INSURANCE

Foreign insurers in China: Opportunity and risk

FINANCIAL SERVICES

AUDIT ▪ TAX ▪ ADVISORY

Insurance industry

Much is printed every day about China, to the extent that it is hard to sift through the information. It seemed to us at KPMG, however, that it would be helpful to the international community to produce briefing papers which give a snapshot of where things are in various areas of the financial services sector in China.

Working with Reuters, we have chosen to do this by bringing together the experiences of senior executives with our own perceptions based on our experiences working with domestic players and foreign entrants into China.

We chose to start with the insurance sector which has until now seen the most frantic activity amongst foreign insurers whilst perhaps not getting quite the attention of the banking sector in the media.

I would like to thank those executives who were prepared to give their time to share their thoughts with us and I hope that this document is of value to those who have an interest in the insurance sector in China.

Simon Gleave
Partner in Charge
Financial Services practice
KPMG in China and Hong Kong SAR

The insurance industry in China today has got to be one of the biggest financial services sector growth industries in the world.

Any business which is essentially about risk and opportunity is going to have a best selling seat in the front row of the biggest industrialisation show in human history in a hundred years.

We need to be clear about what is happening in China. The country's speed and size of economic growth is not just another modern miracle Asian tiger economy. China's scale almost certainly makes it the newest industrialising major economy in a process which started with Britain in the eighteenth century and continued through Germany, the United States, and Japan.

But at this level and juncture of historical change, there are also immense political and economic risks involved for the country, the corporation, and the individual.

This historical process is also characterised by an exponential growth in what is commonly understood as the middle class, which in economic terms usually means people with enough wealth to take a longer-term view extending at least to the end of their lives, and into the wage earning years of their children's lives.

I will not begin to deal with the details of how and why this precise phenomenon is happening in China right now and why that offers one of the biggest areas of financial sector opportunity and growth for foreign companies. This report does that clearly and admirably and I hope you will enjoy it, and benefit from it.

Reuters business is also about defining and reporting risk in human political and economic affairs, and it has certainly been a large part of my working life. It gives me great pleasure therefore to recommend this first financial sector report from KPMG and Reuters.

Eric Hall
Reuters Editor for China, Hong Kong and Taiwan

Opportunity and risk

This report from KPMG and Reuters surveys the risks and opportunities for foreign companies in China's insurance industry, and what it will take to be successful.

The days when foreign companies typically saw China as an almost limitless market which they simply had to step into and tap are long gone. To do successful insurance business in China requires hard work in understanding the market, the rules, the competition, and looking at new and innovative ways of doing business.

The life market in particular is already somewhat crowded. But relative to its growing global economic importance and wealth, China is assuredly under-insured, both in the life and non-life sectors. That is the real opportunity for those who have the insight and the foresight.

KPMG and Reuters have collaborated to produce this briefing paper. This is based upon interviews with a number of CEOs responsible for their companies' insurance operations in China. These interviews have been supplemented by desktop research. The interviews were carried out on the basis of strict confidentiality and the briefing paper therefore does not disclose information specific to any company gained during the interview proccess.

Life insurance – Life in the fast lane

China's burgeoning middle class represents one of the world's greatest pools of human drive and ambition, but it also harbours a terrible fear for its own future.

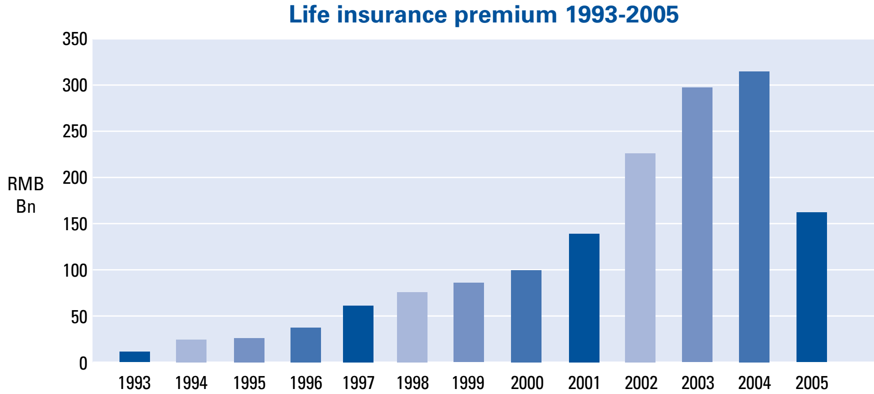
The average urban Chinese worker with a skilled or professional job sees no concrete evidence of their country's ability to provide the right level of financial security for themselves or their family, if the worst should happen.

That simple human fear is the force that help ensure the continued rapid increase of the life insurance industry in China.

Annual economic growth of well over eight percent [1], an individual savings rate which more than matches Japan's at its height, and the entry each year of millions more people into the target bracket of earnings for consumers of life insurance cover is driving an enormous growth rate [2].

The potential for future growth is immense, as less than four percent of China's 1.3 billion people have insurance [3].

