The China Market in Transition: Sharpening for Sustainability

The Chinese insurance market is in a state of transition: after a period of rapid expansion, the market must now adjust for sustainable and healthy growth. Since enhancing risk management and market discipline in recent years, China’s regulator has gradually rolled out plans for solvency reform, less restrictive investment rules, the opening of compulsory motor insurance to foreign players and the partial liberalization of commercial motor rates.

These developments are paving the way for more sophisticated underwriting practices and offsetting market issues brought on by the previous fast expansion. Among the issues expected to affect the industry are stricter regulatory requirements, rising competitive pressure in the motor business and volatile financial markets. Decelerating profit is now a distinct possibility.

Regulatory requirements, business growth, competition, and enhancements to operational, underwriting and distribution systems are all driving the continuing demand to increase capital. However, volatile financial markets have made raising capital more difficult, particularly for smaller, non-listed insurers. For those that are listed, slumping stock markets have dragged down pricing and stock valuations of insurers.

Lower investment yields, further impairments from equity investments and slower organic growth have all exerted pressure on profitability, with the influence more obvious on major life insurers’ business results in 2011 and the first half of 2012. In the non-life market, although premium growth has slowed, overall fundamentals remain strong for insurers, given the improving solvency ratios of the top three insurers over the past three years.

Exhibit 1
China – Premium Growth vs. Other BRIC Countries (2007-2011)
China’s compound annual growth rate over the past five years is ahead of its BRIC counterparts.

* Compound annual growth rate 2007-2011
Source: A.M. Best research; Swiss Re sigma World Insurance Reports.
China’s insurers have long pursued aggressive growth to avoid missing opportunities. Now, amid a slowing domestic economy and depressed global conditions, companies have had to sharpen technical underwriting, improve operational efficiency, initiate new products and develop distribution channels instead of competing on scale for market share. Diversification of business portfolios and geographical presence offers substantial room for growth, given the underdeveloped casualty, liability and non-motor personal lines for the non-life sector. Similar trends apply to long-term care insurance for the life sector. Apart from the first-tier cities of Beijing, Shanghai and Guangzhou, many second- and third-tier cities now present significant opportunities to improve market penetration, particularly in microinsurance for the vast rural areas.

**Exhibit 2**


During the past year, the top players in both the life and non-life markets have raised capital through debt issuance to boost solvency ratios, and their solvency margin ratios are expected to remain above 150. In the first half of 2012, Ping An Insurance (Group) Co. of China received regulatory approval to issue RMB 26 billion (USD 4 billion) of A-Share subordinated convertible corporate bonds. At the same time in the life market, China Life and New China Life received approval to issue subordinated debts of RMB 38 billion and RMB 10 billion, respectively, to replenish capital and boost solvency ratios. For New China Life, the third-largest life company, this followed its listing in Hong Kong and Shanghai in December 2011 with a target to raise about HK$9.69 billion and strengthen its capital base for business growth. However, its shares slumped nearly 10% on the first day of trading amid solvency concerns, highlighting the difficulties that weak stock sentiment has created for fundraising via initial public offerings (IPOs).

The aggressive expansion and strong competition among China’s domestic insurers in the past few years, amid premium growth that averaged 20%, have placed pressure on capital adequacy. Any tightening on capital and solvency requirements would have a bigger impact on smaller players. According to the current China Insurance Regulatory Commission (CIRC) classifications, a solvency margin ratio between 100 and 150 is classed as adequate at solvency level 1.

In China, many local insurance companies still need capital amid strong premium growth and unfavorable margins. A.M. Best believes the current weak momentum of stock markets and tight liquidity in capital markets have resulted in a higher cost of capital for insurers, especially for less capitalized ones.
**Regulatory Developments: Moving Toward the Next Generation of Solvency**

Solvency reform is among CIRC’s key regulatory tasks. In March 2012, CIRC released its plan for the second-generation solvency framework, aiming to bring its system closer to international norms. The framework will be based on three aspects: capital adequacy, risk management and information disclosure. The draft regulations are expected to be released by the end of 2014 and implemented toward 2016.

As this second-generation solvency system develops, maintaining the industry’s stability remains paramount. Following rapid expansion, CIRC has said insurers must focus on preventing risks, including those relating to insolvency, policy surrenders, cash liquidity and use of capital. About 94.6% of China’s insurance companies met the required solvency standard by the end of the second quarter in 2012, according to CIRC.

