International News

August 2009 – Issue Number 48

Xiaokai "Victor" Shi, FSA, MAAA, is senior associate, Actuarial and Insurance Management Solutions (AIMS), at PricewaterhouseCoopers in New York, N.Y. He can be reached at *victor.shi@us.pwc.com*

Mei Dong is an associate, Actuarial and Insurance Management Solutions (AIMS), at PricewaterhouseCoopers in New York, N.Y. She can be reached at *mei.dong@us.pwc.com.*

Wendy Lai is senior manager, Assurance and Business Advisory Services, at PricewaterhouseCoopers in New York, N.Y. She can be reached at *wendy.w.lai@us.pwc.com.*

Capturing Opportunities in a Period of Transition: How Multinational Insurers Can Compete in China

By Xiaokai Shi, Mei Dong, Wendy Lai

CHINA'S INSURANCE INDUSTRY IS ENTERING A TRANSITIONAL PERIOD CHARACTERIZED BY GREATER FOCUS ON RISK MANAGEMENT AND GOVERNANCE

The Chinese insurance industry has experienced tremendous growth in recent years. It reached a milestone in 2004 by accumulating 1 trillion Yuan in assets; within two years, that number doubled, and then grew by an additional one trillion in 2007. In the past seven years, life premiums grew at 23 percent CAGR, and property and Casualty (P&C) premiums grew at 20 percent.[1] By any measure, this growth is extraordinary.

A number of signs now suggest the industry may be entering a period of transition, as companies and regulators assess the risks they have taken during these years of rapid growth and seek to build a stable long term foundation for expansion. While growth may temporarily slow, this time of transition presents an opportunity for multinational insurers to deepen their presence in China, shape the industry's future, and position themselves for the anticipated resurgence of growth in three to five years.

This transitional period is necessary; the Chinese insurance industry is now large enough that companies need to reshape their operations to effectively mature and become more sophisticated businesses. Improving governance and risk management are the key components of the next level of business sophistication, and they will help establish conditions conducive to another cycle of growth.

In addition to internal business evolution, several external factors could accelerate industry reform over the next three to five years.

- **Changing regulatory focus**—Wu Dingfu, Chairman of the China Insurance Regulatory Commission (CIRC), recently signaled in an influential public magazine interview that the Chinese regulators will strengthen regulations on supervision and risk management. He said, "Several years ago, our main mission was to 'repair the roads to make space for more cars.' Now, after these last several years, our goal is simple one: to strengthen supervision, to improve the rules of the road, and strictly enforce them to prevent people from being harmed in accidents." He also commented that "the insurance sector is at the beginning of a new stage of development."

  Informal conversations and interviews with CIRC officials confirm this. Regulators are proposing and discussing new rules that emphasize solvency, capital requirements, risk management, and governance.

  This new tone from officials carries particular weight in China, where the government exerts heavy influence on the industry. The most recent PwC survey[2] of executives of foreign