Life insurance premium 1993-2005



Primary source: China Financial Landscape, December 2, 2002, CSFB;
Update: China Money Vol.10; No.19 and CIRC Web site

Profitability is a moving target in China's insurance market, as nearly every player is in expansion mode. However, several foreign joint ventures have already broken even a process that typically takes five to seven years.

For some, breaking even is a temporary achievement, as new expansion plans will push investment driven losses in the next few years. But foreign players in the market are willing to forsake profitability as a priority for the sake of growth, viewing China as a very long term play. It will take years before returns from the mainland make an impact on their global bottom lines, but for now investments look relatively insignificant given the potential.

1 National Bureau of Labor Statistics, January 25, 2005
2 "Selling Life Insurance to China," The McKinsey Quarterly 2004 Special Edition: China Today
3 "China's insurance sector grows amid ups and downs", People's Daily, October 7, 2004

The competition – Big China brother, fast foreign friends

Right now, China's domestic life insurers have 97 percent of the market, and the top three (China Life, Ping An, and China Pacific Life) own over 90 percent of it [4].

It looks like a hard monopoly to crack. But the reality is that a growing range of permissible investment assets, increasing consumer sophistication (especially at the richest end of the market), and a general lack of experience of how to grow a market through such avenues as bancassurance opens profitable niches for the foreigner, or opportunities to partner with Chinese companies who see the need for new expertise.

China loomed large on foreign insurers' radar screens in the early 1990s, when North American and European providers began courting the government in earnest for licenses. American International Group (AIG), which was founded in Shanghai in 1919, was awarded the first special license to operate as a wholly owned company, an arrangement that has never been duplicated [5].

Rivals then began piling into the life insurance market through the establishment of joint ventures (where they can own up to 50 percent), or through direct investment in the existing domestic insurers.

Top 10 Life Insurance (by premium) in first 5 months of 2005

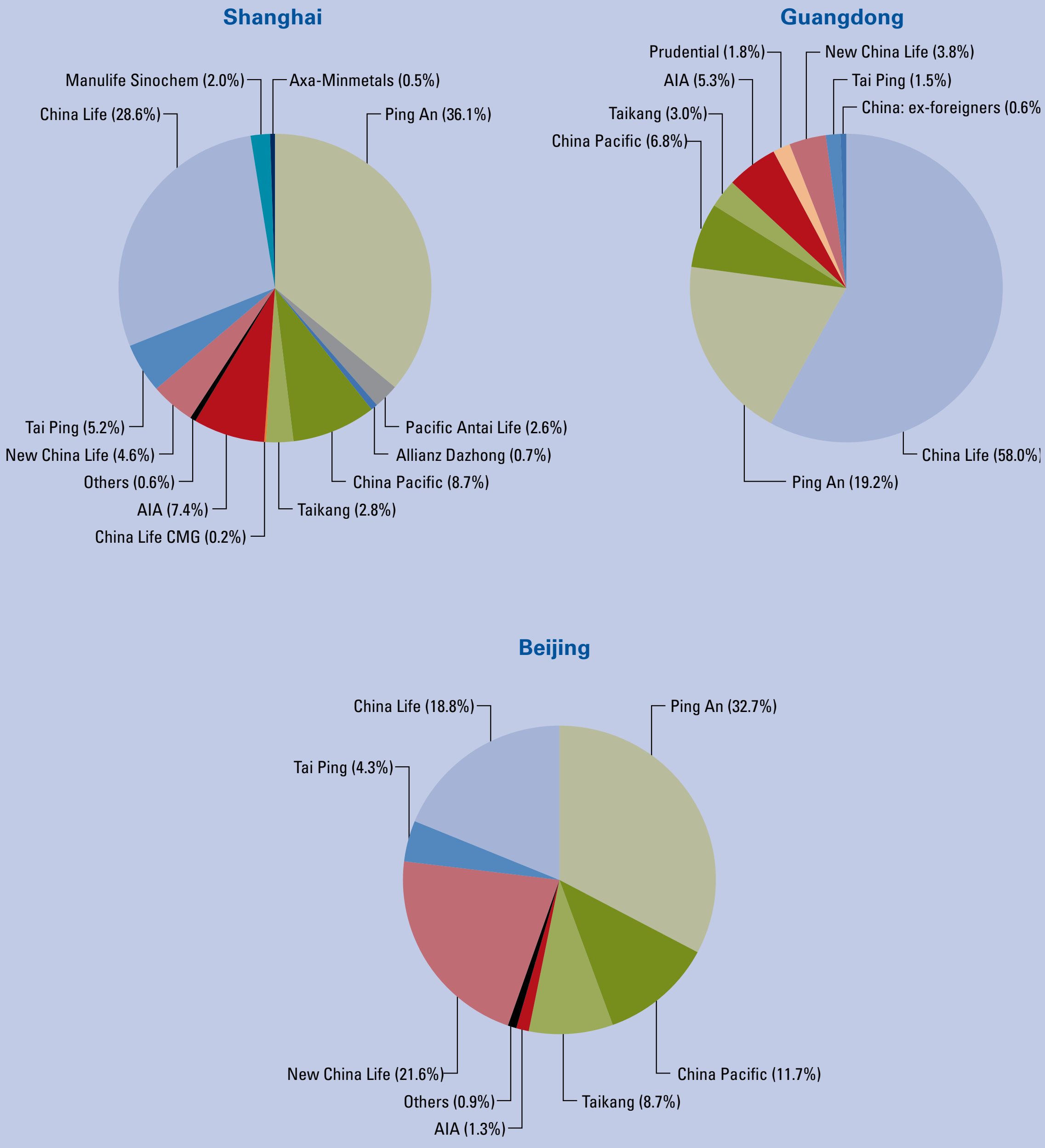
National	Premium RMB (Bn)	Market share (%)
China Life Insurance	79.1	48.7
Ping An Life Insurance	24.4	15.0
Pacific Insurance	17.2	10.6
New China Life Insurance	7.5	4.6
Taikang Life Insurance	6.1	3.8
Taiping Life Insurance	2.3	1.4
Shengming Life Insurance	1.2	0.7
Others	0.2	0.1
National:	**138.0**	**84.9**
Foreign Capital & Sino JV	**Premium RMB (Bn)**	**Market share (%)**
Generali China Life	20.2*	12.4
AIA	2.4	1.5
Aviva-Cofco Life	0.4	0.2
CITIC-Prudential Life	0.3	0.2
Pacific-Aetna Life	0.3	0.2
Manulife-Sinochem Life	0.3	0.2
Others	0.6	0.4
Overall:	**162.5**	**100.0**

