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Chinese Life Insurance Industry Outlook

Strong Growth In An Increasingly Competitive and Differentiated Market

Summary Opinion

The long-term prospects for China's life insurance sector are for continued strong growth, driven by China's growing economy, increased levels of disposable income and reforms to the state benefits system. Increasingly, domestic insurers will have to evolve and differentiate to meet the challenge presented by the influx of new entrants.

China's life insurance industry is currently dominated by domestic insurers, with China Life commanding around 45% of the market share in 2003. However, foreign firm are making significant inroads. As a result of WTO entry requirements, the pace of change should quicken and challenges intensify. That will put increasing pressure on domestic insurers, who at this moment are lacking the capital and technical expertise to bring themselves up to the levels of their international peers. In Moody's view, they will need to hasten their restructuring in order to meet future challenges.

China's insurance industry has grown since the mid-1990s. Much of the growth was generated from sales of insurance contracts with high guaranteed interest rates. This practice has become a major burden on the industry because of the negative spread stemming from the contracts. The limited investment opportunities in China have also resulted in a portfolio of investments, mainly in cash, deposits and government bonds, which has put pressure on investment spreads. The expected relaxation of investment regulations for insurers in the future should heighten asset liability issues previously deemed insignificant in this market.

Inadequate risk management has contributed to insufficient levels of capitalisation. However, because of growth, investors have viewed China's insurance market favourably. The successful restructuring and IPO of China Life in December 2003 helped relieve capital pressures and demonstrated strong demand from investors.

China's solvency margin regulations use an approach similar to that employed in Europe for many years (and now undergoing profound changes) which does not assess capital adequacy based on a company's asset risks. Although the extent to which an insurer can take asset risk is limited by the investment regulations. Compared to the risk-based capital measures used in the USA and other countries, this measurement of solvency does not look rigorously at all the risks inherent in total business operations, thus requiring additional insight when analysing capital adequacy.

Investment-linked products have been quite popular for life insurers. Generally less capital intensive than other insurance products, these should ease the capital management issues; however, the introduction of investment guarantees may reverse this advantage. Competition from other financial institutions to offer similar products will likely be keen.

A new regulatory framework is rapidly evolving towards international standards, with a focus on solvency. Together with competitive changes, it will present challenges for insurance companies to adapt and to plan for the future.

CREDIT STRENGTHS

- China's strong economic growth
- WTO membership increases the presence of world-class partners and aids knowledge and skills transfer
- New regulations will bring the industry to global standards of practice
- IPOs improve capitalisation and transparency
- Bancassurance is gaining popularity as an alternative distribution channel
- Government support of the insurance sector expected to remain, despite reduced state control
- Growing awareness and demand for insurance increasing, although currently at a low level
- The large domestic companies have China-wide distribution networks

CREDIT CHALLENGES

- Negative spread burden for older life insurers
- Weak capitalisation levels
- Limited investment opportunities hamper asset liability management
- Rapidly changing regulatory structure
- Foreign competition and competition from financial institutions offering alternative products is increasing
- The quality of sales is low at some insurers
- Awareness of risk controls and risk management is low
- Inadequate corporate governance and transparency

China's Life Insurance Sector

DOMESTIC INSURERS DOMINATE

The Chinese life insurance market contains 31 registered life insurance companies as of the end of 2003, made up of 9 domestic life insurers, 17 foreign-invested joint ventures and 5 regional branches of AIA (American International Assurance Co. Ltd) — AIG Inc's subsidiary. Of the foreign insurers, all are joint ventures apart from AIA, the first foreign insurer to enter the market and currently the only foreign life insurance company allowed to operate 100% owned branches in China.

The market is dominated by the three largest domestic life insurers, which accounted for 91% of industry premiums in 2002 — China Life (57%), Ping An (24%) and China Pacific (11%). Foreign life insurers accounted for less than 2% of premiums in 2002, however, their growth has been significant in recent years, especially in the prosperous regions — which include the more developed cities, where foreign life insurers' market share is considerably higher. Although the start up costs of operating in China and the expected breakeven period is very long, the number of foreign companies operating and preparing to operate in China suggests that insurers have not been put off by the costs and time of establishing themselves in China.

However, as a result of restrictive entry requirements, foreign insurers have been held back from fully entering the Chinese market, with opportunities restricted to certain towns and cities. This inability to conduct business on a nationwide basis leaves foreign insurers at a disadvantage.

PARTIAL SALE OF STATE-OWNED INSURERS HERALDS CHANGE

The insurance industry has been dominated by state-controlled insurers in both life and P&C — by China Life and PICC (People's Insurance Company of China — the largest P&C insurer in China), respectively. However, both have now become joint stock companies and sold shares in overseas markets. While this has contributed to the gradual opening up of the insurance markets in China, the government maintains a dominant stake in these insurers. For these large, formerly state-controlled insurers, who previously benefited from state support and state-provided business, rapidly adapting into efficient and well run international insurers will be challenging.

In order to create an "attractive" offering in the IPO of China Life, the State restructured the company. The assets and liabilities relating to the old China Life's negative spread policies were removed from the listed vehicle and kept under state management. Moody's expects state support to remain in place through the government's continued majority ownership of China Life. State support was further demonstrated by PICC's ability to negotiate a three year

waiver on its minimum regulatory solvency margin requirements prior to its being listed as a public company. China's life and P&C insurance assets at RMB 649 billion were significantly smaller (less than 3% of) China's banking industry's assets of RMB 24,288 billion at the end of 2002. State support for the banks was demonstrated in January 2004 when RMB 372.5 billion (US$45 billion) of capital was injected into two state-owned banks[1].

WTO ACCESSION LEADS TO GRADUAL MARKET OPENING

China became a member of the World Trade Organisation (WTO) on 11 December 2001. With this, the Chinese government made various commitments to open up the insurance market to foreign insurers in line with WTO requirements, summarised in the table below.

