China and India – Opportunities too big to ignore?

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To enter China and India successfully, an overseas insurer must know the markets and carefully consider the options.

Without doubt China and India offer some of the very largest opportunities for insurers worldwide today. However, they are very different both in regulatory environment and in the potential approaches an interested investor might take. A comparison of the two is instructive in deciding on possible market entry strategies.

Where they are similar is in population size. Currently, China is the most populous country in the world, with a total population of 1.27 billion, followed by India with 1.06 billion (mid-1999 figures). By 2045, it is projected that the Indian population will outstrip that of China – 1.501 billion as against 1.496 billion.

Significantly for international insurers, both markets are soon to enter a new phase. This year China will remove some of the regulatory restrictions which have held back foreign-invested companies in the past. In India, new rules on ownership are likely to give multinational insurers greater scope to expand their level of ownership in future.

While non-life companies in China may be wholly foreign-owned, foreign-invested life companies are required to take the form of joint venture operations. India restricts the maximum foreign holding, in companies writing any class of insurance, to 26%.

However, while the rules on ownership may be unattractive, the foreign insurer has, in many cases, effective control of key management positions and hence of company strategy and operation.

Looking at the reality of doing business rather than the regulatory situation, the position is rather different. While the percentage foreign holding in India is half that of China – 26% rather than 50% – product innovation and less restrictive regulation have enabled foreign-invested life companies to achieve a market share of 13%. In contrast, the tight regulatory environment in China, with restrictions on where foreign-owned companies can do business and their exclusion from the group market (recently relaxed), combined with vigorous competition from local companies, has led to foreign companies winning only 1.9% of life business in 2003 (see Figure 1 overleaf).

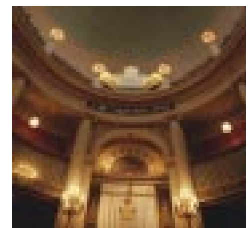
Before considering market entry strategies, it is helpful to take a bird's eye view of the two markets.

Market background – life assurance

In 2003, the Chinese life insurance market totalled US $36bn in premiums – two and a half times the size of the Indian market.

Penetration levels are similar at around 2.3% of GDP. However, there are sharp differences in the make-up of national savings. In India, the proportion of household savings accounted for by life assurance is about 15%, with pension and provident funds taking up a further 19%. This is in sharp contrast to China, where life and pension savings make up only around 5% of retail savings assets, despite the greater size of the market. It is therefore clear that there is a considerably greater potential for transfers of funds from bank deposits to life assurance policies in China than in India (see Figure 2 overleaf).

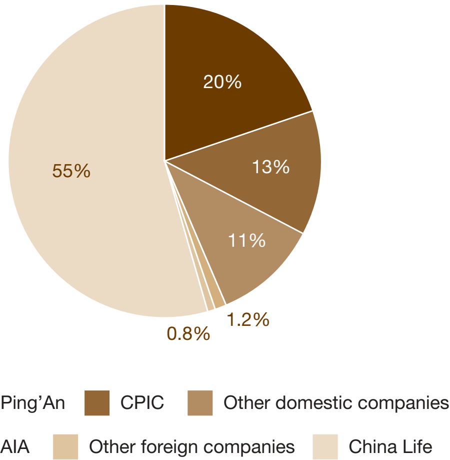
Both markets have seen impressive growth in the last few years. In 2003, the Chinese life assurance market grew by over 30% and in India growth was 18% (2002-03). In the medium term, life assurance premium growth in both countries will increase faster than GDP. In fact, high GDP growth rates, combined with penetration moving towards mature market levels of 4% or more, will ensure double digit premium growth. In the immediate future, growth drivers in China may be stronger, since the population is aging much faster than in India and recent pension reforms lay heavy emphasis on the insurance sector. However, much of the growth of the



Both markets have seen impressive growth in the last few years.

