THE ROLE OF FOREIGN INSURANCE COMPANIES IN CHINA'S EMERGING INSURANCE INDUSTRY: AN FDI CASE STUDY

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Abstract

Our paper focuses on the development of the Chinese insurance industry from 1949 to the present, with particular emphasis on the post-1979 period and the role of Foreign Direct Investment (FDI). We examine the important function that the Chinese insurance industry has played in China's overall economic transition from a planned to a market economy. We then evaluate the opportunities and limitations, performance and problems of the foreign insurance companies as FDI in China's modern insurance industry. Finally, we study the impact of the WTO accession agreements on China's future insurance services, particularly Chinese strategies to prepare for the post-WTO domestic insurance market competition.

We conclude with our observations on the insurance industry as a special case of FDI. We observe how Chinese policy makers have tried to carry out a dual policy of domestic insurance industry development and FDI participation through a mix of controls and regulations to both benefit and protect China's insurance industry. We identified a set of incremental approaches to the development of the insurance market that also are mirrored in other areas of China's economic reforms and that so far seem to have served China's interests well.

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1. The Role of Foreign Direct Investment In China, 1979-2000

Since 1995, China has been the largest recipient of foreign direct investment (FDI) in the developing world, receiving US$ 40.8 billion in 2000. By end of May 2001, China had absorbed a total of about US$ 363.6 billion of FDI. From 1980 to the end of May 2001, these FDI funds had been invested in more than 370,000 enterprises, of which more than 200,000 were still operating, mostly in China's coastal cities. Recently FDI has been directed toward enterprises in China's less developed central and western regions.

FDI has played a significant role in China's economic growth. From 1980 to 1999, about 2.7% of China's 9.7% yearly average Gross Domestic Product (GDP) growth had originated from FDI. Foreign funded enterprises currently employ about 20 million Chinese workers, or about 10% of China's urban labor force. 400 of the world's largest 500 international companies have invested in China. The FDI is invested largely in China's light and heavy industries, and in export processing.

In areas such as financial services, where FDI has so far been more modest, FDI has still played an important and growing role. In this paper, we will examine the role of FDI in one area of financial services, the insurance industry.

2. The Insurance Industry of China

A. History:

Before 1949, most of China's insurance industry was controlled by foreign companies operating from Shanghai. The current largest insurer in United States, American Insurance Group (AIG), was founded in Shanghai in 1919. Most other insurers were large foreign companies that left China entirely after 1949, though some retreated to Hong Kong.

From 1949 to 1976, the insurance industry in China essentially ceased to exist. Few Chinese owned personal property, and almost all businesses enterprises were government-owned and "self-insured."

Beginning in 1978, as part of the Deng Xiaoping-initiated economic reforms and open door policies, China began to resume the insurance industry through the reestablishment of the People's Insurance Company of China (PICC), which had a monopoly position in China's emerging insurance market. In 1996, PICC was divided into three independent companies, overseen by the People's Bank of China. Finally, in 1998, the PICC group was disbanded and, the 3 PICC companies were renamed: China Life Insurance, China Property Insurance (PICC), and China Reinsurance. In November of 1998, the State Council devolved supervision functions from the People's Bank of China to the newly established China Insurance Regulatory Commission (CIRC). Since 1998, CIRC has grown to a nation-wide network of 33 branches overseeing China's rapidly modernizing insurance industry.

Foreign enterprises began to play a role in the revival of China's insurance industry beginning in 1992. In September of 1992, the People's Bank of China granted AIG a permit to begin selling individual life and property insurance in Shanghai. Several years later AIG reoccupied its original building on the Shanghai Bund and expanded its business to include Guangzhou and then Shenzhen. From 1992 to 2000, China gradually approved the re-entry of 16 additional leading foreign insurers, many of whom had operated in China before 1949.

B. Importance of China's Insurance Industry

The insurance industry plays a number of important roles in China's modern economy. Insurance is necessary to protect enterprises against risks such as business failure, and fire and natural disasters. Individuals require insurance services in such areas as health care, life, property and pension. The insurance industry also provides crucial financial intermediary services, transferring funds from the insured to capital investment, a critical need for China's continued economic expansion.

As China has transformed its economy from a centrally planned to a market-oriented one, initiation and development of insurance service industries have been necessary to support continued economic transformation. Foreign insurance companies have been invited by the Chinese government to play an increasingly important, though carefully restricted, role in China's economic modernization.

