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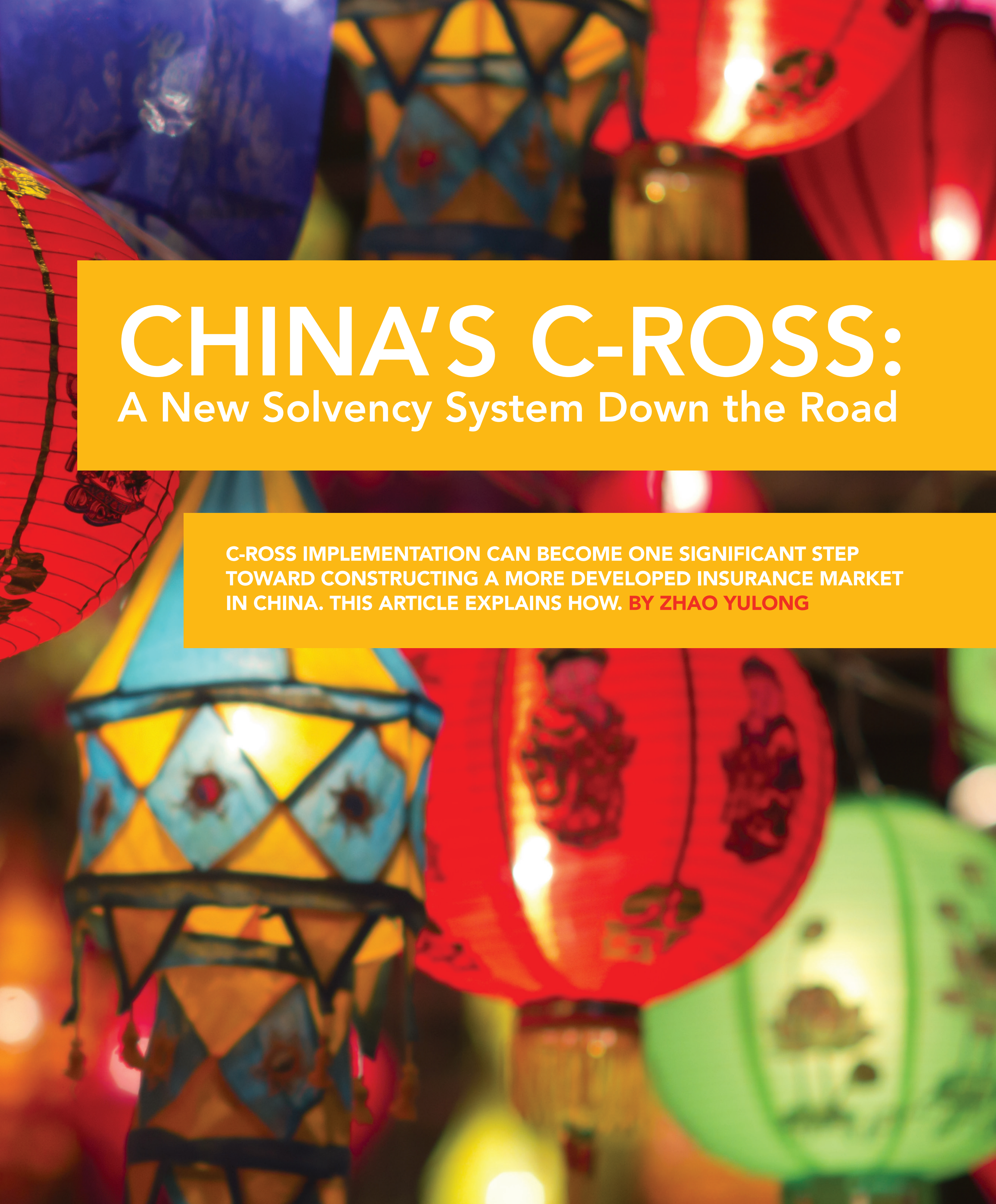


CHINA'S C-ROSS:

A New Solvency System Down the Road

C-ROSS IMPLEMENTATION CAN BECOME ONE SIGNIFICANT STEP TOWARD CONSTRUCTING A MORE DEVELOPED INSURANCE MARKET IN CHINA. THIS ARTICLE EXPLAINS HOW. BY ZHAO YULONG

Since the reopening of its insurance industry in the 1980s, China has become one of the fastest growing insurance markets in the world. The annual premium growth rate in the last 10 years reached 18 percent, and the total annual premium volume exceeded $253 billion in 2012. One of the consequences of rapid growth is that regulators had to consistently chew over how to improve the existing solvency regulation system such that the market continues to develop in a healthy and sustainable way.