Figure 1 — The Deregulation of Foreign Participation in the Chinese Life Insurance Market

	Ownership and Products	Foreign Reinsurers	Regional Restrictions	Mandatory Reinsurance Cession to China Re
Pre-WTO Accession	Allowed to sell individual life insurance to Chinese and foreign citizens. Not allowed to sell group life, health or retirement/annuity products.			20%
Accession to WTO 11 December 2001	Foreign insurers allowed to establish JVs with maximum ownership of 50%	Foreign reinsurance companies allowed to set up branches, JVs or wholly owned subsidiaries. Life and P&C reinsurance may be written without regional or operating license restrictions.	Foreign insurers allowed to operate in Shanghai, Guangzhou, Dalian, Shenzhen and Foshan.	20%
11 December 2002				15%
11 December 2003			10 more cities opened up: Beijing, Chengdu, Chongqing, Fuzhou, Suzhou, Xiamen, Ningbo, Shenyang, Wuhan, and Tianjin	10%
11 December 2004	Product range widened to included group life, health and retirement/annuity products		All regional restrictions will be removed.	5%
11 December 2005				0%

FOREIGN INSURERS INCREASE COMPETITION

At present, foreign insurers cannot compete against the large domestic insurers and their vast nationwide distribution networks, able to reach even remote regions within China. However, by 11 December 2004, all previous regional and operational restrictions on foreign-invested insurers will be removed. We expect the already highly competitive life insurance market will intensify with the opening of all product markets to foreign competitors. With greater financial flexibility and technical resources than domestic insurers, foreign insurers will increase competition, especially in product and distribution areas where the domestics are less experienced such as variable life products and bancassurance. Although relatively new to China, those foreign insurers with an existing strong presence in Asia should be able to leverage off their regional expertise in order to assist their nascent operations in China.

Most domestic insurers have short operating histories. Operations are unlikely to be of the same standard and capabilities as established foreign insurers'. Domestic insurers are rapidly trying to develop and strengthen their technology, management and product expertise in the face of increasing competition.

However, foreign insurers are entering a market dominated by domestic insurers. Market share growth will be a challenge when competing with the huge nationwide distribution networks of local insurers, and therefore the foreign insurers will probably initially concentrate on the wealthier and more developed cities along China's eastern seaboard — such as Shanghai, Beijing and Guangzhou — before expanding into the less developed regions. Data for 2002 supports this; foreign life insurers' market share was around 1.8% across the whole of China, but much larger at around 13.9% in Shanghai.

Almost 50 major international and regional insurers have already set up joint ventures, branches or representative offices in China. Appendix II lists the life insurers that currently have a presence in China.

1. *See Moody's Special Comment "Chinese Government Injections Into State-Owned Banks Should Accelerate Pace of Reform" January 2004*

INCREASING DEMAND WILL PROVIDE STRONG GROWTH

Moody's expects China to provide significant growth opportunities for the life insurance sector, and China's projected economic growth to be the primary driver behind these opportunities. The annual growth in real GDP has been around 8% recently and is expected to continue in this range, given the governments ambitious targets for the economy. With this growth comes increasing levels of income for Chinese households.

Furthermore, China's population demonstrates a high savings ratio (savings to disposable income) of around 40%, which is greater than that of Asian peers Japan, South Korea or Taiwan. Increasing disposable incomes will result in consumers seeking to manage and protect their growing wealth, presenting opportunities for life insurance companies. If insurance companies can attract households to buy insurance policies with their increasing disposable incomes, an opportunity exists for the developing life insurance industry to increase the penetration (as measured by premiums as a percentage of gross domestic product) from just over 2% to the global average of around 5%.

However, there are certain barriers to growth. These stem from the low levels of risk awareness among individuals and their modest current appreciation of the benefits of insurance. At a corporate level, risk management awareness is also low. Therefore, an initial challenge for insurers will be to educate their potential markets as to the benefits of insurance protection.

Increased penetration, together with strong GDP growth, will likely result in strong growth for life insurance. Life insurance premiums have grown, on average, well over 40% annually in the last three years. Although premium income growth is unlikely to continue at such high levels in the next few years, we do expect strong growth in this area.

ACTIVITY WILL BE CONCENTRATED IN CERTAIN REGIONS

Wealth is not spread evenly across all regions of China. There are huge disparities in wealth, salaries and cultures between urban and rural residents, between different provinces and regions, and even among urban residents. The largest average incomes and growth are concentrated around major cities on China's eastern seaboard, which contains the regions of greatest economic development and, therefore, the areas of greatest interest and competition for life insurers.

SOCIAL WELFARE REFORMS PROVIDE FURTHER OPPORTUNITIES

As part of China's economic reforms and the reforms of its state-owned enterprises and government agencies, the old cradle-to-grave social welfare system has been abolished. The provision of social welfare benefits will shift to public and private providers. China's reforms of the insurance sector and the restructuring of the state-owned insurance companies present the insurance industry with the task of providing supplementary benefits, particularly group insurance products as employers look to improve the level of benefits available to their growing workforce, and to health and pensions products due to reforms in the health and pensions systems.

EXTERNAL COMPETITION GROWS FOR THE LIFE SECTOR

Other financial institutions such as property and casualty insurers and mutual fund providers offer additional competition for life insurers. Regulations came into effect on 1 January 2003, allowing P&C insurers to sell short-term life insurance products previously only offered for sale by life insurers. These products include accidental injury, hospitalisation and disability coverage. P&C insurers have taken the opportunity to market these short-term life products to their existing customer base.

During 2003, P&C insurers achieved good sales of these products, with PICC ending the year with the second-highest market share, behind China Life. The ability of the P&C insurers to market these products to corporate clients also poses a risk to the life insurers' group insurance business.

Furthermore, mutual fund providers and other financial institutions will compete with life insurers to attract funds under management. The recent relaxation of investment product regulations has increased their availability. Strong mutual funds sales data and declining life insurance premiums for the early months of 2004 appear to indicate some reduced demand for life insurance products in favour of mutual funds and other investment products. A very strong 2003 sales level for life insurance premiums, as well as the more discerning approach to distribution in several markets, which we expect to lead to better quality business, provides additional explanation for the comparative decline in life insurance premiums.

