Realising the potential: Entry and development in the Chinese insurance market

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Although the potential within the Chinese insurance market is vast, foreign companies need to overcome a restrictive regulatory environment and the established dominance of domestic players. As David Campbell and Felix Sutter explain, addressing these challenges calls for strong relationship building, deep cultural understanding and a clear perception of where, when and how to compete, along with an appreciation of the heightened risk and uncertainty in this evolving market and, not least, the need for patience and perseverance.

China's sheer size and exponential economic expansion make it one of the most attractive developing markets for international insurance groups. Premium volumes have been rising by more than 15% per year since the beginning of the decade,[1] albeit from a low base. China's premiums per head of €40 in 2006 (life accounted for €25.50 and non-life for €14.50) were still far closer to Kazakhstan (€31.70) than Japan (€2,692).[1] This relatively low market penetration indicates that considerable further growth is likely as expendable incomes and risk protection needs continue to increase. Estimates by the China Insurance Regulatory Commission (CIRC) suggest that premiums in 2007 may have exceeded €60 billion.[2] 'Economic and social progress not only gives the insurance industry enormous room for growth, but also place greater demands on the sector… a developed insurance industry is a key sign of social progress and an important guarantee of prosperity', said Wu Dingfu, CIRC President.

A highly visible sign of China's increasing prosperity is the rapid rise in the number of vehicles on the road. More than 30 million Chinese people now own their own car and sales are expected to increase by an average of 30% per year over the next three years,[3] fuelling further growth in demand for compulsory motor insurance. Further opportunities in retail non-life insurance come from the increasing demand for buildings and contents insurance emanating from the rise in private home ownership.

In turn, the surge in investment in industrial infrastructure is creating increasing opportunities on the corporate side. The deep integration of Asian economies opens up particular opportunities for multinational insurers able to offer policies that cut across national boundaries. Insurers familiar with the US market may also be able to provide cover for the many Chinese manufacturers concerned about the growing threat of product liability and recalls.

On the life side, rising affluence is also spurring ever-increasing demand for savings, pensions and other investment products. In a country where householders have built up bank deposits of nearly €1.4 trillion (a savings to GDP ratio of some 80%),[4] the potential for further growth is immense.

However, success for foreign insurers is likely to be hard won. Nearly half of the 80 plus insurance companies in China are either owned by international groups or Sino-foreign joint ventures;[5] dozens more foreign insurers have set up representative offices. Yet, despite their number and accelerating expansion, the market share of these international groups is still only around 6%. The business development challenges they face were highlighted in the findings of a PricewaterhouseCoopers survey, which drew on in-depth interviews with more than half of China's foreign insurers.[6]

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1 Swiss Re Sigma 'World Insurance in 2005' and 'World Insurance in 2006'.
2 Dow Jones Newswire (15.11.07).
3 'China's car craze', a report by Fiducia Management Consultants (01.11.07).
4 'Entering the Chinese investment management industry', a report published by PricewaterhouseCoopers, published in November 2006 (www.pwc.com/financialservices).
5 Xinhua News Agency and China Insurance Regulatory Commission (12.11.07).
6 'Foreign insurance companies in China', a report published by PricewaterhouseCoopers in September 2007 (www.pwc.com/insurance).

Ways in to China

Exacting capitalisation and credit rating rules mean that access to the Chinese insurance market is effectively restricted to the largest international groups. Foreign companies can set up a representative office. After two years, they can then apply for an insurance licence. Options for business development are then as follows:

1. Wholly-owned operation

Non-life insurers, health insurers and reinsurers can open a branch and subsequently seek approval to turn the branch into a subsidiary. While 100% ownership confers full control over strategy, securing licences and developing relationships can be a lengthy process. Foreign non-life insurers cannot sell legally obligatory insurance, which restricts their ability to participate in the motor insurance market.

2. Joint venture

Life insurers must operate through a joint venture with a local financial or industrial partner (non-life insurers, health insurers and reinsurers may also form joint ventures.) Finding the right partner is vital as companies cannot easily chop and change. Notable examples include Generali's partnership with China National Petroleum Corporation (CNPC). In 2005, the JV's €1.95 billion sale of a pension plan covering CNPC's 390,000 employees pushed foreign companies' share of the life market above 10% for the first and only year.

3. Investment holding

Foreign companies can buy a stake of up to 20% in an existing Chinese insurer. To deter speculative short-term investment and encourage long-term development, holdings must be retained for at least three years. Examples include AIG, which owns a significant stake in the People's Insurance Company of China (PICC), the country's leading non-life insurer, and HSBC, which owns just under 20% of Ping An Insurance. Generally, it is expertise rather than capital that is being sought and therefore a stake of as little as 5% may be enough to command a seat on the board.