BACKGROUND

Currently the China Insurance Regulatory Commission (CIRC) adopts a factor-based solvency system similar to Europe's Solvency I regime. This system worked well in the early stages of market development and contributed to solvency management being recognized as a key management issue among Chinese insurers. However, with the growth of the market and increasing complexity, the current solvency regime falls short of reflecting the actual risks

being undertaken. Solvency management is at the core of any insurance business, and so China's current solvency regime needs an upgrade.

Globally, a worldwide trend toward more risk-oriented regulations and governance of insurers' solvency has gained significant momentum in the last decade. The International Association of Insurance Supervisors has set out a series of insurance core principles (ICPs) to provide high-level guidance of insurance supervision, the European Union has been rolling out the new Solvency II regime, and the U.S. National Association of Insurance Commissioners is also working on its Solvency Modernization Initiative. As one of the fastest growing insurance markets in the world, China's development of a new solvency system not only will be designed to meet local market needs, but could also provide pragmatic and invaluable experience for other emerging markets as well as the international insurance community.

ROAD MAP AND THE CURRENT DEVELOPMENT

In April 2012, CIRC formally kicked off the project to establish "China's 2nd generation solvency regulation system." Appearing somewhat ambitious, CIRC's plan is to implement a new risk-oriented insurance solvency regulation system within three to five years. Not only will the new regime follow the ICPs, but more importantly, it will crucially take into account local market characteristics, both currently and in the future.

In May 2013, CIRC published the conceptual framework of the new solvency system, the "China Risk Oriented Solvency System" (C-ROSS), which highlighted three overall objectives:

1. To measure the risks insurance companies undertake scientifically and comprehensively and to link capital requirements more closely to risks

2. To ensure the solvency of China's insurance industry while improving its overall competitiveness, and to promote risk management ability across the industry and

3. To explore an appropriate solvency supervisory model for emerging markets.

CONCEPTUAL FRAMEWORK: THREE-PILLAR FRAMEWORK

Similarly to Solvency II, C-ROSS adopts the "three-pillar" solvency framework. However, by incorporating specific approaches or placing a different emphasis on each pillar, China's "three-pillar" framework is intended to fully reflect its own evolution.

Overall, C-ROSS has three key characteristics:

1. **One supervisory level:** Unlike the European Union or the United States, where supervision is decentralized to regulatory

bodies of each member country or state, CIRC adopts a unified supervision approach at the national level.

2. **Considerations for emerging markets:** Despite its rapid growth, China's insurance market is still at the early stages of development and is exhibiting the behavior of an emerging market. Relative to mature markets, China's market is quite different in terms of market size, growth rate, product features, risk management capabilities, talent management, internationalization, etc.

   For example, an enormous need still exists for capital injections to fuel growth for many Chinese insurers. Thus an overly prudent solvency requirement might heavily burden shareholders and hinder overall growth. Therefore, the aim of C-ROSS is to be careful not to create an unnecessary capital burden for insurers and give more emphasis to improving capital efficiency. As a solvency system designed for emerging markets, C-ROSS emphasizes the following five items:

   i. To rely more on a qualitative supervisory approach as a key supplement to quantitative measurement

   ii. To consider the cost of capital that this new solvency system might bring about and encourage improvement of capital efficiency

   iii. To ensure C-ROSS can adapt to the dynamic and rapidly changing market environment

   iv. To utilize the enforceability and authority of the new regulations to identify and mitigate various risks on a timely basis

   v. To ensure C-ROSS could be implemented efficiently in practice by the industry.

3. **Risk-oriented with value consideration:** Risk prevention plays an important role in solvency supervision and is the primary duty of insurance supervisors. Under C-ROSS, the valuation of assets and liabilities should reflect the actual risk profiles and be able to capture its changes in a timely and appropriate manner. Capital requirements should be linked directly to the actual amount of risks of various types undertaken by insurance companies.

Chinese regulators carefully look for an optimal balance between a usable solvency buffer with robust confidence to retain sufficient protection of policyholders' interests and avoiding too much capital demand to lower the efficiency and robustness of the market. The bottom line of the C-ROSS capital requirement is to prevent regional risks and systematic risks. Once the bottom line is secured, insurance companies should have sufficient freedom to decide on their own capital level to promote capital efficiency. This will enhance the value of China's insurance industry as a whole.

As a result, from a technical perspective, the quantitative calculation model for C-ROSS will not be a simple factor-based model for risk warning purposes, nor will it be constructed as a complicated model such as a full economic capital model. C-ROSS for an emerging market should achieve a balance between risk warning and complete economic valuation.