*Generali China Life figure includes a one off premium of RMB20 billion for a group pension policy.

Source: CIRC Web site

[4] China Insurance Regulatory Commission (CIRC)
[5] "American Intl gets Chinese insurance license," Reuters News, October 5, 1992

Life market share in Shanghai, Guangdong and Beijing



Source: CIRC Insurance Almanac 2003

Manulife set up the first joint venture in 1996 and there are now 24 sino-foreign joint ventures established, approved or pending. There have also been eight foreign investments, most notably HSBC's US$1.8 billion investment for 19.9 percent of Ping An Insurance Co [6].

The market is now fully open. To meet WTO obligations, in December 2004, China lifted its previous restrictions limiting foreign insurers to 15 cities and prohibiting the sale of group policies, which inevitably opens the market to greater external competition [7].

The big China players face other pressures. Typically Chinese financial institutions have hundreds of thousands of agents but with low output. The sales forces at domestic life companies have a productivity rate only a fraction of developed world sales forces and their agents on average last a very short time at one company, creating tremendous instability for companies and customers.

Nevertheless, foreign insurers remain hindered by strict, sometimes opaque regulations, pricing pressures and artificially low interest rates, so the choice of how to do business is critical.

Joint ventures – Leveraging your expertise

Joint ventures have become the most popular route into the Chinese life insurance market, for a number of reasons. Most foreign insurers have aligned themselves with non-insurance partners, yielding a variety of benefits.

First and foremost, perhaps, is to make sure that while the financial investments may be roughly equal, the foreign insurers will have virtual control running the business, as it falls outside their partner's area of expertise.

Along the same lines, linking up with a non-insurer may prove to be a smoother transition in the end, if foreigners are eventually allowed to run wholly owned operations in the future. Given their expertise, it is more likely they could negotiate a buyout of their partner and take over the whole business.

The ability with a non-insurer partner to train a sales force from the bottom up without the headaches of teaching old dogs new tricks has proven attractive for many joint venture companies. However, that route may be getting harder, at least for now, as the number of potential good new sales agents is limited.

[6] "Shifting sands: Benefits of restructuring will take time to surface" Nomura, February 15, 2005; various newspapers and company Websites
[7] "China clears the way for foreign insurers to expand," Straits Times, December 11, 2004

An alternative route for a newcomer is the boutique approach, and the growing number of rich Chinese (as opposed to merely affluent) offers a target market. China's one million richest people are growing their wealth base at 15 percent a year [8]. Even under current restricted assets management rules, such an operation could offer a bigger range of products than is currently on the market, and tailor them to individual needs. Such personal attention is in itself becoming a desired sign of status within China.

Brand and capital are also very important variables in a joint venture, because awareness of Western insurance companies is very limited in China. A good number of joint ventures have chosen to list their Chinese partner first in the title of their joint company to help maximise the local brand.

Foreign insurers have also chosen stable, well-capitalised companies for whom the investment is relatively minor, to help ensure that the relationship will be more even and the joint venture can ride out the leaner times at the early stages of partnership more smoothly.

But deep pockets aren't enough.

Domestic players like China Life, Ping An and PICC all launched IPOs to boost capital,raising billions of dollars on international markets. New China Life and Taikang Life raised more than US$300 million, combined, through recent subordinated debt deals [9].For life insurance joint ventures, the sources of capital is a tricky balancing act. Both partners must match their investments to maintain the joint venture's structure, and mainland partners with little experience in the insurance sector are sometimes unwilling to put up more money.

The issue is only becoming more critical as more branches are being opened, more capital-intensive products are being developed and regulatory and accounting changes will bring greater capital needs. To avoid cracks in the relationship over funding matters, foreign insurers need to carefully detail the capital requirements needed to launch a successful venture to its non-insurance partners.

