China: On its Way Towards a Risk-based Insurance Solvency Regime

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Since China reopened its insurance markets in the 1980s, the Asian giant has become one of the fastest growing insurance markets in the world, with the nominal annual premium growth rate of the property and casualty (P&C) sector in the past 10 years reaching about 22%. According to industry figures, China's premium volume of US$126bn ranked it as the third largest P&C market worldwide in 2013, only marginally behind Germany's US$133bn (the US remains a distant leader with a P&C premium volume of US$726bn

As part of the Chinese government's efforts to further liberalise the country's economic and financial systems, the China Insurance Regulatory Commission (CIRC) has introduced, in recent years, a series of reform measures.

Firstly, CIRC eased net assets and solvency requirements for insurance companies to raise capital through subordinate-debt. Secondly, CIRC encouraged private capital to participate in the China (re)insurance industry, especially in the P&C sector, by making provisions facilitating qualified private-owned (re)insurance companies to raise capital via diversified channels including listings, bond issuance and other supplementary instruments. Thirdly, it expanded the permitted scope of (re)insurers' investment activities, allowing them to move into new types of investments, government bond futures for example, to boost returns and increase portfolio diversification. (Re)insurers that meet certain capitalisation and solvency criteria may also extend their investment interests into areas such as real estate, the equities of non-listed companies and private equity.

Lastly, deregulation reforms in the motor insurance industry now allow insurers autonomy in determining commercial auto insurance rates. Foreign insurers are also now able to operate in the area of compulsory motor business.

These developments bode positively for China's (re)insurance industry. Yet, for the industry to flourish healthily, it is imperative that the regulatory environment also evolve. More discipline will need to be imposed on market participants while encouraging greater self-regulation and responsible use of these new degrees of freedom. The efficiency of capital allocation in the industry also needs to be improved.

These are areas which are among CIRC's priorities to enhance and modernise the country's insurance regulatory regime. In May 2013, it unveiled a conceptual framework of a new solvency system, the 'China Risk Oriented Solvency System' (C-ROSS), which seeks to ensure that companies maintain capital levels that commensurate with their specific risks. The system is anchored on three pillars: quantitative capital requirements, qualitative regulatory requirements and market discipline mechanisms.

A shift from scale/size-oriented to risk-oriented

Currently, the approach to ascertaining the solvency ratio of a P&C (re)insurer in China is quite similar to that of Solvency I, the existing regime in the European Union (EU). That is, it is calculated by dividing actual capital by minimum capital, where the minimum capital is the greater amount of two different calculations; one, based on an (re)insurer's premium in the last year, and the other, based on the average of its incurred claims in the preceding three years. Using this formula to derive the solvency ratio gives a measure of capital adequacy, but does not take into account the risk profiles of different businesses.

The C-ROSS, which was some 10 years in the making, will, among other requirements, expect companies to use a standard formula, rather than internal models, that takes into account national and local market conditions, their specific risk needs and standards that are consistent with international practice.

Expected to be fully introduced in 2015, C-ROSS will require the valuation of assets and liabilities to reflect the (re)insurer's actual risk profiles and their variations promptly and appropriately. Capital requirements will also need to reflect, comprehensively and accurately, various underlying risks. In addition, supervisory measures are expected to be implemented to ensure the effectiveness and responsiveness of related risk management measures, including expectations for companies to establish an internal solvency management mechanism to actively identify and prevent various risks, and to respond promptly to changing risks.

The essentials of China's new solvency system: Three Pillar Framework

CIRC's three pillar approach in its C-ROSS is in line with the Insurance Core Principles published by the International Association of Insurance Supervisors (IAIS) in October 2011. The three pillars are also closely aligned with the proposed structure of the EU's Solvency II and focus on the following three areas:

- Pillar one on Quantitative Capital Requirements targets primarily capital adequacy for three types of underlying risks - insurance, market and credit risks - by proactively identifying and quantifying each accordingly. Additional capital will also be required of certain institutions that are earmarked as systemically important for the country's economy.

- Pillar two on Qualitative Regulatory Requirements is a key complement to pillar one's focus on quantitative risk measurements. Pillar two attends to risks that are difficult to quantify at this stage, such as operational risks, strategic risks, reputational risks and liquidity risks. Companies' own risk and solvency assessments will play an important role in managing these qualitative risks, but CIRC will set up minimum standards of risk management for (re)insurers to evaluate their practices periodically.

- Pillar three on Market Discipline Mechanism enforces oversight of (re)insurance companies by the media, rating agencies, financial analysts and the general public by requiring insurers to meet information disclosure expectations. It will also facilitate and utilise the market's self-regulation power to augment insurers' overall risk management capabilities and market discipline.

Anticipated impact on China's insurance market

Once C-Ross is implemented, it is estimated that about US$6.4bn of capital could be freed up from China's P&C sector. Capital requirements for some lines of business, especially those vulnerable to natural catastrophes such as property, engineering and agriculture, will increase, and this is expected to guide insurers towards a lower risk product mix. On the other hand, a reduction of capital required for other lines of business such as the motor line, which accounted for more than 70% of the P&C sector in 2013, will contribute towards the improvement of the solvency margin of the entire industry sector.

The differentiated minimum capital requirements for different lines of business are expected to result in smarter and more targeted reinsurance purchase by direct insurers, especially as an effective risk transfer solution for the lines prone to natural catastrophes. That said, the lowered capital requirement for the motor business, which forms a majority proportion of the P&C sector, could lead to a general rise in the amount of motor risk business that insurers retain in their own balance sheets. This, in turn, will likely reduce insurers' demand for reinsurance as a means of solvency relief.

Furthermore, under C-ROSS, big market players with strong brands, technical know-how and strength in risk management will likely have a competitive advantage. (Re)insurers that wish to further differentiate themselves from competitors will also be able to provide more risk-based pricing, an option quite similar to the EU's Solvency II regime. Additionally, we will likely see capital management working closely with corporate risk management, which is advantageous in optimising capital allocation. Finally, C-ROSS will also encourage (re)insurance companies towards a more cautious investment strategy, given that different risk charges will be applied on different types of investments, depending on their volatility characteristics.

Conclusion

The impending implementation of the C-ROSS is being met with optimism by the international (re)insurance community as it will bring China's insurance solvency regime more in line with international standards and practices. It is widely believed that the new solvency system, with its refined risk classification and accurate measurement of various risks, will significantly improve (re)insurers' sensitivity and responsiveness to underlying risks while effectively augmenting the industry's capital efficiency. It is also hoped that C-ROSS will curb any irrational competitive behaviour in the market and promote the cultivation of a fair competitive market environment. Ultimately, C-ROSS is expected to enhance the sustainability of China's (re)insurance industry as a whole in the long term.

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China’s development of a new solvency system will meet not only its local market needs, but can also serve to provide an invaluable learning experience for other emerging markets in Asia as well as the international (re)insurance community in their pursuit of a robust (re)insurance industry to support the sustainability of their wider economies. As one of the biggest and fastest growing (re)insurance markets in the world, the success of C-ROSS and China’s (re)insurance industry will be integral in helping to shape, stabilise and sustain the country’s economic development, and along with it, play a critical role in the country’s influence on the future of the international economy.

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