After 20 years of successful economic reform, China is currently facing some difficult but critical economic issues, such as State Owned Enterprise (SOE) reform, which is related to equally important banking reforms. And both areas of reform require a sound and efficient insurance service industry. Vital social security and pension reforms also need the benefits of a mature insurance industry. And finally, the success of these reforms is a prerequisite for China's social stability, which is a necessary political condition for sustaining China's economic growth.

Because insurance is such a strategic industry, the Chinese government on the one hand has opened the insurance industry to foreign investment and assistance. On the other hand, it has carefully regulated the speed and scope of foreign involvement in order to protect China's still nascent domestic insurance industry and to match insurance industry growth with society's demand for insurance services.

C. Market Potential

Foreigners have been motivated to enter China's insurance industry by their desire to participate in the largest potential insurance market in the world. In 1980, when the insurance market was first reopened as part of the post-1979 financial reforms, insurance premiums totaled only RMB 640 million (US$ 77.4 million). Beginning in 1980, China's insurance market grew at an average rate of 26%, reaching RMB159 billion (US$19.2 billion) by the year 2000, a 249 fold increase! The growth rate of insurance premiums is projected to slow to about 12% per year for the next 5 years, reaching RMB 280 billion (US$33.7 billion) by the year 2005.

Even with the impressive current growth rate, China's insurance market is still small compared with other foreign insurance markets. For example, the Chinese insurance density (premiums per capita) was RMB127 (US$15.30) in 2000 while the world average was US$ 360. The market penetration (percentage of premiums in GDP) was about 1% of China's GDP, compared with world levels of 6-7%. Another measure of the current small size of China's insurance market is that its total assets are RMB337.4 billion (US$ 40.7 billion), while an international medium-sized insurance company has assets of over US$ 100 billion.

China's market was also small compared with other developing countries. For example in 1996, Chinese per capita spending on insurance was US$ 7.64 compared with Thailand, US$30, though already much higher than in India at US$1.7.

Given that China's economy has grown at about 8% per year since 1979, even surviving the Asian financial crisis, most foreign investors, including those in the insurance sector, do not want to be left out of the most rapidly expanding and largest potential insurance market in the world.

3. Foreign Direct Investment: The Case of Foreign Insurance Companies

After China opened its doors to the world economy, it began to invite foreign insurance companies to participate in China's emerging insurance industry. As with other economic sectors, foreign insurance participation in China was subject to requirements and regulations aimed at maximizing Chinese benefit while allowing foreign insurers to participate in China's long-term economic growth.

China's strategy for gaining benefits has evolved slowly over the last 9 years. It has included a number of requirements aimed at making the opening gradual and matching the growth of China's insurance industry with its slowly emerging insurance needs. Before 1980, China lacked most aspects of what is usually found in a mature insurance market, such as legal structures and regulatory institutions, trained personnel, a competitive market environment, consumer awareness, experience with insurance products and services, and the necessary financial infrastructure.

Given the extremely underdeveloped nature of China's insurance industry before 1980, the government decided to establish a number of stringent requirements on foreign insurers wishing to enter China's infant insurance market.

In addition to general requirements asked of all foreign direct investment (official evaluation and approval, corporate charters, feasibility studies, market research, and foreign exchange control), foreign insurance companies were also subject to sector specific requirements, both explicit and implicit.

In applying for a business license, a prospective foreign insurer would have to meet the following formal criteria:

(1). To operate a representative office (where no business could be conducted) in China for a minimum of 2 years;
(2). To have parent company assets exceeding US$ 5 billion for a year prior to application;
(3). To have at least 30 continuous years of experience in insurance underwriting; and
(4). For the applicant home country to have a sound financial regulatory and supervision system.

In addition to formal criteria, a number of informal factors have in practice influenced the China insurance permit approval process. First, the company must demonstrate a long-term commitment to China, by among other things, offering financial seminars, setting up research institutes, and making financial investments in both Chinese educational institutions and in industrial sectors. Second, Chinese authorities have approved companies based on the quality of government-to-government political and economic relations and in meeting Chinese foreign policy goals. Third, historical relationships between the company and China have factored into approval decisions. For example, AIG, the first company to be approved and the only foreign company to be granted 4 licenses to sell both life and property insurance in three cities, was founded in Shanghai in 1919. Finally, Chinese authorities tried to maintain a world -wide geographic balance when granting permits to sell insurance.

If an applicant meets the formal and informal requirements, they have a chance to receive one of the limited number of "Insurance Institution Legal Person Permits" from the China Insurance Regulatory Commission set up in 1998 (and before that from the People's Bank of China).

