the Chinese insurance industry has long been operating by a paradigm of *keeping loss ratio as low as possible to make profits* in an environment in which investment has been strictly restricted. This operational strategy could impair consumers' enthusiasm for purchasing insurance products.

Most of the Chinese insurance industry's profits have been generated by positive underwriting results, because investment revenue in a percentage of total revenue is insignificant, *e.g.* ranging from only 2.6% - 5.35% for the four insurers during 1996-2000 (see Table 5.2). Furthermore, the deficiency of investment is also demonstrated by other facts (see section 5.4.1, Chapter 5). For example, investment results (net investment revenues/net premium incomes) of the four insurers in 1996-2000

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[52] In recent years, the CIRC encourages state-owned insurers to increase their capital by shareholding and listing reforms. However, the fundamental solution of the insufficient solvency should rely on the improvement of profitability.

[53] See Annual Reports (FY1999) of Life Insurance Association and Non-Life Insurance Association in Korea.

[54] See Sigma No.5/2001, p8, and No.4/2001, p20.

Table 4.3 Profitability of four major insurers 1996-2000 (Rmb mn, or %)

Companies	1. Total Assets	2. Equity	3. Net Profit	4. Net Profit/Total Assets	5. ROCE*	6. Equity/Total Assets
2000						
PICC(The People's Insurance company of China)	48954	8640	764	1.56	8.84	17.64
China Life Insurance Company	159769.38	5935.3	923.12	0.57	15.55	3.71
The China Pacific Insurance Company, Ltd.	31506.68	3172.91	271.27	0.86	8.54	10.07
Ping An Insurance Company of China, Ltd.	65225	5738	1282	1.96	22.34	8.79
Total	**305455.06**	**23486.21**	**3240.39**	**1.06**	**13.79**	**7.68**
1999						
PICC(The People's Insurance company of China)	46667	9305.7	1431	3.06	15.37	19.94
China Life Insurance Company	131507.12	4263.96	479.85	0.36	11.25	3.24
The China Pacific Insurance Company, Ltd.	23877.77	3181.39	200.88	0.84	6.31	13.32
Ping An Insurance Company of China, Ltd.	45036.06	4721.66	536.28	1.19	11.35	10.48
Total	**247087.95**	**21472.71**	**2648.01**	**1.07**	**12.33**	**8.69**
1998						
PICC(The People's Insurance company of China)	49972	8708.7	854	1.7	9.8	17.42
China Life Insurance Company	96550.79	3953.44	452.24	0.46	11.43	4.09
The China Pacific Insurance Company, Ltd.	17897.26	2980.47	171.98	0.96	5.77	16.65
Ping An Insurance Company of China, Ltd.	32558.61	4150.99	425.86	1.3	10.25	12.74
Total	**196978.66**	**19793.6**	**1904.08**	**0.96**	**9.61**	**10.04**
1997						
PICC(The People's Insurance company of China)	45884.13	5418.37	1773.03	3.86	32.72	11.8
China Life Insurance Company	74609.4	2112.52	81.62	0.1	3.86	2.83
The China Pacific Insurance Company, Ltd.	15911.85	2923.09	151.02	0.94	5.16	18.37
Ping An Insurance Company of China, Ltd.	23786.13	3725.15	376.77	1.58	10.11	15.66
Total	**160191.51**	**14179.13**	**2382.44**	**1.48**	**16.8**	**8.85**
1996						
PICC(The People's Insurance company of China)	40740.45	4132.73	483.31	1.18	11.69	10.14
China Life Insurance Company	52849.36	2179.27	183.58	0.34	8.42	4.12
The China Pacific Insurance Company, Ltd.	11324.29	3062.55	414.51	3 66	13.53	27.04
Ping An Insurance Company of China, Ltd.	14303.77	2244.19	463.24	3.23	20.64	15.68
Total	**119217.87**	**11618.74**	**1544.64**	**1.29**	**13.29**	**9.74**

*ROCE: Return of capital employed

Table 4.4 Costs and expenses of four major insurers 1996-2000 (Rmb mn, or %)

Company	1.Payments/Benefits	2.%of Net Premiums	3.Commissions	4% of Net Premiums	5. Operation Expenses	6.% of Net Premiums
2000						
PICC(The People's Insurance company of China)	24887	67.62	3092	8.4	11369	30.89
China Life Insurance Company	21320.32	32.85	7247.79	11.16	6456.5	9.94
The China Pacific Insurance Company, Ltd.	6128.96	41.32	421.26	2.84	2985.63	20.13
Ping An Insurance Company of China, Ltd.	5649	22.31	1719	6.79	3783	14.94
Total	**57985.28**	**40.87**	**12480.05**	**8.79**	**24594.13**	**17.33**
1999						
PICC(The People's Insurance company of China)	24249	68.07	2810	7.88	9311	26.13
China Life Insurance Company	19827.05	32.85	7718	12.78	6589.45	10.91
The China Pacific Insurance Company, Ltd.	6294.84	52.08	318.29	2.63	2269.89	18.78
Ping An Insurance Company of China, Ltd.	7250.65	33.19	263.24	1.2	5318.14	24.34
Total	**57621.54**	**44.35**	**11109.53**	**8.55**	**23488.48**	**18.08**
1998						
PICC(The People's Insurance company of China)	25099	72.17	2066	5.94	9507	27.33
China Life Insurance Company	21666.28	40.41	8398.04	15.66	5247.89	9.79
The China Pacific Insurance Company, Ltd.	7262.96	58.67	860.87	6.95	2146.75	17.34
Ping An Insurance Company of China, Ltd.	5437.58	32.53	274.22	1.64	4098.06	24.51
Total	**59465.82**	**50.62**	**11599.13**	**9.87**	**20999.7**	**17.87**
1997						
PICC(The People's Insurance company of China)	21615.67	71.81	1757.12	5.83	10019.16	33.28
China Life Insurance Company	17548.8	45.63	926.63	2.4	9366.42	24.35
The China Pacific Insurance Company, Ltd.	2081	16.2	839.63	6.54	1787.83	13.92
Ping An Insurance Company of China, Ltd.	3349.75	24.09	263.36	1.89	4096.23	29.46
Total	**44595.22**	**46.79**	**3786.74**	**3.97**	**25269.64**	**26.51**
1996						
PICC(The People's Insurance company of China)	22341.51	76.09	1578.39	5.37	7265.92	24.74
China Life Insurance Company	11168.59	60.33	764.65	4.13	3187.15	17.21
The China Pacific Insurance Company, Ltd.	1020.6	11.88	482.89	5.62	1043.54	12.14
Ping An Insurance Company of China, Ltd.	2041.55	23.23	212.38	2.41	1615.52	18.38
Total	**36572.25**	**56.05**	**3038.31**	**4.65**	**13112.13**	**20.09**

fluctuated between 2.4%-3.84%. By comparison, the investment results in the US and Canada (five year averages during 1996-2000) were 18.8% and 16.5%, and 24.6% and 15.7% for the UK and Germany (five year averages during 1995-1999).[55] The insignificant investment performance severely impairs the Chinese insurance industry's profitability.

Major state-owned insurers also suffered from heavy taxation. For example, until January 1997, an enterprise income tax at a rate of 55% calculated on a consolidated basis was levied on the former PICC and its three subsidiaries. This was a harsh restriction on their capitalisation through profits. The uniform business tax rate based on the premium income for the insurance industry increased in 1997 from 5% to 8%, and returned to 5% in 2003. The premiums of many long-term saving contracts issued by life insurers are not exempted from this tax. By comparison, most developed countries levy up to 5.15% business tax on insurers, and exempt certain life insurers from the tax.[56]

4.4 Current framework of prudential regulation and supervision

In China, the *2002 Insurance Law*, associated regulations and rules have addressed most of the issues involved in prudential regulation and supervision, mainly including the valuation of assets, restrictions on investment, the adequacy of technical provisions, solvency margin control, and solvency supervision (financial reporting and monitoring, as well as intervention measures). Consistent with China's WTO accession commitments, the framework for the prudential regulation and supervision is undergoing a significant transition from material regulation mode into a combination of solvency and market performance regulation mode.

4.4.1 Solvency margin and capital adequacy

Under the existing regulatory framework, each insurer is required to maintain a solvency margin commensurate with the scale of its business. An insurer's actual

[55] Sigma No. 5/2001, p8.

[56] For example, life insurers in the UK, Germany, and Italy are exempted from premium tax; the tax in most states in the US range from 2% to 3%, and France taxes 5.15% (mutual health benefit societies are exempted).

solvency is the value of admissible assets less admissible liabilities at the end of the insurer's accounting year.[57]

China has taken three steps in insurance solvency and capital adequacy legislation. As the first step, the *1995 Insurance Law* for the first time stipulated the requirements of capital adequacy that "an insurance company shall possess the solvency margin corresponding to its scale of business," and "the balance of the actual assets of an insurance company, less its actual liabilities, may not be lower than the amount prescribed by the financial supervisory body"[58] Furthermore, the law imposed two main ratios relating to capital adequacy. One is that premiums retained by an insurer engaged in the property business in any year can not exceed by more that four times the sum of its monetary capital and common reserve. Another is that the liability of an insurer for each unit of risk (the largest loss that could conceivably be caused by a single insurable accident) can not be more than 10% of the sum of its paid-in capital and common reserves.[59]

As the second step, the *1996 Administration Regulations* stipulated that an insurer's actual solvency is the value of actual assets less actual liabilities at the end of the insurer's accounting year. The regulations also issued instructions on how to calculate the minimum solvency requirements for life and non-life insurers,[60] and set out administrative intervention in insurers that fall below the minimum solvency margins.[61]

As the third step, the *2000 Insurance Company Regulations* rectified the solvency calculation in the *1996 Administration Regulations* and stipulated new standards.[62] The new regulations introduced some calculation methods for solvency margin requirements taken from the *EU Third Insurance Directives*, making the calculation under the new methods more complete and reasonable than that prescribed at the second stage. Such methods include using retained premiums, average annual compensation payments and fixed rates to calculate solvency margins (See Table 4.5).

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[57] Art. 82, the *2000 Insurance Company Regulations.*

[58] Art.97, the *1995 Insurance Law.*

[59] Art.98, 99, the *1995 Insurance Law*

[60] Art.50, 51, the *1996 Administration Provisions.*

[61] *Id.* Art. 52.

[62] Chapter 6, the *2000 Insurance Company Regulations.*

Table 4.5 Solvency Margin Rules of China and EU

China	EU
For non-life insurance companies, the required solvency margin shall be the higher of two bases:	
For a premium basis	
18% of that part of retained premiums less tax on premiums in the given accounting year up to Rmb100mn and 16% of the part in excess of Rmb100mn.	18% of gross premiums written up to Euro10mn and 16% of gross premiums written in excess of Euro10mn.
For a claim basis	
26% of that part of the average annual compensation payments made in the previous three years that is less than Rmb70mn, and 23% of the part in excess of Rmb70mn.	26% of gross claims (averaged over the last three years or over seven years for some natural perils insurances) up to Euro7mn, and 23% of gross claims of that part in excess of Euro7mn.
For life insurance companies, the required solvency margin shall be:	
4% of the life insurance liability reserves at the end of the accounting year for ordinary life insurance business and 1% of the life insurance liability reserves at the end of the accounting year for investment-linked business; 0.1% of the insurance amount for fixed-term life insurance risk where the insurance period is less than three years, 0.15% of the insurance amount where the period is between three years and five years, 0.3% of the insurance amount where the period is greater than five year and for other types of risk.	4% of gross technical provisions (actuarial reserves). For businesses without investment risk but expense risk, 0.1% of gross technical provisions plus 0.3 of the capital risk (mortality risk), with a lower for term insurances under five years.

Although China in principle adopted the EU's solvency margin system (before the implementation of the *Solvency I project),* there are some substantial differences between the two regimes. Firstly, the minimum solvency margin levels for both life and non-life businesses are higher in China.[63] In addition, the EU rules require different minimum solvency margins between non-life and life businesses, plus various margins for different classes of non-life companies, reflecting their inherent underwriting riskiness. China, in contrast, has no such variations. Secondly, the EU model grants reduction of solvency margin for reinsurance.[64] Although this approach is reasonable as primary insurers often use reinsurance to shift their risks, China does not introduce it. This is mainly because there was no individual reinsurer before China Re., the monopoly of the reinsurance market, was incorporated in 1998.[65] Thirdly, the definitions of the actual solvency margins between the two regimes are not the same.

[63] Note 75, Chapter 2. In the EU, the minimum guarantee funds of non-life insurance companies (equivalent to "the paid-in capital in China"), for example, vary from Euro0.2mn to Euro1.4mn.

[64] For non-life insurance, the reduction could be a maximum of 50% (net claims incurred to gross provisions claims incurred) of ceded reinsurance, art. 16, the *First Non-Life Insurance Directive*; while for life insurance the reduction could be a maximum of 85% (net technical provisions to gross technical provisions) of ceded reinsurance. Art.19, the *First Life Insurance Directive.*

[65] Note 37, Chapter 1.

The EU defines the types of admissible capitals for calculating actual solvency margins,[66] while China uses "admissible assets less admissible liabilities" method. The factors that make the results of actual solvency margins different are that the EU model allows the admissible capital to include some items, *e.g.* subordinated loans and certain percentage of unpaid capital, which are not allowed according to the Chinese Accounting law and rules.[67] The second and third differences make the actual solvency margins bigger by using the EU model when the two models are applied to a same insurer. Finally, with the *Solvency I project*, the EU significantly modified its solvency margins for both life and non-life insurance business. Certain standards in the old system that China followed had been significantly raised, including: (1) a 50% higher required solvency margin applies for certain categories of non-life business which have a particularly volatile risk profile (marine, aviation, and general liability); (2) the thresholds for calculating non-life solvency margin have been increased from 10 million *Euro* for a premium basis in the old version to 50 million *Euro* in the new system, and 7 million *Euro* for a claim basis to 35 million *Euro*, and both new thresholds will be indexed in the future;[68] and (3) supervisors have increased powers to intervene early to take remedial action where policyholders interests are threatened, for example, in a situation where an insurer currently satisfies solvency requirements but its financial position is deteriorating rapidly. By 2002, the Chinese authority had not made clear whether it would modify its system correspondingly.

4.4.2 Assets

For the purpose of calculating capital adequacy, the CIRC firstly set out assets valuation and admissibility standards in the *Administrative Provisions for Insurance Companies' Solvency and Supervisory Indexes* (*2001Regulatory Indexes*) which was

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[66] Art.18, *Directive of the European Parliament and of the Council amending Council Directive 79/267/EEC.* (COM(2000)617 final version).

[67] According to Chapter 5, the *1999 Accounting Standards for Insurance Companies*, the statutory accounts of an insurer' equity include *paid-in capital, capital reserve, statutory reserve*, and *retained earnings*.

[68] Regarding the solvency margin requirements for non-life insurance undertakings, see *Directive of the European Parliament and of the Council amending Council Directive 73/239/EEC.*

repealed by a new version, the *2003 Regulatory Indexes.*[69] According to the *2001 Regulatory Indexes,* the general picture is that all assets held by insurers are admissible, except a few inadmissible classes, *e.g.* loans and bonds issued by non central state enterprises that insurers are prohibited from investment. The percentages of admissibility differ among various items (see Table 4.6). Regarding valuation standards, the provisions stipulate that *market value* applies to assets where there is appropriate information on the *market value* of the assets; otherwise the *cost value* or *amortised value* is applicable."[70]

Regarding asset regulation in the *2001 Assets Illustration,* at least three kinds of problems can be identified. Firstly, the valuation standards are not explicit enough, giving rise to ambiguities both in terms of the application by individual insurers and the compatibility of statutory returns between insurers. For example, except for quoted equities and investment funds that are explicitly stipulated to use *market value,* there is no specified valuation method for other asset classes. This, on the one hand, could gives rise to the situation where individual insurers calculate their assets by choosing a method favourable, within the three prescribed methods. On the other hand, insurers could use different methods to calculate the same categories of assets, resulting in incompatible information for regulators. For example, some insurers could use *market value* on their office buildings, whereas other insurers may calculate at *amortised value.*

The second kind of problems is that some provisions are legally contradictory. According to Art.48 of the *2001 Assets Illustration,* "all assets acquired in violation of current laws or without the approval of the regulators are inadmissible". This is reaffirmed by Art.31, which prescribes that bonds issued by enterprises other than

[69] The new version contains six chapters, twenty two articles, and six appendixes, including: general provisions; solvency margin and regulations; solvency indicators for non-life insurance companies and life insurance companies respectively; screening criteria for these indictors; standards for admissible assets; standards for assessing the reserves of non-life insurance companies; and instructions for applying the regulatory ratios and criteria.

[70] Art.8, *Illustrations on Assets Admissibility Standards for Insurance Companies* Appendix 1 of the *Administrative Provisions on Insurance Companies' Solvency and Supervisory Indexes* CIRC 2001 (the *2001 Assets Illustration*).

Table 4.6 Asset Admissibility

Assets	Admissibility (*2001 Rules*)	Admissibility (*2003 Rules*)	Explanations
Cash	100%	100%	
Deposits in banks or in other financial institutions	100%	100%	Questionable deposits (with attached conditions, *e.g.* collateral deposits, or unable to withdraw at expiration) and deposits in troubled banks or in other financial institutions (in regulators' receivership or liquidation) are not admissible.
Bonds	100%	For short-term investments in government bonds, applying *lower cost or market;* For short-term investments in financial bonds and enterprise bonds, applying *lower cost or market* minus *reserve for possible losses;* For long-term investments in financial bonds and enterprise bonds, applying *amortised cost* minus *reserve for possible losses.*	Confined only to government bonds and central state enterprises' bonds.
Policyholder loans	100%	100%	
Other current assets*	40%	Inadmissible	
Receivables	0, 30%,100%**	0,30%, 70%, 100%***	Compensation paid in advance and deposited guarantee funds are 100% admissible
Quoted equities	100%	For short-term investments, applying *lower cost or market* minus *reserve for possible losses;* For long-term investments, applying *amortised cost* minus *reserve for possible losses.*	
Unquoted equities	90%		
Investment securities funds	90%		
Convertible bonds	90%		Confined only to government bonds and central state enterprises' bonds.
Investments in real estates	90%		
Business fixed assets	0, 30%, 40%,80%, 90%****	*Net cost* minus *reserve for possible losses******	
Intangible assets	0, 40%, 50%,100% ******	0, 100%	Deposits of capital guarantee funds: 100%, long-term amortised expenditures: 0.

*For example, prepaid expenses, materials, etc.

**Premium receivables and other receivables with a maturity of 6 months or less are 100% admissible while those with maturity above 6 months up to one year are 30% admissible, and those above one year are inadmissible.
***Premium receivables for primary insurance with a maturity of less than one year are 100% after allowance for doubtful debts. Premium receivables for reinsurance with a maturity of less than 3 months are up to 100%, for those with a maturity between 4-6 months are up to 70%, between 7-12 months are up to 30%, above one year are 0.
**** Office building: 90%, equipment: 80%, buildings in construction: 80%, transportation equipment: 40%, electronic equipment: 30%, fixed assets in disposal: 0.
***** The admissible values of total fixed assets are up to 50% of the sum of paid-in capital, capital reserve and retained profits.
****** Land lease costs: 50%, other long-term assets: 40%.

central state enterprises are not admissible because of the legal restrictions.[71] However, in contradiction, Art.37 admits investments in real estate which are also prohibited.

The third kind of problems is that the admissibility of certain assets is unreasonable because of their features. For example, prepayments in "other current assets" are admissible at 40 percent of accounting value. However, such prepayments are prepaid expenses which are recorded as assets under the *principle of matching incomes with expenses*. Admitting such prepayments will distort the solvency position because they are by nature no longer capable of fulfilling insurers' contractual liabilities.

The *2003 Regulatory Indexes* substantially modified assets valuation and admissibility standards (see Table 4.6). A distinct progress is that it clarifies the standards of asset admissibility by setting forth three principles: *conformity, prudence,* and *legitimacy.*[72] Generally, assets that can be used at an insurer's will to fulfil its obligations to policyholders are admissible in terms of solvency. The CIRC provides a (not detailed) list of admissible assets and inadmissible assets. Those outside the list deem inadmissible. An asset shall be treated as inadmissible if it can not be sufficiently proved admissible. An insurer shall take into account all possible risks and losses thereby preventing an asset from being overvalued, if uncertainties exist on the asset. Both investments in violation of laws, regulations, and the CIRC's rules, and all non-investment assets (*e.g.* materials, and prepaid expenses) are inadmissible.

By clarifying valuation methods for various bonds, equities, and fixed assets (see Table 4.6), the *2003 Regulatory Indexes* rectify the first kind of problems mentioned above, the valuation ambiguities in the old version. However, the last two kinds of problems remain. In addition, given the stringent restrictions on insurers' investment

[71] Similarly, Art.17 stipulates that loans to enterprises are inadmissible due to legal restrictions on this kind of investments.

[72] Appendix 5, "Illusions on Assets Admissibility", the *2003 Regulatory Indexes* CIRC.

(see chapter 5), the existing framework of asset regulation does not contain some essential stipulations that are commonly seen in developed countries and other regimes to control various asset risks. These stipulations usually include: a detailed list of admissible (or inadmissible) assets for solvency;[73] the assets covering the policy liabilities shall take account of the type of risk written and are to be "diversified and adequately spread";[74] maximum proportions of the total assets are allocated on various categories of assets and on an any one investment;[75] and asset-liability matching in terms of duration, and currency.

4.4.3 Liabilities

a. A general description

The major laws and regulations governing liabilities include: the *1995 Insurance Law* (Art.93-96,100)[76], the *2000 Insurance Company Regulations* (Art.76,77), the *Rules for Insurance Companies' Financial Standards* (1999, Art.47, Sec.14), the *Rules for Insurance Companies' Accounting Standards* (1999. Chapter 3 - 2161, 2162, 2171, 2201-2203, 2211), the *Rules for Actuaries* (the CIRC, 1999), and the *Illustration on Admissible Liabilities* (Appendix 6 of the *2003 Regulatory Indexes*).

Insurers must set aside sufficient technical provisions that enable them at all times to meet all their commitments under their insurance contracts. The *2000 Insurance Company Regulations* (Art. 76) clearly specify that "technical provisions of an insurer must be real and adequate". The *1995 Insurance Law* and regulations specify the setting up of various types of reserves and associated calculation methods. Four types of reserve funds and their calculation standards are defined as follows:

- *Portfolio reserve for insurance business other than life insurance (unearned premium reserve)* Non-life insurers are obliged to set aside no less than 50% of the retained insurance premium of the current year to the reserve.[77] The insurers can also choose one standard among "1/8", "1/24" and "1/365" methods.[78]

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[73] Art. 21, the Third Direct Non-life Insurance Directive, and art. 21 the Third Direct Life Insurance Directive.

[74] *Id.* Art.20.

[75] *Id.* Art.22.

[76] These provisions are reaffirmed by *2002 Insurance Law.*

[77] The *1995 Insurance Law,* Art. 93,

[78] The *Illustration on Admissible Liabilities Appendix 6* of the *2003 Regulatory Indexes.*

- *Portfolio reserve for life insurance (life assurance reserve)* Life insurers are required to allocate the full value of the effective life insurance policies to the reserve.
- *Outstanding loss reserve*[79] It is, under the *2000 Insurance Company Regulations*, split into *provision for notified outstanding claims* (according to the claims already made, not exceeding 100% of coverage limitations) and *IBNR provision* (provision for claims incurred but not reported by the balance-sheet date. It requires the allocation of funds not to exceeding 4% of the amount of payments actually made in the relevant year into the provision). Both life and non-life insurers are required to set these two reserves.[80]
- *Equalisation provision* Both life and non-life insurers are required to allocate 1% of the premium revenues of the current year to *equalisation provision*, and cease the allocation when the amount of the provision reaches 10% of the their total assets. The fund of the provision shall be deposited in a commercial bank designated by the regulators.[81]

In general, technical provisions on non-life insurance in China are less prescriptive than on life insurance, as the factors affecting non-life insurers' obligations for future claims payments tend to be subjective and variable. With regard to calculation methods, China requires that *portfolio reserve for non-life insurance business*, *outstanding loss reserve*, and *equalisation provision* are calculated by using statistical methods, whereas actuarial methods are required for the calculation of provisions for life assurance. Actuaries must use the appropriate mortality tables as required by the CIRC or choose certain mortality tables prescribed by the CIRC for specific products. The interest rates for the calculation of life assurance provision shall not exceed the lower between the rates fixed by the CIRC and the assumed rates set by the insurers.[82]

b. Comments

Adequate technical provisions are the cornerstone of sound capital adequacy and solvency regime because regulations concerning capital adequacy are tied in with the required level of technical provisions. Technical provisions account for the majority of an insurer's liabilities, equalling the insurer's contractual obligations to its customers

[79] The *1995 Insurance Law*, Art.93, 94.

[80] The *2000 Insurance Company Regulations*, Art. 77.

[81] The *1996 Administration Provisions*, Art.32.

and other contract beneficiaries. However, as these obligations represent the present value of expected future payments, they can not be known exactly and must be estimated. Under-provisioning harms an insurer's financial positions in at least two ways. On the balance sheet, under-provisioning creates a higher level of owners' equity. Under-provisioning for claims distorts an insurer's judgement concerning the equilibrium of its underwriting, which may lead the insurer to taking commercial initiatives to bolster sales of certain products that appear to be profitable whereas in fact they will eventually incur losses.[83] Therefore, technical provisions of an insurer have to be adequate, reliable, objective, and allow comparison between insurers.[84]

The regulations concerning technical provisions in China are largely consistent with international practices. According to the EU *Directives*, each member state is responsible for legislating and supervising the compliance with the rules regarding technical provisions for an insurer's entire business. Meanwhile, the *Directives* set out principles and detailed rules. In the case of life insurance, the *Third Life Insurance Directive* lays down a number of principles for the calculation of technical provisions.[85] It stresses that "technical life assurance provision should be calculated by a sufficiently prudent actuarial valuation of all future liabilities of existing policies, including guaranteed bonuses and surrender values, policyholder options, future bonuses and future expenses and commissions, taking credit for future premiums due". The amount of non-life technical provision, according to the *Third Non-Life Insurance Directive*, is to be calculated in accordance with rules laid down in the *Insurance Accounts Directive* (91/674/EEC, Art.19-32) which set out the categories of provisions and disclosure

[82] The *1999 Rules for Actuaries* (CIRC, June. 1999).

[83] *Supra note* 22.

[84] Principle 1, *Principles on capital Adequacy and Solvency* IAIS 2002.

[85] The EU *Third Life Insurance Directive* Art.17.

requirements in financial statements.[86] By comparison, China adheres to the principle that technical provisions must be real and adequate. It provides categories of provisions, and applies actuarial methods for calculating life assurance provisions and statistical methods for non-life insurance provisions. By examining the four major insurers' reserve conditions, the technical provisions as a percentage of total liabilities continued to increase from 80.47% in 1996 to 91.11% in 2000 (see Chart 4.5 and Table 4.8). During 1996-2000, the rates of increased reserves exceeded the rates of increased net premium revenues in almost each year (see Table 4.7). Both reflect the prudence of the technical provision regulations of China and the satisfying compliance by the four insurers. However, there are still some concerns over technical provisions.

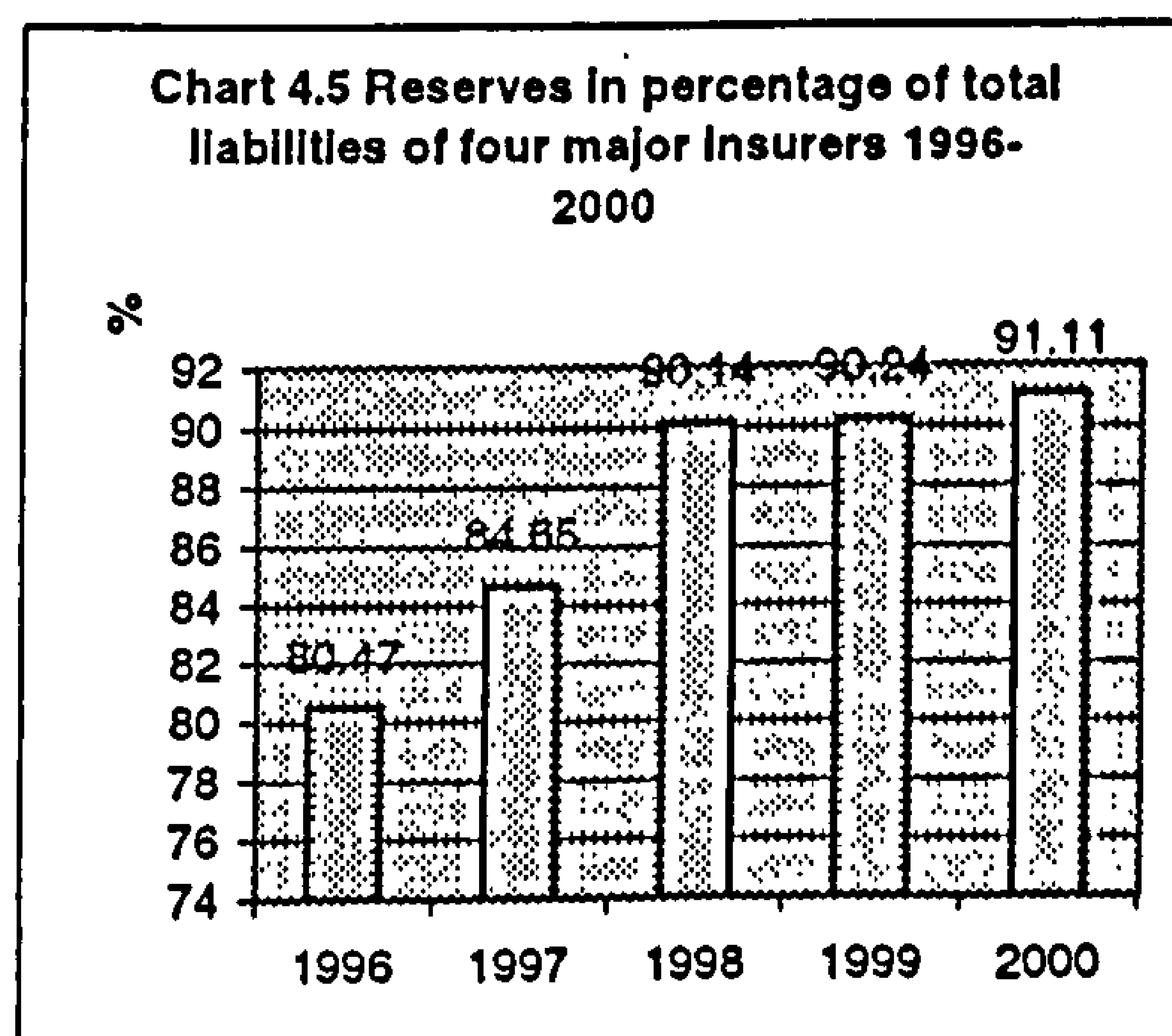

Table 4.7 (% of) reserve increase vs. (% of) net premium increase (four major insurers 1996-2000 Rmb mn, or %)

	1996	1997	1998	1999	2000
Total Reserves	86,594.07	123,612.36	159,725.93	203,714.39	257,807
% of Increase	100	142.75	184.45	235.25	297.72
Net Premiums	65,249.33	95,309.30	117,474.95	129,924.55	141,877.37
% of Increase	100	146.07	180.04	199.12	217.44

[86] Similarly, all OECD countries have regulations for the setting-up and calculation of technical provisions and appropriate supervision. See "Insurance solvency supervision: compilation of country reports" OECD Insurance Committee Secretariat *Insurance and private pensions compendium for emerging economies* Book 1, Part 2:3), 2001.