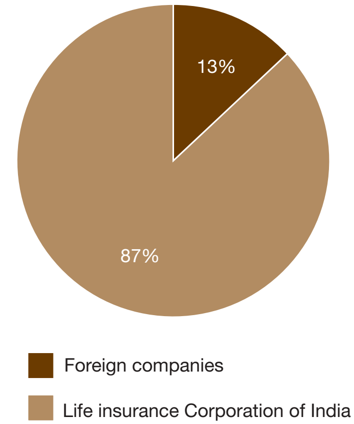
FIGURE 1

Life market share of year 2003 in China



Source: China Insurance Yearbook 2004

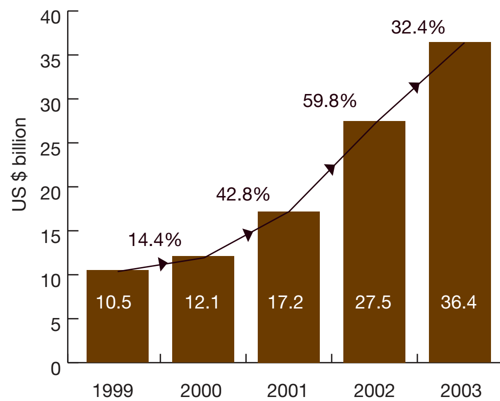
Life market share of year 2003 in India



Source: IRDA Annual Report 2002-03

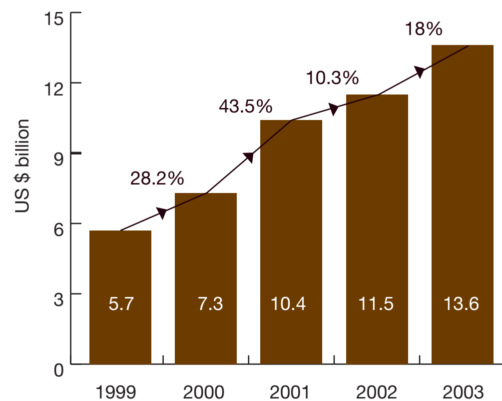
FIGURE 2

Growth of life premium income in China

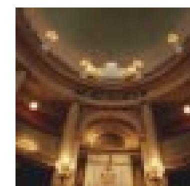


Source: China Insurance Yearbook (2001-2003)

Growth of life premium income in India



Source: IRDA Annual Report 2002-03



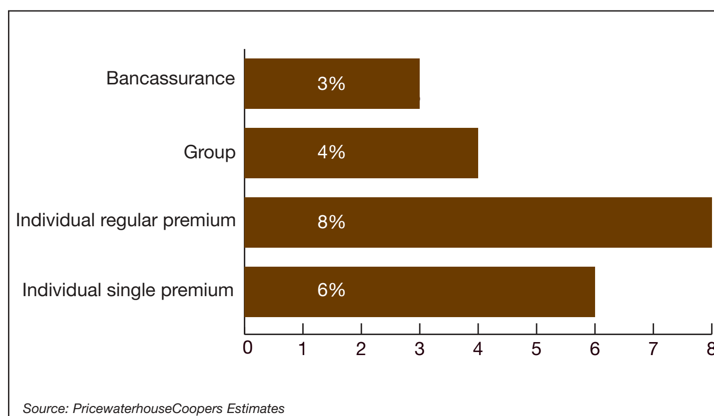
Chinese bancassurance market has been occasioned by the switching of savings from bank deposits to life assurance; a process likely to be dampened by the recent interest rate rise.

While business growth rates have been attractive, margins on bancassurance business in China have been poor. Significantly, management of business mix has been a key factor in the profit performance of the players in this market. Foreign joint ventures have generally had a lower proportion of bancassurance business and no group business, resulting in better gross margins (see Figure 3).

Market background: non-life assurance

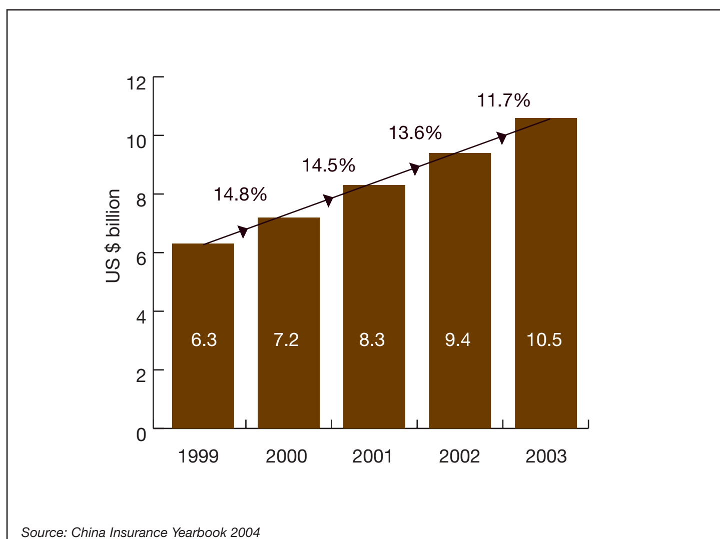
In 2003, China's overall non-life premiums came to US $10.5 billion, dwarfing the Indian market's rather smaller total of US $3.6 billion. The relative sizes of the respective non-life markets are explained by the Chinese economy's greater urbanisation and emphasis on manufacturing. Growth rates are similar – nearly 12% in China and 13% in India – and they are likely to run a little ahead of GDP growth as penetration levels rise from 1% in China and 0.6% in India towards mature market levels of around 2% (see Figure 4).

