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Insurance sector following WTO accession

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Under the WTO accession agreement, China has undertaken to implement significant reforms contributing to the further liberalisation of the insurance sector over a five-year period. This will allow increased foreign participation in ownership in the sector and in the scope of business that foreigners may engage in—geographic limits on foreign operations will be eased considerably.

One hundred per cent foreign ownership of a non-life subsidiary will be permitted within two years of accession; majority foreign ownership (51 per cent) of brokerages for insurance of large commercial risks, reinsurance and international marine, aviation and transport insurance will be permitted three years after accession; and wholly foreign-owned subsidiaries will be permitted five years after China's accession. Upon accession, a foreign life insurance company will be permitted to own 50 per cent of a joint venture with a Chinese partner of its choice (the same percentage has been applied in the recent period). Requirements for an insurance business to cede 20 per cent of its reinsurance needs to China Reinsurance will reduce in tranches to zero, four years after accession.

In the protocols of the Working Party involved with China's accession to the GATs, it is noted that China confirmed that on accession to the WTO, its licensing procedures and conditions would not act as a barrier to access; that for services, China will ensure a transparent procedure for applications for licences; that applications will be open without individual invitation; and that decisions on all applications will be taken promptly.

If an application is refused the applicant will be informed in writing and without delay of the reasons. Approved applicants will also be notified without delay and notice of approval will enable the applicant to start commercial operations upon registration of the company's name with the SAIC for fiscal and other administrative purposes. The registration processes will be completed within two months of submission of a complete application, as required by public SAIC regulations and in accordance with China's Schedule of Specific Commitments under the GATs.

These undertakings represent a significant and welcome change in the approach to the treatment of foreign applicants for licences to undertake insurance business in China. Another and important aspect of China's commitments under the relevant GATs schedule is that upon accession, foreign life insurers—which as noted above will be permitted 50 per cent equity in a joint venture—will be allowed to enter into the venture with a partner of their choice, and those joint venture partners can freely agree the terms of their engagement provided they remain within the limits of the commitments contained in the schedule. This in effect means that while the 50 per cent ownership limit will apply, it will be a matter for decision by the partners, without any legal impediment, as to who will control the enterprise.

Before authorisation, a foreign insurer will need to have 30 years experience in a WTO member country, total assets of more than US$5 billion and to have had a representative office in China for two years. Insurance brokers will be required to have assets of more than US$500 million and two years after accession, brokers will be required to have assets of more than US$200 million.

Upon accession, foreign life and non-life insurers will be permitted to provide services in Shanghai, Guangzhou, Dalian, Shenzhen and Foshan and two years after accession more cities will be open to foreign service providers—Beijing, Chengdu, Chongqing, Fuzhou, Suzhou, Xiamen, Ningbo, Shenyang, Wuhan and Tianjin. Within three years after accession, there will be no geographic restrictions.

The business scope for foreign insurers will be extended on a graduated basis. After accession, foreign non-life insurers will be permitted to provide 'master policy' insurance/insurance of large-scale commercial risk, with no geographic limitation. Foreign non-life insurers are permitted to provide insurance of enterprises abroad as well as property insurance, related liability insurance and credit insurance of foreign-invested enterprises in China. Within two years after accession, foreign non-life insurers can provide the full range of non-life services to both domestic and foreign clients. Within three years after accession, foreign life insurers will be permitted to provide health insurance, group insurance and pension/annuities insurance to foreigners and to Chinese.

The measures that China has agreed to undertake in the insurance sector as a condition of accession to the WTO do represent a major, if graduated, step in the liberalisation of the sector. Within a period of five years after accession, competition for the delivery of insurance services across China by wholly foreign-owned non-life companies will be possible and the total range of life insurance services will be available by entities which may involve up to 50 per cent foreign equity but which may well be effectively controlled by the owners of the foreign equity.

The impact of these undertakings will reinforce changes already underway toward a more market-oriented insurance sector. These changes are reflected in the broad range of reforms which China has been implementing over most of the last decade or so, aimed at deepening and widening its capital markets and modernising the financial system. The changes that will occur over the next five years will almost certainly include the restructuring of the state-owned insurance sector in China.