Table 4.6 Reserves, and in % of liabilities of four major insurers 1996-2000 (Rmb mn, or %)

Companies	1. Claim Res.	2. Life Res.	3. OutS. Res.	4. Deposits	5. Equi. Res.	6. Total Res.	7. % of Liabilities
2000							
PICC(The People's Insurance company of China)	18,474	0	7,409	5,403	1,348	32,634	80.95
China Life Insurance Company	2,964.97	143,893.66	621.31	686.08	1,060.29	149,226.31	96.37
The China Pacific Insurance Company, Ltd.	2,799.31	19,622.64	1,108.16	285.87	430.91	24,246.89	85.58
Ping An Insurance Company of China, Ltd.	2,304	47,395	1,424	103	474	51,700	87.01
Total	26,542	210911.3	10,562	6,478	3,313	257,807	91.11
1999							
PICC(The People's Insurance company of China)	17815	0	6705	6318	964	31802	85.12
China Life Insurance Company	2701.27	111795.53	643.42	936.2	997.14	117073.56	92
The China Pacific Insurance Company, Ltd.	2345.09	14609.56	1029.77	417.93	368.25	18770.6	90.69
Ping An Insurance Company of China, Ltd.	1904.74	32335.5	1297.6	100.35	430.04	36068.23	89.46
Total	24766.1	158740.59	9675.79	7772.48	2759.43	203714.39	90.24
1998							
PICC(The People's Insurance company of China)	17438	0	6105	7621	636	31800	77.06
China Life Insurance Company	2358.08	82795.01	668.91	1413.79	939.31	88175.1	95.22
The China Pacific Insurance Company, Ltd.	2163.74	9656.6	1121.16	671.82	313.02	13926.34	93.36
Ping An Insurance Company of China, Ltd.	1571.7	22386.06	1165.22	307.5	394.01	25824.49	90.9
Total	23531.52	114837.67	9060.29	10014.11	2282.34	159725.93	90.14
1997							
PICC(The People's Insurance company of China)	15624.45	0	4916.17	7993.69	605.18	29139.49	72.01
China Life Insurance Company	0	61111.69	2551.33	1732.33	415.19	65810.54	90.77
The China Pacific Insurance Company, Ltd.	2307.13	7495.55	981.15	940.08	192.87	11916.78	91.74
Ping An Insurance Company of China, Ltd.	1467.37	13460.44	1144.3	435.98	237.46	16745.55	83.47
Total	19398.95	82067.68	9592.95	11102.08	1450.7	123612.36	84.65
1996							
PICC(The People's Insurance company of China)	15304.27	0	4385.15	6749.01	301.67	26740.1	73.04
China Life Insurance Company	0	40735.42	1953.57	2234.44	30.71	44954.14	88.71
The China Pacific Insurance Company, Ltd.	2219.87	2900.89	708.32	803.13	0	6632.21	80.27
Ping An Insurance Company of China, Ltd.	1040.47	6045.67	681.79	467.52	32.17	8267.62	68.55
Total	18564.61	49681.98	7728.83	10254.1	364.55	86594.07	80.47

Notes: 1. Claim reserve. 2. Life assurance reserve. 3. Outstanding reserve. 4. Deposits of policyholders. 5. Equalisation provision

c. Outstanding loss reserve

The existing rules seem not precise. For the *provision for notified outstanding claims*, it does not make clear whether the allocation of funds is based on a *case by case* approach adopted, *e.g.* by the EU.[87] It is also not clear how to deal with claim handling expenses. Expenses that are attributed to claims, *e.g.* the costs of using external loss adjusters to assess the claims (direct expenses), or the administrative expenses of the claims handling (indirect expenses), should be included into the *reserve*.[88] In addition, it also has no provision on how to deal with IBNER (incurred but not enough reported claims). For the *IBNR provision*, the standard of "not to exceeding 4% of the amount of payments actually made in the relevant year" also seems unsound. Although a simple percentage standard is easy to follow, it is static and can not match prudent requirements in a changing environment. According to Art.56, IAD (the EU), *IBNR provision* is generally set up on a prudent basis with an attempt to ensure no adverse run-off. In contrast, some member states of the EU in practice adopt "best estimate basis" which use different statistical methods to determine the provision.[89] For example, insurers in Spain, required by regulatory authorities, use at least two different statistical methods to compute the reserve, and book the higher of the two results. Due to the shortcomings of the existing rules, some insurers in China use *outstanding loss reserve* to manipulate their profits in regulatory returns. Insurers with good operation results sometimes over-estimate the reserve in order to hide profits and delay tax obligations. Oppositely, insurers with sad profits sometimes under-estimate the reserve for wangling the trust from shareholders and policyholders.

d. Provision for unearned premiums

A contentious issue involving the *provision for unearned premiums* is the valuation of the provision. The existing method for the calculation of the *provision for unearned premiums* only contains time apportionment which is simple to use but may not accurately reflect a realistic likelihood of the risk that insurance companies entail. Furthermore, the existing framework does not make explicit provision for the condition

[87] Art.60, the EU *Insurance Accounting Directive* (IAD).

[88] *Id.*

[89] *See* the 2002 *KPMG* Solvency Study, p62-69.

under which a *policy-based method* or a *lump sum method* is used. To be prudent, the provision in principle must be computed separately for each insurance contract (in contrast to the *lump sum method*).[90] Statistical methods, and in particular proportional rate method, could be used where "they may be expected to give approximately the same results as individual calculations."[91] It might be appropriate to take account of the risk profile where there is a marked unevenness in the incidence of risk,[92] as the assumption of a temporal correlation between risk experience and premium is not appropriate in some classes of insurance, *e.g.* travel insurance.

e. Equalisation provision

In the EU, there are inconsistencies between Member States in establishing and maintaining *equalisation provision.* Equalisation provision, also referred to as *(claims) fluctuation provision* or *stabilisation reserve,* is usually the amount set aside on the balance sheet, in compliance with legal or administrative requirements, to equalise fluctuations in loss ratios in future years or to provide for special risks. The amounts set aside for specified types of business (*e.g.* pollution liability or credit insurance) may be referred to as *provisions,* whereas amounts set aside to cover fluctuations of the entire portfolio may be referred to as *reserve.*[93] In China, according to the *1995 Insurance Law* (Art.96), the purpose of setting up an *equalisation provision* is "to safeguard the interest of the insured and support the stable and sound operation of insurance companies." Therefore, the provision can be seen as a reserve to cover fluctuation of insurers' entire portfolio.

The current *equalisation provision* has some problems. It fails to differentiate characteristics between life and non-life business because of the same rate for calculating the provisions of the two businesses. The operation of funds is inefficient, as insurers are required to deposit their funds in designated banks. As some academics suggest, the funds seem to provide low capacity of security for insurers' contingent

[90] In the 2002 KPMG Solvency Study, it quotes the *"Manghetti Report"*(2000) that most non-life companies in the EU are likely to perform the calculation on a policy by policy basis. Also Art. 57(1), the EU *Insurance Accounting Directive* (IAD) states that "the provision for unearned premiums shall in principle be computed separately for each insurance contract".

[91] Art. 57(1) of the IAD.

[92] See Art. 57(2) of the IAD.

[93] "On Solvency, Solvency Assessments and Actuarial Issues" An *IAIS* Issues Paper (Final Version), 1999, p47.

losses, whereas some insurers claim that the funds are over-provisioning.[94] In addition, some insurers treat *equalisation provision* as a liability both in their statutory accounts and regulatory returns while others treat it as an equity,[95] which create incompatibility among insurers. Finally, there is no rule on how to use *equalisation provision.* Some academics suggest that it may be used on a whole industry scale in the liquidation of an individual insurer or to compensate for huge losses incurred by one or more insurers from less-frequent but severe disasters.

4.4.4 Reinsurance

Reinsurance performs important functions essential for a healthy insurance market. Reinsurance enables insurers to even out their operational results when major, exceptional losses occur, control underwriting loss, and manage their assets safely and profitably. Furthermore, insurers can use reinsurance to increase the maximum amount they are able to cover for most insurance portfolios, without becoming overextended. IAIS has recognised five primary functions of reinsurance: capacity, expertise, stability, financial, and protection.[96] From the regulatory stand, ensuring reinsurers' solvency is an essential part of prudential regulation.

Reinsurers' solvency regulation can be broadly divided into two parts: *direct regulation* that deals with issues directly relating to reinsurers' solvency, *e.g.* reinsurers' solvency margins and licensing; and *indirect regulation* that governs the influence of reinsurers' solvency on primary insurers, *e.g.* admissibility of reinsurance assets for primary insurers, and limitations on maximum exposures to reinsurance.[97]

Provisions related to reinsurance in China are scattered; there is no specific reinsurance law or regulation except the *Compulsory Ceding Conditions* (CIRC,1999) and its associated *Rules for Implementing Compulsory Ceding Conditions* (CIRC,

[94] See Huang Cidong & Gao Shenpin *Baoxianfa Ji Xiangguan Fagui Xinzhu (New Annotation on Insurance Laws and Relevant Regulations)* People's Court Publishing 2000, p802-803, and "On solvency and its regulation and supervision in China" *Baoxian Yanjiu (Insurance Study)* 2001. No1.

[95] Such incompatibility can be seen in statutory returns in the *China Insurance Almanac* 1998, 1999,2000.

[96] "Reinsurance and Reinsurers: Relevant Issues for Establishing General Supervisory Principles, Standards, and Practices" Reinsurance Working Group, IAIS, 2000

[97] See "Study into the methodologies for prudential supervision of reinsurance with a view to the possible establishment of an EU framework" KPMG, commissioned by EC, January 2002

2000). The current reinsurance regulatory framework are basically related to "domestic retention" requirements[98] and compulsory reinsurance cessions, both seeking for building up a strong national reinsurance capability and preventing outflows of reinsurance premiums. For example, the *1995 Insurance Law* (Art.101) requires that 20% of gross premiums (except for life insurance business) received by local insurers be ceded to designated reinsurers. In practice, the compulsory reinsurance business has long been monopolised by state-owned China Re. the only one domestic specialised reinsurer in the market.[99] Furthermore, when an insurer needs to reinsure, it must give priority to insurers inside China, but the insurer can reinsure with a foreign insurer where reinsurance conditions at the foreign insurer are clearly superior.

There are also provisions governing other aspects of reinsurance. Under the Art.100 of the *2002 Insurance Law*, an insurer shall reinsure any part of the liability for a "single insured event", which exceeds 10% of the sum of paid-in capital and common reserve of the insurer. All insurers must submit a compulsory reinsurance cession proposal for the next year to the CIRC for approval every year before November 1st.[100] Approval from the CIRC must be obtained where an insurer reinsures with an associated insurer.[101] Licensed insurer may, with CIRC approval, also write inward commercial reinsurance.

Except for the special provisions above, domestic reinsurers are largely subject to the same regulatory regime as direct insurers. In addition, there is no explicit provisions on both direct and indirect regulation of reinsurers' solvency.

The reinsurance market in China is still in its initial stage, and faces many problems and challenges. The monopoly of compulsory reinsurance business by China Re. hampered the upgrade of its reinsurance technology and services, resulting in insufficient reinsurance supply and demand. It notes that compulsory reinsurance made up 88% of the total reinsurance premiums in 2000, thereby indicating that the insurers' cession proportions of commercial reinsurance are insignificant. Furthermore, China Re. lacks sufficient capital funds for further development. Both the insurance and reinsurance market can not meet the demand for the underwriting of natural disasters.

[98] The *2002 Insurance Law*, Art. 103.

[99] According to its statutory returns, China Re. reaped a premium income of Rmb14 bn (US$1.7bn) in 2000, up 21 % from the previous year. Total indemnity paid stood at Rmb7bn (US$843mn) in 2000. The insurer's total assets had reached Rmb15.1bn (US$1.8 billion) by the end of 2000.

[100] The *2000 Insurance Company Regulation*, Art 87.

[101] *Id.* Art. 89.

Regarding challenges, the reinsurance market is one of the first areas to open to the outside world according to China's commitments to the WTO. The rate of the compulsory reinsurance cession is being reduced down to zero. After the entry of WTO, Swiss Re. and Munich Re. had been granted to provide life and non-life reinsurance services in China without geographic limitations on operation. These two factors heat competition in the reinsurance market.

Overall, given the tremendous growth potential of China's direct insurance market, the chances for sustainable growth in the reinsurance market appear to be huge. China needs to further the development of the reinsurance market, including allowing more foreign reinsurers' access to the market. Compared with direct insurance, reinsurance business is international in scope; the emergence of the global reinsurance market is already underway which has being fuelled by reinsurance growth in emerging markets.[102] Allowing more foreign reinsurance companies to operate on the national market strengthens the ability of locally-owned direct insurance companies to compete with their foreign competitors. This is because reinsurance can act as a substitute for the capital of a direct insurer, and support the insurer with underwriting techniques. Correspondingly, China needs to improve its fragmentary reinsurance regulation, and especially, improve reinsurers' solvency regulation.

4.4.5 Reporting system

Implementing prudential regulation means establishing a system to monitor insurers' regulatory compliance. One of the regulators' main tasks of on-going supervision is to check and analyse insurers' regulatory returns (off-site supervision). The *2002 Insurance Law* requires insurance companies to file annual financial reports no later than three months after the end of the financial year, and submit a monthly business statistics statement of the previous month.[103] These documents should be verified by a registered accountant approved by the CIRC.[104] The annual financial reports consist of a financial statement, balance sheet, profit and loss account, and a series of statutory

[102] The global reinsurance market was worth US$207bn in 2000. North America and Western Europe are still the biggest markets for reinsurance, but the growth rate between 1991 and 2000 was less than 4%. However, the average growth rate over the same period was 9% for Asia Pacific Rim, 6.1% for Latin America, and 5.2% for central and eastern Europe. *Reuter News Service*, September 13, 2001.

[103] Art. 119, and 120. *2002 Insurance Law*

[104] The *1996 Administration Provisions*, Art. 72.

reports. The *Law* also obliges both life and non-life insurers to employ the CIRC recognised actuarial personnel and establish an actuarial reporting system.[105] In 1993, China introduced a thorough reform on the old accounting system that derived from the former Soviet Union. The new system is broadly consistent with the *International Accounting Standards* (IAS). In 1999, China enacted two decrees specifically for the insurance accounting system: the *1999 Accounting Standards for Insurance Companies*, and the *1999 Financial Standards for Insurance Companies.* These two decrees set out detailed accounting principles and a wide range of standards for insurers preparing their profit and loss account, balance sheet, and related general ledger accounts and sub-ledger accounts. In particular, the *2003 Regulatory Indexes* require insurers to file annual statutory returns for solvency of previous year before April 30th every year. These returns need signatures of insurers' representative of legal person, the actuary in charge and the chief financial officer, and the verification by a registered accountant. An insurer is obliged to ensure the truthfulness and completeness of its returns.

4.5 Early warning system

4.5.1 A brief history and the current system

China has been making continuous efforts to establish an early warning system. For the purpose of off-site supervision, in 1999, the CIRC issued two decrees aiming at establishing an early warning system within reporting procedures;[106] and previously the PBOC tried a similar method in 1998.[107] The 1999 early warning system contained a set of financial statements and ratios by which regulators test risks entailed by insurers on their financial viability. However, the system was premature, and did not contain the intervene measures necessary for regulators to take in response to levels of an insurer's risks. In addition, the CIRC did not give priority to the system, because the insurance accounting system then had not been fully established.

[105] The *2002 Insurance Law*, Art. 119.

[106] The *Financial Report Forms for Insurance Supervision*, the CIRC, March 1999; and the *Notice of Adjusting Some Items in Financial Reports for Insurance Supervision*, the CIRC, December 1999.

[107] *The Regulatory Indices for Insurance Industry*, the PBOC September 1998.

As an experimental effort, the *2001 Regulatory Indexes* set up an early warning system characterised by containing "a scoring system".[108] It consists of three parts: self-assessment and report-filing by insurers; verification of the files by the CIRC; and, if necessary, the adoption of appropriate intervene measures by the CIRC.

Firstly, insurers are obliged to follow the provisions of the *2001 Regulatory Indexes* to compile their solvency returns. The vital parts of the returns are the regulatory indicators (a set of ratios) that are the bases for calculating a cumulative score presumed to reflect an insurer's solvency condition. The ratios differ between non-life and life insurers (11 ratios for non-life, and 9 for life, see Table 4.9). Each ratio has a given full score, with an upper limit and a lower limit for weighting. Insurers are firstly required to calculate their actual ratios, and then to get a weighted score for each ratio by following a given calculation method before summing up all the scores to get a cumulative score.

Table 4.9 Indicators to insurers' solvency *(2001 Regulatory Indexes)*

For non-life insurers	For life insurers
I. Operational Ratios	1 Change in Long-term Insurance Premiums
1 Change in Gross Premiums Written	2 Change in Short-term Insurance Premiums
2 Net Premiums Written to Equity	3 Change in Product Mix
3 Premium Receivables	4 Combined Short-term Payments to Net Premiums
4 Combined Expenses and Commissions to Net Premiums	5 Change in Equity
5 Payments to Net Premiums	6 Non-Performing Assets to Equity
6 Underwriting Cost Ratio	7 Fixed Assets to Equity
II. Financial Ratios	8 Surrender Ratio
7 Liabilities to Assets	9 Adequacy of Investment Yield
8 Fixed Assets to Equity	
9 Change in Equity	
10 Non-Performing Assets to Equity	
III. Investment Ratio	
11 Investment Yield	

Secondly, the CIRC verify the returns. The provisions require insurers file detailed calculations, assessment methods, data resources and relevant illustrations regarding solvency margins, admissible assets and various reserves. The information assist the verification.

Finally, the CIRC takes certain actions upon insurers' different scores. The perfect cumulative score is 100. An insurer holding an 85 cumulative score or above is deemed by the CIRC as having sound solvency and operations. An insurer with a score between 60~84.9 needs the special attention from the CIRC, and is required to present an analysis of abnormal ratios together with a proposal of improvement. An insurer with a

[108] The *2001 Regulatory Indexes*, art 4.

score below 60 will warrant the attention from the CIRC who may suspend the insurer's business or order it to reorganise within a certain period, or may even revoke the insurer's license.[109] The CIRC carries out a solvency assessment on insurers once a year.

By drawing experiences from the US and the EU, and lessons from its own experiments, the CIRC is determined to develop a modern early warning system that fit to China's realities. In March 2003, the CIRC, by the *2003 Regulatory Indexes*, replaced the experimental system with a new system which abandoned the scoring approach, and instead, simply use a set of ratios to monitor insurers' solvency conditions. Under the new rules, solvency margins are the core indexes of an insurer's financial situation, while the regulatory indexes (11 ratios for non-life insurers, and 12 ratios for life insurers, see Table 4.10, and Table 4.11) are for assessing and monitoring the situation and trend of insurers' solvency. Where an insurer has four or more indicators exceeding acceptable ranges, the CIRC shall, in the light of specific conditions, decide whether to take the following actions:

(1) requiring the insurer to present reports that explain the causes of the abnormality, the influence on solvency and the solution thereof;

(2) launching a full inspection to assess the actual condition and trend of the insurer's solvency; and

(3) based on the results of the inspection, taking necessary corrective actions.

Table 4.10 Indicators to non-life insurers' solvency (*2003 Regulatory Indexes*)

Indicators (Ratios)	Calculation	Range (%)
1 Gross Premium Growth Ratio	Change in Gross Premium/Gross Premium, prior year (%)	-10 ~ 60 999 (for a period less than 1 year)
2 Net Premium Growth Ratio	Change in Net Premium/Net Premium, prior year (%)	-10 ~ 60 999 (for period less than 1 year)
3 Gross Premium Size Ratio	(Primary Insurance Premiums + Reinsurance Premiums)/(Admissible Assets - Admissible Liabilities) (%)	≤ 900 999 (for Admissible Assets ≤ Admissible Liabilities)
4 Change in Actual Solvency Ratio	Change in Actual Solvency/ Actual Solvency, prior year (%)	-10 ~ 30 999 (if Actual Solvency of either this year or prior year ≤ 0)
5 Two Year Overall Operating Ratio	Two Year Expense Ratio + Two Year Loss Ratio (%)	< 103
6 Investment Yield Ratio	Net Investment Income/(Cash + Average Invested Assets) (%)	≥ 3

[109] The *2001 Regulatory Indexes*, Art.17.

7 Short-term Liquidity Ratio	Liquid Assets/Admissible Liabilities (%)	≥ 95 999 (if Liquid Assets ≤ 0)
8 Financing Risk Ratio	Sold Purchase Back Securities/(Paid-in Capital + Cumulative Reserve) (%)	≤ 50
9 Premium Receivables Ratio	Premium Receivables*/Premium Income (%)	≤ 8
10 Admissible Assets-Liability Ratio	Admissible Liability/Admissible Assets (%)	≤ 90
11 Asset Admissibility Ratio	Admissible Value/Value in Accounts (%)	≥ 85

*Premium Receivables with a maturity of less than 1 year.

Table 4.11 Indicators to life insurers' solvency *(2003 Regulatory Indexes)*

Indicators (Ratios)	Calculation	Range (%)
1 Change in Long-term Insurance Premiums	Change in Long-term Insurance Gross Premium/ Long-term Insurance Gross Premium, prior year (%)	-10 ~ 80 999 (for a period less than 1 year)
2 Change in Short-term Insurance Net Premiums	Change in Short-term Insurance Net Premium/ Short-term Insurance Net Premium, prior year (%)	-10 ~ 60 999 (for a period less than 1 year)
3 Change in Actual Solvency Ratio	Change in Actual Solvency/ Actual Solvency, prior year (%)	-10 ~ 30 999 (if Actual Solvency of either this year or prior year ≤ 0)
4 Change in Product Mix	Sum of Absolute Change of Premium in Various Products/Number of Products	≤ 8
5 Admissible Assets-Liability Ratio	Admissible Liability/Admissible Assets (%)	≤ 90
6 Asset Admissibility Ratio	Admissible Value/Value in Accounts (%)	≥ 85
7 Two Year Short-term Insurance Payment Ratio		≤ 65
8 Adequacy of Investment Yield	Net Investment Income/Returns Required by Technical Provisions of Enforceable Long-term Life and Health insurance	125 ~ 900
9 Surplus Relief	(Residue of Allocated Reinsurance Cost - Reinsurance Cost)/(Admissible Assets - Admissible Liabilities)	-25 ~ 25 999 (for Admissible Assets ≤ Admissible Liabilities)
10 Change in Asset Mix	Sum of Change in Each Investment Item Net Admissible Value in Proportion of Total Value of Cash and Investment Portfolios	< 5
11 Financing Risk Ratio	Sold Purchase Back Securities/(Paid-in Capital + Cumulative Reserve) (%)	≤ 50
12 Surrender Ratio	Surrenders/(Long-term Insurance Provision, prior year + Long-term Insurance Premiums)	< 5

4.5.2 Comments

The main purpose of an early warning system is to predict an insurer's insolvency. The system should provide essential information related to an insurer's financial conditions and operational effectiveness, and whereby regulators can give special attention to the insurer's problems at an early stage. This results in regulators' further

investigation into the insurer followed by appropriate corrective measures to avoid the insurer becoming insolvent. Therefore, the merit of an early warning system depends on the accuracy of its predictions and related costs. It is important to recognise that the early warning system is a supplement to, rather than a replacement for, other forms of financial monitoring, *e.g.* on-site inspection.

Fewer early warning systems are seen in insurance regulation over the world than in banking regulation which has adopted many varieties of the systems.[110] In the US, the NAIC is operating two early warning systems for the US insurance industry: the *Insurance Regulatory Information System* (IRIS),[111] and the *Financial Analysis and*

[110] See Ranjana Sahajwala and Paul Van den Bergh "Supervisory risk assessment and early warning systems" Basel Committee on Banking Supervision Working papers No. 4, December 2000 *Bank for International Settlements* (BIS)

[111] The NAIC adopted IRIS in the 1970s. It contains a series of 12 financial ratios (differing among property-casualty, life and health insurers) relating to the detection of actual or potential insolvency. For details, see Peter M. Lencsis (1997) Chapter 6, *Insurance regulation in the United States an overview for business and government* Quorum Books. Also see Robert W. Klein (2000) "Regulating insurer solvency in a brave new world" Working paper *Centre for Risk Management and Insurance* Georgia State University p43-52.

Surveillance Tracking System (FAST).[112] Japan introduced early warning measures for insurance industry in 1998. It is increasingly recognised that insurance regulators can, and should, draw experience from banking regulation on the issue of early warning systems.

Regarding the system in China, data including statutory returns of insurers are not publicly available so far for examining the capacity of the system. Nor is there any available breakdown of its costs. Even so, judged on a theoretic basis, several issues regarding the effectiveness of the system can be raised.

Firstly, it is generally recognised that financial ratios are not sufficient on their own to identify the complex nature of risks undertaken by financial institutions[113] among which insurers entail particularly complex risks.[114] A wide variety of both qualitative and quantitative information relate to risks and management thereof, for example, management and corporate strategy, industry risk, business review, operating performance, investments, capital adequacy (including reinsurance adequacy and reserve adequacy), liquidity, and financial flexibility. This requires both objective judgements, *i.e.* numeric analyses, and subjective analyses and opinions, when assessing an insurer's risks and financial conditions. The subjectivity requires and allows regulators to incorporate non-ratio methods into their early warning systems. In financial regulation (mainly banking regulation), one category of such methods is the *supervisory rating systems* which help identify institutions' risk profiles based on either on-site or off-site examinations. A widely-known example of this category is the

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[112] FAST was introduced by the NAIC in 1989. It consists of a series of financial ratios (differing in numbers and nature among property-casualty, life and health insurers) to help monitor insurers' financial conditions and identify those insurers requiring further regulatory attention. For detailed description, see *id.* In addition, Grace Martin F., Scott E. Harrington and Robert W. Klein, (1998) "Risk-Based Capital and Solvency Screening: Hypotheses and Empirical Tests" *Journal of Risk and Insurance*, 65, and (1998) "Identifying Troubled Life Insurers: An Analysis of the NAIC FAST System" *Journal of Insurance Regulation*, 16, which provides empirical research results claiming that FAST is a reasonably effective system for early warning purposes.

[113] *Supra note 6*, p17-18.

[114] For detailed discussion on insurance risks, see "Report of solvency working party" International Actuaries Association (IAA) February 2002.

CAMEL rating system.[115] Another category is *comprehensive risk assessment systems.* This approach makes a comprehensive and detailed assessment of the risk profile of a financial institution as a whole. One example is the *Risk Assessment, Tools of Supervision and Evaluation System* (RATE)[116] in the UK, which was introduced by the Bank of England and currently used by the FSA. These methods are more risk-focused than the financial ratio method, reflecting the worth of qualitative factors in detecting and assessing risks. As on-site examinations are required for these methods, they facilitate formal links between supervisory bodies and institutions. In summary, combining these methods with financial ratios enables regulators to conduct a more structured supervision with a greater emphasis on formal risk assessment. China's early warning system is characterised by assessment of financial ratios based on off-site examinations. It is therefore desirable to increase the elements of *supervisory rating systems* and *comprehensive risk assessment systems*, in order to make more accurate risk assessments of insurers.

Secondly, there are some shortcomings in ratio selection.[117] Some ratios are not really significant or relevant enough for their inclusion in the system. For example, for non-life insurance, the index of *Investment Yield Ratio* (see Table 4.10) may not be significant enough, because the percentage of investment assets in non-life insurers is very low. Therefore, even a satisfactory *Insurance Yield* may not contribute greatly to

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[115]The CAMEL rating system was introduced by the US supervisory authorities for on-site examinations of banking institutions in the 1980s. It is used by three US supervisory agencies, i.e. the Federal Reserve System, Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC). Under this system, each banking institution subject to on-site examination is evaluated on the basis of six (initially five) critical dimensions relating to the financial condition, operating soundness and regulatory compliance of the banking institution. These are Capital, Asset Quality, Management, Earnings, Liquidity and later-added Sensitivity to market risks. For details, see Rebel A. Cole and Jefferey W. Gunther (1995) "A CAMEL Rating's shelf life" *Financial Industry Studies*, Federal Reserve Bank of Dallas, December 1995, p13–20.

[116] The RATE is applied to all UK-incorporated banks and the UK branches of non-EEA banks. Its objective is to increase the effectiveness of supervision by making it risk-focused. It decomposes a bank or banking group into significant business units and assesses each unit for nine evaluation factors of the business risk profile. Scores are assigned for each factor. A final assessment or score for the bank or the group comes by consecutively aggregating individual scores and assessment results of units from lower level to higher level. For details, see UK FSA "Risk based approach to supervision of banks" June 1998.

[117] It notes that some ratios seem to reflect the industry's realities. For example, the inclusion of "Premium Receivables" could help alleviate the severity of premium receivables, a long standing problem in China's insurance industry.

an insurer's total profit. A replacement with a new concept *Investment Yield Ratio* (= *Investment Profit/Total Pre-tax Profit*) may be more significant because the new ratio reflects not only the size of investment profit but also the proportion of the profit in an insurer's total profit. Another example is *Gross Premium Size Ratio* (Table 4.10). Under art. 99 of *2002 Insurance Law*, "the current year net premium of an non-life insurer may not be more than four times the sum of its paid-in capital and cumulative reserve." By its definition, the *Gross Premium Size Ratio*, although has a purpose similar to the provision for controlling premium size, is not closely relevant to the provision. In addition, some significant ratios are excluded from the system. For instance, no *Two Year Overall Operating Ratio* is for life insurance, which is unable to detect life insurers' operational efficiency. Moreover, adequate technical provisions for liabilities are crucial to insurers' solvency. Some ratios such *as Outstanding Claim Test* (*=Provision for Claims/Claims Paid*) and *Unearned Premium Adequacy* (*=Unearned Premium Provision/Net Premium*) are useful to detect the adequacy of these provisions. However, there is not any ratio for technical provisions. Nor is there any ratio for reinsurance, *e.g. Reinsurance Ratio* (= *reinsurance Recoveries/Reinsurance Expense*), or *Premium Cession Rate* (= *Outward Reinsurance/Gross Premium*), which reflect an insurer's prudence. Moreover, the numbers of ratios are noticeably less than the numbers of FAST.