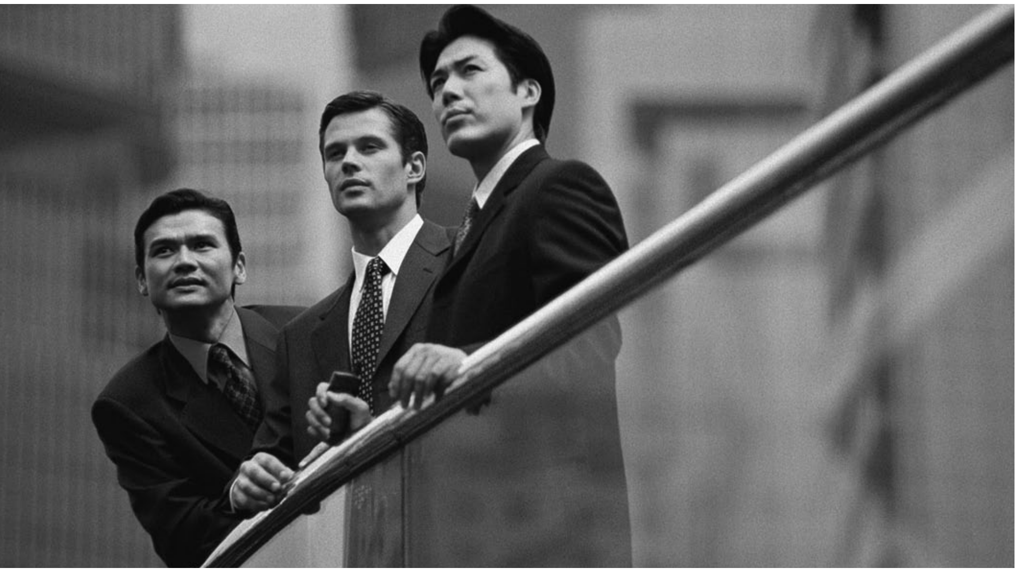
---

1 Source: CIRC 2007 annual market report

2 In 2008, PwC surveyed and interviewed 28 foreign insurance companies in China. The survey report (published September 2008) is available at: *http://www.pwchk.com/webmedia/doc/633555167808468096_foreign_insurance_cn_sep2008.pdf*

CONTINUED ON PAGE 20

Capturing Opportunities … | from Page 19



insurers in China showed they consider regulatory forces the most critical factor influencing insurance business changes.

- **Insolvency concerns**—Currently, 110 domestic and foreign insurers operate in China. However, one recent press report stated that twelve of the companies are experiencing difficulty remaining solvent. Other than the global equity market downturn, the key underlying reasons for this instability are overly aggressive business expansion, underdeveloped self-governance, and lack of sophisticated risk management expertise.

Following one particularly high-profile case, CIRC issued new rules enhancing solvency requirements in July 2008. CIRC also is establishing a regulatory framework and procedures for dynamic solvency testing, similar to one which Canada, a mature market, is actively exploring. As a result, Chinese insurers are paying more attention to risk management and governance. Several of them are actively discussing risk management programs, such as economic capital implementation, reinsurance program redesign, and enterprise risk management (ERM).

- **Vulnerable business concentrations**—Investment or savings-like instruments are easily the most popular Chinese insurance products. By 2007, 53 percent of Chinese life insurance products (including 69 percent of foreign insurers' products) were categorized as savings or investments in the form of participating or unit linked policies.

By concentrating in the investment business, insurers are in direct competition with banks and asset managers, which have the advantage of less stringent regulatory and capital requirements. In addition, China's stock market has fallen more than 60 percent in the past year. As well as hurting sales of new products, this downturn also has challenged the financial stability of the industry because, according to the 2007 year end data,[3] the average Chinese insurer has almost 30 percent of its assets bound to the stock market.

However, in a country that has a huge population and a rising middle class, insurance is expected go beyond investment vehicles to playing a key role in protecting people from unexpected losses. Accordingly, we believe, after this transitional period, the Chinese insurance industry will feature greater protection-focused growth as a wealthier middle class increasingly understands its need for insurance coverage.

- **The global financial crisis—**The global financial crisis, especially the liquidity failure

3 According to CIRC, as of year end 2007, China's insurance total AuM has 18 percent directly in equity and another 10 percent in equity funds as indirect exposure to equity market.

of AIG and Ping An's loss of billions of Yuan when the Dutch government seized Fortis, is likely to serve as a warning to Chinese insurance companies to review their risk management abilities and practices. For many years, Chinese insurers looked to U.S. business models to shape their management, organization, and investment policies, as well as their approaches to legal requirements and solvency regulations. However, the financial crisis—particularly as it has unfolded in the United States—may suggest to Chinese insurers that the model they have sought to replicate suffers from fundamental flaws.

Although it is difficult to predict the long-term impact of the financial crisis on China's insurance industry, it certainly will force many executives and regulators to re evaluate the risks the industry is facing, as well as their ability to manage them. For example, the financial crisis may cause Chinese insurers to reconsider the recent trend of establishing independent asset management companies to invest the insurer's own assets and/or assets from external sources. Such arrangements, if investment risk is highly leveraged, can eventually threaten core insurance operations.