Since the insurance sector in China became open to foreign participation, the world's major insurance/finance firms have expressed strong interest in accessing the market. The reasons for this derive from the underdevelopment of the market and the major growth prospects on offer as China continues its economic and social modernisation.

STRUCTURE OF THE INSURANCE MARKET AND GROWTH OUTLOOK

In 2000, the aggregate premium income in China amounted to 1.8 per cent of GDP with an average per capita premium of just over US$15. Comparable figures for global insurance activity were 7.5 per cent and US$387, respectively, in 1999. The total national premium expenditure in 2000 in China represented only 2.3 per cent of the deposits in the nation's savings banks and only 25 per cent of the Chinese population held insurance policies. These figures indicate that insurance in China is in its early stages of development and insurance penetration is relatively low—particularly when compared to industrial economies generally and some major regional economies such as Japan, Korea, Australia and Taiwan.

Most business revenues of domestic insurers derive from internal distribution channels with only a small proportion of business so far generated through brokers. In some developed markets, intermediaries account for a significant majority of insurance business. Reinsurance has largely been channeled through the state-owned China Reinsurance and this near-monopoly position is a significant market impediment. In the period following China's accession, the role of intermediaries/brokers is expected to develop into a more significant aspect of the market structure and greater competition in the reinsurance market will follow as new players enter the market.

Since the opening of the economy in the 1980s, the insurance sector has grown rapidly at an average annual rate of 37 per cent—much higher than GDP growth. Notwithstanding this, the market, is underdeveloped compared with other economies. The prospects for the industry are for continuing strong growth. This is so for all sectors—life, general and reinsurance—as the modernisation of the Chinese economy continues apace, and per capita income levels move along an upwards growth path.

Under the current 10th Five Year Plan, the economy is predicted to grow by around 7 per cent annually; GDP for 2005 is expected to reach around RMB 12.5 trillion. GDP per capita should reach about RMB 9,400, with disposable income growing annually by 5 per cent. Over the next five years, property and life premium in China is estimated to increase annually by 15 per cent and 20 per cent, respectively. Over the longer term, the growth of property premium income is forecast to moderate, but still to grow by above 10 per cent annually, while life premiums income is forecast to maintain high strong growth.

FOREIGN PARTICIPATION

Foreign insurers' share of the Chinese domestic market is extremely low—around 1.6 per cent of the life market and 0.5 per cent of non-life. Of the existing 33 insurers in China, fewer that 20 involve foreign participation, and these are concentrated mainly in Shanghai and Guangzhou. A limited number of wholly foreign-owned enterprises have been permitted in both the life and non-life sectors. AIA is by far the dominant foreign-owned enterprise in the life, accident and health insurance market and in the non-life market, AIU, Tokio Marine and Fire, and Winterthur are the dominant players, followed by Royal and Sun Alliance and Allianz Dazhong. Since 1998, six foreign insurance groups have entered China; four as minority partners with Chinese firms in the life insurance sector and two as wholly-owned foreign businesses in the non-life sector. In addition, four foreign insurers have made small strategic investments in Chinese life insurance businesses.

Many foreign insurance companies are known to be interested in investing in the Chinese market, attracted by potential rapid growth of the market over the medium to long term. There is no other market in the world where the prospects of growth are so great.

CHANGING MARKET AND REGULATORY ENVIRONMENT

Market opening is being accompanied by a changing regulatory environment. The insurance regulator, the China Insurance Regulatory Commission (CIRC), is applying international standards and codes in an increasingly objective way. This approach will contribute to the prudential strengthening of the sector and will add confidence in the sector for those investing in the insurance market.

CIRC and businesses in the sector now consult about the professional aspects of the insurance business—concerning, for example, actuarial and auditing functions—and in understanding the development of new products such as unit-linked products.

CIRC has reduced the level of 'guarantees' that life companies are required to set aside, and this reflects concerns of the local industry that it was unable to maintain the level required, at a time when interest rates and profitability were falling sharply and the industry was facing solvency problems. The approval process by which new products may enter the market is much less onerous than previously and the scope for product innovation is significantly better than it was only two or three years ago. Unit-linked, wealth accumulation products are now prominent innovations in the market. Premiums are increasingly determined by the market.

