12 China's Insurance Industry: Developments and Prospects

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12.1 INTRODUCTION

In 1980, the insurance industry in China was revived after twenty years of stagnation when economic system reform and opening up began in China. During the past two decades, the insurance industry has developed from a virtually nonexistent, minimal, and closed industry to a large, open industry with potential promise. The volume of insurance premiums grew rapidly from RMB 0.46 billion in 1980 to RMB 388 billion in 2003,[230] ranking China eleventh in the world with 1.6 percent of the global market share (China Insurance Regulatory Commission (CIRC); Swiss Re 2004, p. 35).[231] This fast growing economy coupled with the largest population in the world, rising personal income, and economic system reform could not only explain the rapid growth of China's insurance industry, but also foretell the increasing importance of China's insurance market in the future.

China's insurance industry was deeply affected by the reform and opening up of China since its development was an integral part of the latter. On one hand, the economic system reforms recreated China's insurance market and thus determined the direction of the industry. China's market-oriented economic system reform was a gradual process of institutional change dominated by the government. As a result, only state capital could be found in China's insurance industry and the market was exceedingly concentrated at the beginning of the industry's restoration. The

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[230] RMB stands for Chinese Currency, of which the full name is Ren Min Bi.

[231] Information was provided to the authors directly by the China Insurance Regulatory Commission (CIRC). This notation is followed through the chapter.

government was and still is heavily involved in the industry, although its role is now changing from an administrator to a regulator. On the other hand, opening up to the outside exposed the infant industry to fierce international competition, bringing great opportunities along with grave challenges to domestic insurers.

This chapter provides an analysis of the development of China's insurance industry in the context of China's economic reform and opening up and its future prospects. The first section briefly covers the development of China's insurance industry before 1949, when the People's Republic of China was founded. The second section is devoted to the story after 1949, in particular, the three stages of China's insurance industry after 1980, when China began its reform and opening up: (1) resumption and restoration, (2) market-oriented reform, and (3) opening up and rapid growth. The third section explores and evaluates the opening up of the industry. The fourth section examines the potential of China's insurance industry, points out the key drivers and possible obstacles of its future growth, and forecasts its future trends. Finally, the last section presents the conclusion.

12.2 CHINA'S INSURANCE INDUSTRY BEFORE 1949[232]

As a country with a history of more than five thousand years, ancient people of China developed various measures by which people with similar conditions could share risks and help each other. These measures can be considered the most primitive forms of insurance. According to the Book of Yizhou, an ancient Chinese literary history book, Chinese people realized the uncertain nature of natural catastrophes and began to make efforts to store grain in abundant years for famine approximately three thousand years ago. Years later, merchants conducting freight on the Yangtze River invented a clever method to diversify risks. Each merchant would place his goods on several different boats, consequently sharing the losses incurred from the sinking of one boat with other merchants.

The modern insurance industry did not emerge until the end of the Qing Dynasty (1644–1911), China's last feudal dynasty. Initially, the Qing Dynasty saw China as the center of the world and pursued a closed door policy resulting in serious trouble both at home and abroad. The western powers, which had already completed the industrial revolution, later compelled the weak and corrupted Qing government to accept trade, thus introducing modern insurance to China in conjunction with western commodities to China.

Guangzhou used to be the only trade port in China before the Opium War (1839–1842) between China and England. Usually, foreign insurance companies entrusted their Chinese business to foreign trade firms established in China, the so-called Yang Hang.[233] In 1805, British merchants established the first foreign insurance institution in Guangzhou, China, the Canton Insurance Society. This kind

[232] Ye, et al. (1998), pp. 1–235.

[233] China's foreign trade then consisted of overland trade with Russia and sea trade with other countries. The foreign trade firms actually participated in almost all of the business related to trade, e.g., buying and selling on principals' behalf, banking, insurance, and shipping.

of effort did not gain popularity until the Qing government was defeated in the Opium War and was forced to open more trade ports. Then, the sharp increase of foreign trade resulted in a tremendous demand for insurance. Many foreign firms divested their insurance business and established separate insurance companies in China, which monopolized China's insurance market for a period of time.

In May 1865, the Shanghai Yihe Insurance Society, a freight insurer, was established. It was the first domestic insurer in China and introduced insurance policies written in both English and Chinese for the first time. Previously, policies were written only in English in China. In December 1875, the Insurance Promotion Bureau was founded and it ended the monopoly of foreign insurers for hull insurance. The emergence of domestic insurers was welcomed and supported by the domestic business community. Subsequently, the Renhe Marine Insurance Company, Jihe Fire and Marine Insurance Company, and other domestic insurance companies were set up. Until 1911, there were approximately forty-five domestic insurers operating in China which were highly concentrated in trade ports in Shanghai. In fact, thirty-seven out of forty-five insurers were in Shanghai (Ye, et al. 1998, p. 54).

Although domestic insurers began to develop their market share, they were at a disadvantage in competing with the foreign insurance companies. China's foreign trade was controlled by foreign firms and consequently, it was very difficult for domestic insurers to expand their business. Furthermore, they had to rely on their foreign rivals for reinsurance because of their weak financial strength. As a result, foreign companies continued to dominate China's insurance market and earn substantive profits. For example, the return on equity of the Hong Kong Fire Insurance Company, established in Hong Kong in 1868 by British businessmen, was about fifty percent (Ye, et al. 1998, p. 27).

The Revolution of 1911 not only ended the Qing Dynasty, but also stimulated the development of industry and commerce in China. Consequently, insurers began to expand their business to other trade ports and inland trade cities. Again, foreign insurers maintained their dominant position due to their predominance in capital, technology, experience, and ability to accept ceding business.

It should be noted that American businessmen became heavily involved in China's insurance industry after World War I (WWI). Cornelius Vander Starr, an American entrepreneur, founded an insurance agency called American Asiatic Underwriters in Shanghai in 1919 and then Asia Life Insurance Company in 1921.[234] In the 1930s, American insurers gained an equal position to their British associates and foreign insurance companies thus had about seventy-five percent of China's insurance market (Ye, et al. 1998, p. 120).

Following the War against Japanese Aggression (1937–1945), the Chinese People's Revolutionary War (1945–1949), and the founding of the People's Republic of China in 1949, China's insurance industry was quite volatile as China's economy fluctuated greatly in time of the war. In turn, foreign insurers began to exit the

[234] These companies were the start of the famous international insurance conglomerate known as the American International Group. Mr. Starr moved his company's headquarters to New York in 1939. His business in China was compelled to pause in 1941 by the Japanese army and was resumed after China's Victory in War against Japanese Aggression. In 1949, the center of these companies' business was transferred from Shanghai to Hong Kong and operation in Shanghai ended in June 1951.

market. Furthermore, people, unable to anticipate the unstable economy and in need of economic security, did not purchase life insurance coverage. Therefore, insurance premiums were mainly collected from trade-related businesses and operations subsequently became concentrated in the trade centers.

To sum up, modern insurance was introduced to China by the West, which controlled China's insurance market profitably for a long period of time. This may have contributed to the concern that China's insurance industry might again be controlled by foreign capital and the prudence in granting foreign insurers licenses to operate in China, which was shared by many people even at the end of the 20th century.

12.3 CHINA'S INSURANCE INDUSTRY IN THE ECONOMIC REFORM: PAST AND PRESENT

On October 20, 1949, the People's Insurance Company of China (PICC), the first state-owned insurance company in China's history, was established (Wu 2004, p. 4). PICC developed a mission to "protect state assets, ensure industry safety, promote materials flow, provide stability," and, more importantly, "collect surplus funds and enriching state assets." However, the waning necessity for commercial insurance in a centralized planning economy finally led to the closure of the domestic insurance industry in 1959 (Wu 2004, p. 4). Only a small amount of foreign currency and export related insurance was left. It was not until the 3rd Plenary Session of the 11th Chinese Communist Party (CPC) Central Committee led by Deng Xiaoping at the end of 1978 that economic system reform and economic construction became the main theme of China's development. Soon, nation's financial system, governed by the People's Bank of China (PBOC), came into being. Concurrently, the insurance industry was restored and developed rapidly in the ensuing years. To explore the development of the insurance industry in China, this section is divided into three stages consistent with the gradual development of China's economic system reform: (1) resumption and restoration, (2) market-oriented reform, and (3) opening up and rapid growth.

12.3.1 Period I (1980–1985): Resumption and Restoration

At the initial stage of economic system reform, the control of firms' operations was gradually transferred from the state to firms. The resulting gradual changes in the risk sharing system led firms to seek economic compensation in the market and thus the demand for insurance was created. To meet this new demand, and more importantly, for better management of the financial surplus accumulated in private sector, the government initiated reforms in 1980 aimed at developing the commercial insurance system and encouraging the domestic insurance business. These reforms came twenty-one years after the closure of the insurance industry.

At this stage, all insurance business was monopolized by PICC, which was directly controlled by the central government. Insurance regulation was carried out by the PBOC, China's central bank. The terms and rates of policies were set and/or approved by the "regulator." As a result, the insurance product portfolio lacked variety, there was narrow use of complex actuarial science in pricing, and the price structure was simplistic. Additionally, the distribution channels were limited. Products were distributed primarily through sales staff of branch offices located throughout China (except Tibet and Taiwan), which were established by PICC and specialized in insurance distribution. Also, insurance assets were simply deposited in banks without consideration to an investment policy of diversification between bonds, equities, or real estate.

In 1980, the total gross premium volume of RMB 460 million was solely attributable to non-life insurance. In 1982, gross life insurance premiums totaled only RMB 1.6 million (CIRC). From this very small base, both the non-life and life insurance businesses grew significantly with annual growth rates exceeding GDP growth rates. The nominal growth rate of life insurance once exceeded 500 percent. In 1985, total premiums reached RMB 3.31 billion (CIRC). As Table 12.1 indicates, during this period, the life insurance business was insignificant relative to non-life insurance market. At this stage, enterprise property insurance and transportation equipment insurance (insurance coverage on motor vehicles, keel boats, and fishing boats) dominated the market. In 1985, these two types of non-life insurance had approximately thirty percent and twenty-seven percent of China's insurance market respectively (National Bureau of Statistics of China 1996, §17.14).

Table 12.1. Economic Growth and Insurance Premiums in China, 1980–1985

	GDP		Total Premiums		Non-Life Insurance Premiums		Life Insurance Premiums	
Year	Volume (RMB 100M)	% Change*	Volume (RMB 100M)	% Change**	Volume (RMB 100M)	% Change**	Volume (RMB 100M)	% Change**
1980	4,517.8	7.8	4.6	N/A	4.6	N/A	N/A	N/A
1981	4,860.3	5.2	7.8	69.6	7.8	69.6	N/A	N/A
1982	5,301.8	9.1	10.3	32.1	10.3	31.9	0.0	N/A
1983	5,957.4	10.9	13.2	28.2	13.1	27.3	0.1	550.0
1984	7,206.7	15.2	20.0	51.5	19.3	47.2	0.7	597.1
1985	8,989.1	13.5	33.1	65.5	28.7	48.9	4.4	508.3

Source: National Bureau of Statistics of China (2004), §3.1, §3.3, China Insurance Regulatory Commission (CIRC).

Notes: * Real growth rate. ** Nominal growth rate. As a reference, the annual growth rate of CPI from 1981–1984 was about 2% and in 1985 it was 9.3% (China Economic Information Center 2005; National Bureau of Statistics of China 2004, §9.1).

12.3.2 Period II (1986–1991): Beginning of Market-Oriented Reform

In March 1985, the State Council of China enacted *Interim Regulations on the Administration of Insurance Enterprises*, setting out the requirements for the establishment of insurance companies. The Farming Insurance Company of Xinjiang Production and Construction Group (FICX) was then established on July 15, 1986.

Although this company specialized in farming and animal husbandry insurance and was a quasi captive insurer within the Group, it effectively ended the monopoly of PICC. The number of suppliers in the market started to climb initially with Ping An and Pacific insurance companies established as shareholding multi-line insurers in 1988 and 1991 respectively.

