Market Review

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Sector
Non-Life & Life

Additional Information

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China Life & Non-Life – Market Review

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Harnessing Momentum in China's Evolving Insurance Market

China's insurance market continues to stand out, although companies need to build capital to keep up with the current pace of expansion and must continue to evolve.

While other, more mature insurance markets are stagnating, total gross premiums written (GPW) are continuing to increase in China. However, growth can add particular strain to the balance sheet strength of companies at a time when there is greater attention to their solvency margins. A.M. Best notes:

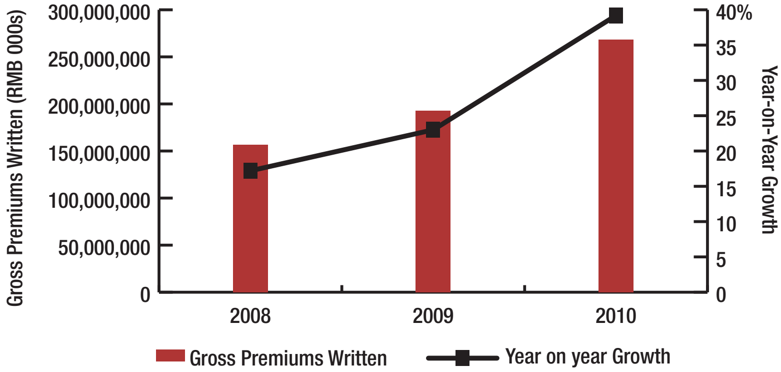
• Companies are attempting to fund further growth by raising capital, for example through planned initial public offerings and the issuing of subordinated debt. Existing shareholders are also pursuing a return of capital from their investments.

• The China Insurance Regulatory Commission (CIRC) has made significant changes to the regulatory regime in recent years. Further legislation is likely to impact insurers, especially rules for companies underwriting cross-border, yuan-denominated reinsurance.

• In addition to keeping abreast of regulatory developments, insurers face other challenges, including operating in a competitive motor market and navigating volatile investment markets.

• The life market has been impacted by insurance legislation that has introduced restraints on bancassurance as a distribution channel. The rate at which the life market has grown has slowed in the first eight months of this year.

China Non-Life – Gross Premiums Written For 3 Largest Insurers (2008-2010)



Source: BestLink A.M. Best Co.

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China's Top-Line Growth Continues

China's insurance market has maintained its phenomenal growth trend, with total insurance penetration as a percentage of gross domestic product (GDP) reaching 3.7% in 2010, compared with 3.3% in 2009. Insurance premiums climbed by 30.4% in 2010 to RMB 1.45 trillion (USD 219.96 billion, based on an exchange rate of RMB 1 = USD 0.1517), reflecting strong economic development that was demonstrated by the 10.3% growth in real GDP (see **Exhibit 1**).

Demand for insurance has continued in recent months, and from January until the end of August 2011, total premiums reached RMB 1 trillion, with non-life accounting for RMB 308 billion of premiums and life for RMB 699 billion, according to the China Insurance Regulatory Commission (CIRC). In the first eight months of 2010, total premiums also stood at RMB 1 trillion, with RMB 263 billion for non-life and RMB 747 billion for life. Life sales have fallen in 2011, in part owing to recent bancassurance regulation, although the non-life market has continued to grow despite a slowdown in motor sales from their record level in 2010, as a consequence of the withdrawal of government incentives to purchase cars. Motor represented 74% of non-life premium income in 2010.

A.M. Best categorizes countries into five tiers, ranging from "CRT-1" (Country Risk Tier 1), denoting a stable environment with the least proportion of risk, to "CRT-5" (Country Risk Tier 5) for countries that pose the greatest risk. China is a CRT-3 country; it has high economic growth rates, driven by a strong export sector, construction and infrastructure development. Its economy has enjoyed relative stability over the past few years as government monetary and fiscal policies have helped ensure economic stability.

The International Monetary Fund has forecasted the Chinese economy will expand by 9.6% in 2011. A preliminary estimate of GDP for the first three quarters of this year was RMB 32.07 trillion, a year-on-year increase of 9.4 percent at comparable prices, according to the National Bureau of Statistics of China. Continued economic growth is providing scope for insurance demand, for example from the manufacturing industry. Contributions are made to the Work Related Injury Insurance Fund, although there is also some demand for employer's liability. Demand for products liability insurance will also rise in Beijing, where coverage will initially become compulsory for industries engaged in high-risk activities such as mining, manufacturing and construction.