MULTINATIONAL INSURERS FACE A NUMBER OF CHALLENGES COMPETING WITH DOMESTIC RIVALS

Since AIG started its wholly owned branch in Shanghai in 1992, the number of foreign insurers in China's insurance market has increased steadily. Today, 48 foreign insurance companies have established a presence in China, operating in life, P&C, and the reinsurance markets. However, despite steady growth, foreign companies continue to play a comparatively minor role in China, representing only a small fraction of the total market. As of the end of 2007, foreign insurers accounted for only six percent of market share, measured by the total of life and non life premiums. This is because foreign companies that want to operate in China face a number of internal and external obstacles, including:

- **Joint venture partnerships complicate operations**—A foreign insurer hoping to do business in China starts by applying for a business license. If it meets broad official and unofficial criteria, it receives a permit from CIRC. Then, the prospective foreign company must meet further regional and business requirements to receive a business license from the local administration of the Bureau of Industry and Commerce.

To establish a life insurance business, foreign companies are required to form a joint venture with a domestic company. The foreign and local companies must share ownership equally. Building a long term relationship with the partner in a joint venture is a complex process and requires mutual understanding of expectations from the outset. For example, most foreign insurers expect short-term losses when starting their businesses in China a reasonable expectation considering the long-term investment nature of the insurance business. However, foreign insurance companies must convince their local partners, the majority of whom are not financial service players, that the joint venture will prove profitable over the long term. Because China's economic boom has created a highly competitive market for capital, foreign insurers must convince potential partners of the long-term benefits of investing in the insurance industry.

- **Challenging business conditions—**Beyond the challenges they face from unusual ownership structure requirements, foreign insurers have to deal with a number of social and personnel issues unique to China, namely:

CONTINUED ON PAGE 20

Capturing Opportunities … | from Page 21

- Cultural differences can lead to distrust between joint venture partners and conflict over management practices. Joint ventures often have several managers from two different companies with totally different corporate cultures. These managers have diverse cultural backgrounds, and may have different points of view on basic issues such as markets, products, distribution, and employee compensation.

- Competition for trained and experienced Chinese personnel is intense, particularly for competent managers. In fact, this is considered the most pressing issue for foreign companies in China, according to the recent PwC survey. An influx of foreign insurance companies is expected to drive demand for Chinese insurance experts beyond the capacity of an even expanded employee training programs.

- Furthermore, retaining top talent is even more difficult than training capable employees. In the authors' view, better compensation is not a real solution to recruiting and retaining talent. Foreign insurers need to understand that talented and high performing Chinese employees are driven by more than money. More than previous generations, they have the desire to make a difference, need constant, fresh challenges to remain engaged, and long for professional—not just monetary—success.

- Foreign companies have complex and sometimes contentious relationships with Chinese regulators, which require them to invest more time and effort in having effective regulatory interactions. These sometimes difficult relationships with regulators also diminish foreign insurers' influence on the regulatory direction of the industry. For example, foreign insurers often complain about the weight of requests from CIRC.

  However, we contend that, even though CIRC's demands may seem onerous, they present an outstanding opportunity for foreign insurers to make their voices heard, as well as help CIRC determine how to better regulate the industry. We also believe that foreign insurers could go a long way toward improving their relationships and stature with regulators if they express their concerns in a common voice by forming a Chinese association of foreign insurers.

- Ongoing social changes affect marketing of insurance products. For instance, the traditionally central role of guanxi, the social relationship between and among individuals or organizations, in shaping business relationships has gradually eroded in urban centers. Insurers must now approach Chinese customers through not only their social groups, but also as individuals. Foreign insurers need to build a broader base of customer segments. As a result, building and leveraging more efficient and diversified distribution channels presents particular difficulties to multinational insurers.

THE TRANSITIONAL PERIOD PRESENTS REAL, BUT FLEETING, OPPORTUNITIES FOR MULTINATIONALS

On balance, the current, transitional period offers multinational insurers significant opportunities both to seize market share and to influence the future of the industry. There are at least three specific reasons to view the transitional period as a period of optimism and opportunity.

- **China needs more and better insurance coverage**—One of the most important byproducts of the Chinese economic boom is the rising Chinese middle class. As it builds its wealth, it accumulates valuable personal belongings, such as cars, houses, and other financial assets. The middle class thus continues to drive demand for various insurance products, including both life and non-life products.