Equally important is managing the expectations for future returns, as it may take five to seven years before the joint venture yields a profit, especially given higher rates of expansion. This may turn into a major sticking point for a Chinese partner involved in businesses such as manufacturing, where investment tends to yield short-term returns. Domestic partners need to be kept aware of the joint venture's present value, to show what they are getting for their investment. Some insurers have tried to solve the capital strain issue by starting out with enough capital to open as many as 10 branches without having to go back for more funding. But for others, disputes over money have disrupted the joint venture and jeopardised its future.

[8] "Earnings Gap Needs Bridging", Beijing Review, March 18, 2004
[9] "UPDATE 3-China'sPing An Insurance in flat HK debut," Reuters News, June 24, 2004 ; "China insurer issues $163 million in subordinated bonds," Reuters News, January 5, 2005

Who is your customer?

Foreign insurers make money on policies that cost upwards of RMB2,500 or US$300, per year. Typical customers are relatively wealthy, to afford that level of coverage, with families, property and education payment needs.

Group insurance limits were lifted in December, but foreign insurers are treading cautiously in this undeveloped market. Long-term benefits can be large, but executives see little material impact in the immediate future, as they weigh how to best capture the customer base.

China's middle class, which is defined by its National Bureau of Statistics as households with annual income of RMB60,000-500,000 (US$7,200-60,400), now makes up 5 percent of the population.

State officials expect that to grow to 45 percent by 2020 and while that figure seems overly optimistic, it is clearly a demographic on the rise [11].

The foreign company's average customer is:

- 25 to 50 years old
- Entrepreneur or executive-level salary worker with a family
- Policyholder with annual premiums of at least US$300
- Living in larger, wealthier cities such as Shanghai, Beijing or Shenzhen
- Annual income of more than US$6,000

Buying a stake – Deep pockets but fast track to market

Buying a stake in an existing insurer generally requires a much bigger initial capital investment but promises a quicker route to the whole existing national market.

Strategic investments are seen as a more complicated entry into the market. For many foreign insurers, the issue of control is crucial, and a strategic investment with limited management and board control does not fit their overriding corporate philosophy.

But for those coming later to the China party, strategic investments offer an attractive vehicle for getting an in-depth view into what can be a very difficult market. Domestic companies benefit from capital infusions and the sharing of international operating and risk management techniques, something that China is hungry for in all financial services sectors.

As ownership rules are relaxed, foreign investors may find themselves owning a significant stake, perhaps a controlling one, in one of the mainland's largest providers.

However, the endgame is much more problematic, as while both parties have much to gain in the short to medium term, at some point a rift may develop over ownership and control.

An interesting example of a niche play investment in the bancassurance market has been the 24.9 percent stake which Brussels-based financial services group Fortis took in Taiping Life in 2001. The new partnership, under Fortis's guidance and experience in this market, targeted people making over US$7,200 a year and has made bancassurance a major part of its business. About half of its premium revenue comes through Industrial and Commercial Bank of China, the mainland's biggest lender [10].

Such niche models usually hold both future risk and opportunity. In the case of bancassurance, Chinese banks still tend to play insurers against each other to get the best short-term returns rather than establishing healthy long-term business. But, as the partnerships mature, the road also opens up for closer insurer-bank cooperation, as has happened in the developed markets.

China's life premium mix in 2003 (by premium)

Participating policies	55.84%
Non-participating polices	30.10%
Health insurance	8.03%
Personal accident	3.31%
Investment linked	2.12%
Others	0.60%

[10] "INTERVIEW: Fortis China insurance JV eyes '06 profit" , Reuters News, February 6, 2004
[11] "China's middle class defined by income", People's Daily, January 20, 2005

Staffing up – People, people, people

In a population of 1.3 billion, manpower is obviously not a problem, skilled manpower is. Foreign insurance executives are pleasantly surprised at the quality of the people they can attract but industry knowledge and experience is hard to come by in such an immature market.

While entrenched state-run companies have historically blanketed the country with hundreds of thousands of salespeople with little training, foreign providers need well-informed, highly professional agents who can explain more complicated products and sell the right product to the right person.

To that end, many of the insurance providers avoid poaching staff from domestic players, instead preferring to hire local college graduates and train them in their own systems. There is still a high turnover rate, as trainees can add a global name to their Curriculum Vitae and hunt for higher job titles and pay packages. But foreign insurers find their incentive compensation programs are well received in China, where employees like the accountability of getting paid directly in line with their achievements.

Joint ventures tend to have Hong Kong-born or foreign-educated Chinese executives. In the top roles, many companies recruit high-level officers from Taiwan given the language compatibility and their experience in a more sophisticated insurance market. At the agent level, the staff are almost entirely local recruits.

Competitive pressure generally for talent is, however, fuelling salary increases for skilled middle management to the tune of 15 to 25 percent per year, depending on circumstances. This is unsustainable but is a current phenomenon.