Natural catastrophe events, including the flooding of 13 central and southern provinces in June that damaged more than 500,000 homes, as well as roads, bridges and railways, have helped raise awareness of the importance of insurance coverage. There is also reportedly greater interest in personal accident and travel insurance in the wake of the high-speed train collision in Wenzhou, in East China's Zhejian province, on July 23, which killed 40 people and injured more than 200.

Exhibit 1

China – Key Insurance Market Statistics (2007-2010)

Indicator	2007	2008	2009	2010
Population (Millions)	1,321.29	1,328.02	1,334.74	1,341.41
Gross Domestic Product (RMB Billions)	26,581.03	31,404.54	34,090.30	39,798.30
Change in Real GDP (%)	14.2	9.60	9.20	10.30
Insurance Penetration (Life) %	1.68	2.12	2.19	2.43
Insurance Penetration (Non-Life) %	0.97	1.00	1.08	1.22
Insurance Penetration (Total) %	2.65	3.12	3.27	3.65
Insurance Premium (Life) (RMB Millions)	446,375	665,837	745,744	967,951
Insurance Premium (Non-Life)* (RMB Millions)	257,201	312,572	367,986	484,846
Insurance Premium (Total) (RMB Millions)	703,576	978,410	1,113,730	1,452,797
Change in Premium Volume (Total) %	24.72	39.06	13.83	30.44

* Non-Life includes Personal Accident and Healthcare
Note: Figures may not add due to rounding.
Sources: International Monetary Fund, World Economic Outlook Database, September 2011; China Insurance Regulatory Commission

Balance Sheet Strength and Challenges to Profitability

While insurers are growing their top lines, this is resulting in higher underwriting leverages as demonstrated by the three largest non-life insurers – PICC Property and Casualty Co., Ping An Property & Casualty Insurance Co. and China Pacific Property Insurance Co.

Aggregated data for these companies show gross premiums written (GPW), net premiums written (NPW) and net technical reserves to surplus have increased from 2008 to 2010 (see **Exhibit 2**). Companies therefore need to raise additional funds to support growth (see **Fundraisings on the Agenda**, page 3).

Some insurers claim to be focusing increasingly on profitability as opposed to growing market share. Aggregated operating expense ratios for the three largest non-life insurers were marginally lower for 2010, in part owing to larger economies of scale achieved through increased premium volumes, and loss ratios and combined ratios improved from 2008 to 2010.

Smaller companies face different challenges, including the struggle to achieve scale. Insurers of all sizes are finding certain lines of business particularly challenging, especially compulsory motor third-party liability (MTPL), which remains competitive. According to the CIRC, in 2010 this line of business posted an operating loss of RMB 7.2 billion.

Insurers' investments are predominantly in cash and bonds, although the volatility of stock market investments is an issue for insurers, with the Shanghai Composite Index falling 16% in the first nine months of 2011. While the Chinese economy is growing, bank lending in China has increased as a consequence of government stimulus programmes, and fears have also risen regarding nonperforming loans. Uncertain economic outlooks for the United States and other export partners could result in a manufacturing slowdown in China.

Fundraisings on the Agenda

In August 2011, the CIRC issued its five-year plan, setting targets to increase premium income to RMB 3 trillion and assets to RMB 10 trillion by 2015, with insurance penetration of 5%. If these targets are reached, this would represent a five-year compound annual growth rate of approximately 16%.

Exhibit 3 shows that the solvency levels of the top three non-life insurers have come under pressure as premiums underwritten have increased. Insurers therefore need to grow their capital and surplus to maintain their solvency levels if the market is to expand as rapidly as the CIRC desires, doubling premium volume in five years. Companies with insufficient solvency levels face restrictions on the creation of new businesses and subsidiaries, payment of dividends and executive pay.

Organic growth through retention of earnings with improved operating profitability will help strengthen capital. Insurers are raising funds to improve their solvency levels as they need sufficient capital to support their business growth. Furthermore, some shareholders are adding pressure on insurers to provide a return on their investments.