At this stage, PBOC's direct administration of the insurance industry began to give way to supervision as the market-oriented reforms progressed. In 1995, PBOC established the Division of Insurance Supervision under its Department of Non-Banking Financial Institutions Supervision, which took over the responsibility of insurance supervision.

During this period, the limit on insurance investment channels and risk control mechanisms were relaxed. This resulted in extensive investment in real estate, securities, and trusts, which led to substantial investment in non-performing assets. However, there were no visible changes in the distribution system and insurance product portfolio. As Table 12.2 shows, while the volume of life insurance premiums was lower than that of non-life insurance, the fast growth of insurance premiums remained higher than GDP growth.

Table 12.2. Economic Growth and Insurance Premiums in China, 1986–1991

	GDP		Total Premiums		Non-Life Insurance Premiums		Life Insurance Premiums	
Year	Volume (RMB 100M)	% Change*	Volume (RMB 100M)	% Change**	Volume (RMB 100M)	% Change**	Volume (RMB 100M)	% Change**
1986	10,201.4	8.8	45.8	38.4	34.5	20.1	11.3	157.1
1987	11,954.5	11.6	71.0	55.1	46.1	33.6	25.0	120.5
1988	14,922.3	11.3	110.4	55.4	72.9	58.3	37.5	50.0
1989	16,917.8	4.1	97.6	(11.6)	78.1	7.1	19.6	(47.8)
1990	18,598.4	3.8	135.2	38.5	106.8	36.8	28.4	45.1
1991	21,662.5	9.2	178.2	31.9	136.8	28.2	41.4	45.8

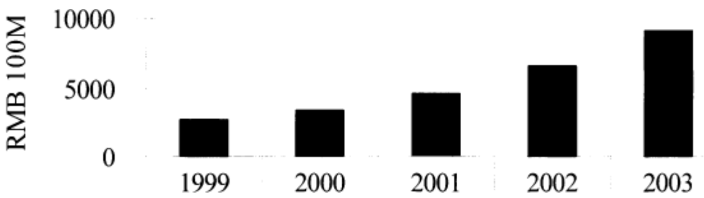
Source: National Bureau of Statistics of China (2004), §3.1, §3.3; China Insurance Regulatory Commission (CIRC).
Notes: * Real growth rate. ** Nominal growth rate. As a reference, the annual growth rate of CPI from 1986–1991 was 7%, 8.8%, 18.8%, 18%, 3.1%, and 3.4%, respectively (China Econonomic Information Center 2005; National Bureau of Statistics of China 2004, §9.1).

12.3.3 Period III (1992–Present): Opening Up and Rapid Growth

The 14th National Congress of CPC in 1992 and the 3rd Plenary Session of the 14th CPC Central Committee in 1993 confirmed China's irreversible commitment to market-oriented reforms. Individuals and enterprises lost their traditional economic safeguard and were responsible for assuming financial risks. As a result, many factors contributed to the rapid growth of the insurance industry, including the fast growing economy, rising personal income, accelerating industrialization and urbanization, and social security system reform. In the remainder of this section, the current state of various aspects of China's insurance market is examined.

Business Volume

From 1992 to 2003, the average annual growth rate of gross premiums remained at over 30 percent. Table 12.3 shows the volume of insurance, both life and non-life and GDP. It can be seen that the volume of life insurance premiums surpassed that of non-life insurance for the first time in 1997 and remained higher in the subsequent years. The rapid growth of premium income and an expanded capital base explain the substantive increase in the total assets of the industry. Figure 12.1 shows that the total assets in the insurance industry increased 2.5 times from 1999 to 2003 and reached RMB 912.3 billion by the end of 2003. Total assets were RMB 1,111.65 billion by the end of August 2004 (CIRC). In contrast, aggregate total assets were less than RMB 400 million when the insurance industry had just resumed (CIRC). Despite the rapid growth and large volume of China's insurance business, it is generally agreed that the operation is far from efficient since the overall return on assets was below 1 percent in 2003 (Editorial Committee of China's Insurance Yearbook 2004).[235]



	1999	2000	2001	2002	2003
■ Total Assets	2,604.1	3,373.9	4,591.3	6,494.9	9,122.8

Year

Source: China Insurance Regulatory Commission (CIRC).

Figure 12.1. Total Assets of the Insurance Industry in China, 1999–2003

Operating Structure

The first *Insurance Law of China* was enacted in 1995. It developed a segregated insurance market structure between the life and non-life insurance businesses by prohibiting the same insurer from engaging in both life and non-life insurance. It was possible, however, for an insurance group to have both life and non-life subsidiaries. As a result, the former four multi-line insurers, including PICC, FICX, Pacific, and Ping An, underwent organizational reform. FICX cast off its life insurance business and turned itself into Property Insurance Company of Xinjiang Production and Construction Group. The other three companies followed the pattern of setting up a holding group with life and non-life insurance subsidiaries. In 1996, PICC was restructured into the PICC Group, which controlled the newly established PICC

[235] The after-tax-profit for the whole insurance industry was RMB 4.61 billion of which 3.15 billion was from the non-life insurance business and 1.46 billion was from life insurance sector (Editorial Committee of China's Insurance Yearbook 2004).

Property and Casualty Insurance Company, PICC Life Insurance Company, and PICC Reinsurance Company. In October 1998, the three subsidiaries were divested and renamed the People's Insurance Company of China (it inherited the original abbreviation, i.e., PICC), the China Life Insurance Company, and the China Reinsurance Company.

Table 12.3. Economic Growth and Insurance Premiums in China, 1992–2003

	GDP		Total Premiums		Non-Life Insurance Premiums		Life Insurance Premiums	
Year	Volume (RMB 100M)	% Change*	Volume (RMB 100M)	% Change**	Volume (RMB 100M)	% Change**	Volume (RMB 100M)	% Change**
1992	26,651.9	14.2	211.7	18.8	147.4	7.7	64.3	55.3
1993	34,560.5	13.5	395.5	86.8	251.4	70.6	144.1	124.1
1994	46,670.0	12.6	500.4	26.5	336.9	34.0	163.5	13.5
1995	57,494.9	10.5	594.9	18.9	390.7	16.0	204.2	24.9
1996	66,850.5	9.6	777.1	30.6	452.5	15.8	324.6	59.0
1997	73,142.7	8.8	1087.9	40.0	480.7	6.2	607.2	87.0
1998	76,967.2	7.8	1247.6	14.7	499.6	3.9	748.0	23.2
1999	80,579.4	7.1	1393.2	11.7	521.1	4.3	872.1	16.6
2000	88,254.0	8.0	1595.9	14.6	598.4	14.8	997.5	14.4
2001	95,727.9	7.5	2109.4	32.2	685.4	14.5	1424.0	42.8
2002	103,935.3	8.3	3053.2	44.7	778.3	13.6	2274.9	59.8
2003	116,603.2	9.3	3880.4	27.1	869.4	11.7	3011.0	32.4

Source: National Bureau of Statistics of China (2004), §3.1, §3.3, China Insurance Regulatory Commission (CIRC).
Notes: * Real growth rate. ** Nominal growth rate. As a reference, the annual growth rate of CPI from 1992–2003 was 6.4%, 14.7%, 24.1%, 17.1%, 8.3%, 2.8%, –0.8%, –1.4%, 0.4%, 0.7%, –0.8%, and 1.2%, respectively (China Economic Information Center 2005; National Bureau of Statistics of China 2004, §9.1).

The financial sectors, including the banking, securities, and insurance businesses, are still operating independently in China. According to the *Banking Law of China* effective on February 1, 2004, China's commercial banks can not invest in non-bank financial institutions except that such investment is allowed by other regulations or state provisions. Additionally, insurance companies are prohibited from establishing securities firms and other enterprises except insurance institutions according to the *Insurance Law*. In a word, banking, securities, and insurance services can only be provided by separate firms; banks cannot own insurance companies and vice versa.[236] Industrial groups, however, are not prohibited from

[236] At the present time, there is no legislation on financial holding companies, although many researchers deem the pattern as a good approach to achieve financial convergence. The only "financial holding company," CITIC International Financial Holdings Limited (CIFH),

owning both bank subsidiaries and insurance companies. There are several historical exceptions to this law. For example, China Ping An Insurance (Group) Company, Ltd. does offer insurance, banking, and securities through its different subsidiaries.

Suppliers of Insurance

On the supply side, China's insurance market is characterized by two things: (1) an increase in the number of insurers and (2) organizational restructuring of the state-owned insurers. In 1992, China began to open its insurance market by using Shanghai as an experimental city. According to *the Temporary Measures for Administration of Foreign-Funded Insurance Institutions in Shanghai* enacted by the PBOC in September 1992, foreign insurers applying to establish branches or joint ventures shall satisfy the prudential requirements stipulated by the insurance regulator to get licenses including the "533" requirements meaning that the applicant's total assets should be more than $5 billion at the end of the year before application, the applicant should have established its representative office(s) three years before application, and have had over three decades of experience in the insurance business. In September of the same year, American International Assurance Company (AIA) and American International Underwriters, Ltd. (AIU), subsidiaries of the American International Group (AIG), were the first to be approved to establish affiliates in Shanghai and thus opened the gate for foreign capital to flow into China's insurance industry.

Since then the number of insurers, both domestic and foreign, has kept rising. After China's entry into World Trade Organization (WTO) in 2001, the State Council enacted *The Regulations on Administration of Foreign-Funded Insurance Companies*, which became effective on February 1, 2002. Many restrictions to foreign insurers to obtain licenses in China were relaxed in a sense, such as the "533" requirements were changed to the "523," allowing foreign insurers who have just established representative offices in China two years before to submit an application.[237] Actually, the requirements to get licenses could easily be satisfied by many foreign insurers and as Figure 12.2 shows, a number of famous foreign insurers obtained licenses to establish branches or joint ventures in China. Most significantly, Munich Re, Swiss Re, and General Cologne Re were approved to set up branches in China in 2003, and this effectively ended the state-owned China Reinsurance Company (China Re)'s role as the only reinsurer in China. At of the end of 2003, there were sixty-one insurance companies, six insurance holding groups, and two insurance asset management companies in China. Of the sixty-one insurers there are twenty-six non-life insurers, thirty life insurers, and five reinsurers (CIRC). However, many applications were turned down because of deficiencies in their application materials or business plans since the requirements and the review process for approval in China are quite prudential, although there are no limits on the number

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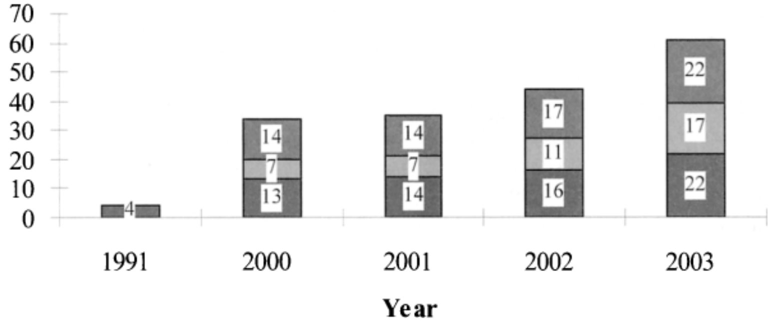
was approved to establish as a "holding company" in 2002 by the State Council and it operates outside of mainland China.

[237] The qualified foreign applicant can apply to set up a company in China and will be given one year to finish preparation work once the application is approved by CIRC. Once the preparation work has been completed, CIRC will conduct a review and make a decision as whether to grant a license or not in 30 days after they receive the entire set of formal application materials.

of licenses issued. For example, fourteen foreign insurers, including AXA and Cigna, received notices from CIRC that they had failed to submit all the materials requested and should begin another application round on April 29, 2002. Many of them, however, including AXA and Cigna, finally obtained their licenses upon submitting all the required materials.



Source: China Insurance Regulatory Commission (CIRC); National Bureau of Statistics of China (2003), p. 709 and (2002), §19.16.

Note: The numbers on the pillars indicate "domestic," "joint ventures," and "foreign branches" from the bottom up. For example, in 2003 there were 22 domestic insurers, 17 joint ventures, and 22 foreign branches in China.