Thirdly, some elements of certain ratios are questionable. For example, regarding *Two Year Overall Operating Ratio*, the measure used to calculate expense ratio are incorrect. The denominator should be *Net Earned Premium* rather than *Net Written Premium* because the latter improperly relates a given year's expense to the real revenue earned for that year. Anther example is *Short-term Liquidity Ratio* (Table 4.10). Normally, the ratio in accounting practice is calculated by *Liquid Assets/Admissible Liabilities*, which reflects a firm's capacity of discharging its liquid debts. It is meaningless to relate liquid assets to total admissible liabilities because the to total admissible liabilities contain long-term debts.

Fourthly, some *acceptable ranges* assigned to ratios also prove to have shortcomings. For example, the *acceptable ranges* for *Gross Premium Growth Ratio* are -10% ~ 60% (Table 4.10, for life insurance, the upper range of *Change in Long-term Insurance Premiums* is even as high as 80%, see Table 4.11). The 60% annual premium growth rate seems very high, measured against either those in developed countries or even those in the history of the Chinese insurance market. An insurer with

excessive growth entails special risks if it is poorly co-ordinated in terms of risk selection, pricing, and financial resources sufficient to supporting the growth.[118] Currently, one main problem facing most Chinese insurers is high-speed growth of premium income accompanied by a gradually reducing profitability. The main reasons behind this are the ignorance of excessive growth risk, one-sided policies on business growth, and neglect of efficiency. To solve the problem, the regulator needs to provide proper incentives. It recommends that the CIRC reduce the upper ranges (in both non-life and life insurance) to, for example, 40%, making the indictors sensitive to the alert of the excessive growth risk.

Fifthly, the current early warning system is based on the annual account data. This may distort insurers' real situations due to the time lag. Generally, only if insurers are examined at frequent intervals and their financial conditions generally remain stable, can relevant ratios be accurate indictors of potential problems. Therefore, to make the results close to reality, examinations need to be carried out in an appropriate frequency, for example, twice a year.

At last but not at least, in order to be a useful tool for regulators, the parameters of an early warning system should be capable of predicting insolvency. To achieve this, regulators may focus the parameters on those failed companies, or more closely, focus on conditions which could lead to insolvency.[119] However, this will not be easy for China. As China has a relatively short-term data collection, and no insurer fails so far, the current parameters may be determined by the CIRC's experience. However, the CIRC needs to adapt indicators and acceptable ranges to changing conditions.

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[118] Viviane Leflaive (2001) "The supervision of insurance solvency: comparative analysis in OECD countries" OECD, p16.

[119] Klein R.W. and Barth M.M. (1995) assert that solvency monitoring systems should focus on those companies that "have dashed into the street" rather than those that "have been hit by a car". They suggest that the parameters should be identical to the conditions which could lead to insolvency. See "Solvency monitoring in the twenty-first century" *Journal of Insurance Regulation*, 13: p284-285.

4.6 Policyholders Protection Funds

This section provides an overview of *policyholders protection funds* (PPF) including their main benefits and drawbacks, and discusses the necessities of establishing such a system in China.

4.6.1 Overview of policyholders protection funds

PPF (or *Insurance Guarantee Funds*) may be defined as funds/systems which will be triggered when an insurer has either fallen into a critical condition which may result in its inability to pay the claims already filed or those to be made later, or has actually gone into liquidation. The system can either pay claims directly (or through a separate company or organisation) to the policyholders based on the fund collected from insurers or from the government; or it can inject necessary money into the failing insurer or into a separate insurer which has agreed to take over the portfolio of the failing insurer.[120] Although detailed provisions differ among countries due to different national conditions, there are common characteristics: coverage, eligibility of claimants, funding, compensation, and organisation of administrating the funds.

PPF are prevalent among OECD countries. It has been reported that at least 21 member countries of OECD have one or more such funds.[121] Funds also exist in some Asian countries and regions (Brunei, Chinese Taipei, Hong Kong, Macao, Malaysia, Philippines, and Singapore) and some economies in transition (Bulgaria, Croatia, Estonia, Latvia, Romania, Slovenia, and Ukraine).[122]

In recent years, there seems a trend in the world towards the creation or renewal of PPF, mostly triggered by the failure of insurers, or otherwise driven by the convergence of financial service sectors. This is especially so where insurance merges with banking, as banks are usually equipped with a deposit insurance scheme. For example, in 2001, the UK enacted a single Financial Services Compensation Scheme that fully replaced

[120] See *Insurance Regulation and Supervision in OECD countries, ASIAN Economies and CEEC and NIS Countries* OECD, 2000, p197. Also see "Policyholder Protection Funds" *Glossary of Insurance Policy Terms* OECD (2938) 1999 p54.

[121] Viviane Leflaive "The Supervision of Insurance Solvency: Comparative Analysis in OECD Countries" OECD 2001.

[122] *Id.*

eight separate compensation arrangements of the financial industry including insurance.[123]

The main benefit of PPF is the payment of compensation to customers of failed insurers. It is generally recognised that the four interacting elements (market conduct regulation, an ombudsman scheme, prudential regulation, and PPF) constitute an organic framework of insurance regulation and supervision in modern society. Among them, market conduct regulation focuses on insurers' market performance while an ombudsman scheme deals with contractual disputes between insurers and policyholders. Prudential regulation serves to secure the safety of insurers in advance. However, some insurers will always fail, especially under the current environment of deregulation and fiercer competition, no matter how solid the prudential regulation is. PPF is expected to serve as the final safety net for policyholders, especially for individuals and non-professional policyholders who face considerable information asymmetry and have limited ability sufficiently to verify the credibility of an insurer. Moreover, individuals and non-professional policyholders are deemed the most vulnerable to losses in the event of insurers' bankruptcy.

It is also said that the existence of PPF could increase consumers' confidence in insurance industry, not only when policyholders get compensation from the funds, but also when no claims need to be made. The development of the insurance industry is built on the public confidence in the industry which assumes risk transfer and mitigation through "favourably unlimited consumers' participation." Naturally, consumer awareness of the existence of the funds, or the comfort derived from the belief that they will be protected in the event of insurers' failure, will encourage consumers to participate in the insurance business, so benefiting both the industry and consumers.

PPF is also considered helpful for developing a dynamic and pro-competition insurance market. Some argue that the funds on a broader scale have been proposed by promoters of deregulation as a means of softening the impact of insolvency which they expect to result from increased competition.[124] Without such a safety net, the authorities would be inclined to place stringent regulations at any cost to minimise or prevent an insurer's failure, as such a failure could cause widespread suffering to policyholders and

[123] Financial Services Compensation Scheme FSA of the UK, 2001

[124] See Werner Pfennigstore Chapter 7 *Public Law of Insurance International Encyclopaedia of Comparative Law* note 985, p143.

a shock across society. This could result in depressed competition and hinder the development of insurance market.

Australia currently has no PPF, as debate about on the merits of the funds is continuing. The mechanism levies mandatory guaranty funds on all insurers, regardless of their insolvency risk. This has been criticised for creating moral hazard and adverse selection among policyholders and insurers when PPF increase the security of policyholders. Firstly, as contributions will eventually be paid by consumers, the implicit cost of this protection to consumers in fact shifts insolvency losses to them. This will reduce buyers' incentives to purchase insurance from financially strong companies, and so reduce their incentives to avoid high-risk insurers through exercising care in selecting insurers. In addition, it seems unfair to force the policyholders of soundly managed insurers to subsidise those who choose to deal with unreliable insurers. Secondly, this implicit cost is not adjusted according to an insurer's financial risk, if insurers must pay a uniform rate against their premiums regardless of their prudence. This could increase the temptation for insurers to engage in irresponsible risk-taking, leading to higher insolvency and resolution costs. It may also increase the temptation for insurers to engage in irresponsible price wars. Thirdly, the burden of financing the PPF may impair the solidity of some insurers. Fourthly, such a mechanism tends to induce regulators to postpone corrective action against financially impaired insurers.[125] In order to minimise the moral hazard and adverse selection incentives and to improve policyholders' and insurers' incentives to act prudently, some proposals have been put forward for injecting proper economic incentives into the systems. These proposals can mainly be categorised into two kinds: *risk based pricing (RBP)* of guaranty funds[126] which aim at fairly pricing insurers according to an actuarial assessment of their respective insolvency risks; and imposing certain costs on policyholders.[127]

4.6.2 The needs to establish a policyholder protection fund in China

[125] See supra note 119, p143.

[126] See W.R. Feldhaus & M.M. Barth, "Risk-based pricing factors for property and casualty insurance guaranty funds" CPCU Journal 45,1992. p239-249.

[127] For example, a partial payment that requires policyholders to share losses with the funds so to encourage them to make a prudent selection of insurers. See supra note 123.

Should China set up PPF in the current wave of strengthening insurance regulation and supervision? There have been few researches on this question. It may be a reflection of the fact that no insurer has failed so far in China. However, it needs to consider whether an insurer's failure is possible and how to sort out policyholder protection in case of an insurer's bankruptcy. Certainly, China needs to establish PPF for the reasons as follows:

Firstly, it is to nurture and maintain public confidence in the insurance industry. There is a widespread recognition that China insurance has a huge potential, but this requires sound public confidence in the insurance business as a prerequisite. However, as surveys revealed, one of the main obstacles to the development of the industry is low consumer awareness.[128] Public confidence in insurance can not be built up without great consumer awareness of the insurance business (On the other hand, low awareness also indicates consumers' scarce insurance knowledge). In addition, being in a primary stage of development, China's insurance market largely comprises consumers vulnerable to losses. These consumers certainly require the guarantee of PPF because they could easily lose their confidence if they suffer losses from insurers' failure.

Secondly, it is necessary to mitigate the insolvency risk of the Chinese insurers. As demonstrated in section 4.3, over recent years, some insurers have faced serious risks of insolvency. The majority of the insurance industry has a low profile of profitability, capitalisation, diversity of products, competitive advantage of prices, and internal managerial competence. In addition, the industry has grown by 34.4 % a year in the last two decades, with a rapid increase of new entrants. It believes that insurers will entail greater risks if they grow excessively and can not support this growth with sufficient financial resources. Although Chinese consumers have not seen an insurer' failure so far and might not believe that such an event would happen in the future, they have witnessed a series of failures in financial services, which they would not have believed a decade ago. In the last years, a number of financial institutes in difficulties were closed

[128] See *China Daily* March 4, 1999, and note 48, chapter 1.

in China.[129] It is inevitable that some insurers will fail in an increasingly competitive market, especially because there always be a certain number of events covered by insurance policies, which could be unpredictable or can not be avoided.

Thirdly, it is a requirement for changing public opinions on the safety of insurance business. Chinese used to view insurance as a state-run business because it was run by the state under the monopoly of the former PICC before 1985 and is still controlled by an oligopoly of the five giant state-owned insurers. Most consumers are used to believing that insurers are "too big to fail". This has been fuelled by the tradition of implicit full guarantees by the government on the insurance business, and the fact that insurers have indeed never failed. The reform of state-owned insurers and opening up have meant that the unitary state ownership of insurers has been changed into a multiple ownership containing stock ownership, foreign branches, and joint ventures besides the state ownership. Even private capital is allowed to invest in insurance sector. The government simply no longer provide the same safety net as it used to. Thus, it has to move from the implicit full guarantee tradition to the new regime of the limited safety net provided by PPF.

Fourthly, it is necessary to protect policyholders by PPF under the current insolvency procedure of insurance companies. The importance of PPF is inversely linked with the level of privileges to policyholders in insolvency procedure. In principle, it may not necessarily introduce the funds if the interests of policyholders are well protected in the procedure.[130] In China, there is neither an explicit definition of closure of insurance companies and nor sufficient protection of policyholders' interests in the relevant procedure (section 2.4.2, Chapter 2). According to insurance law, where a life insurer is closed down or declared bankrupt, its life insurance contracts and reserves must be transferred to another life insurer. The CIRC designates a life insurer to take over these contracts and reserves, where no transfer agreement can be reached between the

[129] For example, during 1997-1999, one commercial bank (*Hainan Development Bank*) and three international trust and investment companies (*China Agribusiness International Trust and Investment Company, China Venture Technology Investment and Trust Company*, and *Guangdong International Trust and Investment Company*) became insolvent. In addition, 23 urban credit co-operatives and 18 rural credit co-operatives were closed during the same period. All these institutions were in the authority's receivership or were dissolved after liquidation. Some local governments provided sums for compensating depositors' losses from insolvent institutions.

insurers.[131] However, the law does not clarify how to compensate the taking-over" insurer when it receives insufficient reserves. In liquidation, policyholders are not secured creditors. Those policyholders who have already made claims on their policies are in third position in repayment order, after the repayment of expenses involved in the bankruptcy and the wages and social security premiums owned to the staff of the insurer in liquidation, but in front of the General Bureau of Taxation.[132] The repayment of policyholders may be on a *pro rata* basis where there are insufficient assets.[133] Given the insufficient policyholders protection in the existing insolvency procedure, China needs to establish *PPF*.

In practice, in dealing with the closure of Guangdong International Trust and Investment Company, the Guangdong provincial government provided the liquidation board with a loan of Rmb780mn for compensating depositors who were natural persons for their losses. However, this was a political decision, not based on an explicitly legal provision. This triggered appeals for the establishment of *deposit insurance* in China. As convergence of financial services has already emerged in China, it needs *PPF* to ensure fair competition between the banking and insurance sectors, if *deposit insurance* is introduced.

Fifthly, it is a requirement of the changing style of insurance regulation and supervision after the WTO accession. With gradually relaxing the restrictions on licenses, business scope and geographic coverage, more and more foreign insurers are gushing into China, stimulating ever fiercer competition. All insurers will operate under the rule of market economy: the *survival of the fittest*. Moreover, China's insurance regulatory and supervisory authority is in the process of transferring from its rigid regulatory style, cultivated in the era of the *planned economy*, to a more pro-competition, transparent, risk-based, and prudential-focussed style. Competition is expected to be pronounced in the new legal environment. How to protect the interests of policyholders, especially non-professional policyholders of insurers eliminated by the mechanism of market economy is an important issue facing the authority. China should set up PPF as important part of market exit systems.

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[130] For example, Germany grants policyholders a secured claim on the assets of the failed insurance company corresponding to the technical provisions over against any claims lodged against the insurance company. Accordingly, Germany has a PPF that only covers motor liability.

[131] The *2002 Insurance Law*, Art. 88.

[132] *Id.* Art. 90.

[133] *Id.* Art. 89.

4.7 Concluding remarks

China is upgrading its prudential regulation and supervision. This mission should follow a clear strategy that keeps track of the trends in the world and draws lessons therefrom in the light of China's realities. China needs to adopt a risk-dealing, comprehensive, synergetic, joint, and dynamic approach to its upgrading effort. In accordance with the discussions in the preceding sections, some suggestions and recommendations are presented as follows:

a. Strategies of improving solvency situation

In the last two decades, the Chinese insurance market has achieved more than most foreign markets ever have. It is likely that the market will keep its momentum of rapid growth in the near future, given the new impetus provided by widespread domestic structural reforms and China's accession to the WTO. However, inadequate capital obstructs the further development.[134] Effective solutions could include allowing more new market entrants and improving the existing insurers' solvency situation through shareholding and listing to attract foreign and private capital. However, realistically, in the short-term and medium-term it can hardly expect that the authority will allow major state-owned insurers to substantially transfer their shares to foreign competitors, or in domestic stock markets. This is due to concerns about protecting the national industry and the volatility of the stock markets. Moreover, healthy operating performance is vital, otherwise insurers will incur new capital shortages. Therefore, the most appropriate solution to the solvency problems for local insurers is to improve their efficiency by adopting comprehensive measures to tackle every aspect of their deficiencies, with focuses on improving internal risk management systems and corporate governance. On the role of insurance regulation and supervision, the authority needs to create an appropriate legal environment for guiding and facilitating insurers' efforts. To this end, a joint approach to prudential regulation and supervision, that relies more on insurers' internal controls and corporate governance and the insurance industry's self-regulation, is worth encouraging. This approach should be accompanied by the supervisor's monitoring.

[134] It has been predicted that the Chinese insurance market will grow at a 30-50% annual rate to 2005, and needs extra capital of Rmb100bn. See supra note 49.

b. Upgrading solvency margin, assets, provisions, reinsurance and reporting systems

With the adoption of a more modern model, that is, *inter alia*, largely harmonised with the EU solvency criteria, the Chinese prudential regulation has been improved. However, according to a study of the *Solvency II project*, there are some shortcomings in the EU solvency model, leaving it not to meeting all the necessary criteria prescribed in the IAIS "Principles on capital adequacy and solvency".[135] Like the EU model, China's solvency margin system does not adequately reflect the full range of insurers' risks. China needs to trace the trend of insurance solvency reform in the EU, carry out researches on the possibility of adopting RBC system, and appropriately adapt its system to changes.

With the gradually easing of restrictions on investment, China should consider to replace the direct control of investment channels with widely applied asset regulatory measures, *e.g.* a detailed list of admissible/inadmissible assets, diversification and spread, asset-liability match, etc. (see chapter 5 for discussions on main problems of insurers' investment and issues on improving investment regulation)

Regarding the upgrading of the current provision system, it suggests that China need to take the following measures. Firstly, *notified claim reserve* needs to be calculated case by case. Both IBNR and IBNER should use "best estimate basis" which use appropriate statistical methods to determine the provisions. Secondly, for *provision for unearned premiums*, China needs to make provisions for the use of analytical methods based on risk profile, so as to allocate premiums appropriately over a period of risk for those classes of business that are not suitable for time apportionment. Thirdly, *equalisation provision* needs to differentiate insurers with various risk profiles. It suggests that different rates be adopted, which are based on an insurer' solvency situation indicated by the *early warning system*. In addition, special kinds of *equalisation provision* need to be set up for those business lines with volatile risks, such as catastrophe insurance and credit insurance.

[135] According to the 2002 KPMG Solvency Study, the existing solvency rules are based on simple fixed ratios which provide for safety margins that do not adequately reflect the full range of risks to which insurers are exposed. A number of implicit capital requirements are imposed through the prudent valuation of assets and liabilities which make it difficult to assess the true financial position and compare the financial strength of companies located in different Member States. There are also inefficiencies in the setting of technical provisions, with high degree of subjectivity involved.

One particular challenge is to build up actuarial capacity within both the CIRC and insurers, and develop essential actuarial standards for the insurance industry. The supervisory personnel need to work closely with actuaries and auditors, as joint participants in prudential oversight of the industry.

As defined by the IAIS in the "Insurance Core Principles", the insurance supervisor must be able to review reinsurance arrangements to assess the degree of reliance placed on these arrangements and to determine the appropriateness of such reliance. From the point of strengthening indirect regulation of reinsurers' solvency (which is closely linked to insurance prudential regulation), a number of issues need to be addressed. For example, firstly, like the EU rules, insurers should be given credits for their reinsurance on solvency margins. To ensure the quality of the credits, certain supervisory requirements are needed. For example, a ceding insurer must hold a collateral contracts to secure its reinsurer's obligations on the reinsurance or constitute a trust fund if reinsurance is not ceded to a reinsurer licensed in the home country of the insurer. Secondly, as proposed by the IAIS,[136] insurers' solvency margin requirements should take into account the relative riskiness and diversity of reinsurance, in deciding whether, and to what extent, reinsurers' assets should be allowed to count towards an insurer's statutory solvency requirement. Thirdly, to reduce the reinsurer default risk, it is essential to ensure diversification of reinsurance through limitations on the amount of credits that can be taken for reinsurance with any one reinsurer. In addition, the CIRC may restrict insurers from use of "unapproved reinsurers." Fourthly, to prevent insurers from overdue exposures to reinsurance, the CIRC needs to impose limitations on maximum exposures or issue guidance on what are appropriate maximum exposures. It is also important to improve the direct review of reinsurance arrangements. At present, the CIRC only issued standards for compulsory reinsurance cession arrangements. With the coming termination of the compulsory reinsurance cession, insurers should be encouraged to cede their risks to commercial reinsurance. To this end, the new standards for commercial reinsurance arrangements and relevant regulatory verification need to be formulated.

The forthcoming *Accounting Standards for Insurance Undertakings* prepared by the IASB, which will greatly influence insurance accounting practice, including valuation of assets and liabilities, need China's special attention for upgrading its reporting system.

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[136] "Principle 11" in "Principles on Capital Adequacy and Solvency" IAIS, 2002.

c. Improving the existing early warning system

In the light of the analyses in section 4.5, it suggests that China need a risk-based approach to improving the existing early warning system by emphasising risk management within insurers.

China needs to incorporate a variety of non-statistical measures (qualitative assessments) into the existing early warning system. The qualitative assessments should include analyses of an insurer's business strategies, with an aim at evaluating its competitive strengths and/or weaknesses. On the strategic front, firstly, the regulator needs to examine the strategic positioning and focuses of the insurer, how the insurer intends to reach its goals, how it measures its achievements, and whether its plans make sense in the light of industry dynamics and the management team's capabilities. Secondly, the quality and credibility of an insurer's senior management team is an important determinant of how successful that the insurer will be in going forward. Regulators need to look into the management's operational skills, *i.e.* their ability successfully to execute their chosen strategies, their internal control systems, how the insurer organises its planning process, and how the process is related to managing and measuring its performance. Thirdly, regulators also need to look into the management's risk tolerance, *e.g.* how various types of balance sheet risk (from investment and underwriting operations, and from choosing a particular capital structure) are measured, controlled, and balanced. This would include a detailed understanding of the management's risk tolerance and guidelines for maintaining levels of solvency or solvency ratios.

Other upgrading measures include increasing the number of ratios and replacing insignificant ratios with material ones, rectifying the meaningless elements of some ratios, modifying acceptable ranges for some ratios to ensure more close to insurers' actual risks, and increasing the frequency of regulatory returns. Regarding the improvement of ratio selection, China should add some ratios correlating to an insurer's solvency, especially those reflecting dynamic changes of the solvency, to the current ratio list. This helps increase the comprehensiveness of the early warning system. For example, it is reasonable to accept ratios on reinsurance and on technical provisions. Both *return on revenue* and *return on assets* are important indicators in an analysis of an insurer' overall performance. Regarding investment, asset diversification (by asset class, sector, maturity, issuer), portfolio liquidity, and asset valuation ("hidden" asset

values: market values versus book values) are important indicators for measuring the quality and diversification of investment. The growth rate of premium needs to be analysed generally over a five-year period, and ideally, in total and by line of business. Regarding the timeliness of information, besides annual regulatory returns, regulatory returns relating to solvency could be submitted on a half a year basis in both electronic and paper forms.

d. Some issues for establishing a policyholder protection fund in China

China should establish PPF according to its realities and by drawing lessons from the experience of foreign countries. The system should be designed carefully to minimise known drawbacks, particularly the moral hazard and adverse selection, and to provide member insurers with incentives for sound management.

PPF should be closely co-ordinated with financial regulation and governmental intervention to protect better policyholders' interests. It widely recognises that timely and appropriate intervention in the troubled insurers is a more effective and efficient way to safeguard the interests of policyholders. This is the reason that some jurisdictions allow PPF to be used to support governmental intervention. When drafting the *Insurance Law*, the legislators clearly recognised that it might better protect the policyholders of life insurers by keeping continuation of contracts. Therefore, the law stipulates the voluntary or compulsory transfer of insolvent insurers' valid contracts and reserves to sound insurers. However, the law does not make clear how to compensate the "take-over" insurers when they receive insufficient reserves. It is desirable for China to remedy this defect by making PPF available for alleviating "take-over" insurers' undue burdens. The funds may also be available for other kinds of governmental interventions such as financing the reconstructing of troubled insurers.

On the compensation, two key issues need to be addressed. Firstly, the system should be designed to share failure costs between policyholders and insurers to restrict moral hazard and encourage consumers to avoid high-risk insurers. The safety incentives could be improved by making policyholders share a great portion of insolvency costs, because this might force them to take insurers' financial risk into greater account when deciding on the right insurance purchase. This, in turn, may improve insurers' incentives with respect to risk taking. However, such measures should be carefully balanced with the sustainability of Chinese consumers. Secondly, it is advisable to set a

maximum level and reasonable standards of compensation to avoid imposing an excessive levy on member insurers for unrealistic compensation.

PPF should be designed to protect those who are least able to protect themselves. Therefore, it is advisable to concentrate compensation on policyholders of natural persons, non-professional policyholders, and small businesses. Further, the funds protection might be greater for individual insurance consumers and less for commercial buyers who are expected to be better able to protect their own interests than individuals.

In consideration of the financial difficulties facing insurers in China, it is advisable to use combination pre-funding and post-funding method[137] for levying contributions so as to avoid funds abuse and minimise impairment of insurers' solidity. The system should have principles to guide the funds operation managed by insurers. Contributions should be levied on a strict basis of matching the funds to compensation and other necessary operation costs.

China should consider risk-based pricing of PPF to enhance incentives for insurers to control risk. Actuarial pricing of insurers' insolvency risks will be imperfect, but it is likely to be better than pricing of PPF that is not based on risk. If insurers had to pay higher guaranty funds premiums because of high-risk strategies, they would reflect this additional cost in the price or benefits of their products. Consumers would have to evaluate whether the PPF surcharge included in an insurer's price was justified by the economic value they derived from the insurer's products. This would effectively internalise the cost of risk to its beneficiaries and eliminate the externalisation of this cost to policyholders of low-risk insurers and the public through flat-rate pricing of guaranty fund coverage. The risk-based pricing could use results of the CIRC *early warning system.*

To demonstrate state support for PPF, China should grant the funds with tax deductions and other effective measures, for example, government loans and government guarantees. It is advisable to treat contributions as expenses thus eligible for tax deductibility of corporate taxes.

[137] The PPF in Norway uses this method. The member companies are required to set aside a contribution each year (named as "*provision for the guarantee arrangement*") under statutory criteria until the accumulated sum reaches a prescribed level. The individual companies retain and manage the contribution before the board of funds is called for payment. The board may levy to make up the deficiency.

The system could establish an independent organisation responsible for running the funds, set out well-structured corporate governance framework for the organisation, and make clear the relationship between the CIRC and the organisation to avoid unnecessary interference from the regulator.

Chapter 5
Issues on insurance investment regulation in China

5.1 Introduction

The Chinese insurance industry has made great progress during the last two decades. However, it has been suffering from severe investment deficiency in terms of volume of and return on investment, which threatens insurers' solvency and their further development. The problem can be traced back to a number of causes, including strict restrictions on insurers' investment channels long imposed by the government, various immature markets, and unsophisticated insurers' investment skills. How to loosen government restrictions and create an appropriate legal environment for rational insurance investment are the issues to be addressed urgently on improving China's insurance regulation. The main purpose of this chapter is to discuss and answer the issues by looking at the realities of China and referring to experiences and lessons from developed countries. These experiences are drawn mainly from three documents published by OECD, namely, "Selected Principles for the Regulation of Investments by Insurance Companies and Pension Funds"(2000), "Insurance Regulation in OECD Countries, Asian Economies and CEEC and NIS Countries"(2001), and "Comparative Tables on Insurance Regulation and Supervision in OECD Countries (Paratte Report 2001)".[1]

The chapter starts with a brief review of roles of insurers' investment, investment risks and the related regulatory issues. It then provides an overview of the regulatory framework governing insurers' investment in China, together with a brief overview of the development of insurers' investment. It goes on to discuss the main problems in the investment to demonstrate the urgent need for relaxing restrictions on the investment and improving investment regulation. The interaction between insurance funds and capital markets is an important issue on further broadening investment vehicles in China. This study highlights that a sound interaction between the two sectors can hardly archive in the absence of insurers' efficient investment management and supportive infrastructure and effective regulation in the both sectors. It then discusses a set of issues related to creating a legal environment for insurers' effective portfolio

[1] These documents are available at <http://www.oecd.org>, visited on October 20, 2001.

management and risk control and at the same time safeguarding the soundness of the Chinese insurance sector. The chapter concludes by presenting some recommendations.

5.2 The roles of insurers' investment and related regulation

Investment is an integral part of insurance business, and its functions and critical importance to both insurers and the economy in general cannot be neglected for a number of reasons. Firstly, investment is an essential aspect of insurance business. Insurers can be seen from one respective as "liability-driven financial intermediaries".[2] They borrow money (premiums) by issuing insurance policies and pay the lenders (policyholders) sums of money (claims) if pre-specified events occur. Like banks, insurers have to invest their funds that are made up with premium income and the capital funds, otherwise they could not realise the increment of the funds and avoid the possible devaluation of the funds due to inflation. Secondly, the role of investment is being strengthened with the growing trend towards higher investment component in insurance products than ever before.[3] This is especially the case with the benefits of investment-linked insurance products depending directly on the investment performance of insurers. Furthermore, with the convergence of different financial services, the distinction between some financial products is blurring. Consequently, insurers, by their superior investment performance, have to compete effectively with other savings instruments such as bank deposits, government bonds, unit trusts and mutual funds. Thirdly, investment earnings are essential for determining insurers' profitability; good profitability enables insurers to give better returns to their policyholders and shareholders.[4] Fourthly, favourable investment returns enable insurers not only to make up underwriting losses but also to be competitive in pricing

[2] For the importance of insurance investment, see generally "The economics of insurance", Swiss Re. 2001, p7.

[3] See Chapter 9, "Life insurance" in "Institutional investment in the United Kingdom: a review" The Myners Report 2001.

[4] For example, according to the analyses by Swiss Re. *Sigma*, 5/2001, net investment results are the critical factor for the profit margins in seven major non-life markets including the US and the UK (See Table 1 Profitability decomposition of major non-life markets). The seven markets had "net investment results" ranged from 12.4% ~ 24.6% of net premiums whereas "underwriting result" ranged from -14.1% ~ 3.3% of the net premiums. All the seven markets had positive profit margins mainly determined by favourable investment results.

products,[5] thereby improving their competitiveness and position in markets. Fifthly, besides the price competitiveness and profitability improvement, good investment performance enables insurers to generate more net assets over the liabilities of reserves. With adequate net assets, insurers will be able to level out the fluctuation in investment earnings caused by cyclical business movements and take advantage of investment opportunities, thus achieving higher investment returns. Sixthly, as major institutional investors, insurers' investment activities have important macroeconomic consequences. Insurers not only play important roles in financial markets,[6] but also facilitate economic prosperity through the optimal allocation of insurance funds among sectors of the economy.[7] By observing the experience in OECD countries, we can see that a country with a developed and efficient insurance market normally enjoys active investment by insurers and great contributions of the investment to both insurers themselves and economic prosperity of the country.[8]

Insurers run certain risks when they invest funds. Generally, the more the yields are likely to be, the more risks insurers are likely to take. Many studies have described in

[5] See J.D. Cummins & F. Grace (1994) 'Tax management and investment strategies of property/liability insurers' in *Journal of Banking and Finance*, vol. 18, No.1, p. 43–72.

[6] For example, by 2001, the UK insurance industry had about £1,147bn invested in company shares and other assets in the UK and elsewhere. The majority of its investments were in shares, amounting to over a fifth of all UK companies' equities.