Insurers are raising funds through a variety of ways. For example, Ping An P&C lifted its registered capital from RMB 12 billion to RMB 17 billion via a capital injection from shareholders in June 2011. This enabled the company to meet the "Grade II" solvency ratio band of more than 150%, which is subject to lesser

Exhibit 2

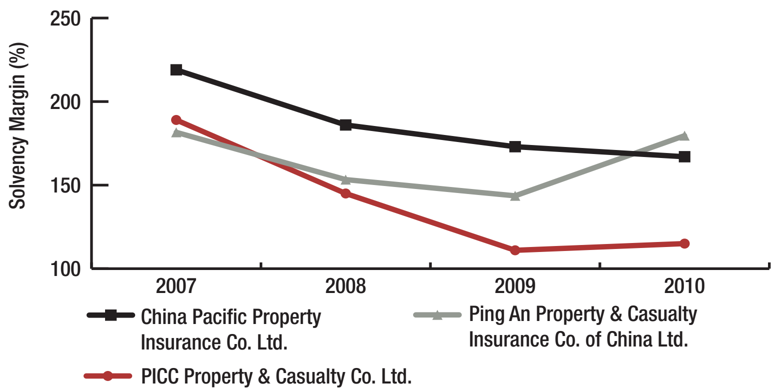
China Non-Life – Aggregated Data for Three Largest Insurers (2008-2010)

	2008	2009	2010
Gross Premiums Written (RMB 000s)	156,623,220	192,672,835	268,247,834
Year on year Growth in Gross Premiums Written	17.2%	23.0%	39.2%
Net Premiums Written (RMB 000s)	120,851,180	164,229,982	233,360,322
Year on year Growth in Net Premiums Written	8.6%	35.9%	42.1%
Net Retention Ratio	77.2%	85.2%	87.0%
Capital & Surplus (RMB 000s)	34,528,740	43,033,893	55,888,708
Change in Capital & Surplus	-9.3%	24.6%	29.9%
Loss Ratio – Non-Life	72.6%	65.4%	63.0%
Operating Expense Ratio – Non-Life	26.4%	26.8%	24.4%
Combined Ratio – Non-Life	99.1%	92.2%	87.4%
Return on Premiums	0.8%	4.0%	8.0%
Return on Capital & Surplus	3.4%	9.9%	25.5%
Net Premiums Written to Surplus	350.0%	381.6%	417.5%
Net Technical Reserves to Surplus	285.3%	290.3%	319.7%
Gross Premiums Written to Surplus	453.6%	447.7%	480.0%

Source: BestLink A.M. Best Co.

Exhibit 3

China Non-Life – Solvency Margins of the Top Three Insurers (2007-2010)



Source: Company annual reports

regulatory action than "Grade I" insurers with solvency ratios between 100% and 150%. In the same month, PICC P&C issued subordinated term debt with a principal amount of RMB 5 billion and a maturity of 10 years. PICC is reported to be planning to raise as much as USD 6 billion in an initial public offering in Hong Kong and Shanghai.

In August 2011, China Life Insurance, the world's largest life insurer, said it would issue RMB 30 billion of subordinated debt to improve its solvency ratio by around 40 percentage points.

Insurers Face Further Regulatory Developments

The insurance market is yet to feel the full impact of the CIRC's new rules in 2010, which permitted broader investment into assets that include real estate projects and private companies. The CIRC is considering further relaxing investment channels – for example, allowing investment in derivative products listed in Hong Kong and raising the 20% limit in domestic unsecured bonds to as much as 30%. While this provides more options for insurers to diversify their portfolios, it may also create greater volatility in insurers' investments.

The motor market continues to be challenging for insurers. The CIRC has launched a pilot scheme in selected cities, including Shenzhen, to liberalise commercial motor premium rates, and it is considering opening the compulsory motor insurance market to foreign insurers. However, this might lead to increased capacity and greater competition on pricing.

In August, the CIRC issued rules regarding cross-border, yuan-denominated reinsurance. Domestic Chinese insurers (excluding those in Hong Kong, Macau and Taiwan) that plan to engage in yuan-denominated reinsurance or retrocession business from foreign markets must have maintained a solvency ratio of 150% or higher in the most recent two consecutive quarters. Insurers need to additionally meet minimum financial strength rating requirements, which for an A.M. Best-rated entity is A- (Excellent) or higher.

International Insurers in China

There is ongoing interest in China from foreign companies, with the acquisition of stakes in companies providing a quick way to enter a competitive market. International companies can establish representative offices in China and after two years apply for conversion to branch offices. However, there is no guarantee that the change in status will be approved.

Direct investment in well-established domestic Chinese insurers might provide a more immediate presence in China and also access to local expertise and a distribution network (which is of particular importance in establishing a presence in the life market). There are some Chinese midsize insurers that would welcome management expertise from foreign insurers.

Recent foreign investments in Chinese insurers have included Insurance Australia Group paying RMB 687.5 million for a 20% stake in Bohai Property Insurance Pty (which is predominantly a motor insurer) in August 2011. Starr International Co., the U.S. insurance holding company run by Maurice R. "Hank" Greenberg, recently became the largest shareholder in Dazhong Insurance Co. In June 2011, Starr received permission from the CIRC to take a 20% stake in the company for an undisclosed sum. Meanwhile, Lloyd's, in addition to its reinsurance licence, began underwriting direct business in China in September 2011.