Professional standards are improving and those involved in the industry—including importantly in agency work forces—are now required to pass professional examinations. CIRC is developing its capacity for on-site inspections of insurance firms.

These developments point to a very serious upgrade in the regulatory approach as China faces the challenges posed by a rapidly changing financial environment.

THE IMPACT OF THE WTO

In many senses, the insurance sector has been adapting to a changing competitive environment for most of the last decade. A number of new foreign firms have entered the market, as well as some domestic privately owned firms, and the regulatory environment is undergoing major reforms. The main impact of WTO accession will be to accentuate these changes. WTO accession will reinforce the policy direction that China has already embarked on rather than mark a sharp change in direction. This is also the case for other segments of the financial services sector.

No doubt the prospect of WTO accession over the last 5 years or so has been a factor in influencing the adjustments that have occurred in the sector, but the deeper reason for the reform program has been internally driven, the key driver being the imperative for China to modernise the financial system to contribute to the continuing growth process that is vital to securing China's future.

CHALLENGES POST WTO ACCESSION

Significant challenges lie ahead and in a sense WTO accession will focus attention on meeting those challenges. The issues confronting the insurance sector are generally common to other parts of the financial sector. A primary issue derives from the segmented nature of the financial sector and this is reflected in a segmented regulatory system.

Reducing financial system segmentation

There were sound reasons why, during the last two decades, the ever-widening credit creation activities of financial institutions in China were reined in. Credit growth by institutions outside the state owned banking sector—but often undertaken by affiliates of those institutions—created the genesis of the financial crisis that developed in China in the late 1980's and early 1990's. The more rigorous control of credit and the more effective supervision of non-bank intermediaries within a reformed and segmented regulatory system evolved in the second half of the 1990's. Success in this area was of fundamental importance in contributing to price and economic stability.

The challenge for China over the coming period is to encourage competitiveness in the financial system so as to satisfy the burgeoning financial needs of a modernising economy, while at the same time continuing to develop a responsive and flexible regulatory system which provides for a stable financial environment. These challenges are a constant factor facing all economies; but they are particularly intense for China as it seeks to maintain a high growth rate but with an as yet underdeveloped financial system.

Pressures will be placed on the regulatory system to reduce regulatory segmentation and to facilitate the convergence of financial services and products. For this to occur, a next phase of regulatory reforms will be needed to allow for the integration of financial intermediaries. This process would not follow from any obligation arising from WTO accession (no provisions of this kind exist in the GATS). Rather, it would arise as a consequence of an imperative on China to develop a competitive and efficient economy to maintain strong growth momentum and to develop its competitiveness in world terms. This imperative will come more sharply into focus as a direct consequence of China's accession to the WTO and as China becomes more closely integrated into the global economy.

Competitive impact on markets and products

Over the next five years, China will provide increased opportunities for foreign participation in the insurance sector (and in banking and other services) in more geographic areas of China. But, given the overwhelming domination of the state-owned insurance institutions, the impact of WTO accession will be only marginal, in terms of market penetration—at least for the next 5 years.

However, as is already apparent in the Shanghai and Guangzhou markets—where foreign players are most prominent in the insurance market—competition will intensify sharply in other cities as they are opened to foreign participation. This will manifest itself in a widening of the range of insurance products—particularly unit-linked, wealth accumulation products; in pricing; and in improvements in the quality of agency sales forces. Competition will intensify, and to respond insurers need to develop new distribution channels, and sales through bank branches and other retail outlets will intensify.

Implementing WTO undertakings

It remains to be seen how China's regulatory authorities will invoke the WTO accession agreement, in terms of allowing increased foreign participation. A large number of foreign insurers are known to have a strong interest in gaining an equity interest in the China market. Over the last decade or so, China has allowed foreign access—to foreign banks and insurers—on a gradual and controlled basis. WTO accession provides for increased opportunity but the regularity by which new entrants may come into the market will be determined by the processes invoked by the regulatory authorities in issuing new licenses. As noted earlier, regarding the protocols associated with accession, China has indicated that it will provide for a transparent process of the notification of procedures and will approve applications from those firms that meet the formal entry requirements within a two-month period. This aspect of WTO accession marks a major and welcome development in the process of market liberalisation.