It is too early to assess the change in capital requirements and subsequent impact on insurers. No insurer has failed in China’s insurance history, a record the regulator wants to preserve. Within solvency reform, CIRC’s goal is to strike a balance among conflicting factors for supervision, industry growth and stability.

With the regulator initiating solvency reform, new requirements are expected to be stricter and more sophisticated. A.M. Best believes there will be a long discussion between market players and the regulator with no rush to implement new requirements, given the current capital adequacy of insurers in China.

**Operational Climate: Watching for Volatile Global Economic Conditions**

China’s gross domestic product (GDP) growth decelerated to a three-year low of 7.6% in the second quarter of 2012, which was driven internally by the cooling property market, slowing investments and weak domestic demand. External downturns remain a challenge for China’s export-focused economy. Export growth dropped to 8.7% in the first five months of 2012, compared with 14.3% in the fourth quarter of 2011.

To prevent a hard landing, the government has taken stimulus measures to encourage new lending, cut interest rates, loosen property market policies and smooth the way for new environmental and infrastructure projects. Easing fiscal policy and opening more sectors to private investment are added measures to support growth.

As part of this drive, CIRC issued a notice in June 2012 to encourage private investment in the insurance industry and infrastructure, and for the development of private insurance companies. Under this new regulation, a private investor or entity will be allowed to own more than 20% of the shares in an insurance entity.

However, poor corporate earnings remain the main headwind facing China’s financial market outlook. State-owned enterprises have a steady appetite for fresh funds but are...
unlikely to get approvals to raise equity until markets recover. At the moment, fundrais-ing continues mainly through bank lending and bond markets.

Poor performance of equity markets has had a material impact on insurers’ investment income, particularly for life companies. The net profit of the country’s largest life insurer, China Life Insurance Co., fell 45.5% to RMB 18.3 billion in 2011 on lower investment income and rising impairments from equity investments. Under the current volatile climate, raising capital in the financial market has become difficult for insurers. The IPOs of insurers such as PICC (Group), the holding company of PICC Property & Casualty, and Taikang Life are still pending amid a pessimistic global investment environment. Solvency concerns also affect IPOs for other insurers, which must first relieve capital pressure.

Inflation falling from 5.4% in 2011 to around 2% in 2012 provides room for another modest cut in lending and deposit interest rates, which is expected to have a mixed influence on insurers. Positive short-term implications are increasing returns from equity investments, higher prices for existing debt securities and renewed interest in life insurance as opposed to wealth management products. However, with China’s insurance industry holding an estimated 30% of investment funds in deposits in 2010, returns from bank deposits would be reduced in the event of further interest rate cuts.

Industry Trends: Slower, but Still Positive Insurance Growth

China’s insurance industry has experienced slower premium growth since 2011. In the first half of 2012, the non-life sector posted a 14% rise in direct premium to RMB 270 billion, compared with 17% a year earlier. The life industry experienced a 2% increase in direct premium to RMB 583 billion, improving from a 5% drop a year earlier, according to CIRC figures.

This points to a slowdown from the industry’s past phenomenal double-digit growth. This trend is expected to persist in the near term because of continuing volatile economic impacts and weakening investment yields, particularly affecting life companies’ profitability. China’s economy is influenced by the external risk of euro debt issues and domestic risks related to the property sector, financial system and local government finances. Despite a worsening external outlook, China has ample room to respond, using fiscal policy with emphasis on measures to support medium-term objectives, according to the International Monetary Fund (IMF). The government is confident that GDP growth will be at least 7.5% this year, according to the IMF.

Non-life insurers have seen profitability improve in recent years, given the better combined ratios of major companies. However, the non-life sector experienced a 30% rise in claims to RMB 123 billion for the first half of 2012, widening from a 23% increase a year earlier. Overall, sustaining profitability will remain a challenge under a volatile economic climate and competitive market conditions.

Despite the economic slowdown, A.M. Best believes insurance premium growth will still be positive but probably less than in previous years. As the overall loss ratio in the market has been stable since 2010, profitability is expected to remain manageable in 2012, and the market should be able to record an underwriting profit in the absence of losses from major catastrophe events.

The high rate of economic growth is a defining characteristic of China, and despite a difficult external environment, A.M. Best believes China’s economy has stayed relatively
stable, in part due to the government’s monetary and fiscal policy responses.