Overcoming regulatory restrictions

Survey respondents see regulation as the chief barrier to development and the main driver of change in the Chinese insurance market (see Figure 1). In part, their concerns stem from the sheer weight and complexity of red tape in China and in part from what some see as an uneven playing field that favours domestic firms.

A particular hurdle is the need to secure operating licences from both the central CIRC and subsequently its various provincial counterparts. The number of provincial licences granted to a foreign life insurer in any given year is generally restricted to two, leaving them at a clear disadvantage in seeking to compete with already nationally established or rapidly expanding domestic competitors.

Many non-life insurers taking part in the survey complained of delays of up to two years in the processing of applications to convert from branches to subsidiaries. Capital requirements make operating through a branch structure unattractive.

Difficulties in gaining approval for new products were seen as stifling innovation, an area that could otherwise be a valuable competitive differentiator for more sophisticated foreign insurers.

Although there are no sure-fire short cuts through this regulatory maze, the process can be made a lot more manageable by hiring local professionals with direct experience of dealing with particular national and provincial supervisors. Moreover, while the restrictions on geographical expansion by life insurers would appear to inhibit rapid growth, it is worth remembering that some of these provinces are larger than many European countries. Ultimately, the potential for delay underlines the importance of planning for the long term, and adopting a strategy for customer targeting and associated product offering that is consistent with step-by-step geographical expansion.

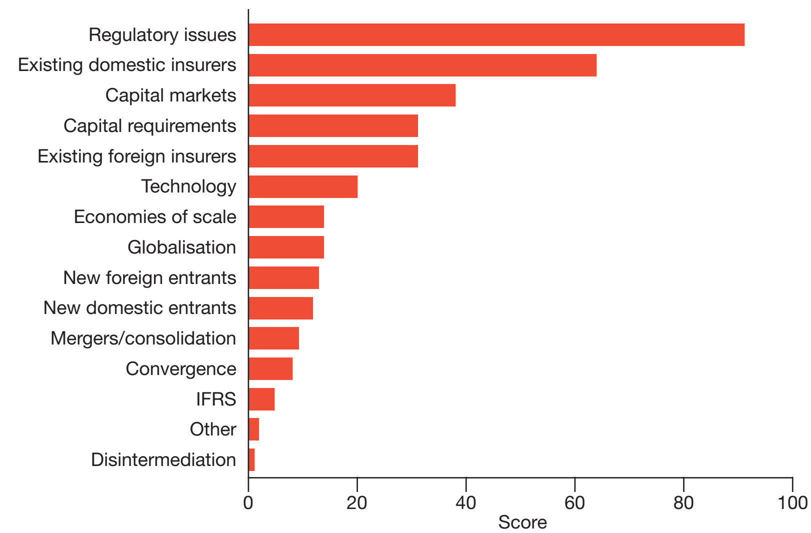
The current restrictions on licensing and product approval may eventually ease as the market begins to mature. Indeed, the emphasis of regulation is already starting to shift from the supply side to the demand side through stronger requirements on risk and solvency management and consumer protection, in line with more developed markets. Key initiatives include an insurance protection fund to reimburse policyholders in the event of an insurer going bankrupt.

Raising consumer awareness

Many consumers' limited understanding of the nature and purpose of insurance presents a further barrier to the marketing of more sophisticated risk protection products.

Chinese people have traditionally viewed savings rather than insurance as the primary

FIGURE 1 **Drivers of change**



Source: 'Foreign insurance companies in China'.

safeguard against adversity. Even when they do choose to take out insurance, the products tend to be seen as an investment rather than a risk protection vehicle. In particular, there is a reluctance to pay money into policies that protect against a risk that may not actually materialise and may therefore provide no eventual payout. Therefore, products such as pure life cover often need to be augmented with a savings element to make them more marketable. The exception to this seems to be health policies such as critical illness cover, where there is greater receptiveness to insurance concepts. Many survey respondents called for tax incentives and public education to help encourage more consumers to protect themselves through insurance.

FIGURE 2 **Most pressing issues for foreign insurers**

Source: 'Foreign insurance companies in China'.