Figure 12.2. The Number of Insurers in China in Selected Years

Corporate governance system reform in China's financial sector started first in the insurance industry. In 2003, the People's Insurance Company of China (PICC), China Life Insurance Company, and China Reinsurance Company, the three purely state-owned insurance companies, successfully underwent organizational restructuring.

- On July 19, 2003, PICC incorporated PICC Property and Casualty Company Limited (PICC P&C). PICC was then renamed and re-registered as PICC Holding Company, which injected all of its commercial insurance operations, together with related assets, liabilities, and subsidiaries into PICC P&C. The initial public offering (IPO) of PICC P&C on the Hong Kong Stock Exchange in November 2003, which was proved to be a great success, raised \$693 million (CIRC). For more information regarding PICC P&C, please refer to Appendix 1.
- China Life Insurance Company incorporated China Life Insurance Company Limited (China Life) on June 30, 2003 and transferred its well-performing policies and related assets and liabilities to the latter. China Life Insurance Company was then restructured to China Life Insurance (Group) Company in July 2003. The IPO of China Life on New York Stock Exchange (NYSE) and the Hong Kong Stock Exchange on December 17 and 18, 2003 respectively was the world's largest that year and raised about \$3.5 billion (CIRC). For more information regarding China Life, please refer to Appendix 1.

- China Re was renamed China Reinsurance (Group) Company in August 2003, and began to incorporate China Property and Casualty Reinsurance Company, China Life Reinsurance Company, and China Dadi Property and Casualty Insurance Company. Unlike PICC and China Life, China Re did not begin its IPO efforts right after the restructuring, but committed itself to improve its internal management first.

Competitive Market Structure

China's insurance market has become more competitive as the number of insurers has increased. On the non-life insurance side, the market share of the leading insurer, PICC, was 96 percent in 1992 and dropped to 70 percent in 2003 (CIRC). However, the top 3 non-life insurers, including PICC P&C, Pacific P&C, and Ping An P&C, still accounted for more than 90 percent of China's gross premiums in 2003 (CIRC). As Table 12.4 shows, the non-life insurance market could be characterized as a typical oligopoly market. The situation on the life insurance side is a little bit better, but still highly concentrated as well. Table 12.4 indicates that the market share of the top 3 life insurers in 2003 was as high as 87 percent (Chen 2004, p. 59). Table 12.5 and 6 list the top 5 life insurers and top 5 non-life insurers in 2003.

Table 12.4. Concentration of China's Insurance Market in Selected Years

	1992		1996		2001		2002		2003	
Market Share by Premium Volume	Life	Non-Life	Life	Non-Life	Life	Non-Life	Life	Non-Life	Life	Non-Life
Top 1 Insurer	N/A	96.0%	N/A	77.3%	57.1%	73.9%	56.6%	70.9%	54.0%	69.8%
Top 2 Insurer	N/A	N/A	N/A	89.6%	85.2%	86.3%	80.1%	84.1%	73.9%	82.1%
Top 3 Insurer	N/A	N/A	N/A	96.9%	95.3%	96.1%	91.1%	94.8%	86.6%	91.7%

Source: China Insurance Regulatory Commission; Jiang (2004), p. 22; Chen (2004), p. 59.
Note: N/A is not available.

Geographic Distribution

Table 12.7 shows that geographic distribution of China's insurance industry is highly imbalanced. In 2003, the top 6 provinces, autonomous regions, or centrally controlled municipalities collected 46 percent of China's gross premiums while the last 10 only constituted about 10 percent[238] (Editorial Committee of China's Insurance Yearbook 2004). This situation is principally a result of uneven economic development in different regions. Because of the structural differences in location and resource endowment of different regions, the geographic deployment of China's industrialization was uneven after the reform and opening up began. Benefiting from this strategy, the southeast coastal regions soon surpassed the middle and west regions in economic development and attracted insurers' efforts with their favorable

[238] The top 6 provinces, autonomous regions, or centrally controlled municipalities are as follows: Jiangsu, Guangdong, Shanghai, Shandong, Beijing, and Zhejiang (Editorial Committee of China's Insurance Yearbook 2004).

demand. Most of the newly established insurers are located in the east coastal area and the number of insurers in the middle and the west market has not increased much. As a result, the competition in the eastern market is much more intensive. For example, in 2003, the market share of the top 4 life insurers in Shanghai was about 64 percent, indicating a healthy competition. However, in some west provinces, China Life still holds a monopoly position (CIRC).

Table 12.5. An Overview of the Top 5 Life Insurers in China, 2003

Rank	Name	Premium Volume (RMB 100M)	Organizational Form	Principal Distribution System (Market Share)*	Ownership Type	Country of the Ultimate Owner
1	China Life	1,625.33	Stock	Exclusive Agency (66.83%)	Insurance Holding Company	China
2	Ping An Life	598.58	Stock	Exclusive Agency (63.84%)	Insurance Holding Company	China
3	Pacific Life	382.40	Stock	Bancassurance (39.52%)	Insurance Holding Company	China
4	New China Life	174.33	Stock	Bancassurance (56.43%)	Industrial Firm	China
5	Taikang Life	135.19	Stock	Bancassurance (53.72%)	Industrial Firm	China

Source: Chen (2004), pp. 59, 164.
Note: * Market share is the ratio of premium income collected through the distribution channel to the overall premium income of the company.

Table 12.6. An Overview of the Top 5 Non-Life Insurers in China, 2003

Rank	Name	Premium Volume (RMB 100M)	Organizational Form	Ownership Type	Country of the Ultimate Owner
1	PICC P&C	606.80	Stock	Insurance Holding Company	China
2	Pacific P&C	106.90	Stock	Insurance Holding Company	China
3	Ping An P&C	83.50	Stock	Insurance Holding Company	China
4	Tian An P&C	21.00	Stock	Industrial Firm	China
5	China United P&C*	18.70	State-Owned	State-Owned	China

Source: Editorial Committee of China's Insurance Yearbook (2004).
Note: The principle distribution system is not available for non-life companies. * China United P&C was formerly Property Insurance Company of Xinjiang Production and Construction Group. It was in the process of switching to stock before this chapter was finished.

Table 12.7. The Distribution of China's Economy and Insurance Industry by Region, 2003

			Distribution of the Economy by Region			Distribution of Insurance Premiums			
Region	Distribution of GDP (%)	Distribution of Population (%)	Primary Sectors (%)	Secondary Sectors (%)	Tertiary Sectors (%)	Non-Life (%)	Life (%)	Total (%)	Premium per Capita for Each Region (RMB)
The East Coast	58.5	37.9	42.5	64.7	60.4	53.9	61.8	59.8	473.2
The Southeast Coast*	34.7	19.5	21.6	39.3	35.8	33.1	35.6	35.0	537.0
The Middle	24.6	33.4	31.6	25.5	22.9	16.7	23.3	21.7	194.6
The West	16.9	28.7	25.9	9.8	16.7	29.5	14.9	18.5	192.7
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	304.6

Source: National Bureau of Statistics of China (2004), §4.3, §3.11; Editorial Committee of China's Insurance Yearbook (2004).

Notes: * The Southeast coast is a subset of the East Coast, including Shanghai, Jiangsu, Zhejiang, Guangdong and Fujian. We include the Southeast region separately here because it is a significant region in China's Economy. These four provinces' GDP represented about one-third of the whole country in 2003. 1.) It is generally accepted that the east coast region includes Beijing, Tianjin, Hebei, Liaoning, Shanghai, Jiangsu, Zhejiang, Fujian, Shandong, Guangdong, and Hainan. The middle region includes Shanxi, Jilin, Heilongjiang, Jiangxi, Hubei, and Hunan. The west region includes Chongqing, Sichuan, Guizhou, Yunnan, Tibet, Shaanxi, Gansu,Qinghai, Ningxia, Xinjiang, Guangxi, and Inner Mongolia. 2.) The primary sectors referr to agriculture, forestry, animal husbandry, and fishery. The secondary sectors refer to mining and quarrying, manufacturing, production and supply of electricity, water, and gas, and construction. The tertiary sectors refer to all other economic activities not included in the primary or secondary sectors.

Product Portfolio

Different kinds of insurance products have been continually introduced to the market as the industry has developed. On the life insurance side, the product portfolio before June 1999 consisted of traditional policies, whose premiums, benefits, and assumed interest rate were hard to adjust after selling, such as ordinary life insurance and endowments. PBOC reduced the interest rates seven times in succession from May 1996 to June 1999, and the nominal interest rate of a one-year certificate of deposit decreased from 10.98 percent to 9.19 percent after May 1, 1996 and then to 2.25 percent after June 10, 1999. While the interest rates dropped dramatically, the assumed interest rates of China's life insurance policies were not lowered and thus the policies became very attractive to consumers. Some insurance companies did not realize the seriousness of implied losses and failed to adopt effective measures to prevent agents from selling more of the old polices. The large demand and loss of control on supply side contributed to tremendous losses from interest rate discrepancies to China's insurance companies.[239] CIRC then required the life insurers to lower the assumed interest rates of newly issued policies in June 1999 and encouraged the companies to develop innovative products, which transfer some or all of the investment risk to policyholders.

Ping An Life Insurance Company first introduced variable life insurance policies to the market in October 1999 and collected RMB 1.23 billion of premium income in the following 14 months (CIRC). This kind of product received favorable responses in big cities due to its high potential returns in the then bull market. Therefore, other insurers began to follow suit. In 2001, the premium income from variable life products in Beijing alone accounted for 21 percent of its total life insurance premium income (CIRC). However, the rapid growth of variable life products was impeded by the crash of China's stock market which began in late June 2001. The Composite Index of Shanghai dropped from its highest point of 2,245.44 on June 14, 2001 to its lowest of 1,514.86 on October 22, 2001 and closed at 1,645.97 at the end of the year (Shanghai Stock Exchange 2002). The crash is largely attributable to the withdrawal of capital, the reduction in state-owned stock, and the loss of investors' faith due to disclosure of insider trading (Li 2002).

Participating, universal life, and other innovative products with lower investment risk, increased flexibility, and higher returns relative to bank deposits began to appear and became popular in the market thereafter. In 2003, premium income from innovative products accounted for 58 percent of gross life insurance premiums (China Economic Information Center 2005). Furthermore, as Table 12.8 indicates, there was a notable increasing trend in health insurance premiums as health related risk became a major focus of the public's attention and health insurance became an important supplement to the medical coverage provided by the reformed social security system.

[239] Because the loss from investment earning is not realized at once and the return on investment keeps changing, an accurate estimate of the loss is unfeasible. In 2002, CIRC declared the volume of the loss at about RMB 50 billion (Ning and Yu 2003). According Goldman Sachs (2003), the volume was about RMB 32–72 billion.

Table 12.8. Market Share by Lines of Life Insurance Business (%), 1998–2003

	1998	1999	2000	2001	2002	2003
Life Insurance*	89.12	87.62	89.09	90.45	91.33	88.66
Traditional	89.12	N/A	N/A	60.99	37.34	30.19
Variable	0.00	N/A	N/A	7.48	2.99	2.43
Universal	0.00	N/A	N/A	2.83	1.50	0.56
Participating	0.00	0.00	N/A	19.15	49.36	55.48
Health Insurance	3.75	4.72	2.83	4.28	5.33	8.03
Accidental Insurance	7.13	7.66	8.08	5.27	3.48	3.31
Total	100.00	100.00	100.00	100.00	100.00	100.00

Source: China Insurance Regulatory Commission (CIRC); China Economic Information Center (2005); Jiang (2004), p. 16.
Notes: * Including pension insurance. The market share of pension insurance was 16.79% and 14.34% in 2002 and 2003, respectively. Owing to lack of data, we cannot get accurate information on pension insurance in other years.