UK Insurance Industry's Total Insurance Investment Holdings 2001

UK public sector securities (including gilt)	£146bn
Overseas public sector securities	£49bn
UK ordinary stocks and shares	£391bn
Other UK company securities	£112bn
Overseas ordinary stocks and shares	£145bn
Other overseas company securities	£49bn
Unit trusts	£77bn
Property	£61bn
Other investments	£116bn
Total	£1,147bn

Resource: Key Facts 2001 The Association of British Insurers.

[7] Damian Ward and Ralf Zurbruegg (2000) " Does insurance promote economic growth? Evidence from OECD countries" *The Journal of Risk and Insurance*, 2000, Vol.67, No.4, p489-506.

[8] See "Insurance Regulation in OECD Countries, Asian Economies and CEEC and NIS Countries", and "Comparative Tables on Insurance Regulation and Supervision in OECD Countries (Paratte Report)" OECD (2001).

detail the risks including investment risks that insurers are exposed to.[9] However, a consensus on risk classification remains to be reached. Jean-Louis Bellando categorises six types of investment risks, namely, depreciation risk, liquidity risk, interest rate risk, risk of mismatched assets and liabilities, valuation risk and risks arising from transactions involving financial derivatives.[10] Inappropriately dealing with investment risks can lead insurers to losses, and in extreme cases, to insolvency. We can learn lessons from experiences in many developed countries. For instance, as A.M.Best revealed, 39 of 640 insurers that became insolvent in the US during 1969-1998 did so because of overstated assets. This was the fourth most common cause out of a total of ten causes that triggered insurers' insolvency.[11] Alternatively, concentrating on mortgage and real estate investments were the causes of the downfall of the US Mutual Benefit Life. The UK Equitable Life's failure to identify the possibility of a $2.1bn shortfall from guaranteed annuities triggered its three-year long crisis.[12] The series of Japanese life insurers' collapses between 1997 and 2001 just showed how inappropriate investments seriously impaired both individual insurers and even the stability of the financial system of the country.[13]

The role of insurers' investment and the harmfulness of investment failures evince the importance of regulation. The general philosophy that insurers must remain in a sound financial condition to protect the interests of policyholders has led governments to impose restrictions on insurers' investment. The distinct purposes often mentioned for investment regulation are: to protect policyholders by seeking to minimise the chances of insurers' bankruptcy due to investment failures; to strengthen the financial stability of insurers and the economy as a whole; to direct the flow of insurance funds;

[9] For example, the "Muller Report" (the EU 1997) presents a detailed classification of risks for life and non-life insurance companies. Also, the "2002 KPMG Solvency Study" (see Chapter 4) gives its view of risk classification.

[10] Note 22, Chapter 4.

[11] See *A.M.Best* "Insolvency: will historic trends return?"(1999)

[12] See Ian Glick QC and Richard Snowden (2001) "The Equitable Life Assurance Society joint qpinion of Ian Glick QC and Richard Snowden for the Financial Services Authority" FSA, the UK.

[13] It was reported that eight Japanese insurers failed during 1997-2001. In addition to low interest yields and falling equity and property values, significant volumes of non-performance loans and an undue concentration of assets were blamed for the insurers' failures. See Michael Freeman and Masahiko Fujiki "Why some Japanese insurers are failing" *Financial services* Tillinghast-Towers Perrin 2001/3 p6-9.

and to keep insurers' shareholdings in other sectors within fixed limits.[14] The investment regulation that is in place in almost all jurisdictions usually covers portfolio composition and spread (or asset diversification and spread), matching of assets and liability, asset location, currency matching, and liquidity.[15] At international level, the OECD states that "Investment regulation should ensure that both security and profitability requirements are respected. It should promote the diversification, spread and liquidity of investment portfolios as well as the maturity and currency matching of assets and liabilities although some temporary dispensations to the last principle may be necessary. Regulations might include a list of admitted assets on which ceilings may be set and requirements on the way in which investments should be valued."[16] IAIS Insurance Core Principle No 6 provides similar guidelines on this matter.[17] However, over-regulation could impair the efficiency of insurers' investment. This introduces a long-standing issue, *i.e.* how to create an equilibrium between governmental regulatory functions and efficient investments by insurers.

5.3 Overview of insurers' investment in China and its regulatory framework

5.3.1 Stages of insurers' investment development in China

Looking at history, insurers' investment in China has approximately evolved three phases since 1980 when China restored the domestic insurance service:[18]

- First phase (1980-1987) During this period, all insurance funds were required to be deposited with banks, with earned interest turning over to the treasury; therefore there was no real meaning to investment for insurers.

- Second phase (1987-1995) In this period, investment was limited. For example, in 1988, the investment amounted to Rmb580mn, 8.23% of total insurance funds, while

[14] See *Investment Regulation* in "Glossary of insurance policy terms" OEEC, No.1938 (1999)

[15] See G.M. Dickinson and E. Dinenis (1996) "Investment Regulations of Insurance Companies Across the OECD" in *Policy Issues in Insurance Investment, Taxation and solvency* OECD, Gerry Dickinson (2001) "Principles for Investment regulation of Pension Funds and Life Insurance Companies" OECD. Also *supra note* 8.

[16] OECD, Principle No.13 in "Twenty Insurance Guidelines for Insurance Regulation and Supervision in Economies in Transition"

[17] IAIS "Insurance Core Principles Methodology ", October 2000.

[18] See generally, Wang Xujin (2001)" Consummating the insurance investment environment and relaxing the control" *Zhongguo Baoxian* (*China Insurance*) No.5, 2001.

total premiums registered Rmb10.95bn. However, the investment then was often imprudent. Insurers invested in lots of areas, including real estate, securities and trusts, and even lent money like banks, because the economy was growing, and there was no explicit investment rule to follow except caps of investment amounts. This blind investment led to massive non-performance properties.[19]

- Third phase (1995-now) This is a period of gradual standardisation. Since October 1995 when the *Insurance Law* was promulgated, China has passed a series of insurance regulations. In line with fast economic development in the period, the insurance premium income industry-wide has grown swiftly. Because investment channels remained narrow and seven successive interest rate cuts by the central bank caused rate pressures on insurers, the regulators have since 1996 adopted a series of measures gradually to loosen restrictions to counter these problems. Such new investment channels as bonds, securities investment funds (SIFs) appeared one after another, resulting in a fast growth of insurers' investment.

However, insurers are still suffering from severely deficient investment in terms of investment vehicles, and volume of and return on investment, mainly due to strict restrictions on insurers' investment. They are also suffering from immature investment markets and unsophisticated investment skills of themselves. Therefore, it is urgent to relax restrictions on insurers' investment and improve investment regulation for heralding the improvement of investment efficiency.

5.3.2 Regulatory restrictions

The *1995 Insurance Law* and associated regulations imposed strict restrictions on insurers' investment in order to curb disorderly investment by insurers. Art.104 of the law restricted investment by insurers to fixed deposits with banks, the purchase of government or financial bonds, and other forms of investment prescribed by the State Council. These stipulations were replicated in the *1996 Insurance Regulations*.[20] The most obvious reason for these restrictions was the disorder regarding insurance investment at the time the law and regulations were drafted. Investment by insurers began as early as 1984 when the former PICC dominated the market. However, for

[19] It was estimated the total amount of non-performance properties reached hundreds million yuan. See, Li Gang "Analysis of the utilisation of insurance funds in China " <http://www.chinainsurance.com> Visited on October 20, 2000.

[20] See Art.33, the *1996 Insurance Regulations*.

many years before the Insurance law was drafted, the former PICC carried out its investment by the principle of "promoting underwriting through loans to consumers". This led many branches of the former PICC to lending to their clients in the situations of *Four Nos* - no knowledge of investment markets, no feasibility research, no professional investors, and no guarantee for the loans. A large amount of these investments became doubtful or bad debts.[21]

Another reason why investment was restricted was simply to keep money in deposit accounts. These money were parts of resources used by the government to support industries, as it arranged every loan to state enterprises (via "aggregate credit plan") according to the requirements of the planned economy. Oppositely, insurers' investment would reduce the resources. As the role of the state "credit plan" is diminishing along with the economic reform, maintaining the stability of the financial situation is highlighted. For fear that insurers' investment failures will aggravate the financial instability already seen in banking and trusts, the authority still required insurers to deposit most of their cash with banks. However, the strict restrictions set out by the *1995 Insurance Law* under the specific situation then are out of date with the changing environment.

In contrast to above national statute and regulation, the *1992 Shanghai Measures*, considering the requirements of the opening up policy and the international practice, allows insurance companies with foreign investment to invest in the further areas:

- corporate bonds (to a maximum of 10 per cent of their total investment fund);
- loans (to a maximum of 30 percent of their total investment fund);
- shares (to a maximum of 15 per cent of their total investment fund).[22]

China also restricts insurance investment through imposing restrictions on the extent and ways of certain insurance funds that insurers can use. The *1995 Insurance Law* laid down a number of provisions on the placement and management of "insurance funds" that were defined as a combination of an insurance company's monetary capital, security bond, working capital, various reserves, common reserve, provident fund, undistributed surplus, equalisation provision, and other funds stipulated by the State.[23] For example, as prescribed in the *1995 Insurance Law*, each insurance company shall allocate 20 per cent of the total amount of its registered capital to a "security bond" to

[21] *Supra note* 19.

[22] Art.31, *1992 Shanghai Measures*. These provisions demonstrate the differentiation regarding investment regulation between foreign-funded insurers and domestic insurers, which still exists so far.

be deposited in a bank nominated by the Supervisory Authority for the purpose of repaying the debts of the company on a liquidation.[24] Each insurance company also shall allocate 1 % of its premium to an equalisation provision to be deposited in a nominated bank.[25]

5.3.3 Gradually loosening restrictions

Under continuous appeals for lifting investment restrictions in the insurance industry, the government has been steadily liberalising its policies:

- Initially, the PBOC gave insurers permission to enter the inter-bank credit market to engage in bond trade in 1998. This marked a big step forward in opening new investment channels for insurers and unifying the money market, although the authority impose certain trading limitations.[26] While insurers can purchase negotiable instruments in the market, they were ineligible for trades such as purchase-back and loan.
- Then in 1998 the Ministry of Finance, for the first time, distributed Rmb6bn treasury bonds to several insurers. The bonds were 5 years duration with 5.68% annual interest rate, and were prohibited to circulate in the market.
- As limited investment tools and the central bank's consecutive interest rate cuts had brought increasing insolvency risks to domestic insurers, the authority enacted rules allowing the insurers access to bonds. In July 1999, the State Council authorised that insurers could apply to the CIRC for permission to purchase State-level corporate bonds of AA+ rating or above, and trade in these bonds in the Shanghai and Shenzhen Stock Exchanges. Under the new regulations, these insurers can spend no more than 2 per cent of their total assets on bonds, with any one purchase not exceeding 10 per cent of the bonds issued at any given time.[27]

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[23] Art.24, the *1996 Insurance Regulations.*

[24] Art.78, the *1995 Insurance Law.*

[25] Note 81, chapter 4. This provision that has no matching provision in the *1995 Insurance Law* derives from the *1985 Provisional Regulations on the Administration of Insurance Enterprises.*

[26] *China Daily* November 18, 1998.

[27] *China Daily* July 25, 1999. By the end of Sep. 1999, only three kinds of accessible bonds were issued respectively by the Ministry of Railways, China State Power Corporation and China Yangtze Three Gorges Project Development Corporation.

- In October 1999, the CIRC was authorised by the State Council for the first time to allow certain insurers to enter the stock markets indirectly by purchasing security investment funds (SIFs). Insurers can spend up to a ceiling of 5 percent of their assets through the funds. Meanwhile, the CSRC distributed newly issued bonds in certain proportions to insurers who were allowed to trade in these bonds in the secondary markets.
- In 2000, the CIRC allowed insurers to invest more in securities.[28] The CIRC raised the ceiling for insurers' securities investment twice in the year and declared that it would raise the ceiling in future according to insurers' asset quality and structure, risk management ability and operating performances.
- In 2001, the CIRC differentiated between investments from accounts of investment-linked products and those from non-investment-linked products. For instance, it allowed Ping An, New China Life and Manulife-Sinochem Life to invest up to 100% of premium income from their investment-linked products with a requirement of setting up separate investment accounts corresponding to various investment-linked products. On the other hand, strict restrictions still applied to investment relating to accounts for non-investment-linked products. Meanwhile, more insurers were permitted to invest more in securities.[29]

5.3.4 The 2002 revision of Insurance Law: restrictions remain

With the gradual liberalisation of investment restrictions by the authorities, insurers had been allowed to invest directly into the inter-bank market and indirectly in the stock markets via mutual funds. The new law (art.105) correspondingly affirmed these changes. Except for these slight changes, insurers are still not allowed to establish special investment companies which could help invest their large quantities of idle funds. The types of investments other than bank deposits, government bonds and financial bonds must be approved by the State Council. The legislative step is apparently not as big as expectations of domestic insurers who have long called for the removal of stiff investment restrictions.

[28] According to *Zhongguo Zhengquan Bao (China Securities news)* June 5, 2000, China Pacific is the first insurance company approved by the regulators to raise its securities investment to 15 per cent of its assets.

[29] For instance, Ping An, Axa-Minmetals Assurance were given permits to invest up to 15 % of their assets in securities investment funds, compared to the former 10 %. *People's Daily* January 3, 2001.

5.4 Main problems regarding insurers' investment

At present, there is an urgent need to improve insurers' investment scale and investment efficiency, which further requires to relax restrictions on insurers' investment and improving investment regulation. This is demonstrated by a number of problems, mainly including: the rapid growth contradicting with deficient investment, the inefficient investment via SIFs, the interest-driven loss in insurers, and pressures from the fast growth of investment-linked products.

5.4.1 Rapid growth vs. deficient investment

China's insurance sector has been growing rapidly in the recent years, but this trend is tarnished by its inefficiency of investment which erodes insurers' solvency and obstructs its future progress. According to the CIRC, premium income of the sector was predicted to grow roughly 12% a year to total Rmb280bn (US$34bn) by 2005, bringing premiums up from 1.5% of GDP in 2000, to 2.3% in 2005 and 3% in 2010. The actual growth in recent years has been even faster than these predictions (see Section 1.3.1 b. Chapter 1).

Along with the overall development of insurance business and the gradually broadening investment vehicles by the authority, the amounts of investments owned by insurers have steadily increased in the last few years. As shown in Table 5.1, during 1999-2002, both *total investments* and *total investments in percentage of total assets* showed a steady growth in line with the increase of *total assets* every year. Within the category of *other investments, government bonds* had been occupying the first place while *investment via SIFs* had grown fast. However, in terms of the distribution of assets, about 46.6% of total assets were *deposits in bank* by 2002, and *deposits in bank in percentage of total assets* grew every year, while *government bonds in percentage of total assets* decreased annually. These results indicate that the investment channels comparatively shrank as total assets swelled. Meanwhile, *investments via SIFs* kept low, only 4.73% of *total assets* by 2002. In addition, it was reported that the *return on*

investments of China's insurance sector just recorded 3.59%, 4.3% and 3.14% respectively in 2000, 2001, and 2002,[30] showing the lean investment profitability.

Table 5.1 Investments and total assets of China's insurance sector (Jan. 1999- Dec.2002 Rmb bn.)

	Jan.1999	Dec.1999	Dec.2000	Dec.2001	Dec.2002
1. Deposits in banks	69.044	92.597	123.538	193.059	302.626
% of total investments	56.43	50.95	48.66	52.99	54.72
% of total assets		35.55	36.61	42.04	46.6
2. Other investments	53.3	89.141	130.322	171.258	250.406
Government bonds	41.086	67.848	95.595	79.582	110.784
% of total investments	33.58	37.32	37.65	21.84	20.03
Investment via SIFs	0	1.479	13.353	20.899	30.777
% of total investments		0.81	5.25	5.73	5.56
% of total assets		0.56	3.95	4.55	4.73
3. Total investments	122.344	181.738	253.86	364.317	553.032
% of total assets		69.78	75.24	79.34	85.15
4. Total assets	na	260.409	337.389	459.134	649.407

Resource: The CIRC website

By examining the situations in the *four major nationals* (PICC, China Life, Ping An, and CPIC), we can get a keen insight into the features of insurers' *other investment* (note: investments except deposits in banks). As shown in Table 5.2, during 1996-2000 the investments by the four major nationals displayed the following salience. Firstly, *other investments* amounts had grown sharply and successively. It amounted to Rmb97,872.41mn at the end of 2000, an increase by 409.05% over 1996 which was just Rmb19,226.33mn. Secondly, accompanying with the growth of the investment, *investment revenues* had a clear growth. It recorded Rmb5,441.99mn at the end of 2000, increasing by 245.91% over 1996 (Rmb1,573.21mn). Thirdly, *long-term investment* had increased in terms of both amount and percentage. Long-term investment that consists of government bonds and corporate bonds reached Rmb71,594.29mn by 1999 compared with just Rmb1,379.47mn by 1996. The *long-term investment in percentage of other investments* realised a glaring increase from 7.17 % of 1996 to 79.23 % at the end of 1999, which was attributable to the broadening of investment vehicles by the government.

[30] See Hong Wei "Analysis of the forms of insurers' investment" *Jinrong Yu Baoxian (Finance and Insurance)* 2002 No.9, "The insurance fund average income rate is 4.3%" *Shanghai Zhengquan Bao (Shanghai Security News)* February 5, 2002, and Xiaoping Wu "Interaction between the insurance industry and capital markets" *Zhongguo Zhengquan Bao (China Securities News)* February 20, 2003.

Table 5.2 Other investments and relevant figures of the four major nationals 1996-2000 (Rmb mn.)

	1996	1997	1998	1999	2000
Other investments	19,226.33	32,882.66	58,488.16	90,353.68	97,872.41
Long-term investments	1,379.47	20,044.33	42,919.00	71,594.29	na
Revenues from other investments	1,573.21	2,940.04	4,227.21	4,002.62	5,441.99
% of other investments	8.18	8.94	7.22	4.42	5.56
% of total revenues	2.60	3.55	4.32	4.09	5.35
Total revenues	60,375.51	82,746.98	97,781.06	97,822.15	101,541.69

Resource: The CIRC China Insurance Almanac 1998,1999,2000,2001.

However, at least five main problems existed. Firstly, *other investment in percent of total assets* remained low, *e.g.* 32.04% in 2000 (see Chart 5.1), although this ratio rose slightly every year except 2000. By comparison, an average US insurer's ratio was 87.03% in 1998. This suggests that China need to further enlarge and broaden investment channels for insurers. Secondly, the *asset leverage* (volume of other investments in percentage of net premiums) was low either, *e.g.* 69.55% in 1999. By comparison, the *asset leverages* in major markets in the world were above 150% in 1999.[31] This figure also indicates that insurers' investment in China was restrained. Thirdly, *investment revenues* consequently only took up an insignificant portion of total revenues (Table 5.2). It therefore implies that the insurers' profitability heavily relied on underwriting profitability, driving the insurers to cut down loss ratio or overcharge consumers or both. China's motor insurance market particularly evinced the implication.[32] Fourthly, the investment profitability had decreased. This was evidenced by the sharp slump of revenues in percentage of investments in 1999 and 2000 (4.43% and 5.56%). The mismatching between investment growth and investment revenue growth (see Table 5.3) further proved it. As showed in Table 5.4, there existed huge disparities on the China side in comparison of certain ratios regarding investment performance between China's insurers and their foreign counterparts in selected countries. Fifthly, regarding the distribution of the assets of the four major nationals in 2000, cash and bank deposits, which were not expected to make satisfactory profit due to unfavourable interest rate, amounted for 32.04% of total assets. Non-investment assets including receivables, real estate and other fixed assets, deferred capital

[31] Swiss Re. *Sigma,* 5/2001 p15,

[32] See chapter 6 for details.

expenditures, land value, good will and miscellaneous reached 35.92%, occupying a big proportion of total assets. In summary, China's insurers need to greatly enlarge their investment and improve investment profitability.

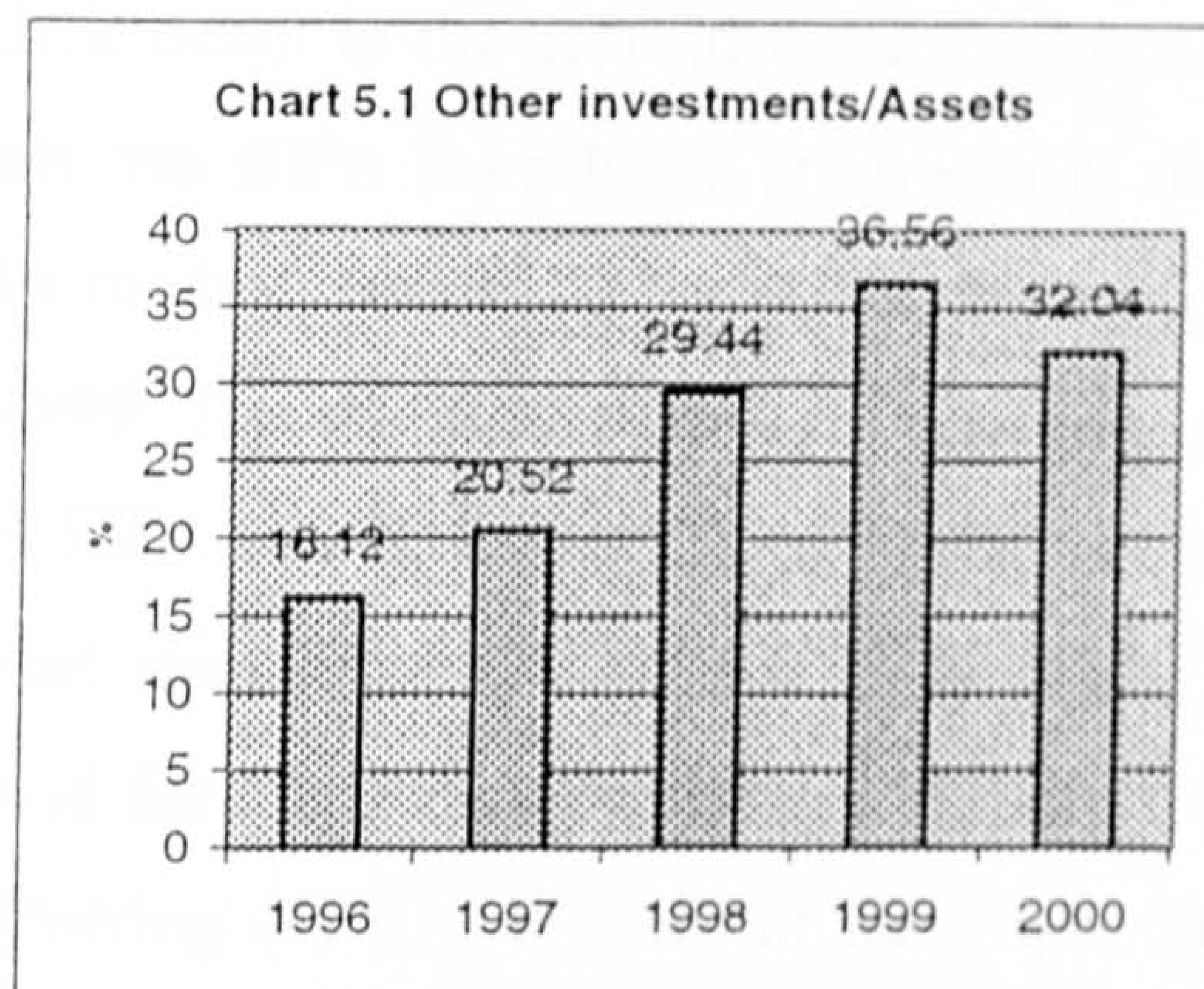

Table 5.3 Comparison between Investment Growth and Investment Revenue Growth

Year	Investment Growth %	Investment Revenue Growth %
2000	409.05	345.91
1999	369.94	254.42
1998	204.20	268.69
1997	171.02	186.88
1996 (Basic year)	100	100

Resource: The CIRC China Insurance Almanac 1998,1999,2000,2001.

Table 5.4 Comparison of selected ratios relating to insurers' investment

Ratios	China's four major nationals	Selected Foreign insurance Industry
Investment in percent of total assets	33.8% (10, 2001)	87.03% (an average US insurer in 1998)[33]
The asset leverage (volume of investment in percentage of net premiums)	86.51% (10, 2001)	150%-280% in US, Canada, UK, Germany, and France (1995-2000)[34]
Investment revenues in percentage of net written premiums	PICC incurred investment loss in 2000 China Life (2.26% in 2000) China Pacific (3.55% in 2000) Ping An (13.34% in 2000)	US (18.8% 1996-2000) Canada (16.5% 1996-2000) UK (24.6% 1996-1999) Germany (15.7% 1995-1999) France (15.4% 1995-1999)[35]

Resource: The CIRC China Insurance Almanac 1998,1999,2000,2001. Own Calculation according to filed financial statements of the four insurers.

5.4.2 Problems in investments via security investment funds (SIFs)

The government allows insurers to invest in securities markets only through SIFs because it wants to minimise their investment risks. From regulatory perspective,

[33] See Swiss Re, *Sigma* No.1, 2000, p5.

[34] See Swiss Re, *Sigma* No.5, 2001, p8.

[35] *Note 22.* All ratios are for non-life insurers.

establishing SIFs is to exploit the advantage of "expert management" thereby providing investors (mainly individuals) with a good investment tool, nurture institutional investors, and promote the stability and development of the securities markets.

Insurers made their debut in the securities markets in October 1999. Since then, the investment amounts via SIFs have been progressing steadily. At the end of 2002, insurers purchased a total of Rmb30.777bn (US$3.67bn) in SIFs, more than 20 times of that at the end of 1999. The purchase was 4.73 % of the insurers' total assets, 23.67 % of the total value of SIFs, and 2.37 % of China's total stock market value. However, the advantage of "expert management" did not fully display because of the immature securities markets and the funds' unsophisticated skills.

Firstly, despite growing quickly, the size of the funds is still too small and therefore is unable to assume a leading force in the securities markets. For example, by the end of 2002, China had 71 funds, including 54 close-end funds and 17 open-end funds.[36] The total fund value stood at Rmb130bn, which was more than 10 per cent of China's two stock bourses' total market capitalisation. In the U.S, the total asset size of mutual funds exceeds US$7tr, accounting for 47% of the total stock market capitalisation.

Secondly, the investment returns of SIFs fluctuated substantially in reflection of the great volatility of the securities markets. For example, during 2001, the Shanghai Fund Index reached a high of 2,245.44 points and explored a low of 1,515.86 points. In the first half of 2001, the index rose by nearly 20% while the stock market indices of Shanghai rose by 5%. However, in the second half of 2001, the index dropped by 16% while the stock market indices dropped by 25%.[37] According to the CIRC, sizeably mirroring the fluctuation of the securities markets, insurers' annual return rates from SIFs differed sharply, 12%, 20% and -21.3% in 2000, 2001, and 2002 respectively.

Thirdly, the mediocre performance and the lack of fund varieties undermined SIFs' acceptance to insurers. For instance, there were about 10% discounts on close-end fund prices in 2000,[38] although the SIFs enjoyed income tax concession and stamp duty exemption, and the transaction fees for closed-end SIFs only represent one-third of those for stock transactions. This made SIFs' expertise doubtful. On the other hand, most existing funds are close-end, which do not like open-end funds that allow investors to withdraw and enter any time they like. Because of the liquidity of assets,

[36] Since *the Tentative Provisions of Securities Investment Fund* took effect in November 1997, the experiment of China SIF has been advancing. See *China Daily* February 26, 2003.

[37] Shanghai Stock Exchange Fact Book 2001.

insurers are reluctant to join in close-end funds. In addition, the numbers of SIFs are only dozens, leaving insurers few options to diverse investment risks. As a result, by 2002, insurers invested only 4.73% of their total assets into the securities markets, much less than 15%, the percentage permitted by the government.

5.4.3 Interest-driven loss in insurers

Operational loss driven by the negative interest margin is one of the major concerns of both the regulator and insurers. China's life insurance sector experienced a peak of business expansion in the mid 1990's, and most life insurers had sold large quantities of savings products which offered a guaranteed return as part of cut-throat competition strategies. During 1996-1999, the PBOC cut basic interest rates seven times.[39] The raid fall in interest rates significantly affected the *assumed interest rates* that life insurers used to calculate premium rates of long term policies. For example, at the end of 1998, the average assumed interest rate was 7.8% (9% for the highest, and 4.5% for the lowest), which was much higher than 3.78%, the official rate. Since fallen rates were below the assumed rates, the consecutive rate reductions created a negative margin between predicted investment returns and actual returns, and left the life sector with very substantial negative spread liabilities. It was reported that the spread in *interest margin losses* alone could have cost the insurance sector as much as US$6.04bn.[40] This potentially threatens the viability of China's insurance industry. Some economists said that the losses could trigger an insurance reimbursement crisis, posing the severest challenge that the industry has to face.[41]

[38] Shanghai Stock Exchange Fact Book 2000, Shenzhen Stock Exchange Fact Book 2000.

[39] **Reductions of basic interest rates by the PBOC**

Date	One year deposit rate
May 11, 1996	9.18%
Aug. 23, 1996	7.47%
Oct. 23, 1997	5.67%
Mar. 25,1998	5.22%
Jul. 1, 1998	4.77%
Dec. 7, 1998	3.78%
Jun. 10, 1999	2.25%

[40] "Insurance industry could face crises of payment" *Zhengquan Shibao (Security Times)* April 16, 2001.

[41] *Supra note 40.*

The *interest margin losses* are not unique to China; similar problem occurred during the 1990's in the UK (*e.g.* the case of the *Equitable Life*) and Japan. Some suggested[42] that the problem in China stemmed from the following factors: unchecked pursuit of premium growth and market share; unwise business incentives to focusing on premium growth, which had been given to most state-owned insurers during 1995-1998. Further factors include managerial deficiencies of all levels for blindly pursuing premium growth; a lack of skilled risk managers; and limited investment vehicles for insurers. Unlike insurers in many other markets, Chinese insurers are limited to very narrow investment channels. This makes it harder for the insurers to escape through funding legacy losses with investment returns. Alternatively, they are engaged in high-margin new generation products to fuel the losses. However, as we discussed above, the sluggish performance of SIFs restrained this effort which was further hardened by an inappropriate switch to participating products as described below.

5.4.4 Pressures from investment-linked products

China's life insurance industry is catching up with its international counterparts with the growing popularity of new-generation products such as *profit-sharing* and *investment-linked policies* including *unit-linked policies* and *participating policies.* In 2002, investment-linked policies made up 54% of total life insurance premium, and 40.23% of the insurance industry's total premium income. With the increasing popularity of investment-linked products, insurers' investment performance has become a crucial factor for their success.