FIGURE 3 **Profit margins of life insurance products in China**

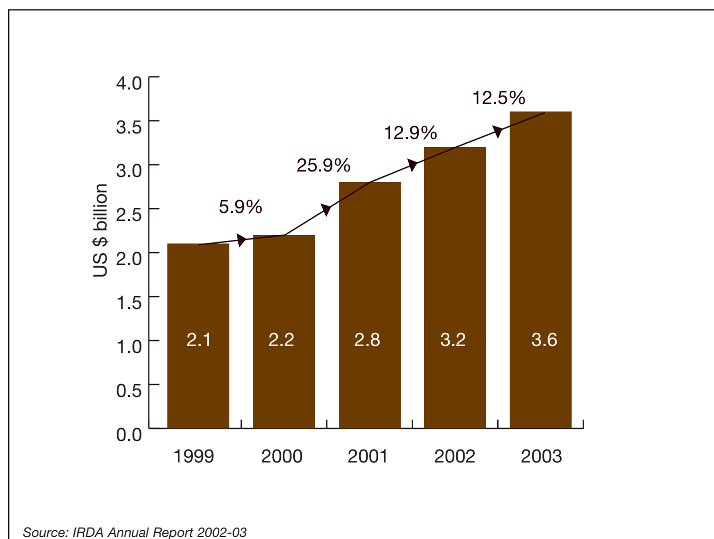


Source: PricewaterhouseCoopers Estimates

FIGURE 4 **Growth of non-life premium income in China** / **Growth of non-life premium income in India**



Source: China Insurance Yearbook 2004



Source: IRDA Annual Report 2002-03

According to published results for the last three years, the Chinese non-life market has been profitable. Although some market segments have relatively low rates, at market level there has been an underwriting profit. In contrast, recent years have seen most Indian non-life companies make underwriting losses – turned into modest profits only by substantial investment returns (see Figure 5).

Regulation has significantly affected market make-up in both countries. The Indian non-life market is divided between five public sector companies and a larger number of new, private sector companies, some of which are joint ventures with foreign insurers. These new companies currently have a combined market share of 14% and, in response to recent poor underwriting conditions, have been more selective as to which risks they will accept.

China has around 11 domestic non-life insurers and 11 foreign companies but, currently, foreign companies' market share is small. Past geographical and product restrictions, not applied to domestic companies, have played a significant part in holding down the foreigners' share. As these restrictions are about to be lifted, the market may now be more attractive to foreign companies. Importantly, though, 60% of the China market is motor business, which is effectively closed to foreign insurers and is expected to remain so (see Figure 6).

While entry to either market is not without challenges and risks for a foreign company, the opportunities are large. With restrictions set to loosen in the life sector in China and ownership rules likely to become more attractive in India next year, more foreign insurers are actively considering these two exciting markets. Over the next few pages, we look at life market entry considerations from the point of view of overseas insurers.

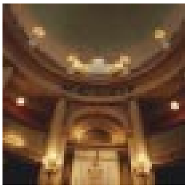
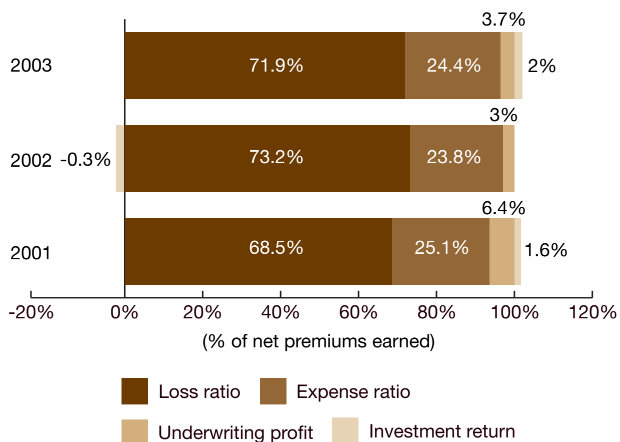