Where to be – Location, location, location

Shanghai is China's insurance hub, which is no surprise given the large number of multinational corporations based there and the city's status as the wealthiest in the country. Eleven of the 21 established life insurance JVs have a presence in Shanghai, and 7 of the 13 established non-life insurers have branches there [12].

Beijing and Shenzhen, particularly for life insurance, are also popular locations given their status as a political centre and south China commercial hub, respectively.

After establishing country hubs, foreign insurers face difficult decisions determining which cities are best for future expansion. They need to pick areas that are wealthy enough to sustain their businesses, but also places where they can best leverage their capital and people investment.

[12] www.circ.gov.cn

For many providers, the lifting of the 15-city limit — which included Shanghai, Beijing, Guangzhou and other relatively affluent areas — had no impact, as they viewed those as the only places currently worth investing time and money in, given their demographics.

But with no single life insurer joint venture having a branch in more than four cities and most non-life players currently operating in only one city, the opportunities of being the first mover into another area can be big. Some joint ventures are pursuing a "go where they ain't" strategy and avoiding the crowd of insurers flocking to the obvious financial centres.

That does not mean an expansion to the further Western reaches of China, but certainly to "second-tier" cities such as Ningbo, Nanjing and Suzhou, which are attracting attention for their relative affluence and proximity to centres like Shanghai.

Sun Life Financial, for example, chose to set up in Tianjin in 2002 and it now ranks fourth in life sales in the city, behind China Life and Ping An [13].

That said, many executives are not overly concerned about competition, taking the view that there is enough business to go around. Given the meagre penetration of insurance in China and the surge in economic growth and income, it seems that providers can grow substantially without having to steal market share from each other.

Limitations on investment channels

- Bank deposits
- Government bills and bonds
- Financial bonds
- Corporate bonds with a credit rating of AA+ and above
- Mutual funds

Facing into the wind – Structural challenges

Not for the "faint-hearted" is an oft-repeated commentary on the Chinese insurance market. Many laws and regulations are difficult for foreign insurers to understand, and the regulators are seen as inexperienced and unpredictable. This is in large part simply due to the developing maturity of the local market, but executives say many problems could be easily resolved if the system was more transparent.

Joint ventures are also stymied by the market share mentality of the local players, who tend to focus on the top-line by providing cut-price policies through their networks of hundreds of thousands of agents. Foreign insurers are not geared to be in an unprofitable market share game, preferring to sell more sophisticated products to higher-end customers, but the cost-cutting done by the Chinese company does eat into profit margins.

This is particularly true at the bancassurance level. Joint ventures much prefer the agency model — greater control, ability to establish deeper relationships and hence further sales — but most do sell policies through Chinese banks. The products there are treated much more as a commodity, and the banks will push those from which they can receive the most benefit.

China's low interest rates are also a problem, as insurers get a low rate of return on their predominantly fixed income investments.

[13] "Sun Life Financial to accelerate share repurchase program and sees double-digit earnings growth in mid-term," CCNMatthews (Canada), November 16, 2004

Major criteria for foreign insurance partners

- Asset base of more than US$5 billion in China
- More than 30 years of established experience as a WTO member
- Set up representative office in China for two consecutive years
- Paid up capital of not less than RMB200 million

Corporate governance – Being on the same planet

Generally weak mechanisms of corporate governance are an issue that the foreign investor needs to keep in mind as a potential threat to their venture. There are three main areas to watch.

Some aspects of China's corporate culture and the mindset of the local management can be rather different to accepted western practices. Simply copying a whole set of corporate policies from overseas for use in a joint venture in China often does not work because local management will not necessarily make the same assumptions as someone working within an overseas organisation. Policies and procedures need to be very detailed and enforced from the beginning at the highest level, leaving no room for ambiguity.

Apart from having very detailed policies and procedures, extra effort is required in overseeing the different types of expenses and advances. Adoption of a detailed review of employee expense reimbursements for example will help in detecting personal-expense-reimbursement fraud, a common area for misappropriation. Different types and levels of controls over the expenditure approval process, including the validation of authorised signatures, are very important in managing costs.

Last but not least, it is very important to choose the right person to be the CFO of the joint venture. No matter whether the CFO is an expatriate, from the local partner or locally employed, they must fully understand their role in reporting directly to their immediate boss as well as having a parallel line to the joint venture partners. They need to have a strong character and high ethical standards to be able to maintain control in an environment where business practices tend not to be straight-forward.

Investing in China – Enforced safety, low return

A major challenge is where to invest in a country where the domestic stock market has been Asia's worst performer and local securities companies have had a slew of scandals.

Restrictions on investment make some decisions automatic. Insurers are required to put most of their money in savings accounts and government bonds, which limits their risk. Some insurers have dipped into the local mutual fund market, which is growing rapidly but is still relatively small, with few experienced money managers to choose from.

Insurers are getting increasing control over where they can invest, including direct purchases of Chinese stocks. However, foreign players plan to avoid that route, with possible exceptions being small, select investments in blue chip companies.