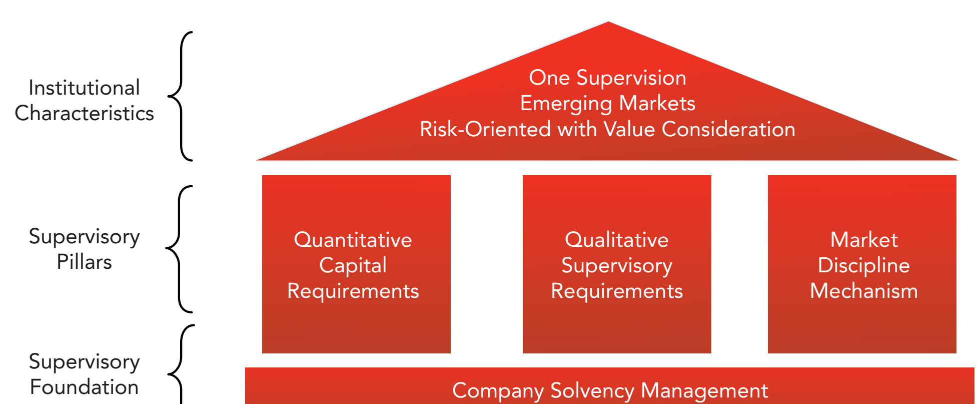
CHARACTERISTICS OF THE "THREE PILLARS"

Bearing in mind the various intentions behind C-ROSS, the details of the three-pillar framework are shown below.

- **Pillar I—Quantitative Capital Requirements**

The calculation for the Pillar I capital requirement uses a bottom-up approach. As indicated by its name, C-ROSS links capital requirements with the underlying risks. Specifically, it links these requirements to three types of risks: insurance risk, market risk and credit risk. The capital requirements for these three types of risks are quantified using a prescribed standard method and aggregated together, allowing for a diversification effect.

On the top level, additional capital might be required for pro-cyclical and systemic risk of systemically important institutions. However,



Realizing that supervisory resources are limited, the self-regulatory effect is a good complement of the proposed C-ROSS regime.

an effective internal risk management program approved by CIRC could reduce the overall minimum capital requirement in Pillar I.

This will provide significant incentive for Chinese insurers to reduce overall risks, by implementing effective enterprise risk management programs.

- **Pillar II—Qualitative Supervisory Requirements**

In Pillar II, CIRC allows for four other types of risks, which are difficult to quantify at the current stage given companies' current technical capabilities and data availability. These four risks are operational risk, strategic risk, reputational risk and liquidity risk. CIRC places the following two supervisory actions in this pillar:

1. Integrated risk rating (IRR): CIRC comprehensively evaluates an insurer's overall solvency based on both quantitative results in Pillar I and qualitative risk assessments in Pillar II, including operational risk, strategic risk, reputational risk and liquidity risk.
2. Solvency Aligned Risk Management Requirements and Assessment (SARMRA): Companies' own solvency management (often called COSM) plays an important role in the C-ROSS regime. CIRC will set up the minimum standards of risk management for insurers and will evaluate their practices periodically, such as governance structure, internal controls, management structure and processes, and it will assess insurance companies' risk management capability and risk profile.

Not only can effective risk management reduce an insurance company's overall solvency requirement, it is also a mandatory part of Pillar II of C-ROSS.

- **Pillar III—Market Discipline Mechanism**

Similar to European Solvency II, Pillar III of C-ROSS enforces oversight of insurance companies by the media, rating agencies, financial analysts and the general public by requiring information disclosure from these companies. It also utilizes markets' self-regulation power to improve insurers' overall risk management capability and market discipline.

Realizing that supervisory resources are limited, the self-regulatory effect is a good complement of the proposed C-ROSS regime. However, unlike a developed market, the concept of market self-regulation is not well recognized, so by placing it formally in C-ROSS, CIRC hopes to enhance the market discipline mechanism in China.

FUTURE OUTLOOK

According to the current pace, C-ROSS could come into effect by the beginning of 2015 at the earliest. Since C-ROSS consists of both quantitative and qualitative solvency requirements covering various key aspects of insurance business management, CIRC hopes insurance companies in China are able to improve not only their overall enterprise risk management but also their capital efficiency by effectively implementing the new solvency regime.

Meanwhile, CIRC will also encourage public oversight of insurance companies in China to forge better market discipline. In this way C-ROSS implementation can become one significant step toward constructing a more developed insurance market.

Finally, with China gaining more influence in the global insurance community, Chinese regulators are actively looking forward to learning from more developed markets and sharing our developing experience with the rest of the world. A

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