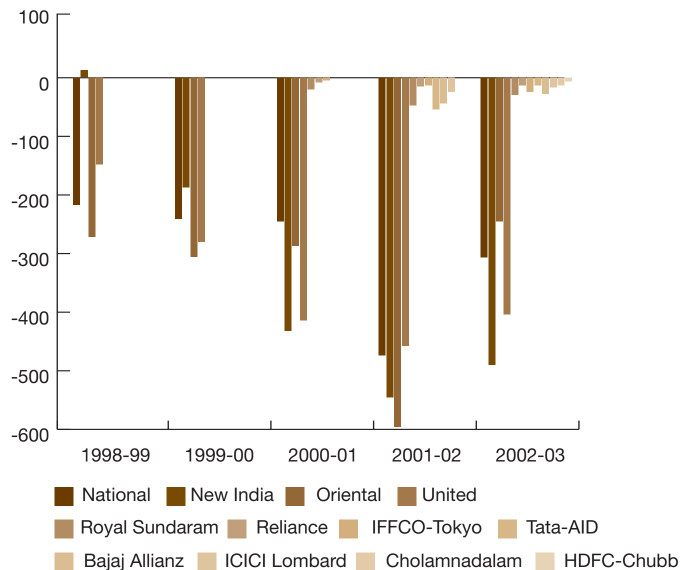
FIGURE 5

Overall profitability of a leading non-life insurer in China



Source: PricewaterhouseCoopers research

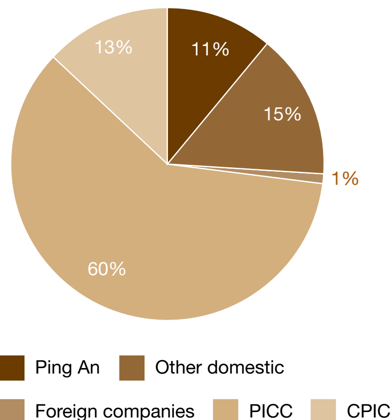
Overall profitability of non-life insurers in India



Source: IRDA Annual Report 2002-03

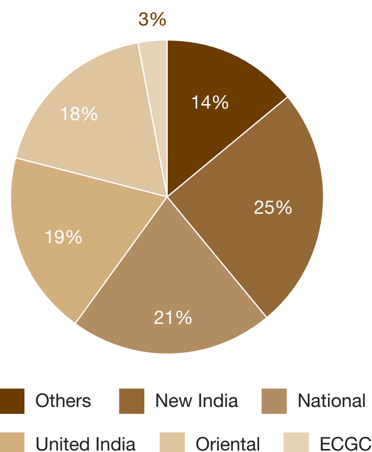
FIGURE 6

Market share of non-life insurer 2004 March in China

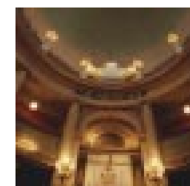


Source: China Insurance Yearbook 2004

Market share of non-life insurer 2004 March in India



Source: IRDA Annual Report 2002-03



Entering the Chinese life insurance market

Entry strategies

Foreign companies cannot operate wholly owned subsidiaries or branches, therefore they must either form a joint venture (JV) or become a strategic investor in a domestic company (with a maximum stake of 24.9%). There are effectively three types of opportunity:

- A joint venture with a Chinese partner;
- A strategic investment in a small or start up domestic insurer; and
- A strategic investment in a large domestic insurer.

To date, most foreign entrants have favoured the joint venture route. A lack of enthusiasm for joint ventures back in head office has generally been offset by the limited alternatives available and the scale of the opportunity. For various reasons, there have been marked differences in the success of joint ventures. Implementation is key.

Most of the restrictions to which joint ventures were subject are in the process of being relaxed. Subject to gaining a license, there is now no practical limitation on the locations in which a joint venture can operate. The inability to transact group business was lifted in December 2004. However, the JV model poses two critical challenges:

- The first is to develop brand recognition and an adequate distribution infrastructure in the face of fierce domestic competition; and
- The second is to keep the Chinese JV partner, whose familiarity with life insurance business is likely to be very limited, comfortable with the growth and capital investment strategy being pursued.

At the moment, strategic investment in one of the smaller, recently-licensed, domestic companies amounts to little more than buying a stake in a license. None of these companies has yet achieved scale and there are several who are still in the set-up phase. Of course, being in at the start of a business offers more opportunity to influence direction than would normally be associated with a minority stake.

It should also offer a faster track to getting into business or gaining regulatory approval for expansion plans. Additionally, this year's recent tranche of new domestic licenses also means that the supply of potential investments has increased, which may exert some downward pressure on the prices being sought for minority stakes.

Making a strategic investment in one of the larger domestic insurers poses stiff challenges. The three major life insurance companies have already either completed deals or are in discussions with potential investors. Global insurers already hold strategic investments in the two medium-sized life companies – Xinhua and Taikang. Buying into an existing operational structure and business strategy offers opportunities, but it also holds risks which are not always easy to identify.