COMPETITION BRINGS INNOVATION

Competition should bring positive developments for the industry. Although high guaranteed interest rates have been offered in the past to gain market share, this type of competition is now unlikely due to regulatory controls. In Moody's view, more disciplined companies will look to other approaches such as product differentiation, alternative distribution channels and improved service. This will bring innovation into the market. The influx of foreign insurers that can draw from their experience overseas should lead to further innovation in the industry. We anticipate successful companies looking to alternative solutions to differentiate themselves from the competition, with a focus on addressing the needs of the increasing customer base in China.

RESTRUCTURED COMPANIES MAY FACE CONTINGENT LIABILITIES FROM NON-TRANSFERRED BUSINESSES

Prior to its IPO, China Life was restructured, with unprofitable business transferred into one entity and the remaining life business transferred into China Life Insurance Company Limited — the entity whose shares were offered in its IPO. The box to the right gives a summary of the restructuring of China Life. Other life companies may use a similar restructuring process in order to facilitate their capital raising plans.

There is a risk that the restructured companies that become publicly traded entities will not be completely separate from the risks within their parent companies e.g. the non-transferred, unprofitable businesses. The non-transferred businesses may pose an ongoing risk to the transferred businesses in such a restructuring. In the case of China Life, it remains majority-owned by a single shareholder — the CLIC (China Life Insurance Company), which is wholly owned by the Chinese government. This majority shareholder may use its influence over the board and management. Therefore, issues such as the timing and amount of dividend payments to the parent company and the amount of share capital maintained in the new company, can enable the majority shareholder to address issues elsewhere in the group, such as the non-transferred and unprofitable businesses. Additionally, the "new" company's senior management and other key personnel will be likely taken from the original company, meaning that a complete fresh start is not likely. The same top management currently holds positions at both China Life and its parent, CLIC.

The Restructuring of China Life

China Life Insurance Company (CLIC) originated out of the separation of the People's Insurance Company of China (formed in 1949) into four businesses (life insurance, P&C insurance, reinsurance and overseas business).

On 30 June 2003, CLIC was transformed into a joint stock company. All insurance policies issued on or after 10 June 1999, the related assets and the majority of management personnel and employees who were employed by CLIC were transferred to China Life Insurance Company Limited (China Life). All other insurance policies were retained by CLIC. Going forward, these unprofitable policies retained by CLIC will be funded primarily by assets retained by CLIC, renewal premiums related to those policies, a portion of tax payments made by China Life, shareholder dividends from China Life and — significantly — funds injected by the Chinese government if the other funds are deemed to be insufficient.

With the objectives of creating a modern corporate governance structure with improved management effectiveness and establishing a competitive life insurance operation with greater access to the capital markets, in December 2003, CLIC offered 25% of China Life's issued share capital through listings on the New York and Hong Kong Stock Exchanges.

The date for separation of the transferred policies was set as 10 June 1999, as it was the date on which the China Insurance Regulatory Commission (CIRC) reduced the maximum guaranteed interest rate on all new business from 6.5% to 2.5%. This was to combat the growing threat of negative spreads caused by declining interest rates — the interest rate on one-year term deposits was 2.25% on this date. Prior to this date, CLIC was using an interest rate of 5.0% on new business. After 10 June 1999, CLIC started selling new policies with interest rates of 2.5% or less.

CORPORATE GOVERNANCE LIKELY TO BE WEAK

Sound corporate governance supported by transparency is in short supply and is likely to be a challenge for the life insurance industry as it aims to reach global standards. The much publicised governance issues at China Life with respect to the National Audit Office of China's audit, which found irregularities carried out by its predecessor and resulted in fines paid by its parent, highlight the potential for governance issues within the industry.

As we noted in our report on the China Banking System[2], inadequate levels of corporate governance exist at state-owned banks and, to a lesser extent, at shareholding entities. Therefore, Moody's expects that the problems discovered at China Life are unlikely to be unique and that are issues to be wary of when looking at other insurers in China.

2. *"China Banking System Outlook," October 2002*

Profitability

NEGATIVE SPREAD BURDEN FOR OLDER COMPANIES

The profitability of China's older life insurance companies continues to be weighed down by a negative spread burden, significantly reducing their financial flexibility. In the 1990s, some insurers sold long-term policies with guaranteed interest rates of 9% or higher in an attempt to gain market share. With interest rates falling and limited investment assets available, insurers became unable to meet these guaranteed returns. The regulator intervened by introducing lower and lower maximum crediting rates, resulting in a 2.5% maximum rate in June 1999.

The decision by China Life to restructure its business by separating pre- and post- June 10, 1999 issued policies, with the IPO relating only to the latter portion of the business, highlights the major impact the negative spread has had on the industry's profitability. China Life's pre-10 June 1999 policies numbered more than the post-10 June 1999 policies. The life insurers who competed with China Life in the 1990s are likely to have similar negative spread issues in their in-force business, although newer companies will probably have avoided this problem.

Although parallels may be drawn to Japan, the problem in China is not as big. Regulatory intervention to reduce the high guaranteed rates being offered helped reduce the impact, together with an increased awareness of the potential investment risks being created. China's life insurers also have not been affected by the volatility of investments in the equities markets like Japanese life insurers, a result of their limited investment opportunities. Additionally, the proportion of business with negative spread continues to diminish as the industry introduces products with lower investment risks and as sales growth of new products helps lift the industry out of the situation.

Investment-linked products are proving popular, and they provide a less capital intensive product with lower investment risks for the insurer. However, until the investment restrictions on life insurers are further relaxed, the attractiveness of these products will be reduced compared to non-insurance alternatives.

APPROPRIATE MORTALITY PRICING ASSUMPTIONS A CHALLENGE

The mortality tables used in pricing insurance products in China are outdated, and new tables are being created. The use of inappropriate mortality tables may lead to mis-pricing. Given China's size, the selection of an appropriate mortality pricing assumption is a challenge. This issue will likely persist, as China's many different geographical regions and different pricing practices invalidate the use of a single table. Successful companies will need to use sound actuarial skills and techniques in their management of pricing mortality risks.

Capitalisation

CAPITALISATION LEVELS WEAK

The negative spread burden has also taken its toll on capitalisation levels. Insurers have not been able to effectively manage their asset liability risks; this, together with undeveloped capital markets and restrictive investment regulations, has been putting pressure on capital.