Prior to the new-generation products, life policies in China were of the traditional types, which were priced in line with current interest rates, paying lump sums at the end of their terms. Different from traditional insurance products that render fixed returns to policyholders, new products provide flexible returns according to insurers' investment returns apart from the traditional functions of savings and protection. Profit-sharing policies pay dividends on surplus revenues as well as guaranteed basic returns. *Investment-linked products* strive to secure policyholders better returns by investing a certain amount of the premiums in the equity market rather than relying on interest rate fluctuations. These premiums would be managed by experienced investment

[42] Feng Wan "On creation and alleviation of margin losses in China life insurance sector" *Baoxian Yanjiu (Insurance Studies)* No.6, 2001; Hong Liu *et al* "Margin losses: long-term restriction on the

professionals within/outside insurers, so a much better return would be expected for the policyholders. Policyholders would get annual dividends from the insurers based on their annual performance in the financial market. Among *investment-linked products, unit-linked policies* enable insurers to invest their premiums into SIFs and other channels, and render the investment returns after deducting a commission to policyholders without guarantee. *Participating policies* would provide the lowest return guarantee and allow the policyholders an access to linking their returns with the performance of insurers.

Ping An in the late 1999 launched the first unit-linked policy in China, while the first participating policy was unveiled in 2000 by China Life. Both products were immediately embraced by customers amid the scarcity of investment channels. For example, Ping An witnessed that its premium income from unit-linked policies soared from Rmb1.2bn (US$144.6 million) at the beginning of 2000 to Rmb8bn (US$963.9 million) by November 2001. It secured 900,000 new customers by November 2001, and 40% of its new premiums in 2001 came from unit-linked policies. However, with the sluggish performance of both China's stock market and SIFs in the second half of 2001, investment returns for unit-linked products gradually thinned out from their initial hefty gains. This led the products to stagnancy from the beginning of 2002. Consequently, participating products with minimum guaranteed returns enjoyed a better market. It was estimated that regarding the new product market share in China's life sector during July 2001-June 2002, participating policies, unit-linked products and others occupied 60%, 20% and 20% respectively.[43]

Obviously, with a shift to investment-linked policies where the benefits ultimately paid to policyholders depend directly on insurers' investment performance, investment return has become an increasingly important factor in product pricing and business success. China's insurers need to improve their investment performance, which allows them to design and market competitive products, additionally, thereby helping alleviate their legacy of *interest margin losses*. Beyond this, the insurers also need good investment performance to compete with other financial institutions as the distinction between financial products is increasingly blurring.

Chinese insurance industry" *Zhongguo Jinji Shibao (China Economic Times)* April 23, 2001.

[43] David Campbell (2003) "The insurance market in China" *PowerwaterhouseCoopers* 2003.

5.4.5 Needs for liberalisation and a complete regulatory framework of insurance investment

The safety and effectiveness of insurers' investment are influenced by both internal and external factors. Researches and evidence, on the one hand, link insurers' investment performance to firm-specific characteristics such as legal entities and the organisational structure,[44] financial planning and investment strategies,[45] asset-liability management (ALM) and risk management.[46] On the other hand, they claim that the viability of investment performance is tightly related to exogenous factors such as the overall economic environment,[47] investment market conditions,[48] and related legal environment.[49]

Regarding legal environment, the Chinese insurance industry is suffering from both the strict legal restrictions on insurers' investment activities and the lack of a complete regulatory framework directly governing the activities. As we analysed in the above sections, the current over-restrictive regulation created an investment bottleneck for the industry, obstructed the further innovation of life insurance products, and undermined the insurers' profitability and long-term security. In a word, it severely impeded insurers' ability to generate sufficient returns to sustain the long-term growth. These negative effects are further promoted by the delay on establishing a complete regulatory framework of insurance investment. As a result, the issue of further broadening investment vehicles, advocated by both the regulator and the industry insiders, is becoming urgent.

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[44]See David Camino (2002) "Ownership structure, investment and corporate value of insurance companies: implication for management" Presentation at International Insurance society, Inc. 2002 Annual seminar. Also see Mayers D., Shivdasani, A. and Smith C.W. Jr (1997) "Board composition and corporate control: evidence from the insurance industry" *Journal of Business* 70(1). 33-61.

[45] See Alberto Franceschetti and Ronald P. O'Hanley (1997) "Making the money work: improving investment performance in insurance" *The McMinsey Quarterly* 1997 No.1 116-125.

[46] See "Asset-liability management for insurers" *Sigma* 6/2000, Swiss Re.

[47] Browne Mark J. and Robert E. Hoyt, (1995) "Economic and market predictors of insolvencies in the property-liability insurance industry" *Journal of Risk and Insurance*, 62:309-327.

[48] *Supra note* 4.

[49] "Japanese life insurance industry" Special Comment Moody's Investors Service 2001.

5.5 Broadening investment channels and increasing the institutional investors' role of insurers

5.5.1 The interaction between insurance funds and the capital markets

a. The two contradictory views

Regarding the scope and speed of the broadening of investment channels, there are broadly two opposite views, the conservatism and the radicalism. The conservatism insists that the government should gradually open certain markets for insurers in order to avoid too risky investments made by insurers who seem not to be experienced investors. Its advocates argue that the investment risks facing insurers are still very high, given the immaturity of various markets (especially the highly volatile capital markets), deficient investment management of insurers and the imperfect legal environment.[50] In contrast, radical views claim that insurers should be allowed to invest in such areas as stocks, real estate, corporate bonds, mortgages and policyholder loans subjecting to prescribed quantitative restrictions.[51]

b. The appeal for entering capital markets and the legislative caution

At present, one overwhelming topic around the Chinese insurance sector is that the interaction between insurance funds and capital markets should be strengthened. Industry insiders and experts have been calling for the securities markets to open up wider for insurers to increase investment returns and fend off the mounting payment risks in the industry.[52] They claim that the development of the insurance business needs lucrative investment returns from sound capital markets. On the other hand, the growth of the capital markets counts on the active participation of insurers as major strategic institutional investors.[53]

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[50] See GuoAn Li (2001) "On improving investment efficiency of insurance funds" *Baoxian Yanjiu (Insurance Study)* 2001 No.12.

[51] See HongTao Zhang (2003) "The policy direction of application of insurance funds under the new situation" *Zhongguo Zhengquan Bao (China Securities News)* February 20,2003.

[52] For example, XiaoPing Wu, the vice-chairman of the CIRC called for at the 2003 *Forum on the Development of The Chinese Insurance* a sound interaction between insurance funds and capital markets. See *Zhengquan Shibao (Securities Times)* February 20,2003.

[53] See "Economist calls for co-operation between insurance, securities industries" *China Daily* May 16,2000.

It was reported that proposals tabled before the Standing Committee of the NPC for revising the *1995 Insurance Law* contained significant reforms, including: abolishing restrictions on insurers' investments in securities funds; adopting the practice of many other jurisdictions by allowing insurers to invest in securities companies; and permitting insurers to purchase bonds issued by large state-owned enterprises.[54] None of them, however, had been accepted in the revision. The result reflects the cautious attitude of the legislature towards the liberalisation of insurance investment.

c. Foreign experiences

Experiences from the OECD countries and some Latin American countries demonstrate that large benefits stem from the interactive process between institutional investors and capital markets. Institutional investors have been growing dramatically in the securities markets of most OECD countries over the past two decades.[55] Insurers especially life insurers, pension funds, and mutual funds are the three major institutional investors, playing an important role in the markets.[56] Institutional investors acted as a countervailing force to the dominant position of commercial banks, and competed with other financial institutions, stimulating financial innovation. By increasing the demand for long-term financial assets, institutional investors promoted capital market modernisation. They also played a major role in enhancing market discipline by stimulating transparency and information disclosure, thus strengthening corporate

[54] "China amends Law to further open up insurance industry" *Beijing Shibao (Beijing Time)* June 24, 2002.

[55] For example, total institutional assets of the main regions in the OECD area rose from US$3.2tr. in 1981 (i.e. 38 per cent of GDP), to US$16.3tr in 1991 (90 per cent of GDP), and to more than US$24.3tr in 1995 (106.5 per cent of GDP). See Hans J. Blommestein (1997) "Institutional Investors, Pension Reform and Emerging securities Markets" OECD.

[56] See *Institutional Investors in the New Financial Landscape* OECD (2800) 1998

governance.[57] Hans J. Blommestein highlighted the common factors of the development of institutional investors in the OECD countries. The main factors are ageing populations and pension reforms, technological progress in communications and information processing, and deregulation of the banking and securities industries. Other factors include positive effects of institutionalisation on the development of capital market, the importance of the role of professional fund managers, and the necessity of appropriate regulation on investments by institutional investors.[58] According to Vittsa, the impact of institutional investors on capital markets may not materialise until a "critical" mass of savings has been mobilised. In addition, the impact may also be shaped by the relative importance of bank and stock market finance in the economy.[59]

d. Formal institutional investors are not playing a substantive role in China

Despite a rapid growth in terms of the number of listed companies and the scale of trade after more than a decade of development,[60] China's capital markets still have major shortcomings in many aspects. The share price is very high with profit/earning (P/E) ratio around 40, compared 25 for S&P 500. The markets frequently see drastic fluctuations of share prices together with extremely rapid turnovers, rampant illegal speculations, and various scandals of manipulation and fraud caused by listed companies and intermediaries.[61] Regarding various investment instruments, the

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[57] See Dimitri Vittas (1998) "Institutional investors and securities markets: which comes first?" *Development Research Group The World bank*, also Impavido G., Musalem A.R., and D.Vittas (2002) "Contractual savings, stock and asset markets" *World Bank* Policy Research Paper 2490, and Impavido G., Musalem A.R., and T. Tressel (2002) "Contractual savings institutions and banks' stability and efficiency" *World Bank* Policy Research Paper 2751.

[58] See Hans J. Blommestein (1997) "Institutional investors, pension reform and emerging securities markets" OECD.

[59] D.Vittas (2001) "Pension reform and capital market development: 'feasibility' and 'impact' preconditions" *Development Research Group The World bank*

[60] According to the CSRC, by the end of 2001, there were altogether 1,160 domestic listed companies and 66.5 million investment accounts in China's capital markets. The total market value topped Bmb4,352.2bn (US$525.6bn), accounting for 46% of GDP, surpassing that of South Korea (US$306.3bn) and Singapore (US$192.9bn). See "Challenge and development structure and supervision of China securities markets" The CSRC, 2002 <http://www.csrc.gov.cn>

[61] For example, in April 2001 Boshi Fund Management and a number of other investment funds were penalised by the CSRC with a fine and confiscated illegal incomes totalling Rmb898mn for stock price manipulation. *Renming Ribao (People's Daily)* April 27, 2001.

development is extremely unbalanced, hampering effective portfolio management and risk control.[62]

To tackle the problems, China is set to encourage more institutional investors in coming years. The authorities believe that institutional investors would, with their professional teams, rational investment behaviour and lower investment costs, stabilise the securities market, improve investment portfolios, and help listed firms in their corporate governance.[63] However, the following facts and analyses suggest that increasing institutional investors is crucial but not sufficient to the maturity of the markets. A sound interaction between insurance funds and the capital markets will be unlikely to archive in the absence of insurers' efficient investment management and supportive infrastructure and effective regulation in the both sectors.

In China, formal institutional investors are not playing a substantive role. Firstly, individual investors had a lion's share in the stock markets. According to the CSRC, by the end of 2001, among total 66.5mn investors' accounts, the institutional investors' accounts were about 5-6%, holding 15% of total tradable stocks, and the rest of the accounts belonged to individual investors.[64] Secondly, while formal institutional investment sector is tiny, a huge number of informal funds, known as *Simu Jijin* (privately raised funds) are active in the markets, mainly engaging in speculative trades. Legally, only qualified investment funds are permitted to collect money from investors and make investments. Nevertheless, it was revealed that capitalisation amounts of privately raised funds, despite their illegality, were significant with a total size at around

Rmb700bn, about 40% of total tradable stock shares.[65] Adding Rmb200bn capital managed by formal funds, the institutional investors' total investments neared 50%,

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[62] By 2001, stock dealing accounted for 92% of total amount of trading products (treasure bonds and convertible bonds 2%, funds 4%, corporate bonds 2%. In addition, only small amounts of commodity futures were trading in the commodities market, while the financial futures were not yet introduced). *Supra note* 60.

[63] For instance, in the late 2002, the government opened the A-share market to selected foreign investors and announced that it would allow foreign investors to buy previously non-tradable shares of state-owned enterprises.

[64] *Supra note* 60.

[65] It is estimated that there are at least 7,000 of these funds operating around the country. The funds vary widely in terms of quality, the number of clients and capitalisation; some act as excellent fund managers, while others engage in illegal transactions including price manipulation by taking the advantage of insider information. Many funds manage the money of 5 to 50 clients, both individuals and firms

similar to that in the US (51.8% of total stock shares). This phenomenon appears contradictory to many analysts' suggestions that the dominant individual investors who usually adopt quick profit-trading strategies cause the volatility of China's stock markets.[66] Thirdly, because about 65% of the total shares are categorised as so called either *state shares* or *legal person shares* which both are non-tradable,[67] formal institutional investors can hold only limited sway. This hardly enables them to influence the management of the invested companies, thus providing them with few incentives to hold long-term stakes. In addition, the overall performances of listed companies which

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(including many state-owned enterprises), and invests mostly in shares. Most of the funds offer returns of above 10 percent, and some up to 50 percent, well above the one-year bank deposit rate of 2.25 percent. See Stephen Green (2001) "The truth about China's stock market" CFO Asia October 26,2001

[66] For example, see "Summary record of the meeting" International round table on securities markets in China Beijing, 24-25 October 2000, Co-organised by the OECD and the CSRC.

[67] **Share structure in China's securities markets on December 31, 2001**

Total Non-tradable Shares 65.3%
Of which: Sponsor's Shares 59.8%
State-owned 47.2%
Sponsor Legal Person 12.7%
Of which: Private Placement of Legal Person Shares 4.7%
Of which: Worker Shares 0.5%
Total tradable shares 34.7%
Of which: A-shares 25.3% (issued to domestic investors)
B-shares 3.1% (initially issued to foreign investors, from 1997 opened to local investors)
H-shares 6.4% (Trading on the Hong Kong Stock Exchange (HKSE))
Source: The CSRC website

are mostly SOEs (95% of the total by 2000) are discouraging[68] and company reports are not very trustworthy due to low disclosure standards and limited transparency.[69] These lead the institutional investors to having the same speculative incentives as other investors. What is worse, some institutional investors used their superior capital and inside information to manipulate share prices.[70]

Manifold factors constrain China from bringing the role of institutional investors into full play. China's financial sector is still a bank-dominated system, with new credit over Rmb600bn annually. The Government essentially remains its view of the capital markets as the vehicle for resource mobilisation rather than for raising the effectiveness of capital allocation. Through its framework of the *aggregate credit plan* and *state investment plans*, the government assigns quotas for primary issues of bonds and equities, resulting in a limited supply of bonds and equities and unequal investment opportunities among investors. These governmental interference, together with the domination of SOEs in the stock markets and the state holding of the majority of shares which are non-tradable, distort share prices. All these factors root rampant speculative investment and price manipulations that are further promoted by a number of regulatory and supervisory problems.[71]

[68] Wang, Xu and Zhu performed a statistical analysis of listed SOEs from 1990 to 2000. They found that the financial performance of SOEs had deteriorated steadily the year immediately before *initial public offering* (IPO). **Selected mean performance statistics of listed SOEs (%)**

	Year -1	**Year 0 (IPO)**	**Year 1**	**Year 2**	**Year 6**
Return on assets	19.6	15.4	9.7	7.4	2.7
Return on sales	16.6	16.2	13.7	7.8	0.2
Capital expenditures/assets	74.3	57.7	43.1	28.2	3.8
Annual slaes growth	28.7	47.8	22.2	10.5	16.5

Source: Wang, Xue and Zhu (2001), World Bank

[69] The most notorious case concerned a listed biochemical company, Guangxia, which falsified profits for several years to present itself as a fast-growing entity with sophisticated technologies. The company reported a net profit of Rmb417mn, but according to CSRC investigators, had actually lost Rmb150mn in 2000. Shenzhen Stock Exchange Fact Book 2001.

[70] *Supra note* 61.

[71] For example, China lacks rules and regulations to protect the benefits of small and medium sized investors. The markets still need to improve the situation related to information disclosure and corporate governance. The means to supervise is in serious shortage since CSRC is not entitled to necessary legal inquiry into illegalities, etc. For details, see *supra note* 60.

In addition, with considerably limited investment activities in the past decade, the insurance industry lacks experienced and skilled personnel on investment although some insurers are clearly capable of learning and absorbing sophisticated tools for managing investment risks. Given the volatility of the capital markets and the fact that many insurers simply lack any experience of direct investments in the markets, it fears that a too rapid liberalisation of investment policy could, without proper and adequate regulatory control, compromise the stability and financial health of the insurance industry.

The above analyses highlight that China needs to allow deficit-stricken insurance funds directly to enter the capital markets that would bring more opportunities of gains for the funds and nurture the growth of institutional investors. Meanwhile, it is essential to create the necessary regulatory framework for this development. Importantly, to control risks, the liberalisation should be accompanied by prescribed maximum level of securities investment. The quantitative restrictions should be gradually relaxed consistent with the increasing maturity of the capital markets and insurers' investment management.

5.5.2 Broadening investment channels

The author believes that the strategy for opening up capital markets to insurers should be applied to other markets. In other words, China needs greatly to broaden investment channels while applying quantitative restrictions to control investment risks. The narrowness of investment channels can lead to inefficient investment and hamper adequate investment diversification thus unnecessarily increasing risks. Investment theories and experience from overseas insurance markets suggest that the broadness of investment is compatible with portfolio management techniques, facilitating both diversification and mitigation of investment risks, and the optimising of investment return. According to a survey by the IAIS, many jurisdictions allow insurers a diversified asset allocation although restrictions on the range of assets used to cover

technical provisions or solvency margin vary.[72] Given the sound macroeconomic environment, insurers' needs for effective portfolio management, and the effectiveness of quantitative restrictions regarding investment risk control, it believes that there is no need to exclude continually the Chinese insurers from major markets such as stock market (shares, bonds that are listed on the stock exchanges), corporate bonds, mortgages, bank term deposits, real estate, government bonds, policyholder loans, and infrastructure. Of course, certain much risky categories of investments may be prohibited, *e.g.* loans without appropriate guarantee, unquoted shares, and derivatives.

Regarding how to impose maximum levels on categories of admissible assets, China's regulator has to take into account constraints and risks of various markets. For example, many state-owned enterprises are in serious financial difficulties. If insurers are allowed to allocate their assets heavily on the bonds issued by state-owned enterprises, it could jeopardise the financial condition of the insurers. The similar situation can be seen in other markets, for example, mortgages, real estate, and so on. Therefore, a desirable strategy is applying tight maximum limits on a newly opened market and then gradually loosening the limits in consistency with the maturity of the market. To restrict the default and liquidity risks of investments and ensure that portfolios are sufficiently dispersed, China also needs to impose maximum limits on a given asset in a category of assets.

5.6 Some issues on improving China insurance investment regulation and supervision

The purpose of this part is to discuss how the investment issues can be dealt with in the restructuring of China's insurance investment regulation and supervision. The

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	Assets used to cover technical provisions(range)	Assets used to cover solvency margin (range)
Corporate bonds	3%-100%	10%-100%
Government bonds	1%-100%	10%-100%
Shares	5-100%	7.5%-100%
Mortgages	2.5%-100%	5%-100%
Real estate	1%-100%	5%-100%
Loans	2%-100%	1%-100%
Cash	0.2%-100%	2%-100%
Derivatives	3%-100%	5%-100%
Unit trusts	5%-100%	7.5%-100%
Advances against policies	5%-100%	5%-100%

Resource: "Report on insurance supervisory legislation and practice" IAIS 1999.

OECD elaborates "Selected Principles for the Regulation of Investments by Insurance Companies and Pension Funds" (hereinafter "Selected Principles") for investment rule restructuring in both member and non-member states. The following examine and discuss most of the principles from the Chinese viewpoints and point out a number of critical issues that China should address in order to build a sound regulatory framework for insurers' investment.

5.6.1 The prior objective of investment regulation: properly balancing safety and profitability

Rules and guidelines usually require that insurers' investment be safe and profitable among other objectives.[73] For instance, the OECD "Selected Principles" suggests: the objectives of regulation of investments "must simultaneously pursue the twin goals of the security and profitability of the funds invested; *i.e.* they must guarantee commitment but generate financial income as well." However, these objectives are not always simultaneously achievable, as they are probably not inherently consistent with one another. For instance, safety and profitability can be contradictory *per se* in the view of economists.[74] For this reason, a delicate and practical requirement is to seek an optimal balance of these objectives under specific conditions in a certain period. Experiences and lessons from many countries elucidate the importance of this requirement. On the one hand, inadequate or too relaxed regulation may fail to prevent insurers from taking too risky portfolios to maximise returns. In the UK, life insurers has long enjoyed relaxed "prudent person rules" rather than strict quantitative restrictions on their asset distribution. However, as the UK equity market has been plummeting since 2000, they had the bitter experience of investing heavily in equity for

[73] Namely, diversification, spread, asset/liability matching, liquidity, marketability, currency matching, and localisation, etc. For example, the *Wisconsin Insurance Code* (s.620.01(1)) states sound investment as following: safety of principal and to the extent consistent therewith, maximum yield and growth; stability of value; sufficient liquidity; reasonable diversification; reasonable relationship between liabilities and assets as to term and nature. Also see *EEC Third Non-life Directive* (art.20). China *Insurance Law* (2002 art.105) stresses: insurance companies must employ funds in a stable and safe manner, and ensure the preservation and appreciation of asset value.

[74] According to investment theories, generally, the more the yields are likely to be, the more risks insurers are likely to take.

higher yield, which severely impaired the whole industry's solvency.[75] On the other hand, as we discussed in section 5.4.5, unnecessary or excessive regulation suppresses insurance development.

Of course, the objective of insurers' investment should first be safety. China should stick to the priori of safety when designing investment regulation system. However, in the past, China's authorities unduly stressed the priori of safety, and consequently neglected the issue of profitability, resulting in the insurance industry suffering from very limited investment opportunities and investment deficiency. As China's insurance market is becoming increasingly competitive and the annual growth rate is keeping above 30% in 2001 and 2002, together with the pressures from low interest rates, insurers are desperate for effective investment to support their survival and development. On the other hand, China's insurance industry is facing many challenges both internal and external to individual insurers. For example, insurers lack investment professionalism, and most importantly, their corporate governance need to be strengthened. Various markets are immature and especially capital markets are highly volatile. Given these realities, China should adopt a rather strict and detailed investment regulation to protect policyholders against the investment risks facing insurers.

A strict regulation approach does not necessarily mean that China should continue its existing stiff investment policies. Rather, considering that China's overall economic environment is predicted encouraging in short and medium terms, China needs to take this advantage, greatly impelling the momentum of the insurance industry development and the role of insurers' investment on promoting the whole economic growth. The effectiveness of insurers' investment should not be judged only by individual insurers' profitability. From a macro perspective, the effectiveness should also contribute to the stability of financial system and the economic development. This means the authority should provide insurers with greater opportunities by broadening investment channels, encouraging diversification of asset portfolios together with certain measures including quantitative restrictions on asset portfolios to control risks.

Furthermore, in order to adapt to the pace of change in the economic and financial environment and the liberalisation of the insurance sector, China should gradually adopt more flexible investment regulation in the future to allow insurers greater room for manoeuvre in the choice of their investment. This should be done under a close

[75] "UK Life Insurance Industry" *Special Comment Moody's Investors Service* December 2002.

monitor of risks generated by possible reverse changes in the overall economic environment, which could mean a shift to rather strict investment regulation.

5.6.2 Properly dealing with interrelation between investment and underwriting

To secure investment performance, it necessarily requires safeguarding underwriting business, as these two businesses interrelate closely within an insurer. A research by *Swiss Re.* examined the key factors and latest trends determining profitability in the major non-life insurance markets.[76] It finds that the price (or underwriting cycle) and investment performance are the two most important factors shaping profitability. Over history, underwriting and investment have been negatively correlated, as strong investment results increase capital funds, softening prices. The research also suggests that underwriting results be improved as the outlook for equity market is less certain and more volatile. One implication of the research is that insurers might not have to entail excessive investment risks if they accentuate a positive result of underwriting.

Chinese insurers used to operate with underwriting as their dominant business and investment business as a support. Under this scenario, insurers realised profits mainly through keeping positive underwriting results. Against a background of increasingly competitive underwriting conditions, pressures from volatile interest rates, and competition from other financial institutions, insurers stepped up to pursue more aggressive investment policies. Consequently, asset leverage and investment yield are becoming increasingly determinative in insurers' profitability composition. However, given limitations on investment and the interrelation between investment and underwriting, the regulator and insurers need to properly balance the interrelation mainly through sufficient product pricing. Otherwise, rapid growth risk may drive insurers thirsty for investment, thus worsening the existing contradiction between high growth and investment deficiency.

5.6.3 "Prudent person rules" or quantitative restrictions

One issue related to balancing safety and profitability is whether China should adopt a "prudent person" approach to investment regulation. Generally, there are two different approaches to insurers' (and pension funds) investment portfolio regulation: *prudent*

[76] *Sigma* No. 5/2001

person /man rules (or *qualitative rules*), and *quantitative restrictions.*[77] The former, a kind of "soft control", can be generally defined as: an investment standard by which "the trustee may invest in a security if it is one which a prudent man of discretion and intelligence, who is seeking a reasonable income and preservation of capital, would buy."[78] In a broad outline, the approach entrusts insurers with discretion in their investment decision-making and focuses on the investment behaviour of insurers, although the details of the *prudent person rules* vary in expression from one country, sector or company to another.[79] The latter, in contrast, is an approach of setting quantitative limits on the investment portfolios of insurers.

Quantitative restrictions approach is believed to have the main disadvantage of inflexibility that hardly allows insurers to change rapidly in response to changing economic circumstances. Therefore, it makes insurers difficult or impossible to manage their investment portfolios efficiently.[80] Assumedly having the flexibility of protecting policyholders with minimum interference in insurers' investment[81], *prudent person rules* approach is enjoying an increasingly acceptance. Gerry Dickinson observed that "there has in recent years been some change in the investment regulations of life insurance companies away from detailed quantitative restrictions on asset choice towards more general guidelines, commonly referred to as *prudent-man rules.*"[82] The OECD "Selected Principles" also suggests that to reduce the number of quantitative regulations, the authorities could incorporate prudent-person principles into investment regulations when they deem adequate.

China should be cautious when considering the introduction of *prudent person rules*. Several reasons are behind this. Firstly, in the EU, what elements that should be included in a *prudent person rules* system is still in discussions.[83] The current EU investment rules in insurance are said to be a "prudent person rules" approach together

[77] See Viviane Leflaive (2001) "The Supervision of insurance solvency: comparative analysis in OECD countries" OECD p20.

[78] See "prudent man rules" *Black's Law Dictionary* (5th ed.) West Publishing Co. (1979)

[79] "Selected Principles" OECD.

[80] See Juan Yermo (2000) "Investment regulation of insurance companies and pension funds" OECD.

[81] For advantages and disadvantages of an investment approach building on the "prudent person rules", see European Commission (2001) Market/2099/01-EN, p7.

[82] See Gerry Dickinson (2001) "Principles for investment regulation of pension funds and life insurance companies" OECD p10.

[83] European Commission (2001) Market/2099/01-EN, p7.

with quantitative specifications.[84] It rests principally on solvency supervision and scrutiny of managerial behaviour, *e.g.* through the monitoring of the corporate governance and internal control procedures set by insurers. The principle of *prudent person rules* laid down in art.20 of the Third Non-life and Life Directives states that "the assets covering the technical provisions shall take account of the type of business carried on by an undertaking in such a way as to secure the safety, yield and marketability of its investments, which the undertaking shall ensure are diversified and adequately spread." Besides this, there are many quantitative restrictions specifically stipulating the allocation of insurers' asset representing technical provisions[85] and insurers' investment portfolios[86]. The "Selected Principles" of OECD also indicates that the modalities of the application of current *prudent person rules* may not be sufficiently precise, and the interpretation thereof may vary substantially.

Secondly, the number of jurisdictions that have applied the approach is still very limited. According to OECD and Gerry Dickinson, only the UK, the US and the Netherlands have incorporated *prudent person rules* into their life insurance investment.[87]

Thirdly, there are rare empirical studies on the comparative effectiveness between the *prudent person rules* and *quantitative restrictions* on insurers' investment. Therefore the judgement, that prudent person rules may have better investment return and asset allocation than *quantitative restrictions* have, could be suggestive rather than conclusive. In addition, E. Philip Davis revealed that regarding the investment efficiency of life insurers, there was rather little difference between *prudent person rules* and *quantitative restrictions* in the average.[88]

Fourthly, as *prudent person rules* is a process-focussing approach, it seems to have the disadvantage that regulators may feel difficult to make sure if insurers' investment

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[84] See "Issues paper on investment regulation", Paper No DAFFE/AS (2000)3, Insurance Committee, OECD

[85] The Third Direct Non-life Insurance Directive, art. 21 and the Third Direct Life Insurance Directive, Art. 21.

[86] The Third Direct Non-life Insurance Directive, art. 22, para.1 and the Third Direct Life Insurance Directive, art. 22, para.1.

[87] See "Issues paper on investment regulation", Paper No DAFFE/AS (2000)3, Insurance Committee, OECD

[88] E.Philip Davis (2001) "Portfolio regulation of life insurance companies and pension funds" OECD, P17-26.

jeopardises its statutory financial health and an intervention is necessary.[89] Therefore, The prerequisites for successful implementation of the approach could include regulatory and supervisory mechanisms that guide and ensure that the corporate governance of insurers is robust to produce appropriate investment decision-makings and sufficient to monitor the portfolio management function.

Since China should adopt a rather strict and detailed investment regulation, it is not desirable to introduce *prudent person rules* hastily. Instead, China needs to trace the tendency of the system for further liberalisation in the future.

5.6.4 Differential regulation for assets covering technical provisions and assets covering capital base

The OECD "Selected Principles" suggests that "investment corresponding to the 'free' component of capital/surplus (assets that represent the capital above the minimum required) need not be regulated, or at least not in the same manner." This is the practice seen in the EU current framework which differentiates investment regulation between two kinds of assets: the assets covering the technical provisions, and the assets covering solvency margin (capital base). For the former, the EU Directives set out a set of rules that contain a list of accepted assets, rules on the spread, valuation, localisation and matching of such assets.[90] Rather, the Directives allow the latter to be invested freely. The justification of this differentiation is that insurers must maintain sufficient and qualified assets to cover all underwriting liabilities. The capital base represents insurers' "own funds" which should not be as constraint as the former in terms of investment. Allowing insurers to allocate the capital base to high yielding investments can reinforce the insurers' solvency although the investments may entail risks.

The author believes that OECD suggestions are recommendable to China. China has long been applying the same strict restrictions on total assets without differentiating technical provisions base and capital base, thus having promoted insurers' stringent solvency. Allowing the investment of capital funds more freedom could enlarge insurers' opportunities of earning a higher return on their investment of capital funds,

[89] See Viviane Leflaive (2001) "The Supervision of Insurance Solvency: Comparative Analysis in OECD Countries" OECD p20, and Table 5: Portfolio regulations for pension funds and life insurance companies.