**Insurance Investment: Easing Restrictions**

As noted above, CIRC made a series of regulatory amendments in June to ease investment restrictions for insurers in various areas, including private equity, unsecured bonds, hybrid and convertible bonds, and real estate investments. The changes aim to gradually diversify and extend insurers’ investment portfolios as China’s insurance industry moves toward international platforms (see Exhibits 4a and 4b). For the financial market, the opening of investment options for insurers is expected to increase liquidity.

In China, insurers have traditionally been constrained by limited investment tools, particularly those for matching RMB or yuan-denominated assets. Increasing investment diversification will help insurers better manage risk and investment returns through more permissible types of fixed-income assets and other tools. Total investment assets for China’s insurance industry amounted to RMB 6.77 trillion in the first half of 2012, according to CIRC. This year, insurers’ investment returns will continue to be challenged by weakening financial markets.

In July, CIRC relaxed restrictions on insurers’ bond investments by introducing new provisional measures. This will enable insurers to invest in hybrid and convertible bonds and alleviate limitations on unsecured bonds, private equity, infrastructure-related debt and real estate.

Insurers are now allowed to invest up to 10% of their total assets in private equity and equity investment funds, twice the previous limit. CIRC has also expanded the scope of insurers’ direct equity investments to include energy and resources companies, modern agriculture companies related to the insurance business, and new trading logistics companies.

In another development, whereas previously China’s insurance companies were required to manage investments directly or through their own asset management companies, they can now employ securities brokerages or fund managers.

However, there has not been a notable policy relaxation for overseas investments. China’s insurers have a minimal proportion of assets invested overseas; this appetite is expected to remain unchanged for now because of weak global financial markets and past loss experiences.
In light of these looser standards, the regulator must instill a high degree of risk management so that changes do not weaken the industry’s capital position. China’s insurance sector is still young in terms of investment experience, and the problem of how to invest funds remains a challenge for insurers, particularly for life companies.

A.M. Best believes the relaxation of investment constraints will provide greater flexibility in matching insurers’ assets and liabilities. At the same time, this will increase the investment risks borne by insurers. The insurance industry has to look into the impacts of credit risk and liquidity risk associated with new allocations in unsecured bonds, private equity or alternative investments, along with interest rate risk and currency risk from overseas investments. The regulator and insurers have to ensure that guidelines for investment and risk management are in place before the new investment strategies are implemented.

**Foreign Non-Life Opportunity: Implication of Gradual Motor Liberalization**

Motor insurance is the biggest non-life line, comprising more than 70% of China’s non-life business. The opening of compulsory third-party liability insurance (CTPL) to foreign insurers and the liberalization of commercial motor insurance pricing are recent regulatory moves with immense long-term, though not short-term, implications.

These two policy changes are not expected to have a material impact on China’s current non-life business (see Exhibit 5); chief among insurers’ concerns are the impacts on competitive pricing and profitability. However, these new developments should foster more sophisticated and healthier long-term growth, reinforcing professional practices in underwriting, distribution, claims and data management.

The opening of the motor market is not expected to erode the strong presence of the top three non-life insurers – PICC Property & Casualty, Ping An Property & Casualty and China Pacific Property – given their operational efficiency (see Exhibit 6), which supports a low combined ratio. CIRC introduced compulsory third-party liability in 2006, based on a “no profit, no loss” underwriting principle. By 2011, there were 36 motor insurers underwriting this coverage for 114 million vehicles, with total earned premium of RMB 91.4 billion. However, CTPL is not profitable, with operating losses widening 27.8% to RMB 9.2 billion in 2011.

In China, drivers tend to purchase both compulsory and voluntary coverage from the same insurer, and restrictions on foreign insurers writing compulsory motor have kept them from engaging in the segment as a whole until now. The opening will create significant opportunities to grow motor business and other personal lines through economies of scale while maintaining operational efficiency.

The challenge for foreign players will be expanding their current small market share despite an inadequate network of branch offices, limited distribution channels and the inability to fully utilize underwriting and pricing capability under the current regula-
Foreign insurers have only ever maintained about a 1% share of China’s non-life market since entering more than 10 years ago. However, foreign insurers now see entry into the CTPL segment as a way to leverage other business development despite concerns about profitability, the strong presence of local insurers, competitive pricing and distribution. Nevertheless, even with the compulsory motor business opening, there will be significant lead time before any conclusions can be drawn, with foreign companies still subject to an application period before approval, along with establishing the infrastructure needed to build the business.