JV partner selection

Some foreign companies who have formed life JVs have experienced conflicts with their Chinese partners. Many complain that their Chinese partner has not delivered operational advantages. Others have found that the new partner's management team lacks the necessary understanding of the long-term perspective needed to write life business and that, as a consequence, financial objectives are not aligned. The partner selection process needs to consider issues such as this very carefully indeed. It is also important not to be dazzled by the names of potential partners but to consider carefully what all potential partners might bring to the joint venture.

In our view, there are several key steps.

Firstly, it's prudent to eliminate industry groups which are generally unattractive to foreign insurers sensitive about their reputations, such as military-related industries or tobacco companies. Secondly, many foreign companies are adverse to stakes in banks or securities companies, and obviously those which already have an insurance JV with a foreign company are ruled out.

Secondly, you need to develop a set of selection criteria suitable for the Chinese market. These might include the usual items such as financial strength, brand position and strength (in China), distribution capability and synergies. These are questions of fact.

Three further criteria are material. The first is the potential JV partner's attitude towards a potential overseas industry investor. In addition, the reputation of the company and its key management personnel is absolutely fundamental. Last, but by no means least, potential investors need to pay close attention to any possible partner's relationship with the government.

Only at this stage should the search for a partner begin. Careful screening against the criteria, using published information but also informal conversations with the potential partners, regulators and others, should be carried out. This will yield a short list with whom more detailed negotiations may be conducted. It is unusual to select a preferred partner until a relatively late stage in the discussions.

Business locations

With the restrictions on business locations having been lifted at the end of 2004, the selection now needs to be a more structured process than before.

For the next five years at least, both growth and market opportunity look likely to remain concentrated in the eastern coastal provinces. The factors below are material to the successful ranking of possible locations.

Growth potential – much of the available data on individual city and provincial markets requires informed analysis.

Target market – foreign insurers who target the affluent market may favour Shanghai and Beijing, whereas those who target the mass market may lean towards Tianjin, Jiangsu, Zhejiang and Guangdong. Accurately estimating the size of the target market in each potential business location is crucial.

Competition – levels of competition vary considerably between cities and the most attractive places to new entrants now will not tend to be the existing hot spots of Beijing, Shanghai and Guangzhou. Those new companies who have blazed a trail in what were seen as secondary cities have been rewarded with significant success, having found the competition for distribution and customers much less intense.

Branding – the level of competition in many areas is such that branding is critical. While, in most developed insurance markets, branding is a national issue, in China, it is local perception of foreign brands which counts and which should play an important part in the selection of business locations. Consumers in some cities are more receptive to foreign brands than are their counterparts elsewhere. For example, there is a big difference in the values with which Shanghai consumers imbue foreign brands and those of other cities.

Profitability

There is significant variation in profitability between market players. Some of those heavily focussed on bancassurance have seen declining margins as the banks have exploited their control over the distribution channel to demand a greater share of the cake. At the same time, the growth in participating business means that, overall, newer business has been inherently less profitable for shareholders than the non-participating business sold in the recent past.

Interestingly, careful management of business mix has enabled some companies, both foreign joint ventures and domestic companies, to do considerably better than the market generally.

Investment environment

The investment options for life insurers remain limited, both in terms of regulatory requirements and the supply of suitable investments. Investments in securities funds, which typically hold 70% in equities, are limited to a maximum of 15% of invested funds. Direct investment in equities is limited to 5% of total assets. Direct investment in property is prohibited. At the time of writing, overseas investment is also prohibited, except to match foreign currency policy liabilities or in other limited circumstances.

In addition, no more than 20% of assets can be invested in corporate bonds. These must be AA rated and relate to Government-sponsored infrastructure projects. (Investment-linked contracts may be wholly backed by bonds or equities.)

The remaining funds effectively have to be invested in Government bonds, bonds issued by financial institutions or bank deposits.

Stock market

China's stock market has a short 13-year history. At the end of 2003, there were 1,287 companies listed domestically (A & B shares) with a total market cap of RMB 4,246 billion. The Chinese government owns the non-tradable portion of the market capitalisation, which is about 70%. The most recent bear market started in mid-2001. After two years of disappointing performance, the domestic stock market finally ended up in positive territory in 2003 (see Figure 7).

Bond market

Compared with more mature capital markets, China's bond market is underdeveloped. As at the end of 2002 it was RMB 2.67 trillion, only about a third of the size of the stock market. Current bond types include treasury bonds, corporate bonds, convertible corporate bonds and policy bonds. These are bonds issued by the China Development and China Import and Export Banks for purposes of generating funds for infrastructure development and international trade. Treasury and policy bonds make up 98% of total bond balances. There are no mortgage or asset-backed securities (see Figure 8).

