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The Growing Pains for China Life Insurance Industry!

By Davout Yean

Since China recreated the insurance market in the early 1990s, the life insurance industry experienced rapid growth. This phenomenon can be easily demonstrated by the speed of the premium growth. Since 1996, the compound annual growth rate reached 28 percent. Even during the period of global financial crisis and recession, the annual growth rate still remained above 10 percent.

Conventional wisdom may say, as an emerging market, this long sustaining rapid growth in the China life insurance industry is not a total surprise. However, China needs to be prepared because no market can keep such a high growth rate for a long period of time, and certainly it will all come to an end. In 2011 the glory did seem to fade a little, and several worrisome situations started popping up.

First of all, the premium growth slowed down. China Insurance Regulatory Commission (CIRC) showed, 2011 life insurance premium income experienced a sharp decline of 9 percent. One of the reasons is that the definition of premium changed in 2011. After 2010, the income of a non-risk contract was no longer counted as premium income, this change artificially pushed the premium income down quite a bit. After we exclude this factor, the growth rate of premium was 8.7 percent, which still fell by 22 percent. In 2012, the situation did not improve, with the growth rate at only about 4 percent. Even if we remove the renewal premium effect, clearly the market was still not out of the woods yet.

Secondly, bancassurance, a main premium income source, is going through a serious setback. The China life insurance industry has already established a multi-channel distribution system. However, captive agents and banks are the two largest distribution channels accounting for more than 90 percent of the total business. Since 2005, banks became a major distribution channel. In the past few years premium from banks and post offices was close to 50 percent of the total premiums. In 2011, for the first time the premium growth rate in bancassurance turned negative and the bleeding continued in 2012. Most people believed the release of "Regulation No. 90" and the fact that banks offer short-term, high-yield products were the two main causes. In November 2010, China Bank Regulatory Commission (CBRC) issued the controversial "Regulation No. 90," which required that each bank and its branches can work with no more than three insurance companies. This new regulation also prohibited insurance company employees from selling insurance on a bank's premises. Obviously, Regulation No. 90 created a huge problem for bancassurance. On top of that, a couple of months later, short-term, high-yield products issued by bank started to gain momentum. Because typically bancassurance sells short-term saving products whose annual yields

are much lower than other similar bank products, there is no way to avoid cannibalization. In 2011, the sales volume of bank issued short-term, high-yield products increased by 65 percent, and it raised three times the funds in 2010. A large portion of them were considered as life insurance replacement business, or "cannibalized" business.

The other major distribution channel was in trouble as well. From 2007 the captive agent force started to decline, and finally in 2011 the turning point showed up. The number of captive agents was 288 million in the end of 2010. It decreased to 238 million in May 2011. In 2012 the speed of reduction slowed down but the trend remained. Low commission income for the agents was the main reason for the deterioration. A CIRC report showed, from 2009 to2010 captive agent monthly income dropped from US$249 to US$217. Captive agent was ranked second to the bottom in terms of professions. What made it even worse was that CIRC decided to raise captive agent education requirements. As we know, the low income and high qualification requirements don't mix well. Further deterioration of the captive agent force is highly possible.

On the financial side, it did not look great either. In 2011 many smaller companies turned profits into losses, and at the end of the third quarter of 2011, company solvency ratios declined by 60 percent on average compared with the beginning of 2011. Quickly, solvency became a concern for almost every company. Many companies started to initiate capital infusion processes and some companies began to reevaluate their market expansion strategy.

Now the entire industry finds itself in a very unfamiliar territory and starts to wonder whether the good times are over. Or maybe this is just the growing pains, after this point it will become smooth again? Or like many other things, the truth lies somewhere in between? Before jumping to any conclusion, let's take a look at the causes and hope they will reveal what we want to know. Without surprise, in the life insurance industry there are many discussions about the causes. The most popular explanations blame the sluggish capital markets that steal all the profits, high labor costs that killed the captive agent force, and finally the previously mentioned problems with bancassurance. On the surface, this does seem to make sense, but if we look at it from a different angle, there are some other things that disturbed the market as well.

We all know that the ups and downs in capital markets is a norm, and to smooth the ups and downs is what we do. When ups come, you try to capitalize as much as you can. When downs show up, you just can't say it is a total surprise or use it as an excuse. Furthermore, interest rates are heavily regulated by CIRC in China. While the pricing interest rate was capped at 2.5 percent, by CIRC, the industry overall investment return rate was 4.2 percent in 2011 and 3.9 percent in 2012. Based on these two figures, blaming the capital market as a cause for poor financial performance doesn't seems fair.

As mentioned above, the number of captive agents shrunk in both 2011 and 2012.This situation might have some connection with the fact that the commission income level for captive agents was flat for many years and in consequence a captive agent's income now was way behind other professions. But considering the poor financial performance for these couple of years, adding more cost to maintain a captive agent force was not a good choice. It seems that the existing captive agent model is at the begging of a deadly spiral situation.

In theory, bancassurance is a non-direct contracted distribution channel. It is simply just the gun for hire by the insurance company. On the bank's side, the motivations to sell insurance are commissions and bringing in insurance long-term products to supplement the bank products, which are short-term

by nature. But if we take a closer look, most of the bancassurance products have shorter terms than five years and more than half of them are single premium products. Selling insurance in banks can be similar to moving customer's money from one account to another account. This movement is incentive to the bank because of a pretty high fee. In the insurance world we have a term for this type of movement—"churning." I believe we would all agree that it is not wise to rely on churning as your major business source, and it is insane to expect churning can last forever.