Strong growth in the industry since the 1990s has also affected capital adequacy. After the opening up of the industry, there was an emphasis on market share, with pricing used as a strategy to grab for position. The resulting growth — coupled with a less than adequate quality of sales, demonstrated by poor persistency — has further affected capital levels. China Life's disclosure of negative capitalisation prior to its restructuring indicates the problems Moody's expects at other insurers, and highlights the need for capital injections to fund future growth.

The weak capitalisation in the industry and its causes demonstrates the need for improved capital, risk and sales management and an increased focus on risk adjusted pricing.

IPO'S BRING IN MUCH-NEEDED CAPITAL

In November 2003, the formerly 100% state-owned P&C industry market leader, PICC, completed a successful IPO, raising over US$700 million by selling 28% of its outstanding shares, including 9.9% to AIG. In December 2003, China Life raised US$3.5 billion through an IPO in Hong Kong and New York and in June 2004, Ping An raised US$1.8 billion through an IPO in Hong Kong, illustrating the strong demand for stakes in Chinese insurance companies. These listings brought much-needed capital into the companies and were aimed at funding long term growth and increasing financial strength. This is an encouraging sign for potential future capital raisings by other domestic insurers who are expected to list in the future.

However, the governance issues arising at China Life's predecessor company may introduce some caution into the investment appetite for Chinese insurers. Furthermore, if IPO demand in general declines dramatically, this may affect future capital raising efforts.

INCREASED TRANSPARENCY AND ACCESS TO FOREIGN MANAGEMENT SKILLS

In addition, the capital raisings give China's domestic insurance companies access to foreign management skills and expertise through partial foreign ownership. Moody's expects the listing of Chinese insurers to increase the transparency of financial disclosures, which have been very limited in the past, and opens the insurers up to increased scrutiny by analysts and investors, which we generally view as a positive credit development. Furthermore, in our view the listed insurers will begin to focus on financial management and shareholder value and therefore highlight profitability rather than business volume.

Products and Distribution

TRADITIONAL LIFE INSURANCE PRODUCTS DOMINATE IN-FORCE PORTFOLIOS

Until 1999, all business sold in China consisted of traditional non-participating life insurance policies such as term insurance, whole life, endowments and education insurance. These products were priced in line with prevalent interest rates, and they remain the largest proportion of the industry's in-force business. Those policies sold in the 1990s with high guaranteed interest rates continue to be a significant burden on life insurers as a result of their negative spread.

NEW PRODUCT TYPES DIVERSIFY PORTFOLIO

In late 1999, Ping An launched the first investment-linked product. The initial sales push for investment-linked products was very successful during a time of rising stock markets. However, initial marketing involved optimistic investment return illustrations — which were subsequently not achieved in the declining stock markets. This revealed important risk factors for the Chinese life insurance market — the levels of training of life insurance agents is low by global standards (China Life disclosed in the run up to its IPO that approximately 37% of its agents had not obtained a qualification certificate from CIRC), and the public's appreciation is low of the risks involved in investing and insurance.

Moody's believes the introduction of foreign insurers with an emphasis on selling investment linked products will increase the interest in those products. Regulations regarding the use of product illustrations will help avoid the problems of poor past sales practices.

Individual participating business was first introduced in March 2000. It has grown to be the most popular product line — making up 37% of premium income in 2002 — compared to individual non-participating business at 34% and individual investment linked at 3% (see Appendix II, Table 3). Participating business has taken the form of policies with cash dividends subject to minimum surplus distribution regulations set by the CIRC. Moody's expects that participating business and investment-linked business will continue to grow as companies look to push these product lines.

Accident and health products are sold to individuals and groups either as riders or stand alone products. Group life and group annuity products are offered to companies and institutions and made up just over 20% of premium income in 2002.

TIED SALES FORCES DOMINATE DISTRIBUTION

The dominant distribution channel in China is currently the insurance companies' own captive agency forces, operating exclusively for a single insurer and with their reach scattered around China. Growing bank distribution and distribution via the post office network and savings cooperatives has developed since 2000, with premiums generated from bancassurance rising from 3% in 2001 to over 25% in 2003. However, it should be noted that sales of single premium products have been popular through this channel given their similarity to bank deposits and may therefore distort the growth rates.

The development of financial holding companies in the future should bode well for bancassurance.

With new entrants targeting bancassurance and the growth of other channels, such as insurance brokers and IFAs (Independent Financial Advisors), the dominance of the tied agency distribution network should recede over time.

Asset Mix

LIMITED INVESTMENT OPPORTUNITIES EXACERBATE NEGATIVE SPREAD AND MATCHING

Regulations stipulate strict investment restrictions on insurers. Currently, life insurers may only invest in local bank deposits, government bonds, domestic corporate bonds and domestic mutual funds. Bank deposits dominate the asset mix of life insurers as a result of the inadequate supply of alternative assets. These generally low yielding assets have exacerbated the negative spread problem for Chinese insurers as they struggle to improve investment returns to match the high guaranteed rates they offered in the past. Additionally, the relatively limited range of assets available has restricted the insurers' ability to duration match their longer-term liabilities, exposing them to adverse changes in interest rates.

INVESTMENT RESTRICTIONS EXPECTED TO BE RELAXED SLOWLY

The investment regulations are slowly being relaxed, with investments in asset management companies (AMCs) and other insurance related entities allowed following CIRC approval. In Moody's view, the establishment of wholly owned AMCs will enhance the investment efficiency and profitability of insurance companies' investment activities due to their independence and ability to attract additional external funds. China Life and PICC were the first of China's insurers to establish their own AMCs.

Additionally, insurers were previously only allowed to invest in the bonds of a limited number of government-owned enterprises — this has now been relaxed to allow investment in any bonds rated Aa or higher by a CIRC-approved rating agency.

The CIRC is expected to allow direct equity and overseas investments in the near term. With the increased diversification, return and duration opportunities available, this should improve insurers' potential investment results and assist them in addressing their negative spread issues. However, new asset liability management skills will be required as the insurers begin to expose themselves to asset volatility and foreign currency risks, which they have not experienced in the past, as they move from a predictable asset portfolio to one with increased risks.