FIGURE 7 **Stock exchange data 2003**

	Shanghai Stock Exchange	Shenzhen Stock Exchange	Total
Number of companies	783	504	1,287
Market cap (RMB billion)	3,011	1,235	4,246
Tradable market cap (RMB billion)	835	485	1,320

Source: www.research.lipper.wallst.com

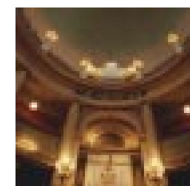
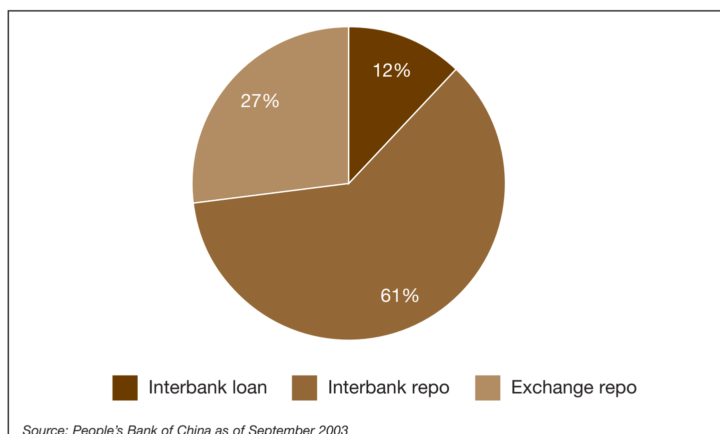


FIGURE 8 **Chinese bond market**

	2002 balance (RMB billion)	2003 issues (RMB billion)	Issue increase
Treasury bonds	1,600.00	628.30	10%
Policy bonds	1,000.00	442.00	44%
Corporate bonds	60.00	40.80	10%
Corporate convertible bonds	8.17	18.10	336%
Total	2,668.17	1,129.20	20%

Source: www.research.lipper.wallst.com

FIGURE 9 **Composition of China's money market**



Source: People's Bank of China as of September 2003

FIGURE 10 **Chinese mutual fund data 2003**

	2002 Number	2003 Newly launched	Total
Closed-end funds	54	–	54
Open-end funds	17	43	60
Total	71	43	114

Source: www.research.lipper.wallst.com

Money market

Current money market instruments include inter-bank loans, government bond repurchase agreements, accounts receivable, central bank bills, policy bills and short-term bonds, of which interbank loans and repos are the biggest proportion. As at September 2003, their total trading volume was RMB 14.22 trillion (see Figure 9).

Funds

The Chinese mutual fund market saw a spectacular increase in 2003 with the launch of 43 new funds bringing the total to 114. As at the end of 2002, the great majority of funds were closed-end but all 43 new funds were open-end – the norm elsewhere. The first five money market funds were successfully launched in December 2003 (see Figure 10).

Regulatory requirements

The reserving treatment to be used for each class of long-term business (annuities, non-annuity business, with-profits business, unit-linked and universal business) is prescribed by the China Insurance Regulatory Commission (CIRC).

The table below summarises the key requirements for long-term life and health products (see Figure 11 overleaf).

Dividend distribution

Dividend distribution must comply with the CIRC's guidance:

- The contribution method must be used to calculate the dividend;
- The dividend may be paid as either a cash or reversionary bonus; and
- No less than 70% of profit must be distributed to policyholders as dividends.

Most companies limit distributions to policyholders to the minimum of 70% and only distribute investment and mortality profits.

FIGURE 11 **Actuarial basis**

	Pricing	Reserving
Interest rate	No more than an equivalent yearly compound rate of 2.5%	No more than the lower of • Valuation interest rate announced by CIRC each year (7.5% currently) • Corresponding pricing interest rate
Mortality/morbidity – non-annuity	• China life insurance experience non-annuity mortality table	• Same as pricing basis
Mortality/morbidity – non-annuity	• China life insurance experience annuity mortality table	• For whole life annuity, the policy reserve is the larger of that resulting from using the following two loadings: • 80% of CL annuity mortality table • 120% of CL annuity mortality table

Source: www.research.lipper.wallst.com

FIGURE 12 **Life business solvency margin**

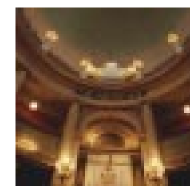
Long-term products	Reserve component	Net amount at risk component
Insurance products	4% of reserves	
Investment-related products	1% of reserves	
• Coverage period: less than three years		0.10% of NAR
• Coverage period: three-five years		0.15% of NAR
• Coverage period: over five years		0.30% of NAR

Short-term business

The following reserves must be established:

- An Outstanding Claims Reserve (in respect of claims reported but not paid) is deemed equal to the estimated losses on claims outstanding as at the balance sheet date;
- IBNR is accrued at 4% of claims expenses incurred in the period; and
- An Unearned Premium Reserve, i.e. a reserve equal to an amount of net premium written in any year but not yet earned.

