Broader Investment Choices for Insurance Companies

The insurance industry in China is growing at a remarkably fast pace. By the end of 2006, this industry will allow foreign insurers to compete with local insurers. To guide this new process, the China Insurance Regulatory Commission has issued the Circular on the Investment in the Equity Interests of Commercial Banks by Insurance Institutions. Will the rules in this Circular diminish benefits for foreign investors? How will local insurers manage the new dimension of competition?

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China's entry to the World Trade Organization (WTO) affects the Chinese economy on many levels. The fast-growing insurance industry is one whose entry into the WTO will allow international entrants to compete with local insurers. In response, the China Insurance Regulatory Commission (CIRC) has introduced new regulations in preparation for the opening of the insurance market to foreign investors.

Parts of the new legislation cover insurance premiums, insurers' licensing, sales practices, commission charges, and the type of assets in which insurers can invest. The latest addition, *Circular on the Investment in the Equity Interests of Commercial Banks by Insurance Institutions*, covers the assets category.

LONG-TERM NATURE OF INSURERS' LIABILITIES

The insurance industry is often compared to the banking industry, as insurance firms also perform a savings function next to pure risk-shifting roles. However, there are some substantial and notable differences. While banks perform a clear intermediary role between borrowers and lenders, the insurance industry's main role of existence is driven by the liability side.

By pooling risks of individuals, insurers can diversify away individual risks and offer services at premiums that are lower than what any individual can achieve alone. Commercial banks' liabilities are typically composed of short-term deposits matched by loans on the asset side of the balance sheet. But the long-term nature of insurance policyholder's claims (especially for life policies) creates an overall liability structure with long to very long maturities in the insurance industry.

On the asset side, the insurance industry has a less clear social role than the banking sector, which serves the needs of borrowers. For an insurer, the main goal of the asset side is to protect the long-term interests of the customers and at the same time to yield a high return on their investments. This ambivalence can create conflict between shareholders' interests (high profit) and individuals' perspective (full coverage).

Because of this conflict, regulators often intervene to protect customers from too much risk exposure and speculation that could result in insolvency, while safeguarding the efficiency and competitiveness of the insurance industry.

Risk management

Risk management of insurance companies consists of three parts:

i. adequate capital that can serve as a buffer to subnormal performance;

ii. a match between liabilities and assets; and

iii. the quality of the assets.

The recent regulation that details investment choices belongs to the last two parts.

Regulators specifically prefer that insurance firms invest in securities with long term payoffs. To ensure that promised payments are made on these long-term assets, regulators apply strict rules on the quality of securities and limit investment in lower grade securities.

Conversely, there are benefits for shareholders and insurance holders when the assets of an insurance company yield high returns. Higher returns can be obtained by taking a reasonable amount of risk in a well-diversified portfolio. Insurance firms active in the international arena typically hold diversified portfolios that contain mostly fixed-income securities, but also equity, property and a variety of asset-backed securities.

Increased competitiveness and the need for further

re-regulation

Both the insurance industry and various regulations have undergone a revolution in recent years. This has been hastened by the projected implementation of the insurance leg of China's WTO membership obligations. For insurance companies, this means that the market will open to foreign competitors, which might have a different and more liberal mix of securities in their investment portfolios. The regulation on the investment opportunities needs revision so that local insurance firms can effectively compete with new entrants.

Until November 2005, insurance companies were only allowed to invest in mutual funds. But in November, the China Securities and Regulatory Commission (CSRC) and the CIRC jointly issued rules that allow Chinese insurers to directly invest in the stock market. The recent Circular allows insurers to further diversify their asset portfolios and invest in stocks of unlisted commercial banks. Following is a summary of the most important aspects of the new guidelines.

Investment in non-listed commercial banks

Investments in non-listed commercial banks are divided into two categories. The first category contains common investments, which are investments of less than 5% of the bank's share capital or paid capital. This type of investment can be considered a simple portfolio investment. The second category, material investments, refers to participations in the common stock of non-listed commercial banks of over 5% of the bank's share capital. This category contains the more strategic partnerships.