Over the last 9 years, 19 permits have been issued, an average of 2 per year. Given that 89 other foreign companies have set up more than 200 representative offices and usually waited as long as 7 years in hopes of gaining permission, this seems like a small number. ING Insurance, a division of Netherlands ING Group, opened its first representative office in Shanghai in 1993 and received its Joint Venture Life Insurance permit in 2000. Minsui Marine Insurance Company Ltd., the third largest property insurer in Japan, has set up representative offices in seven Chinese cities since 1981, but only received approval in the year 2001, 20 years later, to open its first Chinese branch in Shanghai.

Although the pace of approval was slow, the 19 foreign insurance companies approved by the end of the year 2000 were still more numerous than the 17 domestic companies so far licensed to operate in China's insurance sector. There are a relatively few number of domestic insurers because Chinese companies have also been subject to many requirements and restrictions. The total number of insurance companies in China could be many more. For example, there are 40 different insurance companies serving the 6 million people of Hong Kong.

After receiving a Permit, the prospective foreign company must then meet additional regional and business requirements to obtain a business license from a local Administration of Industry and Commerce Bureau. Certain kinds of foreign insurance licenses require the forming of a joint venture with a government approved domestic company. For example, all foreign companies wishing to sell life insurance (except for AIG in 1992) have had to choose a joint venture partner from among government-approved partner companies, both insurance companies (such as Dazhong Insurance, China Pacific, and China Life), and other major Chinese enterprises (such as SinoChem, CITIC, China National Metals and Mining, and China Oil and Gas Group). For selling property insurance, a partner is not necessary but is permitted. Reinsurance business is closed to foreign insurers.

After finding a partner, if required, and receiving a business license, a foreign insurance company can begin to engage in insurance underwriting, but it still will face additional restrictions. First, its license is limited to only one of three locations in China's coastal areas: Shanghai, Guangzhou, or Shenzhen, with 13 of 19 licenses issued for operating in Shanghai. Recently the Chinese government has permitted foreign insurance operations to expand to selected regions and cities adjacent to these three cities. Second, foreign companies can only sell insurance products specified in their licenses. For example, they can sell either only life (with a Chinese partner), or, property. In addition, the foreign life insurance joint venture (JV) can only sell individual, not group, insurance to foreigners and Chinese, whereas Chinese domestic insurers can sell group life insurance policies. The total group insurance premiums in Shanghai in 1996 was RMB 1.86 billion (US$ 224.6 million), 65% of Shanghai's life insurance market.

Also, companies approved to underwrite property insurance can sell only to foreign-invested companies. Premiums collected (by both foreign and domestic companies) can only be channeled into a limited number of investment instruments (bank deposits, treasury bonds, or close-end stock funds). Other limitations on the activities of approved foreign insurers include prohibition against Chinese citizens acting as general managers (Chinese partners usually act as Chairmen of the Board). In addition, all foreign insurance companies are required to have 30% of their insurance policies reinsured by the only domestic reinsurance company, the China Reinsurance Company (for Chinese domestic insurers this requirement is 20%).

There is a capital requirement for all insurance companies, foreign and domestic. Registered capital should be at least RMB 200 million (US$ 24.2 million) for operating in one location. A RMB 500 million (US$ 60.5 million) minimum is necessary for nationwide operations, though so far only Chinese companies have been given permission to operate nationwide. If foreigners form a JV, they need a minimum of RMB 200 million of registered capital. So far, all JV companies have been permitted to carry out only local operations and most JVs have had 50/50 percent ownership, requiring foreign and Chinese partners to each invest a minimum of RMB100 million (US$12.1 million).

There is one alternative method for foreign investors to tap directly into China's growing insurance market. Since 1999, CIRC has permitted foreign investors (some insurance companies and some other financial companies) to own up to 25% of selected Chinese insurance companies with each individual foreign investor owning no more than 5%. CIRC has encouraged Chinese companies to increase their capital base through such foreign participation in order to strengthen them for the coming WTO market competition. For example, Xinhua (New China) Insurance, China's fourth largest national insurance company, has been developing rapidly since its establishment in 1996. Recently it sold 24.9% of its equity for US$116.9 million to five foreign investors including Zurich Insurance Company, the International Financial Corporation (a member of the World Bank), the Japan-based Meiji Life Insurance Company, Holland Financial

Services Company, and a fifth unnamed company. This sale greatly increased Xinhua's capital base. The five Xinhua foreign investors have also agreed to provide advanced technology and management know-how. China's fifth largest life insurance company, Taikang Insurance, has been similarly approved for foreign investment and has also successfully carried out a year-long international private placement. The company's new foreign shareholders include Winterthur Life and Pensions (WLP), The Government of Singapore Investment Corporation (GIC), and Japan's Softbank, all world-class financial powerhouses. Foreign shareholders will buy a total of 2 million shares, or 25% of its total shares outstanding. Foreign shareholders have also agreed to provide comprehensive assistance to Taikang in terms of technology, staff training, and E-commerce, and send their experts to Taikang for diagnosis of company management and practices, leading to specific recommendations for improvement.