While the attractions of China's insurance and reinsurance markets remain, it continues to be difficult for international (re)insurers to compete against major domestic companies, which have established extensive branch networks and sales representatives. International insurers investing in domestic companies also face challenges, including adapting to different cultural and management styles.

Some foreign companies are exiting China, including New York Life, which sold its stake in Haier New York Life Insurance to Haier Group and Meiji Yasuda Life Insurance in 2010. This allowed it to "concentrate" on operations in the United States and on markets in Asia and Latin America where it has strong positions.

Zurich Financial Services recently sold part of its stake in New China Life Insurance to parties that included Nomura Securities, reducing its holding from 20% to 15%. However, Zurich said this was not an exit strategy but part of the group's overall risk management. Its remaining stake is valued at USD 1.5 billion.

Chinese Companies and Their Global Aspirations

In August 2011, China Re stated it is continuing to focus on growth in the Asian market and is also participating in mature markets, including Europe and the United States. China Re highlighted Latin America and Africa as attractive emerging markets. Africa represents a potential area for growth as Chinese companies are investing in infrastructure projects on the continent.

In comparison, Chinese insurers appear largely focused on growing their domestic operations, although some may seek a diversification of risks in the future. Companies in pursuit of a greater international presence may target a few specific markets by obtaining local licences or by opening representative offices, branches or subsidiaries. The larger Chinese insurers may consider buying stakes in local companies in the regions where they hope to expand.

However, international expansion for both insurers and reinsurers can result in higher risk exposure in natural catastrophe-prone regions and, in some instances, the need for capital infusions to support growth in underwriting.

Exhibit 4

China – A.M. Best Rated Insurance Companies

As of 4 October 2011.

Company	Financial Strength Rating (Outlook)	Action	Date	Issuer Credit Rating (Outlook)	Action	Date
Lloyd's Insurance Co. (China) Ltd.	A (Stable)	Affirmed	14/07/2011	a+ (Stable)	Affirmed	14/07/2011
China P&C Reinsurance Co. Ltd.	A (Stable)	Affirmed	25/08/2011	a (Stable)	Affirmed	25/08/2011
Hyundai Insurance (China) Co. Ltd.	B++ (Positive)	Affirmed	21/12/2010	bbb+ (Positive)	Affirmed	21/12/2010
Aioi Nissay Dowa Insurance (China) Co. Ltd.	A- (Stable)	Initial	11/11/2010	a- (Stable)	Initial	11/11/2010
NIPPONKOA Insurance Co. (China) Ltd.	A- (Stable)	Initial	16/09/2011	a- (Stable)	Initial	16/09/2011
China Life Reinsurance Co. Ltd.	A (Stable)	Affirmed	25/08/2011	a (Stable)	Affirmed	25/08/2011
China Reinsurance (Group) Corp.	A (Stable)	Affirmed	25/08/2011	a (Stable)	Affirmed	25/08/2011

Source: A.M. Best Co.

Distribution of Life Products Alters

China's life insurance market enjoyed strong growth in 2010, with GPW (excluding accident and health risks) rising 29.7% to RMB 968 billion. **Exhibit 5** shows that the three largest life insurers ranked by GPW – China Life Insurance Co., Ping An Life Insurance Co. and New China Life Insurance – posted an aggregated 21.7% increase in GPW in 2010 compared with 2009.

It is important to note there has been an impact from new accounting standards. Changes to premium recognition and reserving methodologies have resulted in lower GPW for some insurers, which must now classify part of their income as policyholders' deposits. However, life sales have fallen in 2011 as life insurers have adjusted to recent bancassurance regulation. From January through August 2011, premiums were RMB 699 billion, down from RMB 747 billion for the same period in 2010, according to the China Insurance Regulatory Commission (CIRC).

In view of the fast growth in premium channelled from bancassurance arrangements in recent years, the CIRC introduced new rules from November 2010 to better protect policyholders and ensure that insurers and banks exercise prudence. Bancassurance remains under scrutiny, and various other new circulars and guidelines have been issued. For example, the China Insurance Regulatory Commission (CIRC) and the China Banking Regulatory Commission (CBRC) unveiled guidelines for the supervision of the bancassurance business of commercial banks in March 2011.