Actually, the difficulties we encounter today are not necessarily the result of some mistakes. These difficulties are more likely the symptoms of living in a hazardous environment for too long. Following are the hazards which I think have polluted the life insurance industry in the past.

From the beginning, market expansion was always the top priority. This allowed the life insurance industry to ignore one of their major responsibilities—making a profit. On top of this impairment, in 1999 CIRC capped the pricing interest rate at 2.5 percent. In practice, this restriction gave permission to the life insurance industry to overcharge their customers. For many years these excessive profits facilitated the life insurance industry to acquire the habit of using high investment income to feed underwriting losses. Moreover, encouraged by this excessive profit, the industry carried on the thirst for more assets for a long time. Insurance policies became a tool to accumulate assets. This behavior eventually weakened the core value of the insurance industry.

From YRT Life to the Variable Annuity, the China life insurance industry brought in all the existing products in the world in only 15 years, while these products took more than 100 years to develop in other countries. It might look like a miracle and the abundance of product selection was not a bad thing. We know that certain products only make sense under certain conditions, such as tax code provisions, the investment environment, related social programs, and pension plans, etc. In China many of the conditions did not necessarily fit some of these products brought in to the market in the past 15 years. In a way, many existing products only brought benefit to the insurance company, but did not bring value to the customers. Under this situation, it fueled and made market conduct and misrepresentation a serious issue in the Chinese insurance market.

At first glance, the premium growth was very healthy and the premium growth rate was faster than the growth rate of the size of the captive agent force. But putting these two things together, it did not translate into a healthy income growth for the captive agent. That was because the vast majority of the existing products were savings or investment products. Not only was the risk premium a small portion of the total premium, but also the growth rate was much lower than the total premium growth rate. As a result, the income increase for captive agents was behind inflation and behind other professions.

With all these hazards discussed above, the insurance industry is in danger when the capital market slows down, inflation speeds up, customers become more educated, and the insurance market becomes more mature.

With all the pain and suffering the insurance industry went through in the past two years, I go back to my previous question: is this just the growing pains? It might be. Although the growth rate for premium income slowed down in 2011 and 2012, the Chinese life insurance industry can still be qualified as a fast growth market compared to the average increase of 3 percent globally. The density of Chinese life insurance was $106 in 2010, which was far lower than the world level of $365; the depth of life insurance was 2.5 percent, which was also lower than the worldwide level of 4.0 percent. If we look at the big picture, in the next 10 years the GDP growth in China will probably stay at 6 percent-8 percent, therefore the buying power should be the same or stronger than the past 15 years. All of this information suggests that the Chinese life

insurance market is still one of the most promising markets in the world. That is why I have concluded that what the China life insurance industry went through in 2011 and 2012 was just growing pains. Then the most important question is how to grow out of it. I believe if the industry could quickly implement the following four actions, it might soon bounce back.

1. Enforce the solvency requirement
CIRC currently is in the process of introducing a modified version of Solvency II to the Chinese market. Understanding there are many debates around the advantages and short falls of Solvency II, whether to continue the old system or to bring in the new system is not a key issue. In fact, whether CIRC is willing and able to strictly enforce the rules is the key. I firmly believe that to enforce the solvency requirements is an easy way to bring the financial discipline back and push the industry in the right direction.

2. Remove the cap on pricing interest rate
Sufficient but at the same time not excessive premiums are important. Today, using convoluted Participating Product Regulations to mitigate premium sufficiency problems creates many unexpected and unfavorable consequences. We should trust the market, and believe the power of fair and free competition. Finally, it is time to set the pricing interest rate free or take the safer approach to just simply raise the cap.

3. Embrace the core value and return to the basics.
When the wave comes, it is OK to catch a ride and make some short-term money in the capital market as long as it is not at the customers' expense. The core value is still intact. No industry could ever survive for long if it does not create value for the customer and society. Using a pooling mechanism to offer protection to the individual is the main reason for insurance to exist. The Chinese life insurance industry overly emphasizes saving, therefore investment products are hurting the momentum for the industry to go further. It is time to return to the basics and embrace the core value of life insurance.

4. Develop multiple distribution channels.
Captive agents and banks are the two most important distribution channels now. It is highly possible for this situation to continue. But it should never hinder the development of multiple distribution channels. The purpose is not to look for other distribution channels to replace the existing ones but to find a better, cheaper, and easier way to distribute products while creating a healthy competition environment among all the distribution channels.

In the business world, we consider growing pains as somehow inevitable in the beginning or growth stage of any enterprise. I hope, the issues discussed above are just symptoms of rapid grow and not associated with any serious problems. If this is the case, the Chinese life insurance industry will eventually mature beyond its "growing pains." □

THE NORTH AMERICAN ACTUARIAL COUNCIL (NAAC) Collaborative Research Group has recently initiated a study of regulatory risk conducted by Tom Herget and Dave Sandberg. This risk is when the regulations used to achieve supervisory objectives (or the lack thereof) have a negative impact on the market participants (whether policyholders, shareholders, or regulators acting on behalf of taxpayers). This study will include examples of regulatory risk.

While the researchers will be reaching out to specific individuals in the United States, Mexico, and Canada, they would also welcome contributions from a wider pool of contributors who can provide their personal examples of regulatory risk both within and outside North America.

The researchers would appreciate any contributions section members could make. Please e-mail descriptions of examples of regulatory risk to Barb Scott (BScott@soa.org) for consideration by the researchers. Detailed descriptions are encouraged.