The opening of compulsory motor business may also alleviate solvency pressure for domestic insurers, which experienced strong premium growth of compulsory motor business but deteriorating underwriting results. The regulator views foreign insurers’ expertise and capacity in a supportive role to this sector. Foreign insurers would help improve market conditions by bringing more technical skills and experience, such as better practices in pricing, adverse risk selection, distribution strategy, and data and claims management.

A.M. Best believes the CTPL opening may not lead to very strong competition, given that foreign companies must first make large investments in distribution and operational systems. But insurers are keen to write this line for the opportunity to cross-sell voluntary motor insurance and other non-life products.

Generally, foreign insurers focus more on high-quality services to attract new business and use profitable underwriting instead of achieving top-line growth to build market share. The focus of this operating model
Domestic Non-life Developments: Partial Liberalization of Commercial Motor Rates

The current tariff on premium has been in place since 2007, with three sets of rate structures and policy language for companies to choose from, each being similar in terms of coverage and pricing. Liberalization of commercial motor insurance, which allows voluntary increases in liability, damage and theft coverage, aims to create a more market-oriented pricing structure for insurers. However, only qualified insurers are allowed to set their own commercial motor rates and provisions. Insurers will have to fulfill certain criteria before adopting their own rates. One of the criteria is to have maintained a solvency ratio of 150 or more in each of the preceding two years of operations. It is expected, therefore, that only six insurance companies may qualify.

Pricing reform is seen as a positive move for China’s motor market, forcing insurers to pursue more sophisticated underwriting practices and better leverage customer data. It is hoped this will, in turn, advance internal pricing tools and research. However, an industry concern is that poor management may lead to inadequate pricing and destructive competition, and hence, potential underwriting losses.

Those that qualify for the new rating structure are mostly the big domestic players; thus rates set by them would have a wider impact on China’s motor market, given their size. This new policy will give qualified insurers more flexibility in pricing based on more precise customer segmentation, while driving stronger underwriting practices and more innovation in products and distribution.

A.M. Best believes the regulatory changes in commercial motor insurance will help develop the business, although insurers may face short-term, adverse impacts. The changes will benefit policyholders by enabling rate discounts for good drivers. Strong insurers can differentiate products to attract better risks, but the profit margins of some insurers may fall slightly in the coming year.

Non-life Market: Still Competitive With Focus on Cost Efficiency

Amid weakened exports and declines in domestic demand, the economic slowdown has affected non-life business. The marine, aviation and transportation lines are should be a long-term benefit to China’s non-life market.
expected to bear most of the brunt, while the engineering and casualty lines should benefit from government stimulus measures such as residential housing construction and other new investment projects.

Overall, motor premium growth has been affected by restrictions on new car registrations in some tier 1 cities under efforts geared toward alleviating pollution and traffic congestion. In other areas, there are still strong opportunities to grow other home and non-motor businesses, given the current low penetration. Consumer spending remains resilient, buoyed by government measures.

As premium growth slows, rational competition and efforts to lower expenses by streamlining distribution are important. Price competition has been a challenge, particularly for the motor business, with insurers looking into alternative distribution channels, such as online and direct, to reduce overhead.

China’s three leading non-life insurers, PICC Property & Casualty, Ping An Property & Casualty and China Pacific Property Insurance Co., recorded positive trends in combined ratios and solvency margin ratios during the past three years (see Exhibit 9).

In the first half of 2012, PICC Property & Casualty’s premium income increased 10.6% to RMB 100.91 billion, as new distribution efforts such as telephone and online sales contributed to lower operating costs. Ping An Property & Casualty reported a 19.7% increase in premiums to RMB 48.8 billion in the first half of 2012. Over the same period, China Pacific Property saw a 9.3% rise in premiums to RMB 35.2 billion.

Large, local insurers will look to stay competitive by maintaining a strategic focus on increasing the customer base, providing innovative products, developing new distribution channels and improving sales productivity. At the same time, medium-sized and smaller insurers will face more pressure to sustain and grow profitable business, given their size and limited access to new capital, but they could achieve a greater market presence by carving out specific niche businesses.

Life Market: Lowering Investment Returns Erode Results

China’s life sector continues to be challenged by low investment returns and limited organic growth since 2011.
For the top three life insurers – China Life, Ping An Life and New China Life – collective growth in gross premiums written slowed to 5.9% in 2011, compared with 21.7% in 2010, while net investment returns fell to 4.3% in 2011, down slightly from 4.8% a year earlier (see Exhibit 12). The solvency level of top life insurers remains healthy despite a downward trend in the past few years. Since December 2011, major insurers, including China Life, Ping An Life, New China Life and China Pacific Life, all raised capital by issuing subordinated debts to boost their solvency ratios.