Partly in response to the CIRC's bancassurance rules, banks are increasing their interests and taking controlling stakes in insurers. In February 2011, Agricultural Bank of China took a 51% holding in Jiahe Life. In June 2011, China Construction Bank bought a stake in life insurer Pacific-Antai Life Insurance from a consortium. The company has been renamed CCB Life Insurance, and China Construction Bank is the controlling shareholder with a 51% stake. Insurers are also investing in banks. In August 2011, Ping An also became the majority shareholder in Shenzhen Development Bank.

Many insurers are keen to develop alternative distribution channels, for example, utilising more agents. Cross-selling partnerships include an agreement between non-life insurer China Continent Property and Casualty Co. and New China Life. In view of the rapid growth in Internet insurance sales, the CIRC is developing a set of regulations governing such sales. The aim is to ensure the healthy development of Web-based business in the country, prevent fraud and protect the rights of insurers, insureds and their beneficiaries.

Exhibit 5

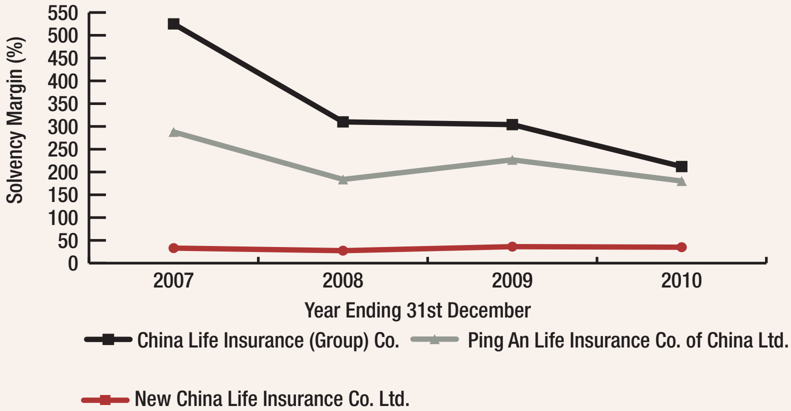
China Life – Aggregated Data For 3 Largest Insurers (2008-2010)

	2008	2009	2010
Gross Premiums Written (RMB 000s)	373,470,510	413,083,252	502,553,069
Net Premiums Written (RMB 000s)	372,387,710	411,860,351	502,089,978
Net Retention Ratio	99.7%	99.7%	99.9%
Capital & Surplus (RMB 000s)	185,045,460	241,133,453	244,921,923
Change in Capital & Surplus	-21.4%	30.3%	1.6%
Benefits Paid to Net Premiums Written	84.1%	90.7%	91.8%
Operating Expense Ratio	19.4%	19.5%	18.9%
Net Investment Returns	5.2%	3.7%	4.0%
Return on Adjusted Assets	1.2%	2.6%	2.0%

Source: BestLink A.M. Best Co.

Exhibit 6

China Life – Solvency Margins Of the 3 Largest Insurers (2007-2010)



Note: New China Life's Solvency Margin is expected to rise to 146.2% following an issue of stock in the first half of 2011.
Source: Company annual reports

Chinese Life Companies' Solvency Margins

As is the case with the non-life sector, life insurers are coming under pressure to improve solvency margins as asset values depreciate. **Exhibit 6** shows the solvency margins of the top three life insurers. New China Life's solvency level stands out, although it is expected to increase to 146.2% after the issuance of stock in 2011.

Life insurers are focusing on traditional products – savings and longer term protection – partly in response to CIRC regulations, although insurers are required to maintain higher reserves. Insurers are developing agencies and attempting to improve claims and expenses. Furthermore, the industry hopes to improve pricing. The Mortality Investigation Office (MIO) was set up under the China Association of Actuaries in Beijing to focus on data analysis. The MIO will help develop actuarial standards and formulate critical illness tables. It will analyse data on insurance surrenders, premiums and investments, and death and critical illness rates.

Insurers are also considering offering different products, including variable annuities, and the CIRC is looking at regulating product management, reserving and disclosure requirements for this line of business. Five cities (Beijing, Shanghai, Guangzhou, Shenzhen and Xiamen) are piloting these products. Insurers offering variable annuities must meet a range of requirements, including maintaining a solvency ratio in excess of 150% over the most recent three years.

Additional Life Business Challenges

Life insurers face some similar challenges to those confronting their non-life counterparts, including increasing uncertainty in the macro economy that could place pressure on growth. Volatility in the financial markets and the low interest rate environment are also major challenges for life insurers to generate favourable investment returns with their increasing size of investment portfolios.

Risk management is still undeveloped, although there is generally a greater focus on enterprise risk management (ERM). The CIRC recently issued guidelines on implementing risk management for life and health insurance companies.

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