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Risk and Opportunity: The new risk arena for Chinese insurers

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ASIA IS AMONG THE WORLD'S FASTEST DEVELOPING REGIONS. As economic growth continues, the number of elderly people and middle class is increasing, developing markets such as China are representing significant growth opportunities for life insurers. Developments in the financial sector and the expansion of foreign influence in the market have fueled rapid growth over the past decade. With new opportunities have come new risks and considerations, the implications of which are still being understood. In this article, we focus on three key risks in the context of China's changing economy: insurance, investment, and operational.

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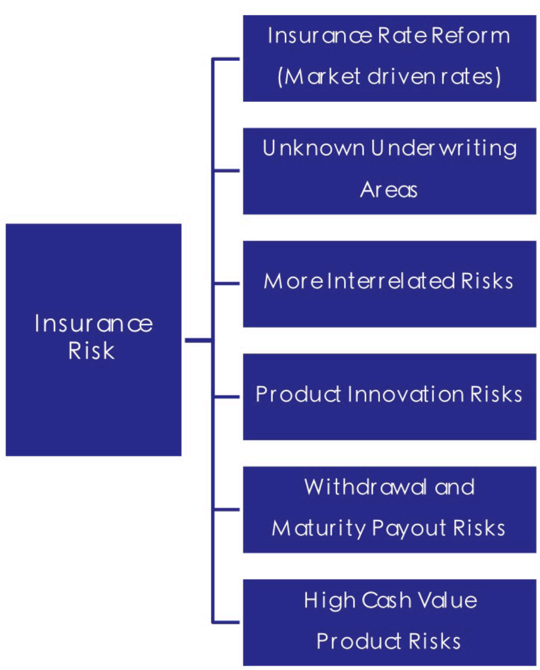
INSURANCE RISKS:

Insurers currently face a complex risk environment. On one hand, companies are struggling with high expenses and low profit margin; on the other hand, they are looking to expand into new fields to remain competitive in the market.



- **Underwriting Risk:** With pressure to remain profitable, some Chinese insurers are expanding businesses into new fields, such as catastrophe and public safety insurance. Another example is the P2P (peer to peer) lending business, where insurers provide protection to lenders against default or failure to meet borrowing rates. Lack of credible data and experience on pricing and underwriting those products introduce significant underwriting risk.

- **Insurance Rate Reform of China:** The Chinese Insurance Regulatory Commission (CIRC) has begun moving towards the direction of lifting the maximum requirement on universal pricing rates, beginning with regular life plans and profit-sharing plans. In the past, the prescribed 2.5 percent rate was used to safeguard insurance companies, although it undermined the attractiveness of insurance products to customers. Deregulation on the prescribed rate allows insurers to compete with banks on yields and returns, better understanding of the implication and market reaction is necessary.

- **Interrelated Risk:** The rapid growth of the Chinese insurance industry has created tighter connections with the general economy. Broadening investment requirements due to new products require partnerships with asset management firms to provide more advanced and complex investment vehicles. Some companies are partnering with local governments to invest in local infrastructure construction projects while others are investing in retirement housing for more stable, long-term cash flow matching.

- **Product Innovation Risk:** While innovations allow companies to gain a competitive edge over peers, they have a risk of pushing away from the realm of traditional insurance into speculation and gambling. This can have major financial consequence, but also draw the attention of the CIRC—as well as fines. An industry saying is "no innovation is too risky for insurance, but many are too risky for compliance."

- **Withdrawal and Maturity Payout Risk:** The rapid expansion of insurance also creates a liquidity risk from two sources: early withdrawals and grouped maturity payouts.

  - Industry data show large blocks of life contracts

"The rapid growth of the Chinese insurance industry has created tighter connections with the general economy."

maturing between 2013 and 2015 (mostly endowment life contracts sold from 2000 to 2005, with an average term of 10 years). This maturity pattern creates a high cash demand. To respond to the liquidity crunch, affected companies are often forced to continue to "sell to cover," meaning they continue issuing new policies for cash to cover maturing contracts rather than for profitability or strategy.

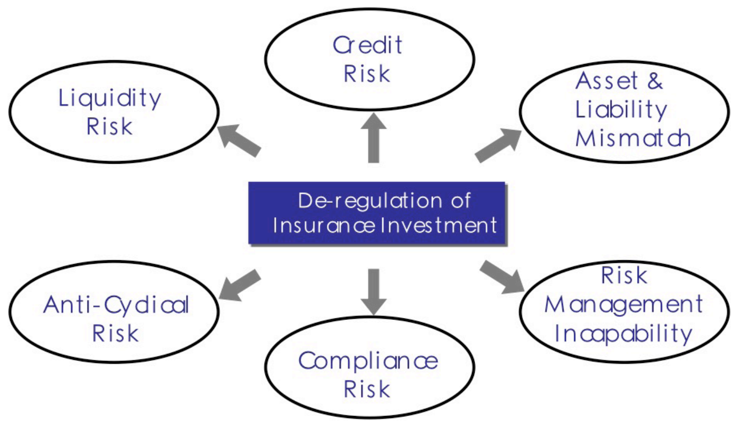
- Some companies chose to focus sales on so-called "bank insurance products" which claim to be able to compete with bank deposit rate. These products are usually short-term, high return guaranteed with no withdrawal penalty after a specific period. Consequentially, high withdrawal rates are observed immediately after the penalty period. The exposure to withdrawal behavior creates enormous cash-flow pressure on these companies, limiting their investment choices based on durations that support short-term products.