Despite the challenges, China’s vast population offers significant potential for private pension and long-term care products in the life sector. The government has proposed a tax-deferred pension scheme for Shanghai as a pilot program that it plans to implement in the second half of 2012. It is hoped this incentive will motivate Chinese consumers who prefer to save money rather than buy pension products. Market leaders such as China Life and Ping An Life are expected to benefit from new business under this program. Other major pension players include Taiping Pension, Ping An Annuity, China Life Pension and Taikang Pension.

Reinsurance Business: Regulation Changes Create Opportunities

China’s reinsurance capacity is still abundant, given reinsurers’ view of the country’s growth potential. Competition is fierce, and there is downward pricing pressure in the absence of major insured loss events. The opening of compulsory third-party liability motor to foreign insurers, the liberalization of commercial motor rates and the regulator’s review of solvency should increase the demand for capital relief from reinsurance and for related services from foreign players. Foreign reinsurers with operational branches already in China include Munich Re, Swiss Re, Scor, General Re, Hannover Re and Taiping Re, but there is increasing interest from global reinsurers in Bermuda and London.

State-owned China Reinsurance (Group) Corp was the eighth-largest global reinsurer
Pursuing international business has become a key strategic focus for China Re. Although domestic non-life reinsurance remains the group’s core business segment, representing 38.4% of premium income in 2011, overseas business accounted for about 4% of China Re’s total group gross written premium in that year.

In 2012, China Re started a strategic partnership with U.K.-based Catlin Group Ltd. by forming a special-purpose Lloyd’s syndicate to write reinsurance cover for an existing Catlin syndicate. In a further move to expand internationally, China Re opened a RMB-denominated settlement account in Shanghai for cross-border reinsurance business in August, which added to existing facilities in Hong Kong, Macau and Singapore. In 2010, CIRC issued a notice governing the use of the RMB for cross-border reinsurance settlement to prevent potential risks and facilitate stability for business development.

The notice aligns with China’s national strategy to further internationalization of RMB. The industry impact is expected to be small because of the limited scope of allowable RMB-based cross-border reinsurance. However, further liberalization in this direction could create a major impact on China’s reinsurance business trends in the future.

### Exhibit 15

**China – A.M. Best Rated Insurance Companies**

(As of September 12, 2012)

<table>
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<tr>
<th>Company</th>
<th>Financial Strength Rating (Outlook)</th>
<th>Action</th>
<th>Effective Date</th>
<th>Issuer Credit Rating (Outlook)</th>
<th>Action</th>
<th>Effective Date</th>
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<td>Aioi Nissay Dowa Ins (China) Co. Ltd</td>
<td>A- (Stable)</td>
<td>Affirmed</td>
<td>June 12, 2012</td>
<td>a- (Stable)</td>
<td>Affirmed</td>
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<tr>
<td>China Life Reinsurance Co. Ltd</td>
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<td>September 12, 2012</td>
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<tr>
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<td>China Reinsurance (Group) Corp.</td>
<td>A (Stable)</td>
<td>Affirmed</td>
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<tr>
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<td>July 26, 2012</td>
<td>a+ (Stable)</td>
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<td>July 26, 2012</td>
</tr>
</tbody>
</table>

Source: A.M. Best Co.
A Best's Financial Strength Rating is an independent opinion of an insurer's financial strength and ability to meet its ongoing insurance policy and contract obligations. It is based on a comprehensive quantitative and qualitative evaluation of a company's balance sheet strength, operating performance and business profile. The Financial Strength Rating opinion addresses the relative ability of an insurer to meet its ongoing insurance policy and contract obligations. These ratings are not a warranty of an insurer's current or future ability to meet contractual obligations. The rating is not assigned to specific insurance policies or contracts and does not address any other risk, including but not limited to, an insurer's claims-payment policies or procedures; the ability of the insurer to dispute or deny claims payment on grounds of misrepresentation or fraud; or any specific liability contractually borne by the policy or contract holder. A Financial Strength Rating is not a recommendation to purchase, hold or terminate any insurance policy, contract or any other financial obligation issued by an insurer, nor does it address the suitability of any particular policy or contract for a specific purpose or purchaser.

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