Regulation and Market Issues

REFORM OF RESTRICTIVE REGULATIONS

China's insurance industry is regulated according to the Insurance Law, which was first introduced in June 1995, and with the CIRC as the insurance regulator from 1999. The Insurance Law was amended for the first time in late 2002, with the changes becoming effective on 1 January 2003.

Initially, the Insurance Law provided a legal framework for the regulation of such issues as:

- The establishment of insurance companies
- The certification and licensing of insurance intermediaries
- The rights of insurers and policyholders
- Policy terms
- Pricing
- Allowable investments

Prior to the amendment of the Insurance Law, there was a focus on pricing and product development control. The amendments to the Insurance Law followed the need to comply with the terms and conditions of China's accession to the WTO, together with the desire to bring the industry up to international standards.

Deregulation is gradually being introduced together with a more solvency-based form of supervision. Deregulation is to focus on increased disclosure, greater product development freedom, increased investment opportunities and more rigorous reserving and solvency requirements. We expect the regulatory focus in the future to continue towards prudential supervision with a focus on solvency — a significant change from the past. Moody's views these developments as a positive credit trend.

We expect the requirement to appoint one or more actuarial professionals approved by the CIRC will strengthen the adequacy of reserves and financial reporting. Furthermore, we believe the CIRC will enhance the role of actuaries with the roll out of actuarial guidelines covering responsibilities such as pricing and product design. At present, there are few actuaries employed within the insurance industry in China, and this remains an area where technical expertise will be much in demand.

EVOLVING REGULATORY ENVIRONMENT STILL MAY BRING THE UNEXPECTED

Although China has tremendous growth opportunities in the life insurance market, it is currently only in the early stages of its development. Insurance companies, products, management strategies and distribution are all evolving, and China is actively attempting to bring the industry up to international standards. China is gradually deregulating its heavily regulated industry with the aim of bringing increased transparency and parity with global standards. For example, in March 2003 changes to solvency requirements were introduced in order to provide increased policyholder protection, and in May 2003 new reserving requirements were issued, with the main outcome being increased reserves. However, the consequence of these changes was to reduce reported statutory profits.

With the CIRC expected to promulgate further regulatory changes in the next few years, the current regulatory landscape may look very different in the medium to long term. Business planning will be challenging as the regulatory and business environment change, and insurers will need to be flexible and manage the evolving regulatory framework effectively.

Appendix I highlights the recent major changes to the regulatory regime.

CHANGE OF REGULATION FOCUS TO SOLVENCY

Historically, China's insurance regulations have focused on product development and pricing. CIRC approval was required for a number of items when new products were introduced. However, the regulator is relaxing its focus on pricing and focusing more on solvency. Increased solvency and reserve requirements have been introduced with an emphasis on disclosure. We see these changes as positive for the industry, as insurers will concentrate their product design with a focus on the needs of their customers and the need to meet solvency requirements.

MINIMUM SOLVENCY MARGIN REQUIREMENT

A minimum solvency requirement was implemented in March 2003, using an approach very similar to that first implemented in Europe in 1973 in the form of the First Life Directive.

An insurer must maintain admitted assets in excess of admitted liabilities not less than the minimum solvency margin. The calculation of the minimum solvency margin is broadly set out below.

For long-term business, the sum of:

- 1% of reserves for investment-linked business
- 4% of reserves for other business
- 0.1%, 0.15% or 0.3% of the total sum at risk depending on policy type and remaining duration

For short-term business, the greater of the following two amounts:

- 18% of the net retained premiums up to RMB 100 million and 16% of the net retained premiums over RMB 100 million, for the current financial year
- 26% of gross claims up to RMB 70 million and 23% of gross claims over RMB 70 million, with the calculation of the average of gross claims over the most recent three years

This approach of measuring capital adequacy suffers from the same criticisms previously levelled at the similar EU approach; namely, there is no explicit allowance for asset risk. (Partial allowance for the creditworthiness of reinsurers is allowed for in the maximum allowance for reinsurance.) Asset risks are separately subject to the investment regulations, which as we have noted has lead to a fairly conservative investment portfolio.

The risk-based capital systems used in the USA and other countries (including the revised ones being introduced in the UK and E.U.) are arguably a more effective measure of capital adequacy, with an integrated and explicit allowance for asset risks. The solvency margin approach is easier to apply, but has significant shortcomings.

When Moody's analyses capital adequacy, we try to look at the measure of risk-adjusted capital or economic capital — i.e. the capital that is effectively available to the insurance company to cover its obligations, which is not necessarily the reported accounting capital. We expect those insurers with a greater understanding and management of their levels of risk adjusted capital to be able to demonstrate a more robust financial strength.

DOMESTICS WILL LOOK TO EXTERNAL EXPERTISE TO MANAGE CAPITAL

With the regulations focussing more on meeting solvency requirements, insurers should be looking to increase balance sheet strength and underlying profitability. Additionally, the adequacy of reserves will likely come under increasing scrutiny. As the number of foreign competitors increase, we expect the domestic insurers will look to foreign expertise in order to address some of these issues, either through increased foreign ownership and/or consultants. Additionally, successful domestic insurers will implement their own innovative strategies and improve internal risk management skills in order to face the challenges of increasing competition and regulatory requirements.

POLICYHOLDER PROTECTION EXPECTED TO IMPROVE

A policyholder protection scheme is in place in China. The sole use of the proceeds of the fund is to finance the resolution of failed insurance companies.

Insurers are required to set aside 1% of annual net premiums each year from accident, short-term health insurance, property insurance and reinsurance business until the fund (the insurer's accumulated contributions) reaches 6% of total assets of the contributing insurer. Contributions are not required for other types of life insurance and long-term health insurance. There are strict stipulations on where the funds can be invested, e.g. deposits in selected approved banks by CIRC and certain government securities. Any usage of these funds must also be approved by CIRC. As the fund increases in size in the coming years, the protection of policyholders covered by this scheme will increase.