- **High Cash Value Products:** As mentioned above, insurers created "bank insurance products." These products were designed to compete with bank deposit products, but customers were often looking for high cash value as well. This further increases sensitivity and exposure to withdrawal and liquidity risk, but has become a necessity to cover benefit payments from existing payments.

INVESTMENT RISKS:

In the past, insurance company investments were heavily regulated. Historical data show most companies followed the same investment pattern: concentration on bank deposits and government bonds with limited public equity investment. There was no use of more complex investment vehicles or so-called "non-traditional investments," either because they were too risky or they were not readily available. Some examples include: debt investment, project oriented investment, infrastructure project investment (bridges and highways), real estate investment, and futures contracts.

The regulation limits investment returns and reduces the competitive edge of strong investment teams. As China's financial industry expands, the CIRC has begun to understand the necessity of broader investment options—strict regulations are hampering the competitiveness and growth potential of insurance companies. As investment regulations relax, Chinese insurance companies are able to increase investments in areas including debt instruments, equity, and real estate, which also increase investment risk exposure.



- **Debt investment:** Most insurance companies invest in real estate or infrastructure related projects with fixed returns over certain period of time (e.g., five to 10 years). While the return and principal payments are mostly guaranteed, credit risk should be considered. Since most of the projects are owned by local governments or large state-owned companies, credit risk is relatively low though.

- **Private Equity investment:** Equity investments are primarily in private companies prior to their initial public offerings (IPO). While these investments have risen over the past two years, companies are still cautious as equity investments are much riskier than debt-based alternatives. Insurance companies are new to the market and therefore do not always have the expertise and experience as investment firms. While the return is potentially higher, conservative appetites of insurers currently still lean towards more stable options.

- **Real estate investment:** By regulation, Chinese insurance companies cannot invest directly in residential real estate; however, they are allowed to invest in commercial real estate, including retirement housing. Commercial real estate is an ideal asset for insurers, as it provides long-term, stable cash flows.

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However, the recent hikes in Chinese domestic property prices have pushed insurers to look overseas to find real estate investment opportunities. A recent example in the news was the purchase of the Waldorf Hotel in New York City by Chinese insurer Anbang. While commercial real estate provides opportunity for diversified investment portfolios, it is a complicated instrument with many volatile factors like property value and occupancy rates.

OPERATIONAL RISK:

According to recent survey, nine out of 10 Chinese insurers would choose operational risk as the no. 1 risk insurance companies face today in China. Specifically, the following risks are mentioned:

- **Fraud:** Fraud is ranked as the top risk in the Chinese insurance industry. Industry estimates that 20 percent to 30 percent of insurance claims have fraud elements. While insurers have gained experience to spot and handle these fraud elements, it is a continually evolving area that requires constant vigilance.

- **Insurance Intermediary:** A large portion of Chinese insurance products are sold through third party insurance intermediaries, such as brokers/agents. Brokers and agents sometimes will lack the training or sufficient experience on understanding the long-term products feature and customer suitability. Sales driven by commissions would result in complaints and fines from regulators. Insurance companies face with high reputation risk.

- **Investment:** Operationally, some companies have yet to create a defined process to control and monitor trade/investment activities, exposing themselves to investment operational risk. Also, from a post-investment perspective, not all insurers have the processes in place to monitor performance, especially if new investments are longer duration in nature and can have substantial implications on company performance.

- **Compliance risk:** Despite recent de-regulations, the Chinese insurance industry is still heavily regulated by the CIRC. It is especially important for companies to meet compliance standards and maintain good standing with regulators.

  Compliance risk is a key issue faced by insurers for some of the following reasons:

  - New regulations, compliance standards, and requirements are issued/changed on a frequent basis during the reform phase. Dedicative resources are needed to keep up to date with any changes to optimize corporate strategies in light of the new regulatory environment.

  - Regulations are not yet fully established for new lines of business or product. This poses a unique challenge to some innovative insurance business, such as P2P insurance. Companies should balance the potential benefits from entering new product lines and markets with the potential penalties and costs if regulations work against them in the future.

  - Innovation, while a business necessity, is also a compliance challenge. Some of the innovative products in recent years were quickly pulled off the shelf as they violated compliance standards. As one industry professional put it: "On one side is innovation and the other might be breaking compliance. If not handled carefully, the line between the two becomes paper thin."

CLOSING REMARKS:

In summary, Chinese Insurers are at a new era which not only offers great reform, innovation, and growth opportunities; it also brings more complex business and thus greater risk. It is not surprising for us to see that the Chinese insurance market will go through big changes in the coming years in the form of company consolidations. Specifically, companies with limited risk management capabilities can fall behind while companies with stronger risk management capabilities can grow bigger and seize more business opportunities, thus more market share. Fortunately, both the Chinese insurance regulator CIRC and insurance companies themselves are fully aware of this situation. They are working to adapt the risk oriented solvency system (C-ROSS) for proper risk management. C-ROSS presumably will go into effect in 2016. With companies managing business on a risk based solvency system, it will foster stronger risk culture and risk management and thus stronger risk management capabilities in the long run. ■