Source: www.research.lipper.wallst.com



Solvency margin

The minimum solvency margin requirement is calculated by applying a percentage to a proxy for exposure to risk (see Figure 12).

In addition, there is an Insurance Security Fund which is accrued at 1% of retained premium income for those policies with terms of one year to a maximum of 6% of total assets. While currently held as part of the insurer's assets, we understand that the regulators are considering setting up a formal centralised insolvency fund (see Figure 12).

Financial reporting and taxation

Financial reporting

Insurers doing business in China must prepare financial statements in accordance with PRC GAAP. This specifies the accounting treatment for the recognition and disclosure of premium income, claims and benefits as well as for the determination of reserves. The statements must be filed with CIRC. They also have to report specifically on participating insurance business, solvency position, other regulatory indicators and other operational and actuarial issues.

Taxation

Insurance companies operating in China are subject to both corporate income tax and business tax. An insurer's eligibility for taxes and the rates paid varies by type of company and also by the economic zone in which it is licensed to operate. Certain insurance products are eligible for business tax exemption (subject to the approval of the State Administration of Taxation). A major review of insurance tax is scheduled for 2006, although no details of its likely scope are yet available.

Key income tax provisions include:

- Domestic insurers pay national income tax on taxable income at 30%. In addition, they also pay local income tax at 3%;
- Foreign Invested Enterprises (FIEs) which have registered or operational capital of more than US $10 million and a ten-year-plus business plan, pay income tax at a rate of 15%. In addition:
  - – No tax is payable in the first year of profit;
  - – For the second and third profitable years of operation, tax is payable at 7.5%;
  - – If the profit is used to increase the registered capital, or for other investment purposes, and the company has been in operation for more than five years, 40% of tax paid can be refunded; and
  - – The tax rates and rules for FIEs above are only applicable if they have more than 25% overseas investment.

Key Business Tax provisions include:

- Business tax is payable at 5%.
- Subject to approval by the State Administration of Taxation, the following items are exempted from business tax – with-profits policies with terms of one year or more, annuity business, health insurance policies with terms of one year or more, agricultural insurance and export credit business.

Entering the Indian life insurance market

As in China, foreign insurers doing business in India cannot operate wholly-owned subsidiaries or branches. In order to be granted a licence to write life business, a foreign company cannot hold (either directly or indirectly) more than 26% of the paid-up capital.

Until 1999, all the life business had been written by a public sector company called Life Insurance Corporation of India (LIC). Currently, there are 13 private companies which hold around 15% of the life insurance market share. A joint venture, green field operation is the only realistic entry strategy.

The general issues which need consideration in selecting a joint venture partner and developing business strategy are similar to those encountered in China.

Regulatory requirements

Insurance companies doing business in India are primarily regulated by the 'Insurance Development and Regulatory Authority' (IRDA). There are separate regulators for other industries in the financial services sector.

New life companies must pay a deposit of 1% of forecast gross premiums – subject to a minimum of INR 1 million (equiv. US $22,000) – and have at least INR 1 billion (equiv. US $22 million) share capital (after deducting preliminary expenses incurred towards incorporation). Companies must usually start writing business within 12 months of being granted a certificate of approval. Business licenses are renewable annually and must be applied for, and the necessary fees paid, before December 31.

A license to issue policies usually allows the company to write all classes of life business and to operate across the country. New insurance companies must adhere to rural and social sector obligations by ensuring that a certain amount of policies are sold in, and a certain level of premium generated from rural and socially backward areas. This part of business is mostly unprofitable.

Investment policy

The IRDA (Investments) Regulations 2000, as amended from time to time, specify the type and amount of permitted investments and also the reporting formats. Approved investments are government securities, approved securities, and approved investments (usually infrastructure or social investments).

Stock market

Around 800 companies from all sectors are listed on the National Stock Exchange (NSE). Current market capitalisation is US $220 billion but significant growth – at a rate of 15.4% per annum – is expected until 2009, which is likely to see the market top US $450 billion. NSE lists securities in both its Capital Market (Equities) and Wholesale Debt Market segments.