[90] Supra notes 85,86.

thus strengthening their long-term financial base. In addition, this approach also provides the insurers with incentives to hold sufficient capital.

Considering that stringent statutory requirements are imposed on solvency margins, the regulator should treat the assets covering the solvency margins more stringently than the assets covering other capitals, when adopting the differential regulation. The ground of safeguarding insurers' stringent solvency situation may also justify this approach.[91]

5.6.5 Integrated approach

Suggested in OECD "Selected Principles", as part of measures ensuring insurers' solvency, investment regulation must be integrated into the overall approach towards financial soundness of insurers. As invested assets are attached with risks, many countries use asset amount as the basis for determining solvency margin requirements in order to cover the investment risk. This is the case in the US and Japan for both non-life and life insurance. For example, the US statutory solvency margin is formed by cumulative ratios calculated on the basis of insurers' assets. The different categories of assets are weighted according to their nature, degree of liquidity and class of credit risk.[92] The solvency margin requirements of the EU model only cover the investment risk for life insurance, which choose ratios based on technical provisions that are further reinforced by investment regulation. However, non-life insurance is entirely absent from investment risks. China's current solvency margin system is largely similar to the EU model. In addition, given that China has no investment regulation for assets covering technical provisions, there is no clear interrelation between solvency margins and investment regulation for both life and non-life insurance. China needs to contemplate a reform on this point.

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[91] One criticism on the E.U. model is the solvency margin should not be given the level freedom with other capitals because of its buffer function. See *Institutional Investors in the New Financial Landscape* OECD No. 2800, (1998) p434.

[92] See "Comparison of the NAIC Life, P&C and MCO RBC Formulas Summary of Differences" American Academy of Actuaries February 2002

5.6.6 Institutional and functional approach

OECD "Selected Principles" suggests that investment regulation incorporate both institutional and functional considerations and link these two considerations. The main reason for this is that investment should be tailored to an insurer's specific conditions and the features of its products, and so is investment regulation. This approach enables the regulation to be as closely as possible compatible to characteristics of insurers and their funds covered by investments, thereby minimising regulatory distortions of risk management.

China needs to consider applying this principle in three respects. Firstly, due to the difference of financial liabilities between life and non-life insurance, it is essential to properly set up different investment regulations for the two sectors.[93] Secondly, investment regulation should be risk-based and flexible, leaving greater discretion to more financially sound insurers. Insurers holding capital and reserves that are significantly higher than the statutory minimum or possessing proven internal investment capability can be granted some additional flexibility. For example, these insurers can be allowed to invest in certain commonly restricted markets (*e.g.* stock market) or exceed certain ceilings within certain limits subject to prior authorisation, as suggested in OECD "Selected Principles". Thirdly, according to OECD "Selected Principles", investment regulation must be tailored to product characteristics. The CIRC has already allowed insurers to invest up to 100% of funds derived from investment-linked products; this differential treatment is worth encouraging. The regulator needs to consider further incorporating contractual liabilities (*e.g.* guaranteed minimum rate, profit share, surrender value, maturity, and payment terms) of different products into investment regulation.

[93] Non-life insurers provide covers against losses stemming from damage to or loss of property and legal liability. Their liabilities are mainly short-term and harder to predict than are those of life insurers who cover the long-term events. Therefore, due to the requirement of a high degree of liquidity, non-life insurers' investment portfolios are much more bound to investment maximum for asset classes than those of life insurers are. See *Institutional Investors in the New Financial Landscape* OECD 1998, p435.

5.6.7 Combining regulatory and insurers' efforts to control risks

Sound investment regulation has to address the combined efforts of regulators and insurers. Obviously, regulation cannot assure, by itself, the optimal investment by insurers. On the contrary, insurers' investment decision-making processes, which include internal controls and risk management systems, function directly. Meanwhile, insurers should be prevented from being unduly vulnerable to shifts in external circumstances, and from incompetent management making speculative or unsuitable investments that endanger policyholder interests. OECD "Selected Principles" suggests that regulators encourage and guide insurers to "set up appropriate systems of internal controls", risk management systems. The main advantage of such a regulatory approach is its directly pointing at these internal determinants, the fundamental factors that directly affect investment results. The another advantage is it could reduce regulatory costs if such systems function properly. However, given the importance of insurers' investment, OECD "Selected Principles" suggests, the regulatory and supervisory function should not be delegated entirely to insurers or to self-regulation of insurance industry. Besides, only spelling out principles of internal control and sound risk management is not sufficient to ensure prudent investment. Therefore, regulators should verify the adequacy of insurers' internal systems in due course. To ensure that regulators act in a transparent and accountable manner, standards and common tools for the supervision need to be formulated.

Considering the deficiency of internal control and risk management seen in the Chinese insurance industry, the strategy of combined efforts is typically suitable for addressing the problems in China. There is a growing recognition by the CIRC that adequate risk management systems should be established within insurers.[94] Further efforts by the CIRC should be the issuance of related standards for establishing these systems and for verification of the systems. The IAIS "Draft supervisory standard on asset management by insurance companies"[95] describes the essential elements of a sound asset management system and reporting framework across the full range of investment activities. It is recommendable to adapt the standard for China's use.

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[94] For example, in 1999, the CIRC published the *Principles Guiding the Construction of Insurance Companies' Internal Control Systems.* See section 3.3.3, d, Chapter 3.

[95] <http://www.iais.org>

5.7 Concluding remarks

This chapter discussed the urgent needs for both further relaxing restrictions on insurers' investment and improving investment regulation. This is demonstrated by discussions on a number of problems, including: the rapid growth contradicting with deficient investment, the inefficient investment via SIFs, the interest-driven loss in insurers, and pressures from the fast growth of investment-linked products. At present, provisions governing insurers' investment scatter in the *Insurance Law* and the related regulations. The government has been aware of the acute need to have a specific and overarching regulation that deals with investment activities.[96]

While investment channels need to be greatly broadened, it is desirable for China to adopt a rather strict and detailed investment regulation to protect policyholders against the investment risks facing insurers, given the current situations of investment markets and insurers' management. Taking the opening up the capital markets to insurers as an example, it showed that a sound interaction between insurance funds and capital market development will be unlikely to archive in the absence of insurers' efficient investment management and supportive infrastructure and effective regulation in the both sectors. The chapter also discussed a set of issues related to creating a legal environment for insurers' effective portfolio management and risk control and at the same time safeguarding the soundness of the Chinese insurance sector. Some recommendations are made as follows: (1) The core objective of investment regulation should be calibrated on properly balancing safety and profitability. (2) To control the rapid growth risk that may drive insurers thirsty for investment, it is necessary to properly balance the interrelation between investment and underwriting. This could be done mainly through sufficient product pricing. (3) Given the basic strategy of adopting a rather strict and detailed investment regulation to protect policyholders against the investment risks facing insurers, it is not appropriate to introduce *prudent person rules* hastily. (4) Regulations for assets covering technical provisions and for assets covering capital base should be differentiated by allowing the capital funds more investment freedom. This could enlarge insurers' opportunities of earning a higher return on their investment of capital funds. Further differentiating treatments between assets covering solvency margin and assets covering other capitals are suggestible. (5) An integrated

[96] The CIRC was reported having engaged in drafting a regulation of insurers' investment since 2001. See *Shanghai Zhengquan Bao (Shanghai Securities News)* December 12, 2001. However, the drafting is still in process so far.

approach that incorporates investment regulation into solvency regulation needs be adopted to improve the current solvency system for both life and non-life insurance. (6) To minimise regulatory distortions of risk management, institutional and functional approaches that enables regulation to be compatible as closely as possible to characteristics of insurers and their funds covered by investments are needed. (7) Sound investment regulation has to address the combined efforts of regulators and insurers. (8) As a developing country in which market circumstances are changing rapidly, China needs to adapt its insurance investment regulation appropriately to the circumstances.

Chapter 6
Rate regulation in China: market-based pricing? how? and experience from the US

6.1 Introduction

There is a common consensus that the objectives of insurance rate regulation are to ensure that premium rates should not be excessive (so high as to lead to exorbitant profits), not inadequate (in the interests of solvency), and not unfairly discriminatory (price difference should reflect expected claim and expense differences).[1] Regulators used to achieve these objectives through rate regulation in various forms.[2] However, ensuring the above objectives while encouraging insurers to develop innovative products is an issue that regulators in many countries are facing. In the global marketplace, insurance pricing deregulation is becoming commonplace on purpose to fulfil the objectives through competitive pricing (or market-based pricing), although the deregulation varies in different countries. In the British insurance market, "the amount of premiums is entirely a matter for the insurer and

[1] For example, *New York Insurance Law*. N.Y.Ins. Law Sec. 2303.

[2] Regulatory approaches to insurance pricing taken by regulators normally fall within the following spectrum of options:

a. *Statutory rates* The regulators set out fixed rates which certain insurers are required to adopt compulsorily;

b. *Prior approval* Insurers must receive approval in advance before any changes in pricing or policy terms can be made;

c. *Flexible rating* Under this approach, companies can increase or decrease rates within a certain range without obtaining prior approval;

d. *File-and-use* Rates and/or terms and changes thereof must be filed with the regulators, which generally will have a certain period (*e.g.* 30-60 days) to review the filings against applicable statutory and regulatory standards before the given rates and/or terms and changes thereof can be used;

e. *Use-and-file* Product and pricing and changes thereof can be used immediately as long as they are filed with the regulators, but the regulators will revoke the filings after checking and measuring these product and pricing and changes thereof against applicable statutory and regulatory standards; and

f. *Competitive pricing* Neither informational filing nor filing is required.

competition led to the end of agreed tariffs"[3] in the 1970s. Across the EU, commercial insurers are free to compete for large accounts without government oversight.[4] Japan and South Korea have liberalised price controls in most insurance lines.[5] In the US, insurance prices are substantially deregulated *de facto* for many commercial property-liability insurance lines while personal line deregulation lags behind. Meanwhile, many insurance markets still see rate regulation, a highly debated issue. As rate regulation and deregulation concurrently exist in the US property-liability insurance markets, especially in auto insurance market, it provide us with a rare opportunity to observe and probe how and why these two contradictory and interrelated issues co-exist.

Over the past decade, the Chinese insurance industry has undergone regulatory reform on its stringent rate regulation. Its objectives are to accelerate competition among insurers thus expanding consumers' options and improving service and the quality of products available to consumers, ensure innovative new products reach market quickly, and reduce negative effects of rate regulation. Regulatory modernisation reshaped the market landscape. Accompanying this backdrop of increasing reliance on marketplace dynamics, the CIRC faces a number of questions. Should China further deregulate insurance pricing control? How can China propel significant reforms in rate regulation to facilitate modernising property-casualty insurance while minimising destructive competition by insurers so the insurance market develops healthily? Experiences of rate deregulation in the US, especially Proposition

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[3] John Birds *Modern Insurance Law* (5th ed.) 2001. *Sweet & Maxwell* p156. The British insurance supervision has for many years relied on "freedom with publicity". There is no regulatory control over premium rates and products. Supervision is focussed on whether the management and control of an insurer was "fit and proper"

[4] The EU demolished insurance tariff of both rates and policies by adopting the *Third Insurance Directives* in 1993 as its governing law on insurance to foster a genuinely internal marketplace of insurance services. It is arguably the least restrictive in the world.

[5] As part of its efforts to stem the financial crisis and alleviate the prolonged economic depression, Japan has taken measures to gradually deregulate insurance pricing control since 1996 when the financial reform (*Big Bang*) took effect. For more information, see Wook Jean Kwon and Harold D. Skipper, Jr. (1998) "Regulatory changes in the Japanese insurance market" *Journal of Insurance Regulation* October, and "Japan's insurance market: a sea change" Swiss Re. *Sigma* No. 8/2000.

103 (*Prop.103*)[6] and rate regulation in California, provide us with valuable cases of advantages and disadvantages of rate regulation, deregulation and re-regulation. The author believes that China should cautiously adopt a comprehensive approach to rate deregulation by learning lessons from the experiences in developed countries and taking into account China's realities and needs.

This chapter is divided into six main parts. Following this introduction, section 6.2 presents some observations and discussions on rate regulation in property/casualty insurance in the US with a focus on *Prop.103.* in California. Section 6.3 briefly describes China's rate regulation, generally comments on the current system, and discusses debates on rate regulation reform in China. Section 6.4 focuses on rate regulation in China's auto insurance as a typical case, and section 6.5 discusses whether market-based pricing fits for the current situations in China. The chapter concludes with some recommendations on appropriate measures needed to escort rate deregulation.

6.2. Some observations on insurance rate regulation and deregulation in the US

6.2.1 Overview of rate regulation in the US

In the US, rate regulation is underpinned by many factors, and differs in different lines of insurance. At the end of 19th century, destructive price wars between insurers caused many insolvencies leaving policyholders without coverage. The insurance industry at that time tried in vain to solve the problem of price wars by promoting "correct pricing practices".[7] These articulated a movement for closely regulating the

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[6] *Prop.103* which applies not only to auto insurance but also to most property and casualty coverage in California was approved by voters in 1988. It includes provisions for a rollback of insurance rates, an elected insurance commissioner, and recovery of prior approval. According to *Prop.103*, prices of auto insurance and the profitability of the insurance companies must be determined by the *California Insurance Department* and ultimately by the courts. For the full text of *Prop. 103*, see <http://www.insurance.ca.gov>

[7] Stephen P. D'Arcy "Insurance price deregulation: the Illinois experience" in *Deregulating Property-Liability*
Insurance Restoring Competition and Increasing Market Efficiency (Deregulating Property-Liability Insurance 2001) J. David Cummins (ed.) *AEI-Brookings Joint Center for Regulation Studies* Washington, D.C. 2001. Also see Morrill Thomas C. (1990) "Nine dramatic decades" *Best review* June 1990.

insurance business including premium pricing.[8] Rate regulation in the US largely relates to property-casualty lines of insurance, although extensive direct controls on rates are also seen in credit insurance and some kinds of accident and health insurance.[9] Contrarily, premium rates for life insurance are often indirectly regulated mainly by legal requirements for reserves, expense limitations (*e.g.* provisions on the maximum sales commissions), surplus accumulation limitations, and surplus apportionment requirements (*e.g.* provisions on payment of dividends to policyholders).[10]

Regarding rate standards, the common principles contained in the insurance rate regulatory statutes in effect in the majority of states are that rates must not be *excessive, inadequate, or unfairly discriminatory.* A rate is excessive if it is likely to produce profits unreasonably high for the insurance provided or if expenses are unreasonably high in relation to services rendered. This induces provisions on what constitute reasonable profits and expenses. A rate is inadequate if it does not cover expected losses and expenses and is likely to lessen competition or lead to a monopoly. Unfair discrimination exists if price differentials fail to reflect equitably the differences in expected losses and expenses.[11] However, these three principles seem to be qualitative. The following essential legal issues have to be addressed when applying these principles.

6.2.2 Appropriate profit margins and premium rates

When judging the suitability of rates, the concept of appropriate profit margins is employed, because rates, as important sources of income, closely relate to profits. In the US, the legal perspective on appropriate profit margins and rightful rates varies between states.

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[8] The US Supreme Court judgement in *German Alliance Ins. Co. v. Kansas* (233 U.S. 389 1913) held that insurance was a business "affected with a public interest", which required governmental involvement. In the court's opinion, insurance was often a legal contractual prerequisite for other market activities and the average consumer was in a comparative disadvantage in the marketplace due to the complexity of the insurance contract.

[9] For instance, "Credit insurance in Texas: better rate regulation needed to protect consumers" A Report by the Center for Economic Justice, Texas, the US, April 1998.

[10] See Peter M. Lencsis (1997) Chapter 7, *Insurance Regulation in the United States*, Quorum Books, London.

[11] See *supra note* 1.

In general, the *competitive market model* is used to deal with this issue. According to the NAIC *Property and Casualty Model Rating Law* (*File and Use version*, v-775-1), a competitive market is deemed by law to produce appropriate profit margins, and therefore rate prior approval for the market is unnecessary. Premium rates and supporting documents are to be filed only for the Commissioner's information. This is called the *use-and-file* system. The *Model Law* prescribes different procedures and standards for deciding whether a market is competitive or not. Some important indicators that are used in making the decision include the number of insurers, their market shares and changes therein, the kind and level of information available to consumers, and profitability level. Markets are presumed to be competitive unless the Commissioner, following a hearing, determines that a reasonable degree of competition does not exist in the market and then requires prior approval to be sought.

Alternatively, a few regulators, legislatures and courts require, in rate approval, a direct evaluation of profit margins, which has two approaches: *total rate of return*[12] and *rate of operating return analysis*. The former calculates returns on both operating funds and capital, and compares insurance returns by line by state with returns in other industries of comparable risk. One example is *Calfarm v. Deukmejian* (771 P.2d 1247 1989). The Californian *Prop.*103 enacted a statutory rate rollback of 20% of premiums and did not allow relief from the rollback unless an insurer was threatened with insolvency. In the case, insurers challenged the rollback as unconstitutional and confiscatory. The California Supreme Court articulated a requirement that relief from the rollback must be granted to an insurer if the rollback rates were "inadequate in that they did not contain *a fair and reasonable rate of return*."

The *rate of operating return*[13] excludes investment income on capital or shareholder supplied funds as one major difference from *total rate of return analysis*. For instance, in *State ex. rel. Commissioner of Ins. v. North Carolina Rate Bureau*,[14] the North Carolina Courts held that investment earnings from insurance operational funds is appropriate in rate making, but by contrast, investment earnings on capital or stockholder supplied funds is not appropriate.

[12] *Profit margin* (under *total rate of return*) = *increased surplus over the year* (equal to *underwriting profit/loss + investment income on current insurance operation + investment income on surplus*)/(*the beginning statutory surplus*).

[13] *Profit margin* (under *rate of operating return*) = *increased surplus over the year* (equal to *underwriting profit/loss + investment income on current insurance operation*)/*earned premium*.

[14] 261 S.E.2d 671 (1979), affirmed in 269 S.E.2d 602 (1980).

However, practically every state requiring prior approval relies on loss ratios (or, equivalently, a combined ratio of losses and expenses), because the loss ratio approach avoids many of the troublesome issues derived from a direct evaluation of profit margins. For instance, both *total rate of return* and *rate of operating return* need to define the eligible costs for calculating the margins because profits depend on costs and incomes. Otherwise, inefficient (high cost) insurers will be favoured over efficient (low cost) insurers if an insurer's actual expenses are used. The direct evaluation approaches also raise the issue of whether to base the rate of return on General Accepted Accounting Practice (GAAP), Statutory Accounting Practice (SAP), or economic value (discounted). In addition, the *total rate of return* requires an allocation of national accounts of insurance groups (such as overhead expenses, investment income, and federal taxes) by line by state based on premiums, reserves, or invested assets. As the division of these elements needs massive work and subjective judgements, therefore, it could produce outdated results which could also be essentially artificial.

6.2.3 Risk classification

"Risk classification"[15] is a major and complex issue relating to rate regulation and deregulation. Debates on *territorial rating* (basing auto premiums on territories/zip codes) relating to the implementation of *Prop.103* typically reflect this complexity. Californian *Prop.103* does not explicitly forbid *territorial rating*. Instead, it orders insurers to base premiums primarily upon three "mandatory" factors: driving-safety records, the number of miles driven annually, and a driver's years of driving. Meanwhile, with the intention of prohibiting insurers from utilising unrelated and non-causal risk classification, it requires other "optional" rating criteria only to be utilised if it can be demonstrated that such criteria have "a substantial relationship to risk of loss". These provisions led to lasting debate and tortuous political and legal battles relating to *territorial rating*.

In 1989, insurers argued in a lawsuit that basing premiums on driving-safety records rather than zip codes would discriminate against bad drivers in violation of *Prop. 103*'s requirement that rates be "fair". The case was ultimately dismissed as moot. Later, the

[15] "Risk classification" or "risk sorting" contains risk selection (insurers' decision on whether or not to insure certain risks), and risk differentiation (insurers' decision on to what extent and with what premiums to insure certain risks).

Californian insurance commissioner, John Garamendi, repudiated a *territorial rating* proposal made by the insurance industry. His decision was based on a survey of 10 million Californian auto policies, which confirmed that zip-code rating raises rates for good drivers across the state, forcing them to subsidise bad drivers. When Quackenbush took the post of commissioner, he enacted regulations allowing zip-code rating; and this led to *Spanish Speaking Citizens' Found. v. Quackenbush.*[16] The court ruled that the regulations violated the statute by allowing zip code to outweigh the three factors specified by *Prop.103.* Quackenbush and insurers appealed to the 1st District Court of Appeal in San Francisco. In 2000, the court upheld the Quackenbush regulations as a "lawful choice among imperfect options", and ruled that the voters could not supplant territorial rating.[17] The main arguments deployed in these battles were the efficiency and equity of territorial rating. Insurers claimed that the price of their policies should be based on risk, and the best determiner of that was the amount and scope of accidents where a person lived, not their driving record. However, consumer advocates contended that zip-code based pricing which charged city dwellers more than those in rural areas not only unfairly penalised city dwellers but also penalised drivers in the rating area with a clean record.

Risk classification is essential to insurance, but it has some technical, political and legal constraints. On the one hand, it is desirable in terms of economics. An essential characteristic of insurance is 'risk pooling' in which members of a group with similar risks contribute with premiums and share losses that are incurred by its members. In theory, equal premiums only make sense if every member of the pool has the same risk of loss, but that is impossible in reality. Risks of each member in most pools vary. To make sure that insurance appeals to members with various levels of risk, insurers must match the premiums of each member to his/her individual risks. Otherwise, low-risk members, who subsidise high-risk members through paying equal premiums, could eventually withdraw from the pool, making insurance business impracticable. On the other hand, accurate risk classification[18] can not be drawn up for several reasons. Firstly, the *transaction costs* and *asymmetric information* prevent the ideal of accurate

[16] Case Nos. 796071-6 and 796082-2 (consolidated) Superior Court of Alameda County, filed 1998.

[17] *Spanish Speaking Citizens' Found. v. Quackenbush,* Court of Appeal, First Appellate District, Division Four 85 Cal.App.4th 1179 (2000).

[18] It means premiums exactly match the risk profile of each member.

classification being reached.[19] Secondly, technological constraints are still heavy although insurers have made ever-greater efforts to use actuarial technology to assess and predict the uncertainty of risks. Thirdly, the costs of risk classification make the classification worthwhile only if its benefits overweigh the related costs. In addition, risk classification faces serious moral and legal challenges. For example, use of genetic test information in life and health insurance is restricted in the US,[20] although some believe that the restriction could lead to adverse selection by insured with genetic defects.[21] Similarly, anti-discrimination provisions forbid insurers from basing premiums on race, creed, or nationality, etc.

6.2.4 Rating organisations

Rating organisations evolved through a winding course and played an important role in the insurance rate regulation in the US. Initially, rating organisations (rating bureaux) were formed by stockholder fire insurers to prevent "rate and commission wars" which had resulted in ruinous competition and many insurers' failures.[22] They were viewed as anti-competitive in several states after the US Congress passed the *Sherman Antitrust Act* in 1890. However, later, in 1910, the *Merritt Committee* established by the New York Legislature to investigate non-life insurance, supported rating organisations, which in the *Committee's* opinion, helped relieve insurers from "rate wars" that ultimately impaired the public's interest. This was followed by *bureau rates* being admitted by statutes in many states. The *McCarran-Ferguson Act* in 1948 affirmed state insurance regulation and taxation, exempted the insurance industry from anti-trust laws which only apply to insurance business not regulated by state law. This enabled rating organisations to continue effectively setting rates. However, with the growing influence of competition, bureau rates, considered as an illegal price-fixing

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[19] Kenneth S. Abraham "Efficiency and fairness in insurance risk classification" Virginia Law Review April 1985.

[20] *The Health Insurance Portability and Accountability Act of the US.* (1998)

[21] Christianson David J. (1996) "Genetic testing: risk classification and adverse selection" *Journal of Insurance Regulation 15* p75-79.

[22] One example is the *National Board of Fire Insurance Underwriters* established in the US in 1866. See Marc Schneiberg "Association and inter-firm competition in the American fire insurance industry" Paper presented at the panel on "Associations, Co-operative Market Institutions, and Economic Performance," at the Annual Meetings of the Society for the Advancement of Social-Economics, Madison, Wisconsin, July 1999.

scheme under anti-trust laws, ended in the 1980s and early 1990s; rating organisations became "advisory organisations". At present, the *Insurance Services Office, Inc.* (ISO) and the *National Council on Compensation Insurance, Inc.* (NCCI), the two major rating organisations, operate nearly nation-wide, while many independent rating bureaux, some of which are mandated or created by statutes, acts on a state basis.[23] They provide member insurers with *advisory average prospective loss costs*[24] rather than *advisory rates*[25] which they once provided and are deemed illegal under antitrust laws. They also provide newly formed insurers with pricing assistance and policy language that the insurers cannot obtain elsewhere, thus enabling them easy entry into the marketplace. They also help insurers create special products. All of these factors seem to enhance competition in the marketplace.

6.2.5 Rate deregulation

Deregulation (on both rates and terms) of commercial lines in the US has been intensifying in recent years.[26] It aims to tackle the burdensome regulatory environment and excessive costs associated with commercial insurance.[27] As large companies have more information and barging power than ordinary consumers, regulatory reviews of rates and forms for commercial lines are thought unnecessary, restricting insurers from competing commercial risks with self-insurance and other alternative markets which gradually increased their market share in commercial lines. The deregulation is expected not only to enable insurers to respond to the exodus of large commercial risks, but also to allow regulators to dedicate their limited resources to solvency and market performance issues.

Controversially, the industry also appeals for rate deregulation of personal lines. Some academics claim that insurance markets with competitive pricing outperform

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[23] See Peter M. Lencsis (1997) Chapter 7, *Insurance Regulation in the United States* Quorum Books London

[24] Advisory average prospective loss costs are estimates of future claim payments, including costs such as loss ratios, claims handling and legal defence.

[25] Advisory rates contain provision for various expenses, contingencies and profits.

[26] See "Commercial-lines deregulation gains momentum nation-wide" *Best Week Property/Casualty Supplement* March 29,1999.

[27] The "White paper on regulatory re-engineering of commercial lines insurance" (NAIC 1997) estimated that complying with rate and form filing requirements cost insurers US$1bn and state budgets US$55mn annually.

those with strict rate regulation. Stephen D'Arcy observed that in Illinois, where there is no rate regulation, a competitive auto insurance market[28] has brought many benefits to both consumers and insurers. For example, overall rate levels are lower than most other states with large populations, high traffic density, and urban areas. Illinois' residual market is very small.[29] South Carolina, which enacted a comprehensive series of reforms including competitive pricing in 1997, has seen substantial improvements in its auto insurance market. The number of insurers doubled and premiums for many low-risk drivers fell, while the residual market declined substantially.[30]

However, competitive pricing also has negative effects and has entailed failures in the US history. Firstly, excessive competition in an open competition market may lead to premium levels that are inadequate and threaten the insurers' solvency seen, *e.g.* in the US market at the end of the 19th century. Conversely, imperfect price competition, price-fixing agreements may lead to premiums which are excessive and contrary to the interests of policyholders. The following description of the overturning of the competitive rating in California is perhaps a strong proof on this point.

Prior to *Prop.103* in 1988, California was one of the few states in the US that did not require insurers to obtain the regulatory approval for rate changes.[31] Despite having a duty to ensure that insurance rates were "neither excessive nor inadequate", the State

[28] In 1998, there were more than 200 insurers underwriting private passenger automobiles, and the top ten share was about 64.0% of the market; Herfindahl/Hirschman Index (HHI) was 1137. See "Annual Report to the Illinois General Assembly on Insurance Cost Containment" *Illinois Department of Insurance* April 15, 2000.

[29] Supra note 8

[30] Martin F. Grace, Robert W. Klein and Richard D. Phillips (April 15, 2001) "Auto insurance reform: salvation in South Carolina" *Georgia State University*

[31] California enacted the McBride-Grunsky Insurance Regulatory Act, an open competitive pricing in 1947. Under this Act, insurance companies were not required to file rates for approval except for health and life. Illinois and New York adopted a similar approach in 1969, and 1970 respectively.

Insurance Commissioner rarely used his price control power.[32] Moreover, Californian law shielded the industry not only from rate regulation but also from competition by exempting the industry from antitrust laws.[33] Thus, neither the free market nor government supervision was permitted to moderate the impact of the insurance cycle on the economy, although entry and firm rivalry were restricted somewhat by law and the state regulated many other aspects of the property/casualty business, *e.g.* risk classification. The competitive market process essentially determined the ultimate reasonableness of insurance rates and profits in California, which showed that the auto insurance industry in California operated in an "open competition" market. Nevertheless, the majority of Californian consumers voted for a sea change as a reaction against the skyrocketing prices which had occurred in the competitive pricing regime that had existed since 1947, and replaced it with a prior approval regime.[34]

There are many (possible) explanations why auto insurance became the target of so-called consumer-based regulatory movements in California in 1988. The immediate impetus for the *Prop.103* initiative seems to have been twofold: partly concern with the large premium increases in the years in the mid- to late 1980s,[35] and partly concern with the large disparity in premiums among individuals with *prima facie* similar risk characteristics.[36]

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[32] See Sugarman, Stephen D. (1990) "California insurance regulation revolution: the first two years of Proposition 103" San Diego Law Review, Vol.27 p683-714.

[33] See Dwight M. Jaffee and Thomas Russell (1997) " The causes and consequences of rate regulation in the auto insurance industry" The US National Bureau of Economic Research Working paper No. 5245 at 8.

[34] Public outrage at the increases of insurance premiums was evidenced by a poll taken several months before the US national election in 1988, which 77% of consumers in California thought that automobile insurance companies charged too much, and 45% of consumers blamed automobile insurance companies for high insurance rates.

[35] Between 1985 and 1988, insurance premiums in California rose dramatically. In 1986 alone, automobile premiums in California increased by 22%, while the consumer price index increased only 3.1%.

[36] Supra note 33, p32-33.

Secondly, market-based pricing may partly instigate the underwriting cycle[37] that is in a state of flux between a "hard" market and a "soft" market. During the decade leading up to 2001, insurance industries in main developed countries enjoyed the longest "soft" market in recent history. Insurers actively competed for customers with comparatively low premiums, excellent coverage, and innovative products, and thus a "buyer's market" existed and premium growth was relatively flat.[38] This was mainly due to the prosperous global/national economies, particularly with respect to booming securities markets and favourable inflation and interest rates.[39] However, since 2001, the main developed countries have seen economic growth stagnant, which has driven the insurance industries into a "hard" market where the overall condition of the insurance markets or a particular segment of them is negative. The event of *9.11* greatly exacerbated the "hard" market.[40] Consequently, customers found out many unfavourable events and an emerging "seller's market". For example, coverage, readily available and inexpensive in former years became no longer available or available only under severe restrictions, exclusion or requirements.[41] Some insurers lost their reinsurance, or had to pay reinsures' higher premiums. Some went into receivership or insolvency.[42] Many customers found that their premiums had gone up, in some cases dramatically.[43]

Pricing freedom partly instigates these premium and coverage fluctuations. Modern insurance companies, unlike traditional insurance which served as a mechanism for mutual risk sharing, seek to maximise profits, just like other financial institutions. They take premiums and set aside part of the premiums as reserves, which are invested with

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[37] Cycles are a fact of economic life characterised by high and low periods of profitability for an industry or an economy. They have many causes, *e.g.* economic, social and political changes, or even changes in natural environment.