Table 1 summarizes the minimum requirements and limits defined in the *Circular on the Investment in the Equity Interests of Commercial Banks by Insurance Institutions*. Panel A in the table outlines the requirements for insurers. Panel B lists the characteristics that target firms must fulfill to be considered a feasible investment for insurers.

Limits to insurers with respect to their non-listed bank investments mainly relate to the size of their investments. The total of common and material investments can not exceed 3% of an insurer's gross assets at the end of the previous year. In addition, common investment in the equity of a single bank should not exceed 1% of an insurer's gross assets at the end of the previous year and balances of other material investments should be submitted to the CIRC for approval. Also, the corporate capital tied to material investments should not exceed 40% of the insurer's capital at the end of the previous year minus aggregate losses. Table 1 shows additional requirements related to the size of the insurer.

Table 1: Summary of Eligibility Requirements for Investment in the Equity Interests of Commercial Banks by Insurance Institutions

	Common Investments	Material Investments	
	<5% of bank's capital	>5% of bank's capital	>10% of bank's capital
Panel A: Insurer's Requirements			
Total Maximum Investment	< 3% of insurer's gross assets		
Investment in a single bank	<1% of insurer's gross assets	submitted to CIRC for approval	
Corporate Capital		< 40% of (insurer's paid-in capital – aggregate losses)	
Number of deals	No limit	maximum 2	
Limits to insurance groups		Gross assets > Rmb20 billion	Gross assets > Rmb30 billion
Limits to insurance companies		Gross assets > Rmb100 billion	Gross assets > Rmb150 billion
Panel B: Target Bank Requirements			
Qualitative requirements	Sound Corporate Governance and investment regulations, strict loan-review and 5-grade classification, stable operations, acting in good faith, rapid business growth in past 3 years, good financial position, transparent, no major violations of laws and regulations		
Capital Adequacy Ratio	> 8%		
Core Capital Adequacy Ratio	>4%		
Provisioning rate for bad debts and NPLs	>70%		
Rate of return on assets before provisions	>1%		
Rate of return on net assets	>12%		
Risk weighted rate of return on assets	>1.2%		
NPL ratio	<5%		
Rating	A or above (domestic credit rating agency recognized by CIRC) or BBB (international credit rating agency)		
		Evidence of strong customer base and network, business brand, business plan and management team with high qualifications	
Gross Assets	n/a	n/a	> Rmb 50 billion
Provision for bad debt and NPLs	n/a	n/a	> 50%
NPL ratio	n/a	n/a	<10%
Bad loans	n/a	n/a	Feasible bad asset disposal and risk reward plan
Seat on decision-making or supervisory committee		1	1 or more

Another important limitation to the insurer is that, in principle, insurance institutions cannot have material investments in more than two commercial banks.

The Circular also details the minimum quality of the bank, using both qualitative and quantitative measures (Table 1, Panel B). The qualitative measures include proof of sound corporate governance, strict loan review and use of a five-grade classification

system, as well as evidence of rapid growth in the past three years. Banks are expected to be profitable, in a decent financial situation and transparent. The quantitative measures are (core) capital adequacy ratios and measures of asset quality, such as return on assets and non-performing loan ratios.

FURTHER CHANGES IN LEGISLATION

The three largest insurers in China (China Life, Ping An and China Pacific Insurance) have led the industry in experiments to allow investments in a broader set of securities. For example, China Life was allowed through special permission to invest in Construction Bank's IPO. In principle, all PRC insurers are also allowed to invest abroad. Besides investments in stocks, and now, unlisted commercial banks, PRC insurers are also moving to diversify their assets in infrastructure projects and other asset-backed securities.

The main trend seems to be that China's insurers will be allowed to invest in an increasing spectrum of assets, which will improve their risk positions and investment returns via diversification. Another interesting trend is the integration and strategic cooperation of banks and insurers, leading to networks that market both banking and insurance projects, which enhances scale and scope effects.

The CIRC's encouragement of material investments is to some extent a nod from the regulators in that direction. Given that growth projections for the Chinese insurance market remain strong, the insurance industry will keep pressure to access a gamma of investment alternatives.