Smaller, but still significant, is the Mumbai exchange, called the 'Bombay Stock Exchange' (BSE).

Solvency requirements

The rules for the valuation of assets, norms for the valuation of liabilities and the methodology for the calculation of solvency margins are primarily contained in the IRDA (Assets, Liabilities and Solvency Margins of Insurers) Regulations, 2000. Separate formats (as defined in the Regulations) need to be prepared and submitted for assets, liabilities and solvency margins in respect of the insurer's total business and the business in India. All the formats need to be signed and verified by the insurer's appointed actuary.

The Gross Premium Method is recommended for calculating mathematical reserves. In respect of linked business, the regulations provide for the separate valuation of unit and general fund reserves. Whatever the method used, it must take into account all prospective contingencies (under which premiums are paid by the policyholders and any benefits payable to them, as determined by policy conditions). Liabilities must be valued on a policy by policy basis.

In the case of any policy where the mathematical reserves are negative, the company actuary must set the value of any reserve to nil for the purpose of calculating the solvency margin and also for computing the surplus available for dividend distribution (Section 49).

Actuarial assumptions are based on the insurer's own experience and generally include an appropriate Margin for Adverse Deviation.

The Solvency regulations require all insurers to maintain assets of at least US $11 million (US $22 million for reinsurers) in excess of liabilities or an equivalent sum calculated using a formula given in the regulations. Insurers are required to maintain a solvency ratio of 1.5 times the statutory requirement.

Reinsurance

Government policy on reinsurance aims to maximise retention within the country, develop adequate domestic capacity, secure best possible protection for the costs incurred and simplify the administration required, and so there are specific rules on retention of risk, cession, reinsurance and retrocession.

Every insurer is required to submit its reinsurance program for the forthcoming financial year to IRDA at least 45 days in advance of the start of that year. Subject to prudent practice, insurers must maximise their retention. IRDA can require an insurer to justify its retention policy and demonstrate that it is not fronting for a foreign insurer.

At present, the only reinsurer in the country is General Insurance Corporation of India, to whom 20% of the non-life reinsurance premiums are mandatorily ceded.

Financial reporting and taxation

Financial reporting

The rules on financial accounting and reporting are prescribed under the IRDA (Preparation of Financial Statements and Auditor's Report on Insurance Companies) Regulations, 2002, and Section 11 of the Insurance Act, 1938.

Separate records are required in respect of life, pensions and unit-linked business. Similarly, separate records must be held on policyholders' and shareholders' funds and business written inside and outside India.

Section 11 of the above Act requires insurers to submit a balance sheet, profit and loss account and revenue account for each year of business. The Regulations specify the required format. The financial statements must be signed by the Chairman (if any), by two directors and by the Principal Officer. Audited accounts must be submitted to IRDA within six months of the end of the period to which they relate.

Taxation

Insurers are liable to both Service and Corporate Tax. Service Tax rates have recently increased from 8% to 10%. In addition, service tax has just been levied on the risk element of life policies. Education cess (a levy towards ensuring development of education in the country) of 2% on all taxes is levied, which implies that the services on insurance would attract an additional 2% on the tax amount. A flat rate of 10.2% is levied on premium received for non-life policies. Furthermore, the life insurance premiums are also subject to the levy of service tax on the portion which can be fully attributed towards insuring mortality risks.

The Life Insurance Corporation of India (LIC) is the only life company actually declaring profits and therefore currently paying corporate tax.

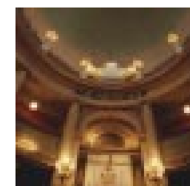
Until now, there are no insurance company-specific taxation arrangements, although recommendations by a review committee on this issue have been given to the Government. New rules are expected in the near future.

Conclusion

The Chinese and Indian life insurance markets are expected to see double digit rates of growth in the medium term.

To capitalise on this, potential entrants need to consider their entry strategy very carefully. They need to:

- Aim for a corporate structure that aligns with their business philosophy. Areas that need particular attention are management control and the ability to use their relative



advantages such as underwriting expertise and ease of exit;

- Adopt a thorough and structured approach to identifying a short list of eligible potential JV partners, taking specific market conditions into account. Preliminary due diligence is essential before any memorandum of understanding is signed;
- Understand the implications of the financial reporting and taxation requirements;
- Thoroughly understand the investment environment in which life companies must operate and take this into account in their business planning;
- Select potential business locations very carefully, taking into consideration overall growth potential, size of target market and especially national and local brand perceptions; and
- Consciously seek to differentiate themselves from local companies (who have a dominant market share) by using focussed distribution methods and differentiated product designs. □

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