[38] See Robert P. Hartwig "2001-Year end results" *Insurance Information Institute*, the US. Also see "The converging road ahead A.M. Best's top 10 trends" *BestWeek Property/casualty Edition*. January 2001.

[39] For example, see "The collapse of HIH and implications for Australian general insurers" Moody's Investors service Global Credit research October 2001.

[40] See "Implication of the September 11 terrorist attacks" *Tillinghost-Tower Perrin*

[41] See "The Equitable Life Assurance Society joint opinion of Ian Glick QC and Richard Snowden for the Financial Services Authority" FSA 2001.available at <http://www.fsa.gov.uk>

[42] See "Looking back and looking forward" *Reinsurance Pricewaterhouse Coopers* October 2001.

[43] In the US, premium rates for the coverage of terrorist risk in some states roared to 20 times the rates of before the 9.11event.

capital to earn additional income. Increasingly, investment returns become the industry's principal source of profits while premiums become their principal source of investment. When investment markets produce high returns, insurers compete for premiums by reducing prices. However, when investment yields are slipping, the industry increases premiums to maintain profit levels. Market-based pricing provides insurers with this freedom, and even enables insurers to increase premiums steeply which may be unrelated to loss ratios to generate revenue to compensate for losses and poor investment outcomes.

Thirdly, insurers could take advantage of pricing freedom to adopt *cost-plus pricing* to maintain their profit rates regardless of whether their management and risk control are good or not. *Cost-plus pricing* means that firms set their price by just adding a certain percentage for profit on top of aggregate costs.[44] The history of Californian auto insurance witnessed this situation. By 1988, California's auto premiums soared to a level unacceptable for the majority of drivers, and insurers claimed that high premiums were necessary for covering costs. However, between 1975-1984, the entire property-casualty insurance industry in the US made a record-breaking profit of US$75bn, and profits of the industry increased from 2.4% in 1985 to 16% in 1987; the profits of the US automobile insurance industry came to US$78bn during 1978-1987.[45] Ideally, according to economics, in a competitive market situation, insurers in the long run will earn only the same (normal) rate of profit as any other business in the economy. In the short run, insurers' profit levels should closely relate to their relative efficiency which largely depends on the quality of their management and operational performance. When insurers are free from using *cost-plus pricing* to maintain their profit levels, they could by this means conceal their management deficiencies and hence impair any impetus towards improvement, and possibly jeopardise consumers' benefits.

Fourthly, market-based pricing could encourage "reverse competition", a specific form of competition among insurers for the favour of persons who control, or who may

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[44] John Sloman *Economics* 3rd ed. Prentice Hall 1997, p201.

[45] Quoted in " Insurance crisis: how insurance companies periodically disrupt the economy and why" note 11, NAIC, (1992) "Report on profitability by line by State 1991" and note 12, (Statement of William J. Anderson, Director, General Government Division, U.S. General Accounting Office (GAO)). "Profitability of the Property/Casualty Insurance Industry: March 13, 1986: Hearing before the Subcommittee on Oversight of the Committee on Ways and Means, 99th Congress. (1986), and U.S. *General Accounting Office*, "Insurance: profitability of the automobile lines of the insurance industry" (Oct. 1989).

control, the placement of the insurance with insurers. In certain lines of insurance, *e.g.* credit insurance or auto insurance, insurers usually vie with each other by paying high commissions or providing other compensation or services to creditors or auto dealers who control the placement of insurance business. Without rate regulation, "reverse competition" tends to increase insurance premiums, or prevent lowering of premiums in order that greater commissions or other allowances may be paid for obtaining such business.[46]

6.2.6 Strict rate regulation and reform

In the US, various rate regulation forms exist in auto insurance markets. Among the forms, *prior approval* (PA) still prevails in most of the 50 states, although there has been a trend towards rate deregulation. According to a survey,[47] (see Table 6.1) during 1972-1998, among the 50 states, 22 states maintained PA, 3 changed from *competitive rating* (CR) to PA, and 5 changed from PA to CR and then return to PA, which means that 30 states applied PA by 1998. In contrast, 10 maintained CR, 9 changed from PA to CR, and only 1 changed from CR to PA and then return to CR.[48]

Table 6.1 Numbers and changes of prior approval (PA) and competitive rating (CR) during 1972–98 in the US

Total CR	20	Total PA	30
Maintained CR	10	Maintained PA	22
PA > CR	9	CR > PA	3
CR > PA >CR	1	PA > CR > PA	5

Source: footnote 47.

However, strict regulatory price regulation, including prior approval, in a competitive insurance industry is thought to have adverse consequences which frequently distort market incentives and harm consumers. Two of the main adverse consequences are *price compression* and *price suppression*. *Price compression*[49] represents restrictions on the factors that insurers use in defining risk categories (*risk classification*). Harrington argued that restricting risk classification in the US, *e.g.* capping property insurance rates in catastrophe-prone areas, or requiring unisex auto

[46] *Supra note* 9.

[47] Scott Harrington "Effects of prior approval rate regulation of auto insurance" in *Deregulating Property-Liability Insurance*

[48] It believed there was no substantial change to this situation by 2000. See "Testimony of Philip R. O'Connor before the Subcommittee on Capital Markets, Insurance & Government Sponsored Enterprises of the Financial Services Committee of the U.S. House of Representatives" June 21, 2001.

[49] *Supra note* 33.

insurance rates, may reduce rates for buyers who face the highest premiums but raise rates for other buyers. Therefore, such restrictions can not enhance the affordability of coverage for most insurance buyers. It also erodes the incentives involved in risk classification for policyholders to take precautions to control losses incurred by high-risk buyers.[50] In addition, risk classification restrictions impose limits on the information insurers can use to assess the risk of loss for different consumers.[51]

Price suppression means restrictions on the overall level of premiums or rates applied to particular categories, which keep premiums or rates artificially low. It leads to total premium income being less than would be collected under competition, and results in a decline in the market value of insurers' equity.[52] It also leads insurers to reducing product quality or even withdrawing from markets where rates are suppressed, thus limiting consumer choices.

Scott Harrington in his review of the impact of state regulation on auto insurance markets finds that laws requiring the prior approval of rates have had little or no impact on rate levels over time. Moreover, he claims that there is strong evidence that prior approval reduces coverage availability, increases the size of residual markets, and increases market volatility for both insurers and consumers.[53] A study by Klein, Philips and Shiu reveals that strict rate regulation can thwart solvency goals by encouraging insurers to maintain higher levels of leverage and financial risk. They also find that insurers under stringent rate regulation are relatively small and less geographically diversified. These insurers are also easily "trapped" in restrictive environments and more vulnerable to insolvency.[54]

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[50] See Scott E. Harrington (2000) "Insurance deregulation and the public interest" AEI-Brookings Joint Center for Regulatory Studies washington, D.C. p42-43. Also "Insurance rate regulation in the 20th century" *Journal of Insurance Regulation* 2000 Winter p204-218.

[51] Wayne T. Brough "Competition serves consumers better than regulation" Issues Analysis 107, Citizens for a Sound Economy Foundation. The US, October 12, 2001.

[52] See Scott E. Harrington (1992) "Presidential address: rate suppression" *Journal of Risk and Insurance* 59, p185-202 for the discussion on this term.

[53] *Id.*

[54] Robert W. Klein, Richard D. Phillips and Wenyan Shiu (2000)" The capital structure of firms subject to price regulation: evidence from the insurance industry" Wharton/Aon Conference on capitalisation in the property-casualty insurance industry.

Some academics[55] discuss two kinds of the regulatory problems that exist in New Jersey and Massachusetts, which both have stringent rate regulatory systems. One is that state regulation, which prescribes auto insurance risk classifications, severely limits rate differentials across territories and yields significant cross-subsidies. This results in many adverse consequences. For example, it discourages appropriate driving incentives between high-cost drivers and low-cost drivers.[56] It also imposes long delays on regulatory filings, and invokes a set of never-ending political controversies over the correctness of the risk classification. Another problem is that the two states rigidly control insurers' profits and prevent them from exiting certain lines by threatening to expel them from the state if they quit the lines. This has led to severe rate suppression. Given the heavy-handed regulatory system, there have been massive company exits from the states. Loss costs have increased substantially over the years and premiums are high relative to the rest of the country.

Inefficiency of state departments worsened the effects of anti-competitive rate regulation. Surveys conducted by the Alliance of American Insurers (AAI) and the National Association of Independent Insurers (NAII) revealed that the most serious problem identified by their members was slow approval, or even acknowledgement, of filings. In some states, it takes up to a year for approving a product, impeding launch of new products and competition. Some impediments to efficiency are from the department red tape culture or excessive regulation. The typical examples include slow review, approval and acknowledgement of filings, inadequate, inexperienced and/or non-supportive staff, too many and too complicated forms, burdensome requirements, rigid rules, multi-layered processes, unwritten standards and "desk drawer" rules, and confusing or unclear instructions.[57]

However, some studies on the effects of the Californian *Prop.103* have revealed that strict rate regulation could achieve some satisfactory results, which conflicts with

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[55] Jack Worrall "Private passenger auto insurance in New Jersey: a three-decade advertisement for reform" in *Deregulating Property-Liability Insurance* 2001.

[56] J. David Cummins asserts that "drivers decide how much and how safely they drive based on the marginal costs and benefits of driving". Subsidised high-cost drivers will have an incentive to drive more and take less care as they do not pay the full marginal costs, while low-cost drivers paying more than their marginal costs will drive less than under competitive rating.

[57] "Testimony by Robert L. Zeman and Rita Nowak of Alliance Insurers & national Association of Independent Insurers before U.S. House committee on Financial Services Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises" Jun.21,2001.

general predictions by some economists on rate regulation. Advocates of *Prop.103* credit it with having reduced auto insurance rates in California since its passage in 1988, while rates surged around the US. They also note that California has enjoyed the lowest rate change in any state since *Prop.103* and incentives embedded in *Prop.103* for safe driving helped control loss costs. They suggest that California's rate regulation be a model for other states, considering its remarkable success.[58] Contrarily, insurers and some academics refute these appraisals. They assert that the improvement of California's auto market was a result of a decline in insurers' underwriting cost, which occurred for a number of reasons, not just the few positive factors in *Prop.103*. They include court decisions unfavourable to bad third-party lawsuits, improvements on highway and vehicle safety, and fraud fighting efforts. Opponents warn against the spread of *Prop.103-type* laws and urge further deregulation of insurance pricing control in property-casualty insurance.[59] However, neutral observations seem to support the positive effects of *Prop.103*. According to Dwight M. Jaffee and Thomas Russell, there is no evidence of the "traditional" adverse consequences of *Prop.103*, such as firm exit, an expanding assigned risk pool, or declining industry profit rates. Contrarily, Californian prior approval system is quite consistent with declines in premiums and increases in profits.[60]

6.2.7 Implications for China

The US insurance rate regulation has undergone a tortuous evolution; its rate deregulation is a long process and one size does not fit all. It evolved from market-based pricing in the late 19th century, then rate self-regulation by the industry and bureau-rating admitted by statutes in the early 20th century, towards widespread state regulation of rates featured by the *prior approval model* in 1940s. Then in the early 1980s, the general deregulation trend in the US extended to the insurance industry and a competitive pricing model emerged. In the last two decades, prior approval and

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[58] See J. R. Hunter (2001) "Why not the best? the most effective auto insurance regulation in the nation" Consumer Federation of America and "Testimony of J. Robert Hunter Before The Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises" The US Congress, June 21,2001.

[59] See "NAMIC urges halt to potential spread of Prop.103-type laws" http://www.namic.org August 24, 2001.

[60] Dwight Jaffee and Thomas Russell "The Regulation of Automobile Insurance in California" in *Deregulating Property-Liability Insurance 2001*.

competitive rating co-existed with rate deregulation gaining popularity. This means rate deregulation and the competitive pricing model should be appropriately chosen at the right time to fit the competition required by special lines of insurance. China's regulators need to consider the issues of diversification and gradualism of the rate deregulation process.

The competitive pricing model appears to function well only in a competitive market in which there is complete competition. This requires few/low barriers to market access and exit, mature insurers with ample data and skills for pricing (or with the help from rating organisations), information disclosure to help consumers make well-informed purchases, and effective solvency and market-conduct supervision. It also requires regulators to monitor the actual level of competition in order to reintroduce strict rate regulation when the market is proved no longer competitive, because the market is changing and so is the competition. In addition, powerful consumer protection organisations help restrain insurers from using their bargaining power to abuse price. China' regulators need to consider these preconditions when adopting market-based pricing. Competitive pricing has seen negative effects and failures, which should lead to the regulator's caution.

Appropriate rate standards, statutory rating elements and a filing procedure are required for both strict rate regulation and competitive pricing. The basic cause of this is that insurance is a relatively unique product. Unlike most businesses that know the price of their products at the time they are sold, insurance cannot be certain of what claims will cost in the future. In addition, on the one hand, there are instances where insurers may engage in under-pricing (due to excessive price competition), overpricing (due to insurers' market power and consumers' lack of information), or cyclical pricing (mainly due to underwriting cycles). On the other hand, regulation can distort market forces and harm efficiency by suppressing and compressing prices. All these require a regulatory and supervisory framework to formalise insurers' pricing behaviour and regulators' activities. There are a number of (model) laws and a wealth of experience on these aspects in the US, which could be learnt by China's regulators. Two regulatory issues worthy of special note are appropriate profit margins and risk classification, because China to date has few rules on the issues.

Strict rate regulation in the US has many shortcomings. Although the regulation usually tries to hold prices down (price suppression), it is thought to increase underwriting costs, ultimately, leading to increases not decreases of premiums, and

resulting in cross-subsidies (price compression). It is also thought to create an expanding assigned risk pool, or declining industry profit rates, so causing insurers' exit from the market, thus reducing insurance availability.[61] Although rate regulation in China usually holds prices up rather than down, it did see price suppression in a few cases and deficiencies in risk classification. On the other hand, the US market also shows that strict rate regulation is still working in many states' auto insurance markets, and especially, appears to operate satisfactorily in Californian market. The comprehensive approach adopted by Prop.103 and other measures, which have contributed to the success of Californian auto insurance market, are worthy of learning by China.

6.3 Overview of China's insurance rate regulation

6.3.1 Evolution of the rate regulation

After the recovery of the insurance business in 1980, China adopted uniform fixed rates nation-wide. When the former PICC maintained a monopoly, its branches at all levels around the country applied uniform rates set by its headquarter. After 1986, the two new entrants, Xinjiang Construction Corp Insurance Company and Ping An, roughly followed the rates of the former PICC due to their small size and deficient pricing skills. After CPIC emerged in 1991, the PBOC, the insurance regulatory authority then, set forth rules reiterating that "all insurance enterprises shall execute rates and policies verified by the authority".[62] In fact, the rates and policies applied in the whole industry then were merely replicas of those used by erstwhile monopoly, the former PICC. The *1995 Insurance Law* (Art.106) maintained this mode by requiring that "the premium rates and the basic insurance clauses for the principal types of commercial insurance risk must be set by the insurance authority". The *Law* also set out that "the premium rates and basic clauses for other types of risk, which although left to the discretion of insurers, need to be reported to the insurance authority together with

[61] Generally, see *Deregulating Property-Liability Insurance 2001.* Also see Scott E. Harrington "Insurance rate regulation in the 20th century" *Journal of Insurance Regulation* Winter 2000, p204-218.
[62] "On Further Cleaning up, Verifying Insurance Business and Organisations and Strengthening Management"(June,1991) and "On Delivery of National Insurance Policies and Rates for Domestic Business" (April,1994)

the documents required for the record." Under the *1995 Insurance Law*, China adopted two kinds of rates: statutory rates, and file-and-use rates.

The *1996 Administration Regulations* further detailed rate regulation:

- the PBOC has the power to determine, and make adjustments to, the main types of risk according to the market situation;
- the head office of the PBOC shall decide the basic premium rates for the main types of risk;
- insurance companies shall submit their proposed insurance premium rates for other types of risk to the head office of the PBOC for record and approval, while branches of insurance companies shall submit their proposed insurance premium rates for other types of risk to the branches of the PBOC at province level for record and approval, and the PBOC shall be deemed to have granted an approval where it does not raise objections to the record application within 30 days of receiving it;
- sub-branches and administrative offices of insurance companies may not propose premium rates;
- insurance companies may apply for a protection period of six months for new types of risk, and no other companies may engage in these types of insurance within the period;
- branches of the PBOC at province level may, according to the local situation, decide on a premium fluctuation range with maximum of 30 percent above or below the unified rates implemented by all insurance companies within the same province;
- all documents related to insurance clauses and premium rates must be in Chinese, although, where there is a need, a foreign language may also be used. However, in cases of discrepancy between the two, the Chinese version prevails;

The *1996 Administration Regulations* also provided the types of documents required for approving rates proposed by insurance companies.[63]

The 2000 *Insurance Company Regulations* assigned responsibility for rate regulation to the CIRC, and made the following supplements:[64]

- the CIRC may require an insurance company to change its policy provisions and premium rates, or to stop using them where they fall into the circumstances provided in Art. 69, the 2000 *Insurance Company Regulations*;[65]

[63] The *1996 Administration Regulations*, art. 40, 43, 44.

[64] The *2000 Insurance Company regulations, chapter* 4.

- the pre-fixed interest rates in life insurance policies may not exceed the relevant standards promulgated by the CIRC.[66]
- insurance companies must implement uniform policy provisions for the same type of insurance, whereas they may formulate premium rates for given areas on the local conditions in various areas,[67] however, such rates may only be implemented after approval from the CIRC; and
- the CIRC may set premium rate standards or a range within which premium rates may float based on actual circumstances.

The CIRC continued to improve rate regulation while increasingly giving insurers more flexibility. As for life insurance, it enacted the *2000 Tentative Rules on Administration of Life Insurance Product Filing*, requiring insurers to submit their designed life products to the CIRC for record, and not to sell these products before approval by the CIRC. In order to improve quality of life products, the *Rules* also introduced a system requiring an actuary and a person in charge to be responsible for the actuarial matters and legal matters of the products respectively. In the *2000 Notification on Relaxing Premium Rates of Short-term Casualty Insurance and Simplifying Filing Procedure of Short-term Casualty Insurance*, the CIRC allowed insurers to formulate rates of short-term casualty insurance except *personal accident insurance in aviation*, and to sell the insurance products as soon as they file with the CIRC.

As for non-life insurance, a great step forward was the *2000 Provisional Measures for Administration of Property Insurance Provisions and Premium Rates*[68] which was

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[65] These circumstances include: they violate prohibitions in laws, regulations or administrative rules; they violate the relevant state policies; they are harmful to the public interest; the contents are clearly unfair or monopolistic, or infringe the lawful rights of policyholders, insured or beneficiaries; the premium rates are lower than cost and constitute unfair competition; the policy provisions or the premium rates are problematic, and may endanger the solvency of the insurance company; and other reasons recognised by the CIRC.

[66] For life insurance, insurers need to use a pre-fixed interest rate to calculate and set premiums of the whole policy period.

[67] In 1999, the newly established CIRC issued the "Revised Rates and Policies for Motor Insurance", and allowed ShenZhen to apply distinctive rates and policies based on the realities of the city. This is for the first time the authority allowed regional rates.

[68] The *Measures* repeals the *1999 Notice Concerning the Issue of Filing Property Insurance Provisions for the Record* and the 1999 *Notice Concerning the Issue of Filing Foreign-funded Property Insurance Provisions for the Record* both issued by the CIRC.

part of China's overall plan to slowly deregulate the insurance industry. It gave non-life insurers free rein in setting their own terms and conditions for certain types of minor insurance policies. According to the *Measures*, the CIRC only sets the basic provisions and premium rates for property insurance for the "main types" of risk.[69] Insurers formulate the non-basic provisions and premium rates for the "main types" of risk as well as the provisions and premium rates for "other types" of risk, such as public liability or burglar insurance, on a "file and use" basis. The measures also set forth the filing rules and other rules governing premium rates and provisions of property insurance.

Summarised from the above description, there were three rating systems before the revision of *1995 Insurance Law*: statutory rates with certain fluctuations for five main types of non-life insurance; file-and-use rates for other non-life insurance and most life insurance; and use-and-file rates for short-term casualty insurance. The *2002 revision of Insurance Law* shifted the rate-setting burden from the regulator to insurers, and established *prior approval* and *file-and-use* systems. This deregulation reflects a function transition of the regulator.

6.3.2 Comments

China has long been implementing a unified tariff system for major risks, especially in non-life insurance. This kind of highly centralised system played an important role in protecting policyholders' benefits and maintaining insurance market order in an environment where the insurance market was underdeveloped and the consumers' consciousness was not strong. However, along with the development of the insurance industry, the opening up of and intensifying competition in the market, the system appeared showing some obvious drawbacks:

Although they had the advantages of simplicity, ease of application by insurers and ease of supervision by regulators, the tariffs were too unified and standardised to conform to the actual local situation. Vast in territory, China's situation is complex with diverse geographical environment, climate, economic conditions, and standards of safety in different areas. "All at once" tariffs violated the principle that the formulation

[69] According to the CIRC, the "main types" of risk include enterprises property insurance, auto insurance, employers' liability insurance, investment insurance and fidelity guarantee insurance. The PBOC and the CIRC had already specified policies and rates for these insurance types except employer's

of premium rates should be "adequate, not excessive, reasonable, and fair", thus resulting in deficient diversification.

Tedious tariff examination and approval procedures seemed unable to adapt to the needs of service development and market condition changes. To launch a new product, an insurance company's branch office must first report and file (via upper offices) to its headquarter office who was required to file it with the regulators. This obviously affected insurers' enthusiasms for launching new products because they run a risk to lose their best marketing opportunity or had to divulge business secrets by the dormant procedures. Furthermore, a branch office of an insurer was also required to report and file layer after layer before it adjusted rates according to the market and operating conditions, making it easy to lose the significance of any price adjustment.

Unified price is disadvantageous to insurers' healthy development. Practice in China proved that stipulated prices were normally higher than the prices in a natural equilibrium. Insurers, who find it easy to survive under such prices, could lack both internal drives and external pressures to improve their management and quality of services. As a result, this undermines insurers' overall quality enhancement and hinders the optimisation of resources disposition through merger and acquisition, ultimately, leading the whole industry to being less competitive.

The current pricing principles and standards are largely outdated due to the fundamental transition of rate regulation. Most provisions of statutory rates are obsolete while the implementation of *prior approval* and *file-and-use* systems needs detailed provisions. Furthermore, the current pricing principles are fragmented and somewhat imprecise. For example, besides provisions in the *2000 Insurance Company Regulations*,[70] insurers must follow the principles of "*fairness, adaptability* and *stability*"[71] in their pricing activities. However, there is no further regulatory explanation of these three principles. According to CiDong Huang and ShenPing Gao,[72] *fairness* refers to that premium rates must be basically based on risks with differentiating premiums by proper risk classification. They also hold that *stability* means that premium rates should remain unchanged for a quite long period. Otherwise

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liability insurance.

[70] *Supra note* 65.

[71] Art.4, the *2000 Provisional Measures for Administration of Property Insurance Provisions and Premium Rates.*

[72] Huang Cidong & Gao Shenpin (2000) Baoxianfa Ji Xiangguan Fagui Xinzhu (New Annotation on Insurance Laws and Relevant Regulations) People's Court Publishing, p399-341.

it will increase insurers' expenses and confuse policyholders in the calculating of premiums. However, they did not explain *adaptability* but proposing two new principles: premium rates must be adequate and helpful to loss prevention.[73] It seems there is divergence of views on rating principles. Furthermore, except for fairness (which largely relates to "not fairly discriminatory"), the other two statutory principles do not seem to exactly reflect basic requirements for insurance pricing. The core objectives of rate regulation are to protect policyholders from being overcharged by insurers or from contractual defaults by insurers due to under-charge that results in insurers' insolvency. Therefore, the ultimate standards should include that "premium rates should be adequate and not excessive".

6.4 Rate regulation in the Chinese auto insurance

6.4.1 The auto insurance market

Auto insurance is the largest class of business in China's non-life insurance sector. In 2001, the industry wrote Rmb42.21bn premiums for auto insurance, representing 61.6% of the total premiums of non-life insurance. That was more than 21 times the premium income of auto insurance recorded in 1988 (Rmb2bn). It was also the first time in 1988 that the auto insurance, accounting for 37.6% of total premiums of non-life insurance, exceeded the *enterprises property insurance*.[74] Since then, the auto insurance has maintained its top position. It realised 19.53% of average annual growth during 1993-2001(see Table 6.2). Auto insurance is very important because of its widespread impact on industries and households across the country in which a total of 14.94 million automobiles had been underwritten in 1999.[75] By 2001, there were nine main market players including PICC, CPIC, Ping An, Hua Tai, Sinosafe, Tian An, Da Zhong, Xinjiang Construction Corp, and Yong An. The market is very concentrated, with the top three insurers (PICC, CPIC, and Ping An) occupying 96% of the market share in 2001(see Chart 6.1). Auto insurance in all the three major insurers was the

[73] They assert that premium rates should include certain proportion of costs which are used in loss prevention or to reward insured's safety records which benefits both insurers and the whole economy. *Id.*

[74] A kind of commercial line in property insurance. It mainly covers damages to an enterprises' property that are caused by fire or other kinds of natural disaster.

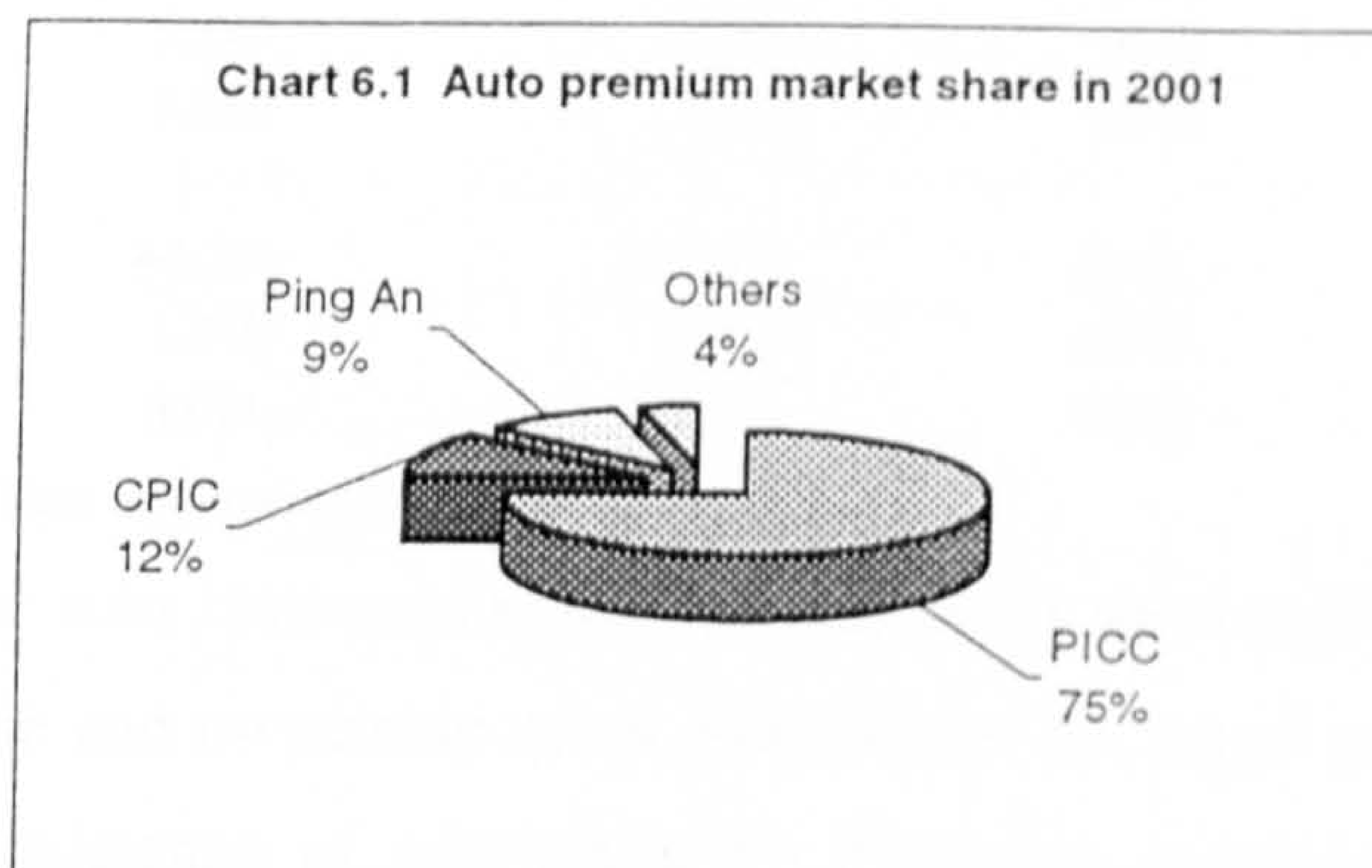
[75] "Auto insurance at a turning point of development" *Zhongguo Jinji Shibao (China Economic Times)* October 17, 2000.

largest class of non-life business and loss ratios range from 53.28-68.39 during 1997-1999 (see Table 6.3).

Table 6.2 Auto insurance premiums in China 1993-2001 (Rmb bn)

Year	1993	1994	1995	1996	1997	1998	1999	2000	2001
Gross written	10.13	14.09	18.97	20.97	20.92	N/A	30.68	36.93	42.21

Source: CIRC China Insurance Almanac 1998, 1999, 2000, and *Jinji Ribao (Economic Daily)* August 8, 2002



[74] A kind of commercial line in property insurance. It mainly covers damages to an enterprises' property that are caused by fire or other kinds of natural disaster.

[75] "Auto insurance at a turning point of development" *Zhongguo Jinji Shibao (China Economic Times)* October 17, 2000.

Table 6.3 Auto insurance business of PICC, CPIC and Ping An during 1997-1999

	Premiums of non-life	Automobile and Third Party Liability		
1997		Premiums	% of non-life	Loss ratios
PICC	N/A	N/A	N/A	N/A
CPIC	5,621	3,279	58.33	66.39
Ping An	3,869	2,153	55.65	51.23
1998				
PICC	39,918	22,204	55.62	58.61
CPIC	5,547	3,224	58.12	68.38
Ping An	3,886	2,112	54.36	61.29
1999				
PICC	44,281	26,580	60.02	56.13
CPIC	5,870	3,520	59.96	58.15
Ping An	4,091	2,371	57.95	53.28

Sources: CIRC China Insurance Almanac 1998, 1999, 2000.