Battle for talent

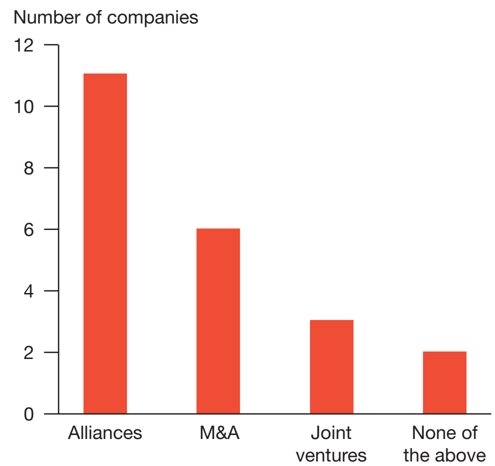
The most pressing challenge within companies themselves is the difficulty in attracting and retaining competent staff (see Figure 2). The limited supply of qualified and experienced personnel is especially marked in sales, actuarial and senior management positions.

Nurturing talent from within would be more sustainable than simply raising pay rates to poach people from competitors. However, domestic insurers are generally seen as providing better long-term prospects than the relatively recent foreign arrivals. International groups may therefore need to look at how to enhance the attractiveness of their training and career development programmes, through more international secondments, for example. Some foreign insurers are also looking to make up for shortages in Beijing, Shanghai and other leading insurance centres by bringing in people from Hong Kong, Taiwan, Singapore or Malaysia.

Developing distribution

A related concern is what many international groups see as the often poor professional standards of independent agents, who form the main route to market in China. It is especially telling that distribution channels and retail sales practices ranked as survey respondents' foremost risks. They are concerned about agent malpractice, loss of agents to competitors and also the fragile and nonexclusive nature of bancassurance relationships.

Figure 3 **Primary focus of restructuring strategies over the next five years**



Source: 'Foreign insurance companies in China'.

Many foreign insurers are pressing the government to ease restrictions on commission levels to enable them to provide more effective incentives for improving agents' performance and customer care.

Many companies have been investing in the further development of bancassurance and direct sales to broaden their access to the market and take greater control over distribution. However, bancassurance margins are often slim and many banks are now looking to launch their own insurance businesses. In turn, most foreign companies still lack sufficient brand awareness and distribution capabilities to sell enough products directly. It is therefore interesting that the survey found that most respondents view alliances as the primary focus of future strategic development, ahead of acquisitions and joint ventures (see Figure 3). These alternative distribution channels could include travel, mobile phone and other branded outlets, rather than simply financial services partners. Successful sales of insurance tied to bank loans and mortgages or by car dealers suggest that alliances may be a useful tool. At the moment, many of those taking up insurance are 'first-time buyers' and awareness levels are low. However, as insurance becomes more widely accepted, sales by internet and phone may be expected to grow rapidly in urban centres that have readily embraced new technology.

Tackling entrenched competition

In a highly concentrated sector, the overriding challenge for foreign insurers is how to compete with the market dominance of China's domestic giants. China Life, the world's largest insurer by assets, controls more than 50% of China's life insurance market,[7] for example. In turn, PICC sells more than 70% of China's motor insurance contracts.[7] Building on the advantages of scale and reach, the largest local players are flush with funds from stock market listings and are fast catching up with the sophistication and strategic ambition of their foreign rivals.

It is therefore far from surprising that survey respondents identified life and motor insurance as among the most intensely competitive segments. The difficulties of making headway were further highlighted by the fact that 25% of the participating life insurers had fundamentally changed their strategy over the previous 12 months and only two had made no significant modifications.

However, there are still a number of niche and emerging market segments that are less developed and competitive than life or motor and therefore offer valuable opportunities for international groups to leverage their expertise. In this vast country, even a niche market could be potentially huge.

Aside from the careful selection of niches, among the largely untapped market openings identified by survey respondents were health and pensions. These openings reflect the growing strains on China's welfare system and the government's recognition of the need for reform and market development to help take up the slack. 'The insurance industry will play a big role in the construction of a harmonious socialist society, assisting society's needy groups by setting up a benefit co-ordination mechanism through the insurance channel', said Gu Xiulian, Vice-Chairman of the National People Political Consultation Conference.

Pensions potential

China's state pension system is already overstretched and will not be able to cope with an elderly population that is expected to exceed 400 million by 2050.[8] It is often said that 'China will get old before it gets rich'. The government is therefore keen to encourage the development of the private pensions segment through tax breaks and market liberalisation.

Current initiatives include the issuance of a fresh round of new licences for the management of enterprise annuity plans (EAP), a defined contribution scheme comparable to the US 401k. The EAP market is expected to grow by more than €4 billion per year over the next five to ten years[9] and could provide one of the most valuable opportunities for international groups.