Table 12.9. Market Share by Lines of Non-Life Insurance Business (%), 1998–2003

	1998	1999	2000	2001	2002	2003
Automobile Insurance	55.56	58.12	61.35	61.61	60.51	62.14
Enterprise Property Insurance	22.27	21.43	19.41	17.66	15.77	14.38
Freight Transport Insurance	7.63	6.69	5.92	5.99	5.38	4.72
Liability Insurance	2.78	3.19	3.45	4.09	4.74	4.03
Household Property Insurance	2.41	2.32	2.14	2.77	3.08	2.19
Hull and Cargo Insurance	2.37	2.10	1.81	1.75	1.67	1.73
Construction and Installation Projects Insurance and Related Liability Insurance	1.19	1.07	0.99	0.88	1.03	1.38
Export Credit Insurance	0.59	0.45	0.49	0.44	0.90	0.92
Agriculture Insurance	1.41	1.20	0.66	0.44	0.64	0.58
Guarantee Insurance	0.22	0.27	0.33	0.58	1.15	0.23
Satellite and Nuclear Energy Insurance	0.43	0.29	0.49	0.73	0.77	0.12
Others	3.14	2.86	2.96	3.07	4.36	7.59
Total	100.00	100.00	100.00	100.00	100.00	100.00

Source: China Economic Information Center (2005).

As for the non-life insurance sector, Table 12.9 shows the market share of the various lines of non-life insurance. The proportion of each line in terms of premium income has been relatively stable these years, and automobile insurance has played the leading role. The market share of enterprise property insurance has decreased due to the fact that many State-Owned Enterprises (SOEs), the major clients of the insurers, performed poorly and had to cut expenses on insurance as the way to reduce the costs. At the same time, the newly established private enterprises often lack insurance awareness.

Distribution Channels

As Figure 12.3 indicates, a diversified distribution system, including direct marketing, insurance intermediaries, and direct response has already taken shape. Direct response refers to the marketing channel, such as the Internet, telephone, and direct mail, through which the insurance companies sell products directly to consumers. Typically, direct response does not involve face-to-face contact during the sales process. In the past, direct marketing, where the salaried staff of insurers deals directly with customers, was the most important distribution channel.

Direct marketing began to lose its dominant position to individual agents in the individual life insurance market in 1992 when AIA introduced the commission-based exclusive agency system in Shanghai. Within a few years, all domestic life insurance companies in China introduced the same system. An exclusive agent is an individual that can represent only one insurance company. They typically do not have an exclusive territory. Insurance agency institutions, as legal entities, can sell products of different insurers. The usual commissions to agents are based on the business volume and vary between 20 percent and 40 percent of premium income collected. Different companies have adopted different commission schedules.

Figure 12.4 shows that the market share of the exclusive agency system in the life insurance market climbed to 73.9 percent in 2000 and direct marketing only accounted for 25.5 percent of the market share instead of 100.0 percent in 1992 (Chen 2004, p. 102). *The Provisional Measures for Insurance Agents Administration* promulgated in 1996 recognized the role of agents by setting standards for the professional practice of agents and requiring agents to pass the Insurance Agents Qualifying Examination organized by CIRC. The number of agents greatly increased and contributed significantly to the high growth of life insurance premium volume. In addition, brokers came into being with foreign enterprises and foreign insurers operating in China. In 1998, PBOC promulgated *The Provisional Measures for Insurance Brokers Administration*. CIRC organized the first Insurance Brokers Qualifying Examination in May 1999 and 162 people out of about 4,800 received the qualification (Wu 2004, p. 172). Individuals who had a criminal record in the past five years, or have ever received a penalty due to unfaithful behaviors in the past three years, were prohibited from being an agent or broker by the financial regulators.

In 2001, CIRC enacted The Measures for Insurance Agencies Administration and The Measures for Insurance Broker Companies Administration and then amended them at the end of 2004. The Measures for Insurance Broker Companies Administration was renewed as The Measures for Insurance Broker Institutions Administration. According to the new regulation, insurance agency institutions and broker institutions in China could only take the form of partnership, limited liability company, or limited stock company and each of them had to deposit 20 percent of its registered capital as a guaranty fund or buy required professional liability insurance.

Institutions other than agency companies and broker companies (referred to as other institutions later), such as commercial banks, auto dealers, and post saving offices, can also act as insurers' agents to distribute insurance products after they get licenses from CIRC and come to an agreement with insurance companies.[240] Bancassurance started in 1996 in China and gained popularity on the life insurance side after Ping An Life Insurance Company developed "Century Dividend" in the year 2000. "Century Dividend" was specially designed for sales via commercial banks. The employees of banks' branch offices recommended the insurance products to their customers while doing banking business with them over the counter or used various direct response techniques to sell insurance policies to their existing customers. This distribution channel proved to be cost-effective and a great success. For example, 75 percent of the life insurance premium income for Taiping Life Insurance Company in 2003 came from bancassurance (Chen 2004, p. 104). As Figure 12.4 shows, direct response, such as marketing through telephone and the Internet, has also arisen lately, but the market shares are trivial by comparison.

As we can see in Figure 12.3, by the end of 2003, there were 506 insurance agency companies operating in China and 207 were preparing to start operation; and there were 83 insurance brokerages in operation while another 82 were preparing to start operation. Other institutions engaged in insurance sales totaled 117,185 with 48,489 for non-life insurance and 68,696 for life insurance. Nationwide there were 26,789 insurance branch offices and 1.28 million exclusive agents. These intermediaries played an important role in insurance sales. Figure 12.4 shows the relative importance of all kinds of distribution channels for life insurance in recent years with Figure 12.5 for non-life insurance side.

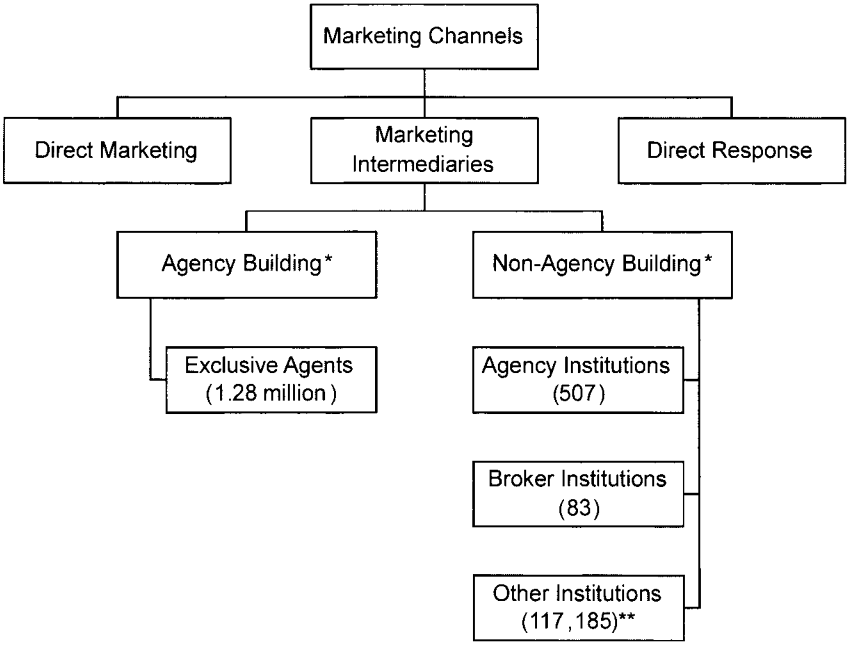
Investment Management

At the beginning of this period, investment channels were wide open, but due to the lack of investment expertise and management experience, more than RMB 10 billion of non-performing assets were engendered from 1992 to 1993 (Wu 2004, p. 187). The *Insurance Law* enacted in 1995 thus put strict requirements on insurance investments in order to ensure the solvency of the insurance companies, specifying that insurance funds can only be invested in the form of bank deposits, government bonds, financial bonds, and other investments as approved by the State Council (and these requirements were not changed in the 2002 amendment).[241] Subsequently, China's insurers were gradually allowed to widen their investment channels, as the financial market developed. They were allowed to invest in corporate bonds rated AA+ issued by the central government-controlled SOEs (July 1998), government securities repurchased (August 1998), negotiated bank deposits (October 1999), mutual funds (October 1999), corporate bonds rated AA (June 2003), central bank notes (July 2003), and stocks (October 2004). The proportion of each kind of

240 In China, only China Post, a government-run postal enterprise, could provide all kinds of postal service. Other enterprises, including foreign companies could conduct only certain express delivery service and logistics service. China Post also conducts savings and remittance businesses. Every post saving office of China Post could sell insurance after it received a license from the CIRC.

241 Financial bonds refer to securities issued by financial institutions in China's inter-bank bonds market requiring repayment of interest and principal within a given period. Until now, financial bonds were just issued by state policy-related banks.

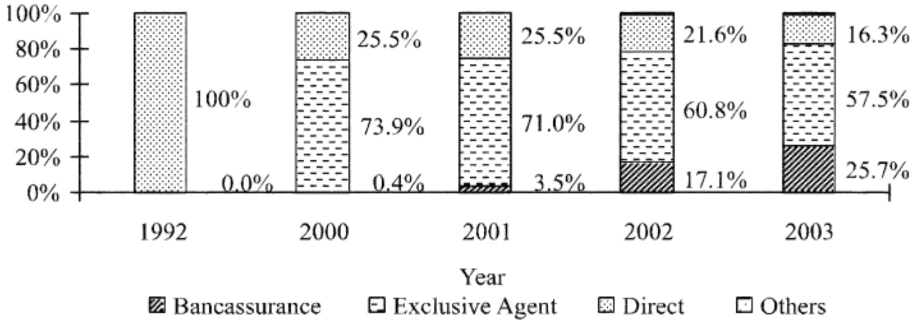
investment to the total investible fund, however, had to comply with the prescription of the regulator.[242]



Source: Wu (2004), pp. 176–179.
Notes: * We divide marketing intermediaries into two classes depending on whether the insurer is attempting to build its own agency sales force. Thus, insurers following an agency building distribution strategy recruit, train, finance, house, and supervise their agents. The non-agency building strategy means that the insurers rely only on established agents for their sales (Black and Skipper 2000, p. 603). ** Including 48,489 in non-life insurance business and 68,696 in the life insurance business, which takes insurance marketing as part of their busines, similar to commercial banks.

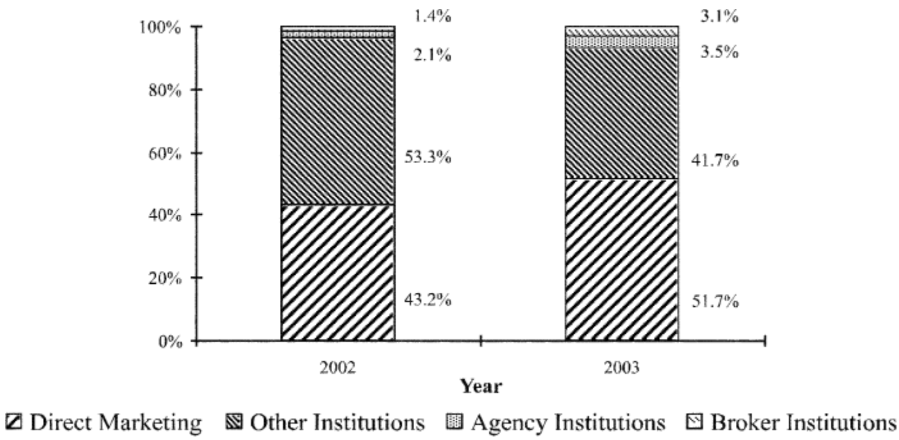
Figure 12.3. An Overview of China's Insurance Distribution System, 2003

[242] There are no upper limits on bank deposits, government bonds, financial bonds issued by state policy-related banks, and central bank notes. A negotiated bank deposit is a kind of long-term deposit by non-bank financial institutions the terms of which are set by bilateral negotiation. They should exceed RMB 30 million and last more than five years. The proportion of corporate bonds investment should not exceed 20 percent of the insurer's assets at the end of last month and the investment in one corporate bond should not exceed the minimum of 15 percent of the circulation and 2 percent of the insurer's assets at the end of last month. The proportion of mutual funds investment should not exceed 15 percent of the insurer's assets at the end of last month, while the proportion of funds in separate accounts of variable life insurance is 100 percent and for universal life insurance is 80 percent. As to stocks, the stocks of one listed company held by one insurance institutional investor shall not reach 30 percent of the RMB common stocks of the listed company and the specific proportion of stock investment of an insurance institution investor shall be separately specified by CIRC. The limits may be changed when necessary according to the actual situation observed by CIRC.