The demand for auto insurance is created mainly by three different forces: the risks involved in the use and ownership of an automobile, the rapid growth of China's auto market, and the existence of administrative discretion requiring drivers to possess motor third party liability insurance. Firstly, China has established a system of liability for injury or damage caused by automobiles, which is characterised by fault-based civil liability.[76] An automobile accident can result in liability for injury or death to the driver, passengers, occupants of other vehicles, or even pedestrians, leading to liability for medical care, earning losses, and other damages. It can also result in liability for property damage either to one's own property or to another's property. An automobile can be damaged or stolen. All these risks generate demand for insurance. According to official statistics of China, in 1999, China recorded 412,860 deaths resulting from road transportation, among which 383,217 of deaths were from automobile accidents. The compensation accounted for Rmb2.86bn for the deaths and Rmb2.12bn for injuries besides huge financial loss in terms of damage to property.[77] Secondly, China's domestic auto market grew at about 20% annual rate in recent years. The ever-growing number of automobiles in turn strongly supported a flourishing auto insurance market.

[76] For example, the *1986 General Principles of Civil Law* and associated legislative interpretations set out a tort law system which also applies to road traffic accidents. Regarding the procedure, when an accident occurs, any party to the accident shall report to the Public Security Bureau (Police) in reasonable time, or they must bear the total liability. The police carry out an investigation and determine the respective liability of the persons concerned. An administrative review is available if any party disagrees with the police determination of the liability. The issues of tort and compensation are determined by the parties through negotiations in which insurers may participate when insurance coverage is involved. Any party may resort to litigation if they fail to reach an agreement.

[77] <http://www.stats.gov.cn/sjiw/ndsj/zgnj/2000>

Thirdly, although there is no nation-wide law making auto insurance compulsory so far, third party liability insurance is required in practice by the Transportation Administration Departments of the Public Security Bureau in charge of auto licensing and annual vehicle registration.

China's auto insurance has huge potential for the near future. According to the forecast by General Motors (US),[78] there were about 7 million families with the purchasing power (*i.e.* annual disposable income exceeding Rmb30,000) for a car in 2000. By 2005, the number of the families is expected to reach 42 million. In 2010, China is predicted to be the third largest auto market in the world with 6% of the global auto market share, close to that of the U.S and Japan. The premiums of auto insurance just for new automobiles will arrive at Rmb20bn annually if annual new car sales reach four millions and premiums assume Rmb5,000 for each car.

Auto insurance policies

Having designated auto insurance as one of the main types of risk, China mandated a uniform auto insurance system nation-wide, and had introduced several versions of auto insurance policies and rates, of which the latest was in 1999, with a partial revision in 2000.[79] The *1999 policy* consists of a number of different coverage including, *basic liabilities* (*vehicle-damage liability*, *third-party liability*), and *additional liabilities* which can be only selectively purchased by policyholders of the *basic liabilities*. All auto insurers were required to follow the *policy* except for those in ShenZhen where the CIRC issued a specific policy for local auto insurance.[80]

The *basic liabilities* provide two types of coverage (see Table 6.4). *Third party liability* is a traditional auto liability that covers the legal liabilities in tort incurred by the insured. The coverage compensates for deaths, injuries or damage to property sustained by third parties including pedestrians, the driver and passengers of other vehicles, when the policyholder is found to be at fault. It typically includes medical expenses, wage losses, and damages to property. There are five compensation limitation levels (Rmb50,000, 100,000, 200,000, 500,000, and 1mn), which are optional to policyholders when contracting. The coverage typically lasts one year and there is no limit on the number of accidents. Each accident occurring in the coverage

[78] *Zhongguo Jinji Shibao (China Economic Times)* Feb.27, 2002. Also see "A positive outlook for China's auto market" *PricewaterhouseCoopers* 2000.

[79] See the CIRC *Automobile Insurance Policy* 1999.

period might generate claims up to the compensation limitations. According to the policy, insurers have rights both to review the compensation agreements that policyholders made, on their own decision, and to refuse to follow such agreements.

The second *basic liability* is *vehicle damage coverage* which compensates policyholders for damage to the insured vehicle, caused by a collision, a turnover, some natural disaster, or some other accidents. The compensation is limited to the insured amount, and the coverage will cease after compensation reaches the full amount. Insurers also cover the reasonable expenses incurred by the insured to protect or save the insured vehicle in an accident.

Both *third party liability* and *vehicle damage coverage* apply *absolute exception of compensation* based on the degrees of the insured's fault. For example, an insurer only pay 80% of total compensation when the insured is held fully to blame for an accident, or 85% when the insured bears the main responsibility.[81]

The *additional liabilities* include nine different types designed to protect against specific types of losses. They are divided into two categories: pure property losses *e.g. whole-automobile-stolen coverage, vehicle fire damage loss,* and combined losses including damage to humans and property, *e.g. liability to occupants of the insured vehicle, no-fault loss.* The former needs *vehicle damage coverage* as a precondition, while the latter needs *third party liability.*

6.4.2 Auto rate regulation and its negative effects

a. Auto rate regulation

The premium (before a deregulation trial in GuangDong province in 2001) rates of both basic coverages and additional coverages were all set by the CIRC.[82] Insurers were prohibited from making any amendments to meet the requirements of different market needs except that of charging premiums within a fluctuation range of up to 30 percent above or below the unified rates. The actual fluctuation range should be approved by the CIRC before being implemented by an insurer.

According to the *1999 Automobile Insurance Premium Rates,* auto insurance premiums are designed with the "type of vehicles" in mind instead of reflecting "the characteristics of both drivers and vehicles". The premium rates have several

[80] The CIRC *Automobile Insurance Policy for ShenZhen* 1999.

[81] Art.17, *supra note* 79.

[82] The CIRC *Automobile Insurance Premium Rates* 1999.

determinants (see Table 6.4). Firstly, between commercial usage and non-commercial usage, the minimum premiums for the commercial usage are the higher. Secondly, there are different minimum premiums and rates relating to different types and sizes of vehicles. Thirdly, for *vehicle damage coverage*, minimum premiums are applied when premiums calculated by rates and insured sums are less than the minimum premiums. In addition, imported vehicles and those of Chinese-made vehicles bear different minimum premiums, with higher premiums for Chinese-made vehicles, as they are assumed to be generally inferior to imported vehicles. Fourthly, *third-party liability* has fixed premiums divided into five stages to match the five stages of liability limitation. The premiums of *additional liabilities* usually are a certain percentage of premiums, insured sum, or compensation limitations of basic coverage. For example, the premiums of *no-fault loss* are 20% of actual premiums of *third-party liability*, and *whole-automobile-stolen coverage* are 1.2% of the insured sum of *vehicle damage coverage*.

b. Comments

Insurers in developed countries normally determine auto insurance rates mainly by the characteristics of drivers together with the characteristics of vehicles. The insurers believe that driver-oriented pricing is an efficient and effective way of risk classification in auto insurance, which contributes to the efficiency of the business and avoidance of consumers' adverse selection. When determining the rate for particular coverage of auto insurance, the insurers usually consider certain factors including the insured's driving safety record, the number of years of driving experience, the number of miles driven annually (as prescribed in *Prop.103*), and the age, gender, marital status, and place of residence, of the insured. The insurers justify the use of these variables by statistical differences in the likelihood of the driver being involved in an accident and the amount of financial liability.[83] The driver-oriented pricing method has

[83] For Example, an investigation in the US in 1992 showed that disproportionate share of accidents existed in drivers of different age groups. The age group of 25 to 34 constituted 23.9% of all drivers and 26.5% of accidents and 25.6% of fatal accidents, while ages between 20 and 24 comprised 9.9 % of licensed drivers, but accounted for 15.9% of all accidents and 15.6% of all fatal accidents. See *Property/Casualty Facts*. Insurance Information Institute, the US, 1994 p88.

Table 6.4 Statutory premium rates of Automobile insurance (abstrct, Rmb yuan or %)

Nature of usage	Non-commercial								Commercial							
Coverage	Vehicle damage			Third party liability					Vehicle damage			Third party liability				
	Basic rates		Rates	Fixed rates					Basic rates		Rates	Fixed rates				
	Domestic	Imported	%	Up to 50t.	Up to 100t.	Up to 200t.	Up to 500t.	Up to 1m.	Domestic	Imported	%	Up to 50t.	Up to 100t.	Up to 200t.	Up to 500t.	Up to 1m.
1.Passenger vehicles up to 5 seats	240	600	1.2	800	1040	1250	1500	1650	480	1120	1.6	1200	1560	1870	2240	2460
2.passenger vehicles 6-19 seats	600	800	1.2	900	1170	1400	1680	1850	800	1160	1.6	1300	1690	2030	2440	2680
3.Passenger vehicles 20 seats & above	680	880	1.2	1000	1300	1560	1870	2060	880	1400	1.6	1400	1820	2180	2620	2880
4.Cargo vehicles below 2 T	200	560	1.2	630	820	980	1180	1300	400	760	1.6	880	1140	1370	1640	1800
5.Cargo vehicles 2-9.99T	480	800	1.2	1000	1300	1560	1870	2060	960	1600	1.6	1450	1890	2270	2720	2990
6.Cargo vehicles 10T & above	1000	1400	1.2	1100	1430	1720	2060	2270	1600	2000	1.6	1580	2050	2460	2950	3250
....																

obvious advantages over the vehicle-oriented pricing method that China adopted, although some characteristics such as the driver's age, gender and marital status, especially the place of residence may neither be actuarially strong nor used without the approval of insurance regulators.[84]

That China opted for a vehicle-oriented pricing method was most likely due to the fact that for a long time the majority of vehicles were subject not to individual ownership but enterprise ownership or state ownership. Such ownership structures means that many people could driver a certain vehicle. Therefore, it was difficult in practice to decide premiums based on drivers' risk profile. However, vehicle-oriented pricing had led the Chinese insurers to managing risk inefficiently and ineffectively because of its inadequacy in terms of risk classification. The vehicle-oriented pricing, uniform rates and strict rate regulation in the Chinese auto insurance market demonstrated at least three negative effects, *viz.* price compression, price suppression, and price exploitation.

Price compression As the regulators adopted vehicle-oriented pricing and prohibited insurers from designing their own premiums and policies for auto insurance products, insurers can not use risk classification to differentiate various risk-profile drivers. Neither can they launch competitive rates according to their respective situations. Stringent rate regulation provided insurers with few incentives to design customer-favoured products. Alternatively, it became one active factor that drove insurers to be involved in irregular and unhealthy competition.

Price suppression Although statutory rates in China usually support excessive pricing rather than the capping of premiums, we can still find some traces of price suppression. For instance, both compensations and premiums of third-party liability were capped by the regulators who failed to increase them to adapt to inflation and legal environment changes. In 2000, the ZheJiang branch of the PICC registered a loss of *third-party liability* of over 100%.[85] Several factors are behind this. Firstly, the statutory premium rates had remained unchanged over years, while the local average living standards - the main parameters of compensation for third-party liability - had steadily increased annually. Secondly, compensation in tort cases had accordingly increased. Thirdly, there were huge disparities between the actual compensation

[84] For example, in California of the U.S. the *Prop. 103* states that no auto insurer could use these characteristics of drivers to determine premiums without the approval of the insurance commissioner of the state.

amounts paid out in different provinces, while the regulators still maintained a nation-wide uniform premium rate system. Insurers, having to provide the coverage without the right to adjust premiums, suffered from this price suppression.

Price exploitation is the opposite of *price suppression*. Where price exploitation exists, premiums or rates are fixed by regulations at a level which is artificially higher than it would be in a competitive market. This results in extra profits for insurers who could consequently lose the incentive to improve their management or take advantage of these statutory profits to embark on irregular or illegal price competition in order to seize market share.

Rate regulation in the auto insurance market witnessed typical price exploitation frequently exploded in the mass media.[86] It was reported that in Beijing, the average premium in 2001 for a Rmb120,000 new car was around Rmb5,000, of which 15% was given to car agents as commissions. In some cases, the commissions reached as much as 38% or even 50%.[87] By contrast, the statutory commission was just 8% of premiums actually received by insurers. By examining auto insurance's cost composition (see Table 6.5), it can be seen that high commissions definitely jeopardise insurers' profitability and hence worsen their solvency. The problem is some insurers had to pay high commissions, since more than 50% of auto insurance contracts were reached through agents, especially car dealers.[88]

In addition, the premium level set by the regulators much higher than what it should be provided insurers with space to manoeuvre. To compete in the auto market, insurers had no scruples about engaging in every kind of irregular and unhealthy competition supported by their extra profits due to the price exploitation. In the end, consumers suffered.

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[85] See "Analysing problems in auto insurance pricing" *Baoxian Yanjiu (Insurance studies)* No.11, 2001.

[86] See "Auto insurance: can hidden discounts turn into visible discounts" *Zhongguo Jinji Shibao (China Economic Times)* Febuary 27, 2002, and YaReng Sheng "Reform of the Chinese auto insurance system" *Baoxian Yanjiu (Insurance studies)*, No.4, 2000, p24-25.

[87] *Jinji Ribao (Economic Daily)* Aug.8, 2002

[88] It was reported that about 80% of auto insurance business of ShenZhen branch of HuaTai insurance company was handled by agents who are car dealers. See *Zhongguo Zhengquan Bao (China Securities Newspaper)* September 2, 2002.

Price exploitation also brought insurers few incentives to improve the quality of their services and to lower operational costs thus lowering premiums. Instead, many insurers strove to secure their market by fostering connections with local governments.[89]

Table 6.5 Cost composition (excluding expenses) of auto insurance

Items	% of premiums
1. Refund for a no accident record	0-10%
2. Business tax	6.5%
3. Loss of reinsurance (balance of statutory reinsurance premiums minus compensations by reinsurers)	4%
4. Commissions	8%-50%
5. Loss ratio	45%-65%
Total	63.5%-135.5%

Sources: based on *Zhongguo Zhengquan Bao (China Securities Newspaper)* September 9, 2002.

6.4.3 Experimental deregulation since 2001

During October 2001- December 2002, a pilot deregulation project had been carried out in South China's Guangdong Province,[90] as a prelude to the CIRC's initiation of auto insurance rate deregulation. The main purpose of the reform is to end the rigid rate control over the auto insurance market, thereby eliminating insurers' dependence on statutory rates, increasing competition in the market, and finally reducing auto premiums.[91] According to the CIRC, insurers in the experimental regions are entitled to set their auto premium rates according to their respective situations. By examining limited data available since then, we find some striking and problematic results.

Guangdong province has been leading the country in insurance premium income since 1984. By the end of 2000, the province had nine domestic and overseas insurance companies or branches, and one insurance brokerage company, which together had 50,000 employees and operated 670 sub-branches across the province. Meanwhile, 22 foreign insurance firms opened representative offices in the province.[92] Insurance premiums accounted for 9.22 % of the country's total in 2001, reaching Rmb19.48bn (US$ 2.36 billion), 38.44% from property insurance.[93] By 2001, five non-life insurers

[89] See "Rectifying insurance industry and prohibiting illegal competition" Beijing Gongshang Guanli (*Beijing Administration of Industry and Commerce*) No. 4, 2001.

[90] The CIRC "Pilot Project of Auto Premium Reform in Guangdong Province" September, 2001.

[91] "A freer auto insurance market" *Chinadaily Business Weekly* October 16, 2001.

[92] "Survey on insurance market in GuangDong province" *Baoxian Yanjiu (Insurance Studies)* No.8, 2001.

[93] <http://www.chinainsurance.com> March 11, 2002.

(PICC, CPIC, Ping An, Huatai, and Sinosafe) ran auto insurance in Guangdong. Prior to the experiment, PICC had the biggest market share, with 70% of the auto insurance market; auto premiums were nearly 70% of the property insurance income of the five insurers.

a. Experience in ShenZhen

The deregulation of auto premiums started in ShenZhen with three steps. At the first step (April-July 2001), the local regulator of the CIRC adjusted rate structures. For example, it increased rates of *third party liability* due to the high loss ratio of the product. At the second step (July-September 2001), *premium fluctuation range* was deregulated to reduce auto rates while increasing *no accident discounts*. The market then saw a fierce price war and a frequent price fluctuation. Insurers vied with raising premium discounts from 10% up to 72%; premium rates changed even weekly. At the third step (since October 2001), all insurers in ShenZhen were allowed to set their own auto rates, based on the CIRC auto insurance policies and rates and their respective conditions. Insurers must first file with the local regulator their self-set rates and then stick to the rates. After the reform, there was a gradual fall in auto rates. For example, average premium decreased from Rmb6,683 (September 2001) down to Rmb4,070 (April 2002).[94] Meanwhile, auto insurance business was increasingly concentrated in large insurers while small insurers' market share shrank. Besides rates and commissions, insurers' strength and service quality became important competitive edges.

b. Price wars and price collusion in GuangZhou

In October 2001, GuangZhou, the capital of GuangDong province, embarked on a same pilot reform as that in the third step in ShenZhen. However, it saw consecutive price wars similar to those of ShenZhen. At the beginning of the reform, Huatai, the fifth largest non-life insurer in the country in terms of premium income, and a new entrant in Guangdong, announced a price-cutting policy. It reduced its auto insurance premium rate according to different automobiles, drivers, and the relationship of demand and supply in the auto insurance market. It also reduced premium rates by differentiating vehicle usage. The premium rate of *vehicle damage coverage* for government vehicles fell about 55%, whereas private vehicles for non-commercial

[94] *Zhongguo Baoxian Bao (China Insurance News)* September 18, 2002.

usage was reduced by only 25%; rates for commercial usage remained unchanged. Huatai also launched a bonus plan, *e.g.* up to a 30% discount for vehicles that have a *no-accident record* for the past three years.

Other local insurers first responded by secretly reducing their rates for *third-party liability* by 10% or more. Such discounts were normally available to two categories of consumers: 15% discount for those non-commercial vehicles through direct marketing; 10% discount for those having *no accident record* in the previous year.[95] Later, fierce price wars spiralled. Rate discounts rose, even up to 72%. The primary result of pricing competition was the redistribution of auto premiums among insurers. PICC reported that due to its customers moving to lower-rate insurers, its auto premium income declined by 11% in November 2001, meaning that its profit from auto insurance could drop by around Rmb100mn.[96] Interestingly, HuaTai, the first insurer to launch a price war also saw its auto premium income decreased. This was caused by the defection of its car-dealer agents, whose auto insurance transaction had once contributed to 80% of HuaTai's auto premium income, to insurers paying higher commissions.

To avoid competing with each other, the insurers resorted to price collusion. During just six months, they made agreements for five times trying to fix commissions and prohibit irregular competition, but none of the agreements was a success due to undercutting the agreed prices by some insurers. The insurers then resorted to self-regulation. They established a co-ordination team for auto insurance in GuangZhou, and set out self-regulation pledges containing a standard of up to 15% for commissions and penalties for unhealthy competition. Meanwhile, insurers carried out internal audits in preparation for offering rates that would be as accurate as possible, according to historical data.

c. National liberalisation of auto insurance premiums and rates

Although chaos arose in the pilot reform in GuangDong, the CIRC is determined to further liberalise auto rate control and expand the reform across the country. The nation-wide auto rate liberalisation started on January 1, 2003.[97] All auto insurers were required to file their auto premiums and rates with the CIRC before that day and then follow their pre-set prices. In preparation for this sea change, other insurers were

[95] See "Opening auto premiums in Guangdong insurance market entering into war era" *Jinji Cankao (Economic Reference*) December 25, 2001.

[96] *Id.*

reported not having filed until PICC - the market leader - presented its prices,[98] which seems a shortcut in competition.

6.5 Can market-based pricing properly function in China?

Debates on rate deregulation mainly focus on two kinds of topics: one is China should speed up the deregulation; another is whether the deregulation is appropriate for the current Chinese insurance market. Tao Liang asserts that China already met the preconditions for speeding up rate liberalisation.[99] For instance, within the insurance market, China established a primary competition mechanism with monopoly passing away. Policyholders are getting mature, and the insurance legal system has been preliminarily built. Outside the market, the market economy has replaced to large extent the former planned economy, together with the establishment of many kinds of markets, *e.g.* money market, capital markets, labour market and real estate market. However, some believe that rate liberalisation should have prudential regulation, market transparency, and a complete supervisory system as its preconditions which China has not yet met. Therefore, market-based pricing does not fit the realities of China.[100]

In my opinion, China has not been ready for a rash liberalisation of rate regulation, although market-based pricing is a right direction towards further reforms. As analysed in section 6.2, competitive pricing (market-based pricing) in some US auto markets only works effectively under certain conditions. The market must be competitive, which means that at least no access barriers exist. There is also a well-established legal environment in which both solvency regulation and market performance regulation have been substantially constructed, and information is appropriately disclosed. These are further reinforced by legal standards directly relating to rate regulation, such as standards for determining insurers' profit margins, rate standards, and procedural provisions on rate approval and filings. All these conditions force insurers to compete

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[97] *Zhongguo Jingyin Bao (China Management Newspaper)* September 20, 2002.

[98] *Id.*

[99] Tao Liang "On speeding up liberalisation of premium rates" *Baoxian Yanjiu (Insurance Studies)* No. 8, 2001.

[100] See ZiChao Liu "Competitive pricing is not appropriate in the near future" *Baoxian Yanjiu (Insurance Studies)* No. 1, 2001.

in a healthy manner. In addition, consumer protection organisations powerfully monitor insurers' pricing and market behaviour, and have an important influence on insurance commissioners' administration. On the other hand, most insurers are mature, having ample actuarial data to set reasonable prices. Meanwhile, we also observed that strict rate regulation, especially the prior approval approach, still exists in many insurance lines in many states, and it works satisfactorily in some places such as the Californian auto insurance market.

In contrast, the Chinese insurance market does not yet have similar conditions for market-based pricing. Firstly, the Chinese insurance market is still in its infancy. Market access is under the tight control of the CIRC, which leads to limited players and oligopoly in the market. Consequently, competition in the market is incomplete. A rash liberalisation of rates could easily lead to insurers' price-cutting competition and price collusion which were already seen in the deregulation reform.

Secondly, the Chinese insurance market does not lack fierce competition, and unhealthy competition indomitably refused to vanish although the regulators carried out repeated overhauls. Long-term tight government controls and the incomplete evolution of the competition mechanism in the industry mainly caused this. Furthermore, most importantly, the majority of local insurers are new entrants, possessing neither sufficient historical data nor skilled personnel for setting appropriate prices. Some insurers have not built effective and manageable distribution channels, and we saw the high dependence on car-dealer agents in some insurers. In addition, most insurers have low-profile corporate governance and internal risk control, leading them to taking up a strategy of offering unsustainable low prices to acquire market share. All these show that the industry is not ready for a swift sea change to market-based pricing.

Thirdly, a fear of destructive competition launched by insurers, especially those new entrants, is realistic, as competition is becoming fiercer in the wake of the WTO accession. When adopting market-based pricing, one challenge for the CIRC is to prevent a powerful foreign insurer or a domestic insurer, especially a new entrant (even one not as large as existing insurers), from launching destructive price wars. As we saw in the pilot reform, such destructive competition can easily blow up and weaken insurers' financial strength and solvency.

Fourthly, China has not established a legal environment for market-based pricing. Neither an integrated prudential regulatory system nor a market conduct regulatory

system has been well established.[101] Nor has been established an effective complaint-handling and dispute-solving system for protecting policyholder benefits. Also significant is the fact that China has not established a complete rate regulation system favouring to a market-based pricing. The main shortcomings are that there are no explicit rate standards, and provisions for rate administration procedure are not well-knit. For example, in the pilot rate reform, insurers are required to file prices before the prices become effective. However, the meaning of "file" is ambiguous. It could mean that the prices need no approval by the regulator. Nevertheless, the insurers are required to stick to their prices once filed, which means they can not adjust the prices according to changes in the market. Nor is it made explicit whether the regulator has the right to change the filed prices, based on its own judgement on the accuracy of the prices or on market changes. In addition, provisions on rates and information disclosure are deficient, and self-regulation by the insurance industry is at a primary stage. Insurance intermediaries are seriously problematic, and fledging policyholder organisations are badly in a need of growing. In summary, under such legal environment, rate liberalisation must be carried out with caution. Otherwise, a rash liberalisation could cause a chaotic market.

Fifthly, a market-based price reform needs associated reforms to make it more successful than one-side rate deregulation. The objectives of insurance liberalisation, including rate deregulation, are not just to reduce premiums. Goals more important are to introduce a competition mechanism into the industry while setting best standards for insurers and ensuring that they provide enhanced services for consumers. These require to consider many factors that interact with premiums and rates. Besides reasonable rate standards and rating elements, the regulator needs to improve transparency and disclosure in premium pricing, commissions, essential contract terms and insurers'

[101] These two conditions are essential for even a country with market-based pricing, e.g. the UK. In the mid 1960s, the UK general insurance industry received a wake-up call with the scandal of the *Fire, Auto and Marine Insurance Company* systematically defrauding policyholders. Another typical case occurred *when Vehicle & General*, a new entrant to the motor market, adopted an entirely new rating system, ignoring the industry-negotiated "tariffs", and soared to dominance of the market but later collapsed into insolvency. These events led to the UK government enhancing regulation and actively supervising compliance by insurers. See "Report of the Tribunal appointed to inquire into certain issues in relation to the circumstances leading up to the cessation of trading by the Vehicle & General Insurance Company Limited" (1972) H.L.80/H.C.133. HMSO.

contractual obligations, thereby facilitating well-informed purchases and monitoring by consumers.

One important factor is that premium level and policy terms interact closely. Without a simultaneous improvement of policy terms, rate deregulation can hardly succeed on a full scale. Many cases in the auto insurance support this. For example, the *whole-automobile-stolen coverage* has a large market potential. However, this coverage is required *vehicle damage coverage* as a precondition. There are also other kinds of tie-up sales, and insurers have no right to break them up to cater for consumers' needs. Another case is that insurers often abuse the term that "insurance companies have rights to review the compensation agreements that policyholders made, on their own decision, and to refuse to follow such agreements."[102] In practice, consumers have complained a lot on this issue. The regulator needs to further specify in what circumstances insurers can refuse to follow the agreements. Complaint handling is another important issue, which requires an effective and efficient solution (see section 3.4.3, Chapter 3).

6.6 Concluding remarks

This chapter examined rate regulation and the potential impacts of deregulating prices in China's non-life insurance markets, focusing on auto insurance as a typical case. From observing rate regulation and deregulation practice in the US, we learn that competitive pricing can only work effectively in a well-functioning competitive market. Moreover, it requires a set of general rate standards to assess whether premium rates are excessive, inadequate or unfairly discriminatory. There is also a need for standards to assess whether a market is competitive and change to prior approval is necessary if the market is found not competitive. Other essential elements to ensure that competitive pricing works effectively include prudential regulation, market performance regulation, consumer protection organisations, adequate disclosure requirements, and certain rate advisory organisations. In contrast, China's insurance market is still far from maturity and lacks complete competition. In addition, China lacks an integrated and comprehensive framework of rate regulation. The current rate principles and standards are outdated and fail to properly reflect the basic requirements of insurance pricing. Other necessary legal infrastructures are still in construction. Under these conditions,

[102] *Supra note* 82.

the regulator's initiation of rate deregulation reform in the auto insurance market has inevitably led to irrational price wars and collusion between insurers.

The essential point concerning market-based pricing in China's insurance sector is the conflict between the urgency of rate deregulation and the *de facto* immaturity of the preconditions for rate deregulation. There is no other solution for this conflict than actively creating the required conditions while cautiously and gradually adopting deregulation measures. Accordingly, the author recommends the following proposals:

Firstly, the core objective of premium rate deregulation is to establish an orderly market-based pricing system, thereby ensuring that insurance prices are set according to the *price mechanism*[103] in a competitive market. This means that the premium rates of most insurance products should be set by insurers themselves rather than by regulators. Even the "basic premium rates for property insurance for the main types of risk", which are currently required to be approved by regulators, should be given the consideration of the *price mechanism*. To fulfil these requirements, China needs to reform the existing rate regulation system, gradually transferring the current statutory rates and prior approval system into a market-based pricing system. Ideally, premium rates should not be excessive, inadequate or unfairly discriminatory but flexibly and appropriately reflect changes in risks and in the relationship between demand and supply, through the *price mechanism* together with indirect regulation. Considering that China is not yet ready for a rash rate liberalisation, a gradualist approach to the liberalisation is thus suggestible, beginning with relaxing the controls on premium rates of regional business, short-term policies and file-and-use for large commercial lines.

Secondly, China needs to speed up the construction of a competitive insurance market, as market-based pricing needs complete and healthy competition to limit insurers' setting prices arbitrarily. This requires an interaction with the liberalisation in other areas, *e.g.* market access, insurance investment, and policy terms.

Thirdly, while supporting competition, China must not eliminate regulation totally. An appropriate framework contains some essential elements, including: (1) rate standards; (2) standards for assessing market competitiveness; (3) explicit provisions on prior approval and competitive pricing systems; (4) explicit provisions on filing procedures; (5) complete prudential regulation; (6) an effective market performance

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[103] It represents a system in a market economy whereby changes in price response to changes in demand and supply has the effect of making demand equal to supply. See John Sloman *Economics* 3rd edition *Prentice Hall* 1997, p15.

monitoring system; (7) certain advisory organisations or insurers' associations that help insurers collect basic data but are prohibited from recommending rates or engaging in other anti-competitive behaviours; (8) adequate rating records which should be maintained by insurers, advisory organisations or insurers associations, and can be examined for compliance with laws and regulations; (9) consumer protection organisations who monitor insurers' pricing behaviour with rights of access to helpful information on pricing and coverage; (10) provisions on appropriate disclosure by insurance firms; and (11) a streamlined, effective complaint-handling and dispute-solving mechanism.

Fourthly, China needs to adopt a comprehensive approach to ensuring the success of market-based pricing and the improvement of overall quality of insurers' services. Regarding the auto insurance, for instance, the regulator needs to adopt certain measures to improve road conditions and vehicle safety as in the case of *Prop.103*, because these elements are closely related to loss ratios. It is also important to strictly enforce the existing provisions on the commissions payable to intermediaries to avoid auto premiums being unduly inflated by high commissions. Regulations that ensure adequate control over non-traditional distribution channels such as car-dealers are very important; otherwise, car-dealers' non co-operative conduct can offset the positive effects of rate deregulation, as seen in the pilot reform in GuangDong province. Other measures relating to providing policyholders with high quality services include the use of loss assessors to provide independent loss assessments, and encouraging the setting forth of a code of practice for customer service by the insurance industry.[104]

Finally, the regulatory efficiency of the existing prior approval system needs to be improved. To speed up the process of rate approval, the CIRC needs to eliminate desk-drawer rules, set out and comply with clear procedures and checklists regarding timeframes and documents required in a filing of proposed new rates or rate changes. To effectuate its operational efficiency, the CIRC also needs to deal with regulatory culture changes which focus on serving competitive environment for the benefits of both consumers and the insurance industry.

[104] For example, the *General Business Claims Code*, governing general insurance claims made by private individuals, implemented by the *Association of British Insurers* (ABI) in 2000.

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