4. Foreign Company Market Performance

Because of the many restrictions to entry, foreign companies have so far only participated in a limited way in China's insurance market development. Since 1992, of the 19 approved foreign insurance companies, most are currently operating in China. But, they still have gained only a small fraction of China's insurance market. For example, in the first quarter of 2001, the total premiums for the entire Chinese insurance industry was RMB 43.76 billion (US$ 5.29), of which foreign-invested insurance companies received only RMB 711 million (US$85.87 million), or a 1.6% market share. Foreign premiums were up 37.52% the first quarter of 2000, slightly higher than domestic competitors' premiums, which rose 34.26%. AIG, the first foreign company to enter the Shenzhen life insurance market in October of 1999, received RMB 7.78 million (US$.939 million) in the first half of the year 2000. But their market share was only 1% of the Shenzhen life insurance market, with China Life holding a market share of 43.67%. AIG's premium income from new policies surpassed the third largest life insurer in Shenzhen, China Pacific Insurance, and they have rapidly expanded their employee from just over 100 when they opened to the current level of 500.

In addition to governmental restrictions and regulations, foreign insurance companies have also faced a number of Chinese market challenges. Joint venture management appears to be very difficult in China. For example, recently, three experienced senior managers of Sino-foreign JVs were removed from their management positions in AXA Minmetals Assurance Co (France), Allianz Dazhong Life Insurance Co. (Germany), and China Life and Colonial Life Insurance Co.(Australia). There are a number of reasons for the management challenges. First, there are cultural differences such as conflict between the JV partners and lack of mutual trust and agreement on management practices. For example, AXA Minmetals had seven managers from four different country-regions. The managers with different cultural backgrounds had different points of view on many management issues such as the insurance market, marketing insurance products, and employee compensation. They also had to answer various questions from AXA headquarters some 8,000 miles away.

Second, China's insurance market is constantly changing. There are more competitors every year. For example, in 1996 in Shanghai, there were five insurance companies, but by 2001, there were more than 20, 10 of which were selling life insurance. Therefore market research done five years ago is obsolete, making a huge gap between market data and actual operations.

Third, there is a lack of familiarity with the Chinese business climate leading to problems in the localization of international enterprises. Companies such as AXA, Manulife, and AIG, some of whom have had many decades of international insurance experience including in Hong Kong and pre-1949 China, have found many difficulties applying their experiences in the current Chinese market. For example, the foreign companies did not realize that many Chinese today have more interest in insurance or financial products that are closely linked to investment and financial management. Another social change in China that has affected marketing insurance products (as well as doing business in China generally) is that the traditional central role of "guanxi" has gradually diminished and Chinese customers therefore must be approached not only through their social groups but also as individuals.

5. Impact of the WTO Accession Agreements on China's Insurance Sector

China's WTO accession agreement has included a number of commitments to further open China's financial services industry, including the insurance market. Among the commitments are:

(1) China will permit foreign property and casualty firms to insure large-scale risks nationwide immediately upon accession and will eliminate all geographic restrictions within three years of accession.

(2) China will expand the scope of products for foreign insurers to include group, health, and pension lines of insurance (together about 85% of China's current insurance market) over five years.

(3) China will award licenses based solely on prudential criteria, with no economic needs test or quantitative limits on the number of licenses granted.

(4) In terms of investment, China will allow foreign ownership of JV life insurance companies to be up to 50% (no change), but be able to freely choose a joint venture partner. China also will allow up to 51% ownership in non-life JVs and permit the formation of wholly foreign subsidiaries within 2 years, and the reinsurance business will be completely open to foreign investors upon China's WTO accession (100% with no restrictions).

These change should vastly accelerate the license granting process during the next five years, and consequently increase foreign competition in China's emerging insurance markets. For example, most of the 89 foreign companies with representative offices should now be able to obtain licenses to underwrite casualty insurance anywhere in China. In terms of life insurance, they will be able to freely select JV Chinese partners to operate anywhere in China. Foreign companies should also be able to enter the reinsurance market without restrictions.

An important area of competition will be for trained and experienced Chinese personnel. Even though there has been a rapid expansion in insurance training programs, the expected expansion in the number of foreign insurance companies will translate into vastly increased demand for Chinese insurance industry experts. Foreign companies will be able to offer better compensation packages and career development opportunities to attract Chinese talent. Another area of competition will be for the public's confidence.