Related Research

Banking System Outlook:

Banking System Outlook: China, May 2004 (87170)

Industry Outlook:

Chinese P&C Insurance Insurance Industry Outlook: Growth Brings New Challenges, June 2004 (87244)

Special Comment:

Chinese Government Injections into State-Owned Banks Should Accelerate Pace of Reform, January 2004 (80981)

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

Appendices

APPENDIX I — RECENT CHANGES IN CHINA'S INSURANCE REGULATIONS

APPENDIX II — CHINA LIFE INSURANCE INDUSTRY FINANCIAL INFORMATION

APPENDIX III — SOVEREIGN RATING OPINION

APPENDIX I — Recent Changes in China's Insurance Regulations

The CIRC has announced a wide range of new and potential changes to regulations in order bring the insurance industry up to international standards. The following table sets out major changes we expect will impact the industry.

New Regulation or Potential Change	Potential Effect or Outcome
CIRC is taking steps to deregulate the operations of foreign insurers. With effect from 15 June 2004, the maximum stake of individual foreign shareholders in domestic insurance companies will double to 20%. By December 2004, regional restrictions as well as restrictions on writing health, group and retirement/annuity products for foreign life insurers will be lifted.	With the gradual opening up of the market and greater flexibility in the way foreign insurers can conduct their businesses, we will see an increase in foreign insurers operating in the market, thereby increasing market competition. This will eventually bring about a transfer of skills and expertise to the local market.
New solvency margin requirements were introduced in March 2003.	CIRC is moving towards a solvency based form of regulation. Insurers will be required to demonstrate to the CIRC the effects on solvency when considering new products, operational restructuring, new branches and major changes to investment portfolios.
The amount of paid-in capital that foreign insurance firms need to pay when expanding operations has been reduced with the upfront payment of RMB 200 million remaining unchanged. Foreign insurers will need to maintain RMB 20 million for each branch up to a maximum of RMB 500 million. Formerly an insurer need to maintain RMB 300 million for three additional branches and RMB 50 million for each subsequent branch up to RMB 1.5 billion.	This will make it easier for insurers to expand their operations throughout China.
The ability to invest in corporate bonds has been relaxed from allowing only investments in railway operators, power companies, "Sanxia" project-related enterprises and telecom corporations, to all qualifying corporate bonds rated Aa or above. Additionally, the limit on investments in corporate bonds rose from 10% to 20% of total assets.	This will allow insurers to take advantage of developments in the local corporate bond market and increase the diversification of an existing limited portfolio of assets. We expect corporate bonds to become a major segment of insurers' asset portfolios. Further, the State Council announced in early 2004 that insurance companies' funds may be allowed to directly invest in the domestic capital and stock markets. We expect to see further deregulation of investment portfolios.
CIRC has issued guidelines to approve the formation of insurance asset management companies, which will be effective from 1 June 2004.	With professional asset management companies, greater operational efficiency and economies of scale may be achieved, as opposed to managing funds in-house. This move may also boost the development of the financial sector in China.
A new requirement on the actuarial certification of new individual insurance products (including pricing and reserving) has been implemented.	The greater employment of actuaries in the pricing and reserving of various products reflects CIRC's intention to inculcate proper underwriting and reserving standards in the insurance industry.
In 2001, CIRC rolled out a regulatory framework on various insurance intermediaries, including the way these entities conduct their businesses, and the qualification of management.	Improved operating standards for insurance intermediaries with the effect of improving sales practices.
In September 2002, CIRC announced a new requirement for establishing reinsurance companies. Capital of RMB 200 million is required for a life reinsurer or a non-life reinsurer and another RMB 100 million is required for a composite reinsurer.	This, together with the phasing out of mandatory reinsurance cession to China Re by December 11, 2005, will increase competition — both domestic and foreign — in the previously state-run reinsurance market.
Starting in 2003, insurers' agent fees are tax-deductible, subject to a cap of 8% of total insurance premiums for the period.	The tax deductibility of agent fees will boost the income of insurers. Moody's believe that insurers may expand their agency forces to maximise such tax advantage.
The revised Insurance Law implemented from 1 January 2003 requires all insurers to separate life insurance from non-life insurance and allows both to sell short-term personal accident products and health products.	This corresponds to a WTO accession requirement. The entry of P&C insurers into the accident and health market increases competition for life insurers.
From 1 Oct 2003, the restrictions on insurance companies setting up local branches/subsidiaries in remote regions have been lifted. Companies can now choose to set up marketing/service offices or to tie up with a local professional insurance intermediary in these areas.	The benefits are two-fold. It improves the access to operate in remote areas. Secondly, it will promote the growth and development of professional insurance intermediaries.
The criteria on qualified senior managers in insurance companies have been relaxed from 2003.	This will allow more qualified people to join insurance companies and enhance overall personnel quality.
From February 2004, CIRC's screening time for applications filed by foreign insurance firms intending to set up representative offices in the mainland has been reduced to 20 days.	This enhancement of the approval process of setting up representative offices stems from WTO entry requirements.

APPENDIX II — China Life Insurance Industry Financial Information

1. Comparison of GDP Growth with Insurance Penetration of the Life Insurance Industry
2. Top 10 life insurers in China by Premium Income and Market Share — 2000 to 2002
3. Total Premium Income Business Mix — 2000 to 2002
4. Life Insurance Industry Income Statement — 2000 to 2002
5. Life Insurance Industry Balance Sheet — 2000 to 2002
6. List of Life Insurance Companies and Foreign Branches
7. Life Insurers with Representative Offices in China

Table 1: Comparison of GDP Growth with Insurance Penetration* of Life Insurance Industry

	Premium Income of Total Insurance Industry			Life Insurance					
Year	Total (RMB Billion)	Change% Y to Y	Insurance Penetration (%)	Total (RMB Billion)	Change% Y to Y	Prem Income as % of total industry	Insurance Penetration (%)	GDP (RMB Billion)	GDP Growth
1997	108.8		1.5%	60.2		55.3%	0.81%	7,446.3	8.80%
1998	126.2	16.0%	1.6%	75.4	25.2%	59.7%	0.96%	7,834.5	7.80%
1999	144.5	14.5%	1.8%	88.5	17.4%	61.2%	1.08%	8,206.8	7.10%
2000	160.0	10.7%	1.8%	99.0	11.9%	61.9%	1.11%	8,946.8	8.00%
2001	211.2	32.0%	2.2%	142.4	43.8%	67.4%	1.46%	9,731.5	7.30%
2002	305.4	44.6%	3.0%	227.5	59.8%	74.5%	2.22%	10,239.8	8.00%