Source: Chen (2004), p. 64, pp. 100–102.

Figure 12.4. Market Share by Distribution Channel for Life Insurance in Selected Years



Source: Tang (2004), p. 122.

Notes: The four numbers on the pillars indicate "direct marketing," "other institutions," "agency institutions," and "broker institutions" from the bottom up. For example, in 2003, 51.7% of the premium was collected via direct marketing, 41.7% via other institutions, 3.5% via agency institutions and another 3.1% via broker institutions.

Figure 12.5. Market Share by Distribution Channel for Non-Life Insurance, 2002–03

Table 12.10 provides an overview of insurance investment in China for 2002–03. It is worth noticing that bank deposits, despite the low return, have always been the most important investment channel for insurance funds, and government bonds took second place. Conservative investment strategies resulted in a low rate of return, which was only 2.68 percent in 2003 (Wu 2004, p. 189). Insurance asset management companies, which specialize in fund management for insurance companies, have become the latest trend in insurance investment. PICC Asset Management Company and China Life Asset Management Company, established in 2003 and 2004 respectively, were the first two asset management companies in China.

Table 12.10. An Overview of Insurance Investment in China, 2002–03

	2002 Volume (RMB 100M)	% of Total	2003 Volume (RMB 100M)	% of Total
Bank Deposits	3,026.3	54.7	4,549.7	52.1
Government Bonds	1,107.9	20.0	1,406.9	16.1
Financial Bonds	404.8	7.3	828.7	9.5
Corporate Bonds	84.6	1.5	389.0	4.5
Mutual Funds	307.8	5.6	456.6	5.2
Others	599.2	10.9	1,108.1	12.6
Total	5,530.6	100.0	8,739.0	100.0
Rate of Return	3.1%		2.7%	

Source: Jiang (2004), p. 54; Rate of Return is from Wu (2004), pp. 188–189.

Legislative Environment and Supervision

Progress in market-oriented reform and remolding of the role of government brought forward the need for efficient mechanisms to coordinate the industry and led to great efforts in developing insurance legislation and the regulatory system. *The Insurance Law* enacted in 1995, its amendment in 2002, the *Regulation for the Administration of Insurance Companies* enacted in 2004, the *Regulation for the Administration of Foreign-Funded Insurance Companies* enacted in 2001, and other regulations and measures compose the current framework of China's legislative system for insurance. The *1995 Insurance Law* consisted of insurance contract law and insurance professional law, governing different aspects of the insurance industry such as the insurance contract, insurance business, market access, and insurance regulation. In order to adapt to the new situation of China's opening up, especially its entry into WTO, the amendment of the insurance law began in 2002. The new law abolished mandatory reinsurance, gave prominence to solvency regulation, allowed P&C insurance companies to operate in short-term health insurance and accidental insurance, and deleted the provisions that stipulated that the terms and premium rates of insurance policies should be set by the regulator.

The establishment of CIRC on November 18, 1998 was a milestone in China's history of insurance regulation. It ended PBOC's function of administrating the insurance industry in China, which had continued for quite a long time. At present, CIRC is still the superintendent and regulator of the industry, but its direct involvement in administration of the industry is gradually decreasing as reform progresses. One important aspect of reform is to put more emphasis on solvency regulation, while loosening the former strict restrictions on insurers' market behavior.

In March 2003, CIRC enacted *Regulation on the Solvency of Insurers and Regulation Indicators* based upon the actual situation in China and experiences from the European Union. According to this regulation, insurance companies in China are required to ensure that their actual solvency margin (i.e., the difference between the admitted assets and liabilities) is larger than the minimum, which is calculated based on the methods prescribed in the regulation. CIRC might change the regulation when necessary. The minimum solvency for P&C insurance companies in the 2003 regulation is the maximum of (1) 18 percent of retention of gross premium in last fiscal year (excluding sales taxes and associate charges) below RMB 100 million plus 16 percent of the part above RMB 100 million or (2) 26 percent of average combined loss payment (the sum of loss payment, the difference between reserves in the current year and reserves carried over, and reinsurance loss payment minus reinsurance loss repayment and income of loss payment recovered) below RMB 70 million and 23 percent of the part above RMB 70 million.[243] The minimum for life insurance companies is the sum of minimum solvency of long-term business (carrying an insurance period more than one year) and short-term business. The minimum solvency of long-term business is the sum of (1) 1 percent of mandatory minimum reserve of investment-linked products and 4 percent of other products and (2) 0.1 percent of amount at risk for term life products carrying an insurance period less than three years, 0.15 percent for term life products carrying an insurance period more than three years but less than five years, and 0.3 percent for other life products. The calculation of minimum solvency of short-term business is the same as that of P&C insurance companies.

In addition, CIRC has loosened the former strict limitations on market access, regions of operation, rates, and policy forms. For the non-life insurance side, reform which began in 2003, focuses on automobile insurance. Insurers no longer need to use the rates and forms set by CIRC and can develop their own polices and use them after getting approval from CIRC. For the life insurance side, insurers are permitted to develop their own policy forms and rates and just need to file related materials (including terms and rate schedules, cash value illustration, and legal statements) with CIRC within seven days after sale of the products. However, they must get approval prior to launching certain products according to the *Notice on Several Issues about Administrative Measures on Life Insurance Products* (CIRC 2005n).[244]

All these measures, in return, have inspired many innovations in the industry, e.g., the introduction of automobile premium rate based on insured's personal information such as driving record and sex, the Bonus-Malus system, and the electronic loss assessing system.[245]

Generally speaking, the competitiveness of the market has been on the rise as the number of insurers has increased over time, but China's insurance market is still characterized as a typical oligopoly market. The government remains heavily

[243] The minimum for insurance companies, which have been in the business no more than three fiscal years, is what prescribed in (1).

[244] Include mandatory insurance products, products recognized to be related to public interest by CIRC, and life insurance carrying death protection recognized as new type by CIRC. For more information, refer to CIRC (2005o).

[245] The Bonus-Malus system is a kind of no-claims discount strategy which can be chosen by the insurer to eliminate the moral hazard problem. In China, almost all insurers have adopted some form of no-claim bonus schemes in their auto insurance contracts, and the typical maximum premium discount is 10%. A particularly simple Bonus-Malus scheme is termed a "one up/one down" scheme. It rewards individuals for each claim-free period by a reduction in premium to the next lowest category and each claim generates an increase in premiums to the next highest category.

involved in the industry, though not as much as before. In December 2001, China became a member of the World Trade Organization. This further opening up to the outside world has brought significant challenges and great opportunities to China's young insurance industry which are discussed in the next section.

12.4 AFTER OPENING UP: OPPORTUNITIES AND CHALLENGES

12.4.1 Stages of Opening up and China's WTO Commitments

China's insurance industry began to open up to the outside world step by step at its initial stage of restoration. The central government first allowed several foreign insurance companies to set up representative offices in China in the early 1980s which started the first stage of opening up. 1992 was the start of the pilot stage as the State Council chose Shanghai to be the first experimental city for opening up. More cities followed the suit thereafter. Upon China's accession to the WTO in 2001, the government made certain commitments with respect to the insurance sector and thus led China's insurance industry to a completely new stage. The current stage is characterized by an overall opening instead of a limited and restricted opening and it is viewed as more predictable, based on a legal framework, with mutual openings among WTO member countries.

The Chinese government's WTO commitments concerning the insurance sector can be summed up in the following four aspects: corporate forms, regional restrictions, business restrictions, and mandatory insurance.

Corporate Forms

The Chinese government promised that upon WTO accession, foreign non-life insurance companies would be allowed to establish branches or joint ventures with a maximum ownership stake of 51 percent; and 100 percent owned subsidiaries would be allowed two years after WTO accession. Foreign life insurance companies would be allowed to freely choose Chinese partners and establish joint ventures with maximum ownership of 50 percent upon WTO accession. Foreign insurance brokerages may set up joint ventures with maximum ownership of 50 percent upon accession, 51 percent within three years of accession, and 100 percent owned subsidiaries within five years of accession. Foreign reinsurance companies would be allowed to set up branches, joint ventures, or fully-owned subsidiaries to provide life and non-life reinsurance without regional restrictions or numerical restrictions on operating licenses. The new establishments are subject to licenses approved by China's insurance regulator (the approval process has been described in the above paragraphs).

Regional Restrictions

Upon WTO accession, foreign life insurance, and non-life insurance companies were allowed to operate in Shanghai, Guangzhou, Dalian, Shenzhen, and Fuoshan. Within two years of WTO accession, they were further allowed to operate in ten more cities: Beijing, Chengdu, Chongqing, Fuzhou, Suzhou, Xiamen, Ningbo, Shenyang, Wuhan, and Tianjin. All regional restrictions were removed at the end of 2004, three years after the accession.

Business Restrictions

Upon WTO accession, foreign non-life insurance companies were allowed to engage in the sale of "master policies," which cover the insured's properties and liabilities located in different places without regional restrictions and were also allowed to underwrite large commercial risks. Foreign non-life insurance companies were allowed to provide property coverage, related liability, and credit insurance for subsidiaries of foreign companies operating in China. Within two years of accession, these companies were allowed to provide the whole range of non-life insurance products except mandatory insurance to both Chinese and foreign clients. Foreign life insurance companies were allowed to provide individual (non-group) life insurance to both Chinese and foreign citizens. Within three years of WTO accession, these companies were allowed to provide health, group, and retirement/annuity products to both Chinese and foreign citizens.

Mandatory Insurance

China Re, the former national reinsurance company, was granted a 20 percent mandatory reinsurance from domestic companies before the WTO entry. This percentage was reduced by 5 percent each year after WTO accession and zeroed out four years later. However, foreign companies were still excluded from mandatory insurance for automobile third-party liability, public transportation vehicle liability, and commercial vehicle driver/contract mover liabilities.[246]

Overall, the intense efforts by the developed country members of the WTO on negotiation involving the insurance sector have proven to be effective and China's insurance industry has opened to a greater extent than other emerging insurance markets in the world.

12.4.2 The Status Quo and an Evaluation of Insurance Opening Up

Status Quo of the Opening Up of China's Insurance Industry

By the end of 2004, 17 foreign insurers (including thirteen P&C insurers, one life insurer, and three reinsurers) from 8 countries /regions set up their branches and/or subsidiaries in China and another 20 life insurers from 12 countries/regions accessed Chinese insurance market by setting up joint ventures in China (CIRC).[247] The

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[246] Automobile liability insurance is mandatory in China. The compensation to the injured third party in traffic accidents is based on a tort liability system according to the *Road Traffic Safety Law of the People's Republic of China* effective May 1, 2004 (CIRC 2005h). CIRC was preparing *The Regulations on Mandatory Automobile Liability Insurance* when this chapter was being written and details concerning the mandatory insurance, such as the minimum insurance required, were not available when we completed this chapter.

[247] According to China's schedule of commitments in the insurance industry, foreign life companies can only operate in China through the establishment of joint ventures now. As a result, foreign life insurers established after WTO accession are all joint ventures. The existing foreign life branches are affiliated to AIA, which received its licenses in China before China's

foreign insurers had about 1.2 percent of the non-life insurance market and 2.6 percent of the life insurance market in 2004 (CIRC 2005p). With the huge potential of China's insurance market, there are still quite a few foreign insurers waiting for licenses. As of the end of 2004, there were 188 representative offices established by 124 foreign insurance institutions from 18 countries/regions in China (CIRC).

As noted above, China, following its WTO commitments, has allowed foreign insurers to operate in extensive areas of the country and provide many types of insurance. However, the foreign insurers already in business have actually focused on the relatively developed cities, such as Shanghai, Guangzhou, and Shenzhen. These cities offer better infrastructure, high per capita incomes, and the benefits of the cluster effect. Shanghai, the first experimental city to open, was the home of over 45 percent of the foreign insurers (by number) operating in China by the end of 2004 (CIRC).