Protectionist tensions

While some domestic interests will be more concerned with protecting the state-owned institutions from increasing foreign competition, others will see the need to force the pace in the modernisation of the financial system. These tensions have been a factor in Chinese policymaking during the economic reform era, and the reformists have generally been successful. One indication that the insurance sector will embrace more foreign participation would be signalled by a decision to introduce private equity into state-owned insurance businesses.

Depending on the business structures that would flow from such a decision, participation in the major part of the market now serviced by the state insurance firms could involve foreign companies. Such a development would involve the creation of new legal entities, and would mark a very important move by the Chinese government in the drive to create a modern financial system. Once such a policy is implemented there would be no basis to continue to protect the local industry from new foreign entrants.

It may well be the case that by the time the phasing-in of the WTO accession undertakings has been completed, China's major domestic insurers will have been restructured into stronger operational and profitable businesses, involving foreign equity. If that scenario were to unfold, the period beyond the 5 years after WTO accession would be one where foreign access to the Chinese market by new foreign insurers would be essentially dependent on the assessment of profitability by those foreign firms, and their capacity to meet capitalisation and other regulatory requirements.

Improving insurance sector performance and profitability

There is an urgent need to improve the profitability of China's insurance sector. The sector has gone through a period of very poor profitability, partly associated with the level of 'guarantees' required to be provided to policy-holders. More recently, the returns on premium income invested have been low and competition in the industry has reduced prices. Profitability is a fundamental concern to industry—state and privately-owned firms are similarly affected by the problems just outlined—but given the predominance of state-owned institutions in the life sector, state institutions have been particularly affected. It is partly as a consequence of these developments that the policy moves noted earlier—to privatise the state-owned sector—are now under consideration.

Clearly, the infusion of new capital into the state-owned institutions in the insurance sector (but also in the banking sector) will be of fundamental importance to ensuring the long-term stability of those sectors which are integral to the efficient functioning of the economy. And clearly, the benefits that should flow from market opening—the *raison d'etre* of WTO accession—will not be fully realised if major domestic components of those sectors do not have the capital base on which to conduct profitable and efficient businesses.

The development of risk-based products and investment liberalisation

Of long-term importance to the insurance industry will be the growth of risk-based products in which policy-holders share in the profit or loss on earnings of invested premium income. Greater flexibility in the area in which insurance companies can engage would also help companies improve their profitability and reduce the risk that arises from over-concentration of investments in a limited range of instruments. Investment guidelines applying to insurance firms were recently widened to include investment in stocks.

CONCLUSIONS

To ensure that the benefits of WTO accession are fully realised, it is important that the regulatory and financial policy environment promote profitable industry growth and development to improve provisioning against future claims, to meet regulatory solvency standards and to provide more acceptable returns to shareholders. To improve competitiveness in the industry, would involve the diminution and, ultimately the phasing out of 'implicit' official support for the state-owned sector of the industry. As noted earlier, China is adopting international regulatory standards for the prudential supervision of the insurance sector. This will greatly enhance the stability of the insurance sector and benefit those investing in the sector.

The infusion of new capital into the sector is also a pressing requirement and while some part of this will be provided by foreign insurers as they enter the market, capital for the privatisation of the state-owned insurance sector—given the dominant role it plays in the market—is critical. This would provide for the upgrade of the technical base of the industry and for the introduction of new systems and skills. The devolution of ownership and control to private sector interests—both domestic and foreign—which can best supply those needs will be highly important in ensuring that the insurance sector in an aggregate sense can develop efficiencies to meet the challenges ahead.

As the capital market develops—a key objective of the financial system reform program—investment opportunities will widen. Major reforms in the securities sector and in the social security and pensions system are foreshadowed in the near term and these will not only contribute to the deepening of the capital market but also to the integration of the financial system. The insurance sector can expect to find significant opportunities arising from pension system reform and the development of securities markets.