(Sources: Yearbook of China Insurance; The People's Bank Of China Quarterly Statistical Bulletin)
** Premiums as a percentage of gross domestic product*

Table 2: Top 10 Life Insurers in China by Premium Income and Market Share for 2000 - 2002

2000

No.	Company	Amount (RMB Mn)	Market Share (%)
1	China Life	65,164	65.8
2	Ping An	22,435	22.7
3	China Pacific	8,404	8.5
4	New China Life	1,506	1.5
5	AIA (Shanghai)	1,218	1.2
6	Tai Kang Life	719	0.7
7	AIA (Guangzhou)	463	0.5
8	Manulife-Sinochem	151	0.2
9	Pacific-Antai	81	0.1
10	AXA-Minmetals	30	0.0
Total Industry		**99,000**	**100.0**

(Source: 2001, Yearbook of China's Insurance)

2001

No.	Company	Amount (RMB Mn)	Market Share (%)
1	China Life	81,314	57.4
2	Ping An	40,056	28.1
3	China Pacific	14,343	10.1
4	New China Life	2,298	1.6
5	Tai Kang Life	1,616	1.1
6	AIA (Shanghai)	1,406	1.0
7	AIA (Guangzhou)	598	0.4
8	Manulife-Sinochem	243	0.2
9	Pacific-Antai	210	0.1
10	CITIC-Prudential	121	0.1
Others		195	0.1
Total Industry		**142,400**	**100.0**

(Source: 2002, Yearbook of China's Insurance)

2002

No.	Company	Amount (RMB Mn)	Market Share (%)
1	China Life	128,768	56.6
2	Ping An	53,540	23.5
3	China Pacific	24,902	10.9
4	New China Life	7,983	3.5
5	Tai Kang Life	6,560	2.9
6	Taiping Life	1,658	0.7
7	AIA (Shanghai)	1,577	0.7
8	AIA (Guangzhou)	828	0.4
9	Pacific-Antai	447	0.2
10	Manulife-Sinochem	403	0.2
Others		834	0.4
Total Industry		**227,500**	**100.0**

(Source: 2003, Yearbook of China's Insurance)

Table 3: Total Premium Income Business Mix — 2000 to 2002

Product Line	2000 Amount (RMB Bn)	2000 %	2001 Amount (RMB Bn)	2001 %	2002 Amount (RMB Bn)	2002 %	CAGR %
Individual Participating	—	—	18.4	12.9	83.9	36.9	356.0
Individual Non- Participating	78.0	78.8	71.4	50.2	77.1	33.9	-0.6
Individual Health	1.2	1.2	7.9	5.5	6.8	3.0	138.0
Individual Personal Accident	0.6	0.6	1.0	0.7	5.6	2.5	205.5
Individual Investment Linked	—	—	17.7	12.4	5.8	2.5	-67.2
Group Participating	—	—	9.0	6.3	28.6	12.6	217.8
Group Non-Participating	19.1	19.3	8.4	5.9	12.9	5.7	-17.8
Others	0.1	0.1	8.6	6.1	6.8	3.0	724.6
Total	**99.0**	**100**	**142.4**	**100.0**	**227.5**	**100.0**	**51.6**

Table 4: Selected Items of Life Insurance Industry Income Statement — 2000 to 2002

(RMB Billion)

	2000	2001	2002
Premium Income	99.0	142.4	227.5
Reinsurance Income	0.0	0.0	0.1
Transfer from Reserve for Life Underwriting Portfolio	116.9	215.8	300.5
Other Income	2.7	8.0	4.4
Losses Paid	5.2	7.1	8.7
Reinsurance Expense	1.8	2.1	4.6
Life Liability Reserves Withheld	151.5	300.7	205.8
Other Expenses	7.8	50.2	26.7
Net Profit	0.7	-1.8	2.7

(Source: 2001- 2003, Yearbook of China's Insurance)

Table 5: Balance Sheet of Life Insurance Industry — 2000 to 2002

(RMB Bn)

Assets	2000	2001	2002	Liabilities	2000	2001	2002
Short-Term Assets	109.2	225.7	320.6	Current Liabilities	12.9	38.4	41.7
Long-term Investments	48.0	63.4	105.2	Long-term Liability	151.4	265.1	399.7
Fixed Assets	15.1	21.5	22.4	Owners' Equity	9.8	12.1	18.2
Deferred Assets	0.7	2.7	2.0				
Others	1.1	2.4	9.5				
Total	174.1	315.7	459.6	Total	174.1	315.7	459.6

(Source: 2001- 2003, Yearbook of China's Insurance)

Table 6: List of Life Insurance Companies and Foreign Branches (as of year end 2003)

Name	Name
China Life Insurance Co.,Ltd.	John Hancock Tianan Life Insurance Co.,Ltd.
China Life Reinsurance Co.,Ltd.	Generali China Life Insurance Company Ltd.
Tai Ping Life Insurance Company,Ltd.	Sun Life Everbright Insurance Company,Ltd.
Minsheng Life Insurance Co.,Ltd.	ING Capital Life Insurance Company Ltd.
China Pacific Life Insurance Co.,Ltd.	Haier New Life Insurance Co., Ltd.
Ping An Life Insurance Company of China, Ltd.	Generali China Life Insurance Company Ltd.
New China Life Insurance Company,Ltd.	Aegon-CNOOC Life Insurance Company Ltd.
Tai Kang Life Insurance Company,Ltd.	Cigna & CMC Life Insurance Company,Ltd.
Sinolife Insurance Company,Ltd.	Nissay — SVA Life Insurance Company,Ltd.
Eastern Life Insurance Company,Ltd.	Henghan Standard Life Insurance Company,Ltd.
Manulife-Sinochem Life Insurance Co.,Ltd.	Skandia-bsam Life Insurance Company,Ltd.
Pacific-Antai Life Insurance Company,Ltd.	American International Assurance Co.Ltd. Shanghai Branch
Allianz-Dazhong Life Insurance Company,Ltd.	American International Assurance Co.Ltd. Guangzhou Branch
AXA-Minmetals Assurance Company, Ltd.	American International Assurance Co.Ltd. Shenzhen Branch
China Life-CMG Life Assurance Co.,Ltd.	American International Assurance Co.Ltd. Beijing Branch
CITIC-Prudential Life Insurance Company, Ltd.	American International Assurance Co.Ltd. Suzhou Branch