As the insurance market opens up further, the number and the business volume of foreign firms in China continue to increase. The total assets of foreign insurers reached RMB 29.4 billion at the end of 2004, 2.5 percent of that of China's insurance industry (CIRC). The market share of foreign companies in the overall industry was 1.7 percent in 2003 and increased to 2.3 percent in 2004 (CIRC 2005p). In some regional markets with more foreign players such as Shanghai, Guangzhou, and Shenzhen, the market share of foreign insurers, especially life insurers, far exceeds the national average. For instance, in Shanghai alone, the market share of foreign companies reached 15 percent (Shanghai Insurance Regulatory Agency 2005). It is safe to say that foreign insurance companies tend to grow very fast and show a strong momentum.[248]

In addition, it is notable that foreign insurers tend to choose non-insurance firms, especially large industrial enterprises, as their joint venture partners. Observations on the 18 joint ventures already in business before August 2004 show that only 4 of them took on domestic insurers as their Chinese partners and the other Chinese partners include large industrial firms, such as Haier Group, Beijing Capital International Airport, China National Cereals, Oils and Foodstuffs Corp., and China Minmetals Corp. This fact reveals the market-oriented nature of foreign insurers. Foreign companies, if they invest together with domestic insurers, will not only have to spend a lot of efforts to integrate different corporate cultures, variant mindsets, and modes of operation and management, but also face the possibility of conflicts of interest between the joint venture and the domestic insurer. In contrast, if foreign insurers work with large non-insurance firms who are financially strong, have favorable good will, and enjoy the status of SOEs, they will enhance the likelihood of seeing positive returns sooner rather than later by avoiding the aforementioned risks and benefiting from securing customers, building a good image in the market, and influencing the market direction. Generali China Life Insurance Company

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WTO entry. Furthermore, since foreign non-life insurance companies are allowed to establish branches, no joint ventures engaging in the non-life insurance business have been established.

[248] Foreign insurance companies collected 19.42 percent of the premium of newly issued individual life policies in Shanghai in 2003, while in 2002 it was 31.55 percent. This decline might prove the relative advantage of domestic insurers in competition, yet it is hard to conclude that the competence of domestic insurance companies has been improved materially without further evidence (Chen 2004, p. 289).

Limited can serve as a convincing example. On March 31, 2005, this company, a joint venture of Assicurazioni Generali S.p.A. (Generali) and China National Petroleum Corporation (CNPC), sold a "Generali China Sunlight Group Pension" policy to CNPC and collected RMB 20 billion premium. This policy raised the rank of Generali China Life from number 14 in 2004 to 4 in 2005 with respect to market concentration in China.[249]

Evaluation of Insurance Opening Up

In general, extensive opening up to the outside world has undoubtedly brought valuable opportunities to China's insurance industry and has proven to be a success in view of its effects on the development and reform of the industry. First, opening up has helped to improve the quality of development, i.e., the industry has seen product and service innovation in addition to sales growth. Foreign insurance companies' access to China's insurance industry through various channels has brought not only substantive needed capital, but also many resources necessary for effective improvement in the quality and productivity of assets. These include experienced talent, advanced technologies and experience, abilities in research and development (R&D), superior management, and the capacity for understanding customers' demand. Actually, China's domestic insurance companies have made great progress profiting from foreign rivals' new ideas and advanced knowledge in actuarial science, product development, management, marketing, and service. What is more, foreign insurers often engage in R&D, with domestic research institutions or organizations, which provide positive spillover benefits to domestic insurers. For example, Swiss Re has completed, together with Beijing Normal University, *The China Natural Catastrophe Maps*, which includes geographic and meteorological data related to major natural catastrophes in the recent 500 years and provides the insurers with a reliable basis to evaluate risks.

Second, opening to the outside has compelled China's domestic insurance industry to reform at a faster pace. Foreign insurance companies have become models for domestic insurers. Thus, fierce competition has erupted in China's insurance market. This will be intensified as foreign insurers further penetrate China. The strengthened competition will also compel domestic insurers to reform their ownership structure and build modern governance, management systems, and operating rules, and fully adopt the market economy mindsets. Furthermore, opening up has accelerated the formation of market-oriented legislation and a regulation system with the characteristics of transparency, equity, and effectiveness.

However, it is, without doubt, apparent that severe challenges to domestic insurers came with these opportunities. In an historical view, China's domestic insurers, who came into being just after the restoration of China's insurance industry, were quite young compared to their foreign rivals, who came from developed

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[249] Some may think that the reason that foreign insurance companies search for partners outside China's insurance sector is that domestic companies do not want to partner with foreign firms. However, this is not the case. In fact, China's domestic insurers do desire foreign insurers as partners in order to enhance their skills in management, product development, and marketing. Furthermore, almost every domestic insurer that has a large market share, either has foreign insurers as strategic investors, or is searching for foreign investors, e.g., PICC P&C has AIG as a strategic investor.

markets and were already mature themselves. Early opening has been difficult for domestic insurers, since they are at a disadvantage with regard to many aspects, such as financial strength, administration, governance, management, accumulated knowledge, and expertise.

At the same time, problems resulting from the activities of the domestic insurers themselves, after WTO entry, also magnified the challenges to a great extent. First, domestic insurers mostly adopted a "volume expansion" strategy that focused on short-term sales volume while ignoring product differentiation and core competencies. In the face of intensifying competition, domestic insurers only concentrated on customers and lines which could be easily reached through their available and identical marketing channels, engendering an overcrowded market and identical product portfolios along with considerable unmet demands. Second, domestic insurers generally placed an emphasis on learning and mimicking foreign experience and technologies while neglecting the enhancement of their abilities to innovate. Third, domestic insurers gave most of their attention to learn foreign knowledge in marketing and product development and little to service. The extensive use of exclusive agents became the norm after AIA introduced the exclusive agent channel in 1992. The domestic insurers, especially life insurers, immediately began to heavily employ individual exclusive agents. This action proved to be extremely successful since more than half of the life insurance premiums were collected through exclusive agents over the past several years. However, domestic insurers interpreted "marketing via individual exclusive agents" as simply employing a quantity of salespersons and utilizing them to sell products. This partial understanding led to large numbers of insurance agents trained to compete for market share and premium volume only. The agents often attached little importance to service and made little effort to recommend insurance products that were best suitable for the consumers. While the agents sold new policies to customers in this underdeveloped market, the performance along with the growth and development of the industry were affected negatively in the long run since the creditability of the insurance industry was doubted by the consumers. Generally speaking, the domestic insurers have many things to learn from their foreign competitors to improve their competence.

12.5 THE FUTURE OF CHINA'S INSURANCE INDUSTRY

The accelerated economic globalization is netting more and more national and regional economies into the worldwide market. However, as a process full of conflicts, globalization not only has positive effects, but also inevitably brings a series of problems. China's insurance industry must confront these challenges and make the most of the opportunities offered by globalization.

12.5.1 Great Potential of a Developing Market

With the deepening industrialization in China, various service industries have been established and the framework of the service sector has been completed.[250] However, the development of the tertiary sector does not lend itself to an optimistic evaluation.[251] As Figure 12.6 shows, the ratio of output from the tertiary sector to GDP first decreased and then increased somewhat from 1992 to 2003 with the highest level of 34 percent in 2002 and the lowest of 30 percent in 1996. These figures suggest that the tertiary sector of China falls behind not only that of developed countries, but also behind that of developing countries at a similar stage of economic development. For example, the ratio of output from the tertiary sector to GDP of India was 36 percent in 1980 and kept on rising thereafter (Guo and Wang 1999, p. 7). Moreover, as Figure 12.7 indicates, the share that China's financial service sector contributes to the output of the service sector is quite low in comparison with that of developed countries. Furthermore, the share has been decreasing in recent years despite the increase in the volume of the financial sector output. Along with the progress in China's economic development and economic system reform, many sectors such as information technology, education, and entertainment grew faster than the financial sector grew. As Figure 12.8 shows, the ratio of output from financial sector to that of the whole service sector decreased from 20 percent in 1996 to 17 percent in 2002, while in the U.S., the ratio reached 22 percent in 1970 and kept increasing, although at a decreasing pace. These data suggest that the financial service sector in China is still underdeveloped and has plenty of room to expand. China's insurance industry, as the "developing industry in a developing market," undoubtedly has tremendous potential. It is anticipated that China's insurance industry will soon take a unique role on the world stage and become the key focus of insurers from developed countries.

12.5.2 Key Drivers of Future Growth of China's Insurance Industry

Excellent Economic Prospects

Experts predict that China's economy is expected to continue its robust growth for at least a few years with annual real growth rates of higher than 7 percent (Li, et al. 2003). Increased national income will surely have positive impacts on people's purchasing power. The increase of all types of uncertainties accompanying accelerated industrialization and urbanization will cause individuals to adjust their risk expectation upward and thus raise their willingness to purchase insurance. The combination of strengthening purchasing power and willingness will certainly drive the robust growth of insurance demand. It is in the traditional culture of the Chinese

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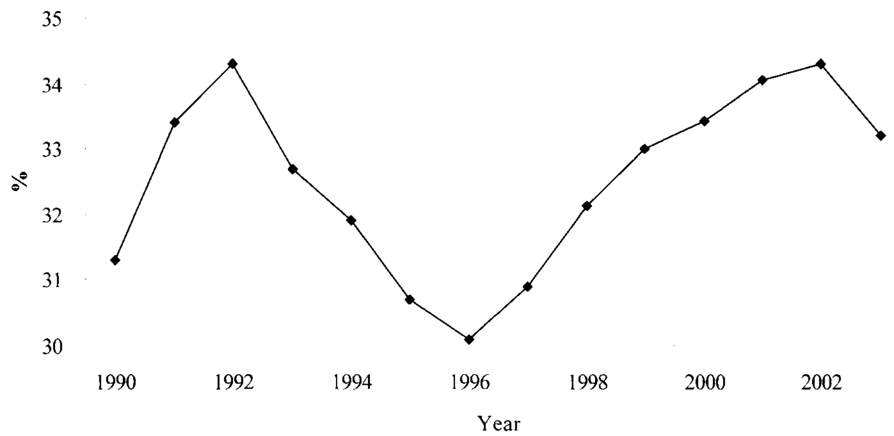
[250] The ratio of output from the primary sector to GDP has decreased from 28.1 percent in 1978 to 14.6 percent in 2003. The employees in the primary sector accounted for 49.1 percent of the entire workforce in 2003 vs. a 70.5 percent in 1978 (National Bureau of Statistics of China 2004, §3.2, §5.2).

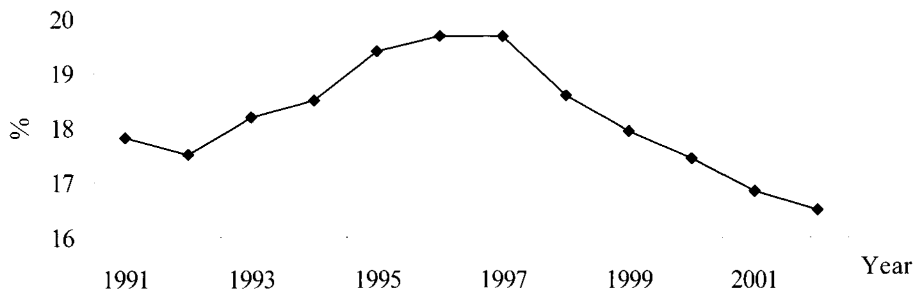
[251] The tertiary sector refers to all other economic activities not included in the primary or secondary sectors. The primary sector refers to agriculture, forestry, animal husbandry, and fishery. The secondary sector refers to mining and quarrying, manufacturing, production and supply of electricity, water and gas, and construction.

for individuals to be strongly motivated to prepare against possible economic losses. Thus, one could reasonably assume that increases in income levels will boost insurance demand, other things being equal.



Source: National Bureau of Statistics of China (2004), §3.2;
Notes: There is a crash in the tertiary sectors' output to GDP in 1996. One explanation for this is that although the output from the tertiary sectors of China has kept rising, the secondary sectors grew much faster while the ratio of output from the primary sectors to GDP decreased slowly during the period from 1992 to 1996.

Figure 12.6. The Ratio of Output from the Tertiary Sectors to GDP, 1990–2003



Source: National Bureau of Statistics of China (2004), §3.6 and (1992), §3.6.