7 Dun and Bradstreet company overview, December 2007.
8 International Herald Tribune, 18.12.07.
9 China Daily, 29.08.07.

A key driver of growth in the market is the setting up of EAPs by state-owned enterprises preparing to list on the stock market. These companies typically curtail their pay-as-you-go defined benefit schemes before listing and partially replacing them with an EAP, which can take advantage of an injection of funds from day one.

Although the licences for custodianship are likely to go mainly to banks, insurers are well placed to secure approval for trusteeship, administration and investment management operations. However, the licensing process in this new market can be complex and involves not one, but two, regulators. Many foreign insurers may feel they need an alliance with a domestic financial services institution in order to compete effectively.

Health

China has never had universal medical cover. A contributory social insurance system was introduced in 1998, but only covers around 10% of the population and even for them, may only take care of a limited proportion of potential treatment costs.[10] As a result, over 50% of healthcare spending in China comes out of patients' own pockets and indeed the need to pay for possible hospital fees is one of the reasons why the country has such a high savings rate.[10]

The government is therefore keen to encourage the development of the health insurance market, both to make up for the shortfalls in public provision and to release money tied up in savings that could help to sustain economic growth and foster a shift towards domestic consumption to balance the economy. As a result, health insurance now accounts for around 5% of annual life insurance sales and is growing faster than the sector as a whole. For international groups, there are opportunities to bring more sophisticated and personalised products into the market and improve the often poor patient care and cost control with the hospital network by taking on direct management of medical services. Many foreign insurers presently operating in China do not have the full range of skills in health insurance and strategic alliances are likely here too.

10 'Healthy Choices: The changing role of the health insurer', a report by PricewaterhouseCoopers in October 2006 (www.pwc.com/financialservices).

Forging partnerships

Although most of the larger domestic players have already secured foreign investment and joint ventures, a number of smaller, often regionally focused companies may still be looking for international partners.
In particular, there may be opportunities to look beyond the more economically advanced coastal provinces, where insurance markets are already highly developed and competitive, to the relatively untapped, though often fast growing, interior regions.

However, the most attractive targets are being rapidly snapped up and the scarcity value of the remaining candidates is reflected in the price. For this reason, it may be unrealistic to apply the same deal risk and return criteria as in lower growth home markets. It may also be unrealistic to expect deals to be sealed in a matter of weeks or even months in the Chinese business culture. Indeed, while the potential rewards are considerable, European insurers may need to weigh this up against a higher level of risk and uncertainty than they would be accustomed to in their home markets. They will also need to discern ways to compete within an acceptable risk profile.

Developing and cementing the necessary relationships demands considerable time and care. This includes nurturing ties through visits by senior executives and reciprocal invitations to view operations in Europe. It is also important to bear in mind that Mandarin and not English is the lingua franca of Chinese business. It is therefore vital that at least some of the negotiating team or their advisors are fully conversant in the language and the many nuances of the local market, culture and customs.

Ultimately, expectations need to be geared towards the long term. It can take at least five years to achieve a return on investment as measured by the capital value of the holding and may be even longer before products begin to deliver a consistent profit. It is also important to ensure that the objectives and return expectations of the foreign and local partner are appropriately aligned.

Growing optimism

While our survey highlighted the challenges faced by international groups, it also revealed strong optimism about future development. Most respondents expect the market share of foreign insurers to surpass 10% by 2010 and around a quarter believe it will be more than 20%. Most also expect that the market will have become more sophisticated by the end of the decade, including greater professionalism among agents and better awareness among consumers of the value and purpose of risk protection products.

The government also believes that the insurance market is entering a period of important change. ‘Looking to the future, the insurance industry’s development is at the starting point of a new era; the potential and the opportunity are both huge’, said a statement from the State Council. ‘The industry, whose role combines the functions of compensation for economic loss, capital transfers and taking care of society, is the basic method of risk management in a market economy and a key component of the financial and social security systems. It will have an important impact on the process of establishing of a harmonious socialist society.’

Foreign insurers have many advantages stemming from their global scale and multinational experience, and they can add significant value to the Chinese market through the depth of their expertise. However, they may need to sidestep direct competition with dominant local players by developing new and niche markets. They may also need to look beyond conventional routes to market by forming alliances with companies outside more developed economic regions or even the insurance sector altogether. Ultimately, the most successful foreign insurers have and will continue to be the companies that base their strategy on the market’s long-term potential rather than the immediate rewards through the patient development of local understanding, market penetration and all-important relationships with customers, regulators and business partners. □

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