Currently it is difficult for Chinese customers to differentiate between foreign and domestic insurance products. Competition will focus on gaining the confidence of China's growing base of insurance consumers.

Foreign competition will greatly increase in part because foreign companies can bring rich experience in developing and marketing various kinds of insurance products and services, but all products and prices must be approved by CIRC. For example, AIG brought aggressive door to door sales techniques to Shanghai's individual life insurance market.

6. China's Insurance Industry Preparations for the WTO Accession

The Chinese government has taken a number of steps and measures to prepare China's insurance market for the post-WTO accession competition.

(1) China is improving the legal structure by having CIRC issue new regulations for insurance firms in general and also for foreign-funded insurance firms. China is considering amending its basic insurance law in the near future. CIRC has already set up a nationwide regulatory framework with 33 branches throughout China in preparation for the expansion of China's insurance industry, by both domestic and foreign companies.
(2) In order to further develop its insurance market structure, China is taking aggressive measures to develop its intermediary insurance market by having CIRC approve three Chinese insurance brokers, by the setting up of 33 Chinese professional agents and by the approving of 3 loss adjusters. CIRC has approved an increase of four new insurance companies, Minsheng, Oriental, Shengming and Heng'an, to provide partners for foreign life insurance companies and to increase the number of Chinese companies (to 17). CIRC granted these and other Chinese insurance companies the rights to operate in more Chinese locations. Two sub-companies of China Reinsurance Company have been opened to increase China's ability to offer reinsurance products.
(3) In order to strengthen Chinese companies in their coming market competition with entering foreign insurers, CIRC has encouraged domestic insurers to seek international private placements to increase their capital basis. Taikang and Xinhua, for example, have both completed private placements in the year 2000 that have greatly increased their capital. The three largest state-owned insurance companies, China Life, PICC, and China Reinsurance, are considering selling shares of their branches to Chinese institutional investors in order to increase their capital and pave the way for future public listing. In 2000, PICC and China Life have reorganized their operations and streamlined their workforces by 8,000 and 383 respectively. Many Chinese insurance companies have made alliances with banks and other financial institutions to strengthen their marketing and customer service capabilities. Pingan Insurance Company and Guangdong Development Bank have teamed up to offer credit card service to their customers. The Industrial and Commercial Banks of China (ICBC, China's largest commercial bank) and the People's Insurance Company of China signed an agreement for long-term "all around" cooperation, where they will act as each other agents, and where ICBC will collect insurance premiums and pay claims on behalf of PICC. Chinese companies have also been encouraged to develop new insurance products, such as Pingan and Xinhua Life's new "unit-link" policies, tying insurance products more closely to financial investment. Chinese Life has tried to improve its quality of service by establishing customer

service centers in its 3,400 branches nationwide. PICC has set up a 24 hour national service hotline to serve its insurance customers.

(4) China has also initiated training and other kinds of support for China's insurance companies. CIRC has conducted various classes for senior managers of Chinese insurance companies to help them be better able to manage in the coming more competitive environment. CIRC has approved Chinese insurance companies to invest a portion of their insurance premium proceeds into Chinese stock-based funds, up to 10-15% for certain insurers in the year 2000.

These and other steps should help prepare Chinese insurance companies to be more efficient and responsive to customer needs. These steps combined with the expansion in the number of and kind of Chinese insurance companies, should permit China to better compete in the post-WTO Chinese insurance market.

7. Conclusions

China's insurance industry has made rapid advances over the last 20 years, and particularly since the 1992 opening of the market to FDI. China has developed a good start from almost no insurance services. It has been aided by FDI, both in terms of industry expertise and modestly in terms of foreign capital. Now, as a result of WTO negotiations, China has agreed to more completely open its financial services market, including insurance. And as with the development of the insurance industry until now, the future changes will be gradual and incremental, even after the five years of the WTO agreement transition period.

The WTO accession has stimulated much additional Chinese reform activity to prepare China's domestic insurance market for vastly increased foreign participation and competition. Even with WTO agreements, however, the Chinese government will continue to have sufficient regulatory powers to assure at least minimum protection for China's still fledgling insurance industry.

We believe that with much continued effort at reform including foreign participation, China will successfully prepare itself both to meet increased domestic market demands and the intensified competition of foreign insurers. The Chinese insurance market will continue to grow, though at a manageable pace, and it will be shared by both Chinese and foreign insurers. Since 1992, China's insurance industry has benefited from and not felt threatened by FDI, both directly and indirectly, and therefore FDI in the insurance sector will continue to be welcomed, though much more foreign competition can be expected.