Figure 12.7. The Ratio of Output from the Financial Services Sector to the Tertiary Sectors, 1991–2002

Economic System Reform

As mentioned above, market-oriented reform has fueled insurance demand and created the current insurance market in China. We predict that further progress in the reform and opening up will continue to fuel the insurance industry on the supply side. Furthermore, forthcoming reform policies will underlie sustained growth of insurance demand in China. Two of these reform policies are focused upon here. The first is investment system reform. The State Council of China enacted the *Resolution on the Reform of the Investment System* in July 2004, which abolished old administrative measures on the investment activities of firms. The old measures required that every investment must get ex ante approval from local or state government according to its size. Now, most investment decisions are in the hands of firms themselves. The exclusions are those projects that might have negative impacts on public interest. Consequently, the economic power of the firms has increased greatly, while the government's involvement in the economy has decreased as a part of the gradual institutional change in China. We can foresee that the investment enthusiasm will be inspired considerably and the exposure to greater investment risks will surely increase the firms' demand for insurance, especially for non-life insurance, since the government will no longer be responsible for a firm's investment risk.

The second reform is related to the social security system. China's efforts to establish the social security system (previously called the labor insurance system), which began shortly after the People's Republic of China was founded, were held back during the Culture Revolution. The Ministry of Finance promulgated *The Opinions on the Reform of Several State-Owned Enterprises' Financial Systems (draft)* in February 1969, which required that state-owned enterprises stop collecting social insurance funds, and instead treat reimbursements for payments of labor insurance as a non-operating expense. Thus, labor insurance was actually changed into a pay-as-you-go system running within an enterprise. This old system later proved to be a huge obstacle to China's economic system reform. The 3rd Plenary Session of the 14th CPC Central Committee held in 1993 formed *The Decisions on Several Issues about the Establishment of Socialist Market Economic System*. They decided to establish a multi-pillar social security system suitable not only to China's economic development stage, but also appropriate to the financial strength of the government, firms, and individuals. The current social security system in China thus focuses on providing the most basic economic security to laborers. Reform has led to a widening gap between the economic security provided by the social security system and individuals' actual needs. Consequently, there exists a high demand for commercial life and health insurance.[252]

Demographic Changes

China's population was 1.29 billion at the end of 2003, about 1/5 of the world population, and is still increasing. It is expected to reach 1.32 billion by the end of 2005, according to the United Nations (2004). The Chinese aging population will continue to grow due to the family planning policy. It is expected that the percentage of people aged 65 and above will increase from 7.50 percent at the end of 2003 to 13.40 percent by 2025 (National Population and Family Planning Commission of

[252] For example, based on the current basic pension system, the target monthly old-age benefit for each retiree is about 58.5 percent of the average wage of the society at the time of their retirement (Ministry of Labor and Social Security of China (MOLSS) 1998, p. 51). If we take the life cycle approach, many retirees' income right before retirement would be higher than the current social average level, for which the target replacement ratio of China's basic pension system is much lower than 58.5 percent.

China (NPFPC) 2003). The average family size (person/household) has decreased from 4.41 in 1982 to 3.38 in 2003 (National Bureau of Statistics of China 2004, §4.4 and §4.7). China's large population and demographic mix will drive the solid growth of China's insurance industry, especially in life insurance, health insurance, and pension insurance.

12.5.3 Factors That Might Have Negative Impacts on China's Insurance Industry

While we are optimistic about the future of China's insurance industry and believe that the growth trend will not be reversed, we have to concede that some factors may impede the fast pace of the development of the industry.

Immature Capital Market

The history of the world insurance industry has made it clear that investment management will be more and more important to insurers' survival and development as the insurance industry expands and matures. Presently, China's insurers are allowed to invest in domestic capital markets and the available investment channels have materially increased in 2004. However, China's capital market has not yet reached a desirable condition and is currently flooded with speculation. The average turnover rate of Shanghai Stock Exchange and Shenzhen Stock Exchange in 2003 was 251 percent and 214 percent respectively (National Bureau of Statistics of China 2004, §20.16), much higher than that of mature capital markets.[253] If insurers invest heavily in these markets, their financial strength may be threatened. In fact, China's insurers are now still reluctant to invest in the stock market when they were authorized to do so in October 2004.

Shortage of Professional Personnel

Over the past approximately twenty years companies were directed by the central government to pursue volume expansion strategies because the government viewed insurance premiums as a form of revenue generation and an approach to collect financial surplus. This strategy impelled companies to focus on short-term growth of sales volume, while profitability, management efficiency, and long-term development were neglected in the long-term. The domestic insurers competed fiercely for the low hanging fruit and did little research and development. To make things worse, the problem was masked by the high growth rate which was attributable only to the high potential of China's insurance market. This strategy not only led to low productivity and high operating costs, but also resulted in a lack of insurance education and career training. Lack of professional personnel, especially the lack of high quality managers, has proven to be a severe bottleneck for the development of China's insurance industry in the long run.

[253] The average turnover rate in year t, TO_t, is defined as: $TO_t = V_t / N_t \times 100\%$ in which V_t represents the volume of transacted shares in year t in the stock exchange, and N_t represents the number of negotiable shares in the exchange during the same time period.

Unfavorable Image of the Industry

The image of China's insurance industry, especially that of domestic insurers, is not desirable and calls for immediate attention. Many consumers believe it is difficult to obtain the promised insurance indemnity and that the procedure of claims filing is inefficient. Some agents and sales staff of insurance companies are perceived as low quality, not acting in good faith and with professional behavior. Some of them concealed important clauses in insurance contracts and even misguided consumers in their insurance purchase decisions. Others refused to meet their contractual obligations. Still, some insurers have acted against regulations and charged exorbitant commissions, used rebates, and/or insufficient premium rates to stimulate sales. The situation mentioned above has been worsened by the fact that the public knows little about insurance. According to a survey conducted in 2002 by the Development and Research Center of the State Council of China (DRC) in 50 big cities, 36 percent of the interviewees said that they were ignorant about insurance on the whole (Market Economy Institute of DRC 2002). Even in Shanghai, the most developed insurance market in China, 73 percent interviewees said they knew just a little about insurance and only 2.4 percent said they were acquainted with insurance (Horizon Group 2004). Thus, it is not surprising that the mistakes made by some individual insurers can be easily spread out quickly and erode the public's trust in some insurers and even in the whole insurance industry.

Lack of Public Good Faith

It is very important to the development of the insurance industry that consumers act on good faith. However, the situation in China at present is unsatisfactory and the development of many product lines, especially credit insurance and guarantee insurance, is restricted. For example, PICC P&C and some other P&C companies were forced to exit the auto loan insurance market temporarily because of the high default risk. Thirty percent of personal auto loans were in default and 10 percent were bad debt resulting in massive losses for the insurers. One can see from the claims practice that the insureds were often concentrated within certain areas or groups and sometimes with the clear intention to cheat (Wu 2003). Additionally, according to a conservative estimate by non-life insurance companies in Beijing, about 20 percent of the automobile insurance payments were frauds, including intentional damage, exaggerated claim amount, and claims of automobiles stolen that are false (Li 2004).

12.5.4 Future Trends for China's Insurance Industry

We forecast that China's insurance industry will maintain a two-digit growth rate in the coming eight to ten years and the growth rate will be descending over time. As to the development of the industry itself, the market system will keep up with international standards gradually and the following trends will be the most prominent features in an environment characterized by globalization, financial integration, aging population, and dynamic information technologies.

Growing Competition in the Insurance Market
China's insurance market will be more competitive as more foreign capital flows in and the number of insurers increases. The Herfindahl index of the life insurance market and non-life insurance market was 2,750 and 3,682 respectively and the respective market share of the top 3 insurers in these two markets has decreased to 75 percent and 80 percent in 2004 (CIRC 2005p).[254] The competitiveness of the insurance industry is growing at an accelerating pace. We anticipate that in next 3 year both of the respective market shares of the top 5 insurers in the life and non-life insurance sectors will fall to about 65 percent and 70 percent respectively and that the largest life insurer will hold about 40 percent of the market while the largest non-life insurer will hold about 45 percent. At the same time, the fierce competition will drive the insurers to pay a great deal of attention to the quality of service and the functions of insurance products. However, on the whole, China's insurance market will still be characterized as a concentrated oligopoly in the medium-term.

Deepening Cooperation with Other Financial Institutions, Especially Banks
Since October 2004, China's insurers are allowed to invest in domestic stock market, after a long time of tradeoff between the possible risks and return, indicating an even closer relationship between the insurance industry and the securities sector. But as China's capital market is still immature, insurers will be very prudent in investing in the stock market due to the potential risk of loss. So the insurers' investment in the stock market will not increase on a large scale in the short-term and the prospective role of insurers in the capital market will depend on the maturing progress of the latter.

The cooperation between insurers and banks will be strengthened greatly. Bancassurance has been a success in China, because banks have advantages over insurers in customer resources and marketing. People in China are acquainted with and have steadfast trust in banks and therefore, bank services can be easily accepted. Bancassurance can be expected to continue to be one of the major distribution channels for life insurance. Besides strengthening strategic cooperation between the two industries, there will be more and more holding companies controlling both banks and insurance companies.

Finally, with a view to the coming financial integration, various innovative measures for the controlling of systematic financial risks, such as insurance securitization, will become popular, but not in the near term. The development of insurance securitization is a complex project and is demanding for both the insurance market and the securities market. Presently, the preconditions for insurance securitization do not exist in China, including theoretical research, the training of professional personnel, and the establishment of required infrastructure (e.g., legislation system). However, alternative risk transfer mechanisms will surely be important means for risk management by China's insurance industry.

[254] The Herfindahl index is an index of market concentration calculated by adding the squared value of the individual market shares of all firms in the industry. Market share here is measured by premium volume.

Optimization of the Product Portfolio

With respect to China's life insurance sector, the demand for health and pension insurance will increase rapidly and steadily along with the aging population and the deepening of social security reform. On the health insurance side, while currently the government provides a large portion of health care in urban areas, this portion is declining. Consequently, the role of private health insurance is rising. Note, however, that there is hardly any private health insurance in rural areas of China. However, it is worth indicating that severe adverse selection and moral hazard exist, and domestic insurers lack experience in risk control. Therefore, China's insurers need to improve their health plans and intensify their cooperation with hospitals in order to control the medical costs and reduce adverse selection and moral hazard. Managed care plans will be introduced in China and will likely become the major operation pattern of health insurance in the next five to eight years. As for pension insurance, the insurance industry is faced with great opportunities and foreign insurance companies specializing in pension will play an important role in the market.

With regard to China's non-life insurance sector, property insurance and motor vehicle liability insurance will continue to dominate the non-life insurance market. These types of insurance are expected to account for more than 50 percent of the premium income generated by the non-life industry in the next 5 years, primarily due to the increasing number of motor vehicles (especially private automobiles) and legal requirements for carrying liability insurance. There is likely to be solid growth of liability insurance, construction and installation projects insurance, enterprise property insurance, family property insurance, and credit insurance owing to the gradual clarification of the concept of private property rights, large scale infrastructure construction, fast growth in home ownership, family wealth, and increased public awareness of the value and need for insurance.

Diversification of Distribution Channels with Agents and Brokers Still Playing Important Roles

Innovative distribution channels, including bancassurance, postal insurance, and direct response have already emerged in China and their market share will certainly increase over time. The insurance distribution channels in China will become more diversified. Agents and brokers will remain important and irreplaceable since the applicability of innovative distribution channels will depend on consumers' need for advisory services and the traditional distribution channels are much more effective for complicated policies with long insurance periods and large face amounts. As a result, there will still be a need for agents and brokers to serve consumers face-to-face frequently. In addition, rising wealth levels will drive the demand for comprehensive risk management and financial planning services rather than simple advisory services on insurance purchase decisions. The requirements for well-trained agents and brokers will consequentially be much higher.

12.6 CONCLUSION

China's insurance industry developed rapidly from a virtually nonexistent, minimal, and closed industry into a large, open industry with great potential. This is supported by the growing insurance demand resulting from the government's efforts to create market-oriented reforms in the 1980s. As to the supply side, China's insurance market is characterized by an increase in the number of insurers and organizational restructuring of the state-owned insurers, which gradually lost their former monopoly of insurance market. While the market has become more competitive, it is still characterized as a typical oligopoly and the government remains heavily involved in the industry, though not as much as before. Furthermore, the geographic distribution of China's insurance industry is highly imbalanced.