There is also a daunting asset-liability mismatch challenge: while a policy liability has a duration of 20 to 30 years, there is scant supply of long-term bonds and very few high quality corporate bonds with long durations. Faced with these discrepancies, insurers are reliant on bonds with durations of three to seven years, or simply putting their money in the bank and taking interest payouts. This is a challenge, however, that could develop into an advantage as limitations are eased and foreign insurers are more able to flex their more sophisticated investment skills.

Battle of the agents – Price wars

For many domestic providers, any policy is a good policy. Prior to their stock listings, China Life and Ping An had to work through a legacy of negative interest spreads, as policies they wrote in the early 1990s offered high guaranteed rates, while their return on investments was much smaller due to low interest rates.

China Life, Ping An and PICC are all public companies and although China Life has been stung by shareholder lawsuits in the United States, all three have been profitable operations with an ever stronger focus on high-end products. Their sheer size makes them formidable competitors, and Ping An is widely cited as a world-class company, with the backing of HSBC [14].

The local players are now publicly listed entities that have to answer to shareholders, which will only spur them to increase efficiencies, embrace new technology and become even stronger rivals for foreign joint ventures.

However, the market is still impressed by size, meaning many of the domestic sector's far-flung agents – and their superiors – see top-line growth as the best measure of success.

The market share mentality wreaks havoc on profit margins, and the price war can only get worse as Beijing recently approved more than 20 new domestic insurance companies and there will be further liberalisation of the pricing regime.

The new insurers, keen to make a splash, will go about building a customer base first and worry about profits later. Rising staff costs and more competition for experienced people will meanwhile push expenses higher. Distribution plays a key role in prices and profitability.

Product dictates distribution. More expensive, sophisticated products need to be sold through experienced agents who can develop deeper customer relationships than a bank clerk. As a result, profit margins for agent sales can top 8 percent, while bancassurance margins linger at 3.5 percent, or below.

For foreign insurers, bancassurance as a percentage of overall sales has remained low, as relationships with banks have been slower to develop and many domestic providers have worked with the same banks for years. There is also little loyalty among banks, which choose insurance products that give them the highest commissions, hence cutting into the insurer's bottom line.

China's banks, particularly its massive "Big Four" state lenders, can provide enormous scope for an insurer's products. But these sprawling banks are only beginning to centralise operations, giving great autonomy to local managers. As a result, insurers are finding that "national contracts" are not honored at the local level, where managers have struck their own deals.

[14] "HSBC paying $1.04 bln to life Ping An stake to 19.9 pct," Reuters News, May 9, 2005

Summing up life

While the market is opening up under WTO guidelines, China's insurance sector is still restrictive.

Life insurance joint ventures are capped at 50 percent foreign ownership, while non-life joint ventures are limited to 51 percent, although non-life players also have the choice of establishing wholly-owned subsidiaries on the mainland.

To start up a branch, life (and non-life) insurers must put up at least RMB200 million (US$24.15 million) in capital, while re-insurers must have upwards of RMB300 million in capital to set up life and non-life related operations.

The branch approval process can be slow and having to expand in such a staggered manner, city-by-city, can delay profitability.

Domestic insurers can only sell up to 24.9 percent of their equity to foreign investors, and each foreign investor can't hold a stake of more than 19.9 percent.

Geographic restrictions to 15 cities were only lifted in December 2004 and foreign insurers have been able to sell group insurance only since the beginning of this year.

Life and non-life insurers can only invest in bank deposits, government debt securities, corporate bonds rated AA+ or higher and mutual funds.

The future of regulation is murky. Foreign executives engage in constant dialogue with mainland regulators, helping to educate both sides, while they also lobby for greater reforms.

For example, it is unclear when, if ever, a foreign life insurer could buy out its mainland partner. On the positive side for foreign investors, the government is gradually easing restrictions on which securities insurers can invest in. However, limitations are still a major hindrance and insurance executives are lobbying regulators to allow greater variety of investment vehicles, including property, and pushing for easier flows of currency out of China. It can take more than a year before money flows back to the foreign insurer's home coffers.

However, China is listening to industry experts and talking to other regulators around the world, including Taiwan, to deepen their knowledge and try to keep liberalisation moving at a steady clip.

It will be the first country that will require insurers to report embedded value to regulators in a sign of its forward thinking.

Insurers work within existing guidelines, usually taking a qualified optimistic view about the pace of future reform. The general consensus is that Beijing is moving in the right direction, although not as fast as many would like.

The worst scenario for the foreign investor is that China may get cold feet and look to restrict foreign participation. It has already indicated that it may tighten entry into the banking sector to protect its debt-laden domestic lenders from lethal foreign competition.

But that seems unlikely in the insurance sector where, within the limitations of the joint venture structure, insurers already have relatively free control over their own expansion. China's domestic insurers are generally in much better shape than their banking cousins, so there is simply less need to protect the local industry.

Much of China's potential is linked to regulatory development, and to its credit Beijing realises that it must rely on a rapidly improving insurance industry to pick up the slack as it dismantles its cradle-to-grave "iron rice bowl" system.

To that end, regulators are keen to develop products linked to agriculture and healthcare; ones that are protective rather than traditional savings and investment products.