However, a significant portion of this group still remains unaware of the importance of insurance, or lacks the knowledge to choose appropriate insurance products for themselves and their families. If foreign insurance companies continue to target and educate the growing Chinese middle class population, they will benefit from its demand for insurance products.

The threat of natural disasters also provides a real opportunity for growth in the Chinese insurance market. China's P&C insurance system still remains inefficient in providing effective social buffering in the face of major disasters. A paralyzing snow storm in January 2008 and a catastrophic earthquake in Szechuan province in May 2008 further revealed the inability of the Chinese insurance system to provide proper protection and compensation to natural disaster victims. In the next five years, the Chinese insurance market likely will continue to focus on developing appropriate products that provide coverage for both recovery and reconstruction in the wake of natural catastrophes.

- **Foreign insurers' expertise gives them an advantage—**The Chinese insurance industry is maturing in much the same way that insurers in developed countries did decades ago. Insurers from developed countries possess experience and expertise that provide them with an advantage when competing with domestic ones. Most foreign insurers are accustomed to the sophisticated business challenges in a highly regulated and highly competitive global environment. For example, while most Chinese companies have not yet faced severe financial shocks, many large multinationals already posses decades of experience designing and selling sophisticated products that can help them weather various stages in economic and underwriting cycles.
In addition, foreign insurers continue to make advances in areas such as new product development and risk management. They can draw on this experience and culture of innovation to design and sell insurance products uniquely suited to the needs of Chinese consumers. For example, products such as weather derivatives, which are common in the US, are still largely unheard of in China. In light of the unpredictability of the weather, as well as the heavy Chinese reliance on agriculture, the Chinese market is poised for demand growth in this sector. Foreign insurers, with years of experience in developing such products, as well as abundant data and models to support their design, can take a lead in introducing them to Chinese consumers.

- **The next five years is a promising time to expand in the Chinese market**—Over the next five years, foreign insurers likely will see their last—yet best—opportunity to both influence the regulatory direction of the Chinese insurance industry and obtain strong, market share for the long term.

The increasing number of well-educated Chinese expatriates who are expected to return home in the next five years represents a competitive pool of human resources—many of whom have spent five years or more working at multinational insurers or consulting firms—that foreign insurers can utilize. Within the insurance industry, this talent has ex-

CONTINUED ON PAGE 24

Capturing Opportunities … | from Page 23

tensive industry knowledge and sophisticated business development skills. At the same time, their language ability and understanding of Chinese culture give them a pronounced advantage over foreign executives who plan only short business tours in China. Accordingly, these Chinese expatriates can serve as the ideal links between the local Chinese market and the home offices that operate under western style management.

However, this opportunity may not last very long.

- Domestic companies are experiencing strong growth and are attracting increasing numbers of talented Chinese employees, both locally and from overseas. It will be even harder for foreign companies to compete in five years time because their domestic competitors will be much stronger then than they are today.
- CIRC is rapidly increasing its regulatory knowledge and skills. Over the next five years, CIRC likely will develop much stronger regulatory capabilities and make major, far-reaching policies and rules. As a result, if they cannot effectively articulate their opinions, foreign insurers will be operating in a considerably more mature Chinese insurance industry, with established rules and regulations tailored to domestic insurers. In order to better align their strategies with the development of the industry, it is very important that they be able to offer their opinions and make their voices heard during this transitional stage. At the same time, they need to make credible and well-coordinated attempts to influence the development of the industry in a manner in line with their own corporate goals.

In conclusion, the next five years is an era of considerable opportunity and some major challenges for foreign insurers who remain interested in the Chinese insurance market. It is critically important that those insurers take a long term view, plan their penetration into the Chinese market strategically, vigorously develop their local teams, actively build relationships with local partners, and carefully interact with CIRC. Foreign insurers who take advantage of this transitional period can effectively leverage their global expertise, resources, and best practices, and thus expand their presence in the Chinese insurance market. This includes attracting and retaining top local and overseas talent, building a stronger and broader customer base, exploring efficient distribution channels, constructing a diversified business portfolio, and applying prudent legal compliance with regulations. The companies who best capture the opportunities of this transitional stage will be the ones that enjoy significant long-term success in China in the years to come. □