Opening up to the outside world, especially China's WTO accession, has brought the young domestic insurers into fierce competition with foreign insurance companies. On the one hand, the presence of foreign rivals helps to improve the quality of developments of China's insurance industry and enhance the competitive environment. On the other hand, China's domestic insurers are at a disadvantage in many aspects compared to their foreign rivals, such as financial strength, administration, and governance. Thus, they face severe challenges. However, the domestic insurers themselves magnified the challenges to a great extent. They adopted a so called "volume expansion" strategy while ignoring product differentiation and core competencies, placed an emphasis on learning and mimicking while ignoring the enhancement of the ability to innovate, and paid a lot of attention to learning foreign knowledge in sales and product development while ignoring service.

As a developing industry in a developing economy, China's insurance industry undoubtedly has tremendous potential. Some factors, including excellent economic prospects, accelerated economic system reform, and the large and aging population will drive China's insurance industry to grow continuously and rapidly. However, the development of the industry might be bottlenecked by the immature domestic capital market, shortage of professional personnel, unfavorable image of the industry, and lack of public good faith. Despite these challenges, we forecast that China's insurance industry will maintain a two-digit growth rate in the forthcoming eight to ten years and the growth rate will be decreasing over time. As to the development of the industry itself, the market will catch up with international standards gradually and become more and more competitive. There will be deepening cooperation between insurers and other financial institutions, especially banks. Optimization of product portfolios and diversification of distribution channels are also expected, though agents and brokers will continue to play a crucial role.

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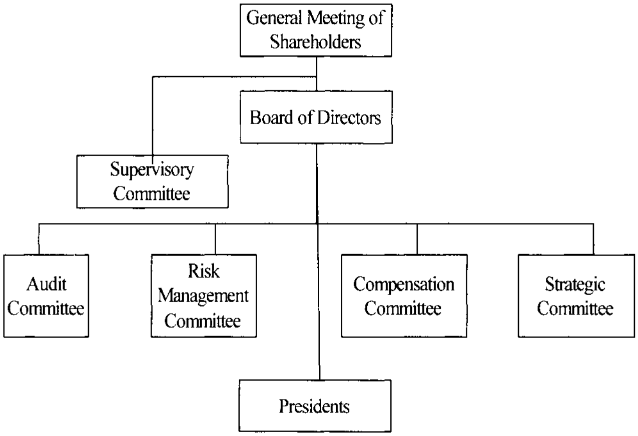
12.8 APPENDIX 1: An Overview of the Top Insurance Companies in China's Life and Non-Life Industry

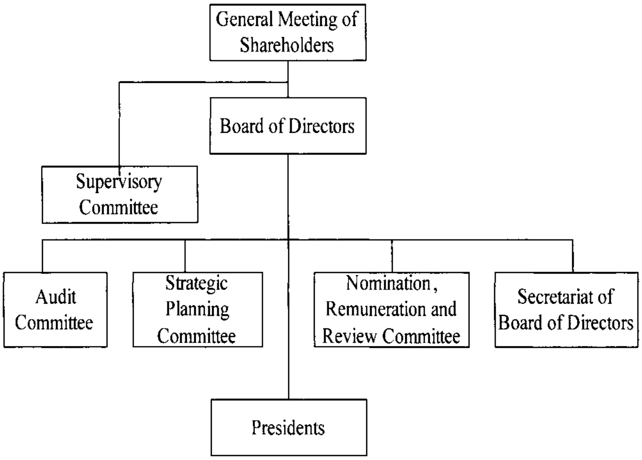
China Life Insurance Company Limited (China Life) and PICC Property and Casualty Insurance Company Limited (PICC P&C) are now the leading insurance companies in China's life and non-life insurance industry. In 2004, China Life accounted for 46.9 percent of China's life insurance market and the PICC P&C accounted for 58.1 percent market share (CIRC).

The following table covers some of the main characteristics of these two companies:

	China Life	PICC P&C
Company Profile	▪ Incorporated on June 30, 2003 by China Life Insurance Company, which transferred its well-performing policies and related assets and liabilities to China Life and was then restructured to China Life Insurance (Group) Company in July 2003.	▪ Incorporated on July 19, 2003 by PICC, which injected all of its commercial insurance operations, together with related assets, liabilities, and subsidiaries into PICC P&C and then renamed and re-registered as PICC Holding Company.
Top Management	▪ The Chairman is appointed by CIRC. The board of directors appoints the president while the candidate is nominated by CIRC, given that the State is still the majority shareholder. ▪ The now Chairman of the Board and President, Mr. Chao Yang, got his appointment in June 2005. He has been the president of China Life Insurance (Group) Company since May 2005. Between March 2000 and May 2005, Mr. Yang was the chairman and the president of both China Insurance (Holdings) Company Limited and China Insurance H. K. (Holding)	▪ The Chairman is appointed by CIRC. The board of directors appoints the president while the candidate is nominated by CIRC, given that the State is still the majority shareholder. ▪ The Chairman of the Board is now Mr. Yunxiang Tang, who joined PICC in 2000 as general manager. He was previously the vice chairman of CIRC and assistant president of the People's Bank of China. Mr. Tang graduated from Shaoyang Normal College of Hunan Province and has 41 years

	China Life	PICC P&C
	Company Limited. He graduated from Shanghai International Studies University and Middlesex University in the United Kingdom. Mr. Yang majored in English language and business administration and has obtained a master's degree in Business Administration. ▪ The former Chairman of the Board and President was Mr. Xianzhang Wang, who served as President of China Life Insurance Company since 2000. Mr. Wang graduated from Liaoning University of Finance and Economics (now Northeast University of Finance and Economics) with a major in foreign economics and trade in 1965.	of experience in business operation and management. ▪ The President and CEO is now Mr. Yi Wang, who joined PICC in 1979 and was previously deputy general manager of PICC. Mr. Wang graduated from the Chinese Communist Party University with a bachelor's degree of economics and management in 2000 and a master's degree of political science in 2004.
Corporate Governance	 **China Life**	

	China Life	PICC P&C



PICC P&C

	China Life	PICC P&C
Financial Results for 2004	▪ Net Premiums Earned and Policy Fees: RMB 65.0 billion ▪ Investment Results: RMB 10.0 billion ▪ Benefits and Claims: RMB 52.8 billion ▪ Net Profit: RMB 7.2 billion ▪ Total Assets: RMB 433.7 billion ▪ Total Shareholders' Equity: RMB 66.5 billion	▪ Net Premiums Earned: RMB 50.6 billion ▪ Investment Results: RMB 304 million ▪ Net Claims Incurred: RMB 38.9 billion ▪ Net Profit: RMB 208 million ▪ Total Assets: RMB 88.3 billion ▪ Total Shareholders' Equity: RMB 16.8 billion (PICC P&C also carries a RMB 2-billion subordinated loan)
Business Segments in 2004	▪ Gross written premiums and policy fees attributable to individual life insurance in 2004 were RMB 54.9 million, 80.6 percent of which were collected from participating products, representing 82.9 percent of its gross written premiums and policy fees for the year. Participating endowment products become one of the most important product series of the Company. ▪ Accidental and short-term health insurance accounted for 7.51 percent and 8.5 percent of its business respectively in 2004.	▪ Automobile insurance products became the most important product line of the company. In 2004, the gross premiums attributable to automobile insurance accounted for 69.2 percent of the gross written premiums. ▪ Enterprise property insurance took second place with a market share of 12.9 percent.

	China Life	PICC P&C
Shareholders	▪ China Life Insurance (Group) Company holds 72.2 percent of China Life's equity. Public investors hold the other 17.8 percent since China Life is a listed company both on New York Stock Exchange (NYSE) and the Hong Kong Stock Exchange.	▪ PICC Holding Company holds 69.0 percent of PICC P&C's equity. Public investors hold the other 31.0 percent since PICC P&C is a listed company on the Hong Kong Stock Exchange. ▪ AIG bought 9.9 percent of PICC P&C's equity at its IPO with a five-year lock-in period and became the latter's strategic foreign investor. AIG has begun to cooperate actively with PICC P&C in the field of accidental and health insurance.

Source: 2004 Annual Report of China Life Insurance Company Limited; 2004 Annual Report of PICC Property and Casualty Insurance Company Limited.

12.9 APPENDIX 2: Average Exchange Rate of RMB to Main Convertible Currencies (Middle Rate), 1980–2003*

Year	100 US$	100€**	Year	100 US$	100€
1980	149.84	N/A	1992	551.46	N/A
1981	170.50	N/A	1993	576.20	N/A
1982	189.25	N/A	1994	861.87	N/A
1983	197.57	N/A	1995	835.10	N/A
1984	232.70	N/A	1996	831.42	N/A
1985	293.66	N/A	1997	828.98	N/A
1986	345.28	N/A	1998	827.91	N/A
1987	372.21	N/A	1999	827.83	N/A
1988	372.21	N/A	2000	827.84	N/A
1989	376.51	N/A	2001	827.70	N/A
1990	478.32	N/A	2002	827.70	800.58
1991	532.33	N/A	2003	827.70	936.13

Source: State Administration of Foreign Exchange (2005); National Bureau of Statistics of China (1996), §16.2 and (2004), §18.2.

Note: N/A is not available. RMB is Ren Min Bi, the Chinese currency.

* Middle rate is the annual average exchange rate is calculated as the weighted mean of the daily exchange rates during the year.

** China began to publicize the exchange rates of the RMB to the Euro on April 2, 2002 after the Euro began circulating.

12.10 LEXICON

AIA. American International Assurance Company.

AIG. American International Group.

AIU. American International Underwriters, Ltd.

Bonus-Malus System. The Bonus-Malus system is a kind of no-claims discount strategy which can be chosen by the insurer to eliminate the moral hazard problem. No claims bonus schemes are an important feature of some insurance contracts, most notably those for auto insurance. A particularly simple Bonus-Malus scheme is termed a "one up/one down" scheme. It rewards individuals for each claim-free period by a reduction in premium to the next lowest category and each claim generates an increase in premiums to the next highest category.

CCISSR. China Center for Insurance and Social Security Research at Peking University.

China Life. China Life Insurance Company Limited.

China Re. China Reinsurance Company.

CIRC. The China Insurance Regulatory Commission is the regulatory body of China's insurance industry directly under the State Council.

CNPC. China National Petroleum Corporation.

CPC. Chinese Communist Party.

Direct Response. Direct response, including Internet, telephone, and direct mail, is the marketing channel through which the insurance companies sell products directly to consumers. This channel does not involve face-to-face contact during the sale process.

DRC. Development and Research Center of the State Council of China.

FICX. Farming Insurance Company of Xinjiang Production and Construction Group.

Financial Bonds. Financial bonds are securities issued by financial institutions in China's inter-bank bonds market. They require the repayment of interest and principal within a given period.

MOLSS. Ministry of Labor and Social Security of China.

Negotiated Bank Deposit. A negotiated bank deposit is a kind of long-term deposit by non-bank financial institutions, the terms of which are set by bilateral negotiation.

NYSE. New York Stock Exchange.

NPC. National People's Congress.

NPFPC. National Population and Family Planning Commission of China.

PBOC. PBOC is the People's Bank of China, the central bank of China.

PICC. PICC is the People's Insurance Company of China. It is the first state-owned insurance company in China's history. It was restructured into the PICC Group in 1996.

PICC P&C. PICC Property and Casualty Company Limited.

Primary Sectors, The. The primary sectors are agriculture, forestry, animal husbandry, and fishery.

R&D. Research and Development.

RMB. RMB is Ren Min Bi, the Chinese currency.

Secondary Sectors, The. The secondary sectors are mining and quarrying, manufacturing, the production and supply of electricity, water, and gas, and construction.

SOE. State owned enterprise.

Tertiary Sectors, The. The tertiary sectors are all other economic activities not included in the primary or secondary sectors.

WTO. World Trade Organization.

WWI. World War I.