Group pension, retirement, annuity and health products, along with the aforementioned businesses, are the future of China's insurance sector. As China's bloated state-run enterprises are quickly being pared down and transforming into publicly held corporations, insurers must provide the backup that was in place under the old regimes.

Foreign insurers stand to benefit greatly from these initiatives, given their long track records in product development and their ability to act as market leaders from an innovation standpoint.

Non-life – May you live in interesting times

The old Chinese saying "May you live in interesting times" was actually a curse – interesting times being periods usually full of instability and risk. For the insurance industry in China today, it ought to be more of a blessing.

China is a nation brimming over with opportunities for the non-life underwriter in every sector of industrial and agricultural activity, every aspect of transport and trade and every part of the booming consumer sector for luxury goods.

All the challenges which have just been laid out above for the life industry are in part or wholly relevant to the non-life sector in China. The market share of the big China companies is also similar in both life and non-life sectors, with People's Insurance Company of China taking more than 50 percent [14].

So far foreign companies have experienced good business and reasonably secure profits, but they have tended to stick to limited areas, largely doing business with other overseas multinationals in China who feel more comfortable dealing with foreign insurers.

Big field, cautious play

In theory, non-life players starting out in China have more options than life insurers. In addition to setting up a JV or making a strategic investment, they are also able to set up branches and upgrade them to wholly owned subsidiaries. In June 2004, new CIRC rules allowed joint ventures or wholly owned foreign enterprises with capital of RMB200 million to put up only RMB20 million for each additional new branch. Previously, each new branch required RMB200 million in new capital.

Foreign companies have, however, made relatively little headway in gaining market share, with just over one percent of the country's business in 2004, although the market share for cities such as Shanghai is more than six percent. China's compliance with WTO rules saw the 15-city limit to non-life business lifted in December 2004, but most foreign insurers have kept their operations in one city.

Profitability has been elusive for those ramping up quickly in the market, but executives seem prepared to book investment-driven losses over the next two or three years as they expand.

[14] "UPDATE 2-PICC to trim equity exposure to below 10 pct," Reuters News, August 24, 2004.

It seems to take about five to six years for a non-life operation to break even, and while expansion is important, executives are not interested in opening up in a wide number of cities, preferring to focus on Shanghai and nearby cities, Beijing and the Pearl River Delta.

While the recently lifted limit on city expansion was not viewed as a major impediment, insurance executives are frustrated by the lack of international broker companies that can act as intermediaries for winning corporate clients.

In December, Beijing lowered the entry threshold for foreign brokers by slashing the capital requirement for setting up operations in half, to RMB5 million (US$604,200) [15].

Willis Group, the world's third-largest insurance broker, has a joint venture in Shanghai but very few international brokers have entered the market. Japan's Sumitomo, Sompo Japan Insurance and Aioi Insurance have all taken small minority stakes in mainland brokers, but foreign players need to play bigger roles demonstrating their value to local regulators and companies.

By teaming with local players, they can lend their expertise and access customers on a national scale, which allows underwriters to sell their products through big brokerage teams operating throughout the mainland, which could open the door for larger scale deals.

Sailing charted waters

Loss ratios for foreign companies are very low and there is great confidence that the current business model works, despite relatively low investment returns. But this good payment record also reflects the generally conservative selection of customers.

Foreign insurers are very popular with foreign multinational corporations (MNCs) operating in China as the companies prefer going to a global name for their insurance needs. Many of the relationships formed in China were a result of the groups being linked in other parts of the world and hence allowing MNCs to run their businesses with more continuity.

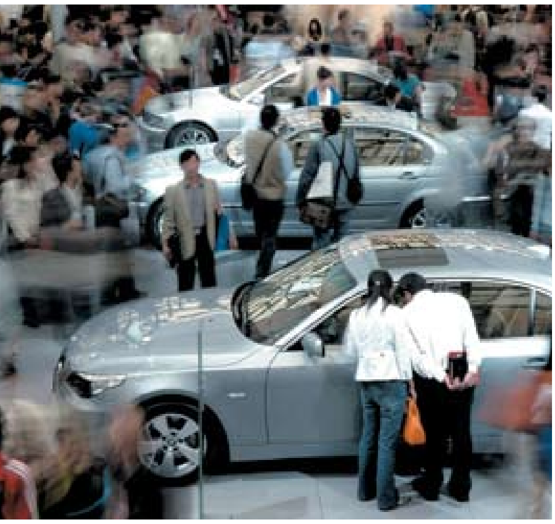
For insurers, chasing MNC business has led to lower loss ratios, and the ability to know their clients better in an often opaque market.

Once again, AIG was first into the market with a license for its non-life arm, American International Underwriters, in 1995 and now has branches in five cities. Hong Kong's Ming An Insurance is the only other foreign company that has more than two mainland branches. AIG also took a 9.9 percent stake in PICC Property & Casualty in October 2003.

[15] "China lowers entry bar for insurance brokers", Reuters News, December 24, 2004

Yet while AIG has been typically active, Tokio Marine and Fire Insurance has almost an identical market share of about 3 percent in Shanghai, where it opened a representative office in 1993. CIRC statistics cited in the KPMG report.