Table 7: List of Life Insurance Companies with Representative Offices in China (as of year end 2003)

Name	
MLC Limited, Beijing Rep Office	Meiji Life Insurance Co, Beijing Rep Office
DKV Deutsche Krankenversicherung AG, Shenzhen Rep Office	Nippon Life Insurance Co, Beijing Rep Office
CNP Assurances S.A., Beijing Rep Office	Nippon Life Insurance Co, Shanghai Rep Office
Cardif Insurance Co Ltd, Shanghai Rep Office	Sumitomo Life Insurance Co, Beijing Rep Office
Samsung Life Insurance Co Ltd, Beijing Rep Office	Cathay Life Insurance Co Ltd, Beijing Rep Office
Korea Life Insurance Co Ltd, Beijing Rep Office	Cathay Life Insurance Co Ltd, Chengdu Rep Office
AEGON International Life Insurance Co Ltd, Beijing Rep Office	Shin Kong Life Insurance Co Ltd, Beijing Rep Office
The Manufacturers' Life Insurance Co, Beijing Rep Office	Taiwan Life Insurance Co Ltd, Beijing Rep Office
Canada London Life Insurance Co, Beijing Rep Office	Fubon Life Insurance Co Ltd, Beijing Rep Office
Canada Life Insurance Co, Beijing Rep Office	HSBC Life Insurance Co Ltd, Shanghai Rep Office
Sun Life Assurance Co of Canada, Beijing Rep Office	HSBC Life Insurance Co Ltd, Guangzhou Rep Office
Sun Life Assurance Co of Canada, Chongqing Rep Office	HSBC Life Insurance Co Ltd, Beijing Rep Office
The Prudential Co, Beijing Rep Office	Great Eastern Life Insurance Co Ltd, Shanghai Rep Office
Metropolitan Life Insurance Co, Beijing Rep Office	The Asia Life Insurance Co Ltd, Beijing Rep Office
Metropolitan Life Insurance Co, Shanghai Rep Office	Prudential plc, Beijing Rep Office
John Hancock Life Insurance Co, Beijing Rep Office	Prudential plc, Shanghai Rep Office
New York Life Insurance Co, Guangzhou Rep Office	Standard Life Insurance Co, Shanghai Rep Office
New York Life Insurance Co, Beijing Rep Office	Standard Life Insurance Co, Beijing Rep Office
New York Life Insurance Co, Chengdu Rep Office	AMP Limited, Beijing Rep Office
Principal Life Insurance Co, Beijing Rep Office	Colonial Mutual Life Insurance Group, Beijing Rep Office
The Dai-ichi Life Insurance Co, Beijing Rep Office	

APPENDIX III — Sovereign Rating Opinion: China (19 MAY 2004)

Credit Strengths

Rating support factors of the government of China are:

- Prudent management of external debt
- A very high level of official foreign exchange reserves
- A greater reliance on FDI than on external debt
- Strong export performance
- Pragmatic reform and WTO liberalization policies.

Credit Challenges

Risks and challenges include:

- Maintaining sustainable growth to ensure employment and social stability
- Restructuring a very weak financial system
- Absorbing the private sector into a state-led economy
- Strengthening the regulatory and supervisory system
- Ensuring competitiveness and monetary stability under a fixed exchange rate.

Rating Rationale

China's foreign currency country ceiling was raised to A2 from A3 in October 2003. The strengthening that has occurred in China's strong external payments position prompted the upgrade. The smooth transfer of power to a fourth generation of leaders suggests that political and economic policymaking will continue to minimize social stability risks. Even though the foreign currency ceiling for bank deposits was also raised to A2, from Baa1, Moody's nevertheless considers that the creditworthiness of all other issuers should be assessed separately from the sovereign, taking into account their fundamental creditworthiness. This is consistent with the government's external debt management and foreign exchange control polices.

Foreign exchange controls and a restricted capital market also provide insulation to external shocks--Moody's expects the authorities to liberalize cautiously capital controls and to manage effectively pressures on the BOP and exchange rate. The authorities have a track record of being able to manage the economy through periods of turbulence. Challenges arise from the need to maintain social stability as WTO liberalization commitments are implemented and the role of the state sector is scaled back.

Rating Outlook

The stable outlooks for China's foreign currency country ceilings are supported by the exceptional strengthening in the country's external position, and the expectation that China's external performance will likely remain strong enough to withstand foreseeable pressures, external or domestic. China's official foreign exchange reserves stand have risen to a level that is twice that of its total external debt. The performance of exports and foreign direct investment have continued to fare well despite global and domestic (i.e. SARS most recently) disturbances.

China's new leaders will continue pro-growth economic policies and pace reforms so as to maintain social stability. The acceptance of capitalists into the Communist Party reflects the recognition that a vibrant private sector is crucial for economic prosperity and social stability. Economic regulations and laws are being revised accordingly.

What Could Change the Rating — UP

The maintenance of a strong external payments position and social stability as the economy undergoes the transition from a state-controlled to market determined system. This implies a strengthening of China's economic, legal and regulatory institutions.

What Could Change the Rating — DOWN

A deterioration in the external payments position because of policy mistakes or economic instability. Downward pressure on the rating could also arise if there is a setback in peaceful, cross-Straits relations.

Recent Developments/Results

Administrative controls, coupled with somewhat tighter monetary and fiscal policies, are slowing China's torrid real GDP growth rate, which reached 9.7 percent in the first quarter of 2004. Fixed asset investment growth moderated to 35 percent in April (year-on-year) from 43 percent in the first three months of 2004. Consumer prices have moved abruptly from deflation last year to close to a seven-year high of almost 4 percent (year-on-year) in April. The authorities have announced a policy target of containing inflation below 5 percent. The external payments position remains strong, with double-digit export growth and official foreign exchange reserves well above $400 billion, more than twice the level of total external debt.

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