Tokio Marine has demonstrated the very long-term and costly, but often ultimately successful, model of building relationships in China over many years to prepare the way for future business. The Japanese company was laying the groundwork in China back in 1990, when it held seminars on disaster prevention in Beijing to grow brand awareness with local officials [16].



Growth – Globalisation, greater risk

To grow non-life business further in China there are two prime routes: targeting a new generation of Chinese companies with global aspirations, or simply taking on greater risk in new sectors.

Competing against the big local players for domestic business has proven very tough but foreign insurers are starting to find that Chinese companies which are themselves begining to globalise, for example in the energy sector, are interested in doing business with them to access their international expertise and pricing power.

Domestically, the big growth areas are automobile and property insurance.

Automobile insurance makes up more than 60 percent of the market, reflecting the under-insured nature of many other parts of the Chinese economy as well as the enormous growth in this sector.

That figure appears to be rising as more and more cars hit the road. The number of cars nearly doubled in 2003 and although growth in China's automobile sector is slowing after, it is still expected to grow 10 to 15 percent this year, after rising 15 percent last year [17].

Foreign providers are not allowed to enter the third-party motor insurance market, but neither are they particularly keen to rush into this area as the business carries a much greater degree of risk and requires more capital. However, if the restrictions were lifted, it would level the playing field further for overseas companies.

Property insurance has an even bigger growth story, as premiums in this sector grew 27 percent in the first quarter of 2005 to RMB35.3 billion [18]. But once again greater risk is an aspect which overseas insurers would have to address.

[16] "Tokio Marine to Hold Seminar in Beijing," November 26 1991, Jiji Press English News Service.
[17] "Volkswagen faces flat China landscape", Reuters News, April 21, 2005
[18] China Insurance Regulatory Commission

Winning the game

Foreign non-life providers have made encouraging inroads to China by following their global customers to the mainland, allowing some of them to break even as quickly as if they were operating in other parts of the world. However, the country's real growth comes from its purely domestic business. Foreign players have to determine whether they have the pocketbook, and stomach, to invest for the long term and establish relationships with relatively small corporate clients who have the potential to become international companies.

Those who fail to make a serious commitment will fall by the wayside and potentially miss out on the next great insurance market, while those who proceed in earnest will have to accept and manage greater risk to harness the country's huge potential.

www.kpmg.com.cn
www.kpmg.com.hk

www.reuters.com

KPMG contacts

Northern China

Beijing
8th Floor, Tower E2,
Oriental Plaza
1 East Chang An Avenue
Beijing 100738, China
Tel : +86 (10) 8508 5000
Fax : +86 (10) 8518 5111

Qingdao
4th Floor, Inter Royal Building
15 Donghai West Road
Qingdao 266071, China
Tel : +86 (532) 8907 1688
Fax : +86 (532) 8907 1689

Eastern and Western China

Shanghai
50th Floor, Plaza 66
1266 Nanjing West Road
Shanghai 200040, China
Tel : +86 (21) 2212 2888
Fax : +86 (21) 6288 1889

Chengdu
18th Floor, Tower 1, Plaza Central
8 Shuncheng Avenue
Chengdu 610016, China
Tel : +86 (28) 8673 3888
Fax : +86 (28) 8673 3838

Hangzhou
8th Floor
West Tower, Julong Building
9 Hangda Road
Hangzhou 310007, China
Tel : +86 (571) 2803 8000
Fax : +86 (571) 2803 8111

Southern China

Guangzhou
29th Floor, Guangzhou International
Electronics Tower
403 Huanshi Dong Road
Guangzhou 510095, China
Tel : +86 (20) 8732 2832
Fax : +86 (20) 8732 2883

Shenzhen
9th Floor, China Resources Building
5001 Shennan East Road
Shenzhen 518001, China
Tel : +86 (755) 2547 1000
Fax : +86 (755) 8266 8930

Special Administrative Regions

Hong Kong
8th Floor, Prince's Building
10 Chater Road
Central, Hong Kong
Tel : +852 2522 6022
Fax : +852 2845 2588

Macau
23rd Floor, D, Bank of China Building
Avenida Doutor Mario Soares, Macau
Tel : +853 2878 1092
Fax : +853 2878 1096

REUTERS contacts

Hong Kong
10th Floor
Cityplaza 3
Taikoo Shing
Hong Kong
Tel : +852 2520 3688

Beijing
6/F Beijing Sunflower Tower
No.37 Maizidianbei Street
Chaoyang District
Beijing 100026, China
Tel : +86 (10) 6586 5566

Shanghai
30th Floor, Azia Center
Luijiazui Huan Road
Pudong
Shanghai 200120, China
Tel : +86 (21) 6104 1688

Shenzhen
Unit 09, 27th Floor
Diwang Commercial Center
Shun Hing Square
No. 5002 Shennan East Road
Luohu District
Shenzhen 518008, China
Tel : +86 (755) 8246 3318

Macau
13th Floor
Nam Kwong Building
223-225 Av. Dr. Rodrigo Rodrigues
Macau
Tel : +853 713 863

Reprinted in March 2007