The Development and Regulation of China's Insurance Market: History and Perspectives

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Sharon Tennyson
Cornell University

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PERSPECTIVES

The Development and Regulation of China's Insurance Market: History and Perspectives

Bingzheng Chen
Sharon Tennyson
Maoqi Wang
Haizhen Zhou

Abstract

China's private insurance market has been developing rapidly since the 1980s. Regulation of the market has developed in tandem with its growth. This article provides a systematic overview of China's insurance regulatory system and the evolving process of insurance supervision and regulation. The nature and direction of regulatory changes are evaluated in light of theories of public reform and the special character of China among developing economies.

Introduction

Although China's modern commercial insurance market has a history of over 200 years, due to the socialist planned economy the domestic insurance industry was effectively closed from 1958 through 1979. On November 19, 1979, the People's Bank of China held the National Insurance Working Conference in Beijing and made the decision to reestablish the domestic insurance business. From 1980 onward, China's insurance industry has developed rapidly, becoming one of the fastest growing industries in the economic system and one whose importance continues to rise. Nominal premium income has grown at an average rate of over 30 percent per year, and China's insurance market now ranks as the sixth largest in the world.[1]

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Bingzheng Chen is a Professor in the Department of Finance, School of Economics and Management, Tsinghua University, Beijing, China. Sharon Tennyson is a Professor in the Department of Policy Analysis and Management, Cornell University, Ithaca, NY 14853; phone: (607) 255-2619; e-mail: sharon.tennyson@cornell.edu. Maoqi Wang is a Ph.D candidate in the Department of Finance, School of Economics and Management, Tsinghua University, Beijing, China. Haizhen Zhou is an Associate Professor, School of Finance, Zhejiang University of Finance & Economics.
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[1] Insurance premium growth calculated from *China's Insurance Yearbook*. The ranking of China's insurance market is measured by total premiums in U.S. dollars obtained from SwissRe Sigma (2012.02). That report ranked China sixth in the world, after the United States, Japan, Great Britain, France, and Germany, in 2011.

Concomitant with the development of the private insurance industry, China had to develop a modern insurance regulatory system. In 1995, the promulgation of the Insurance Law of People's Republic of China (the Insurance Law) marked a critical step in the standardization of China's insurance regulation. To implement the Insurance Law, the People's Bank of China established an Insurance Division responsible for the supervision of domestic insurance companies. In 1998, insurance regulation was separated from banking and securities regulation through establishment of the China Insurance Regulatory Commission (CIRC). This marked the beginning of a comprehensive insurance regulatory system in the country.

This insurance regulatory system is still young and evolving. As the insurance market has matured, new regulatory issues have emerged and created the need for regulatory changes. Prior to 1995, the regulatory emphasis was on market behavior, with solvency supervision receiving little emphasis. With China's entry into the World Trade Organization (WTO) and the opening of the insurance market to foreign capital in 2000, solvency regulation began to be the core focus of regulatory oversight. The modification of the Insurance Law in 2009 strengthened information disclosures, standardized contracts and procedures, and expanded the rights of consumers in order to increase the transparency of insurance transactions and enhance market functioning.

Regulatory philosophy has evolved as well. Until recently, the role of China's insurance regulators was seen to be primarily the promotion and development of the domestic insurance industry. As problems associated with the rapid development of insurance markets have become apparent, regulatory focus has changed to that of creating a fair and orderly market environment. This change is evidenced by the remarks of Mr. Wu Dingfu—the chairman of the CIRC—in 2010, who stated that "the regulators used to be the coaches of the industry, who are concerned with building the market; but in the new era, insurance regulators should act more like judges, whose efforts should change from market construction to market supervision."[2] In keeping with this evolution, the 2009 modification to the Insurance Law and recent department rules issued by the CIRC focus on improving supervision of both solvency and market conduct. Increasingly, it is recognized that prudential supervision and consumer protections work together to maintain confidence in insurance markets and to promote the healthy development of the industry.

This article provides an account of China's insurance market development, with special emphasis on developments in insurance law, regulation, and supervision over the past decade. The current insurance market situation and problems are discussed, and the outlook for market development and regulation in China is also considered. The next section of the article describes the development of China's insurance market, and following that "China's Insurance Regulatory System" describes China's insurance regulatory system. The evolution of insurance regulation in recent years is discussed in the section "Evolution of Insurance Regulation and Supervision," and the final section provides the authors' perspectives on insurance regulation in China.

[2] An interview of Mr. Wu Dingfu, Chairman of the CIRC. *"China Finance,"* 2010.06.

CHINA'S INSURANCE MARKET[3]

Market Size and Development

The private insurance market in China encompasses life insurance and property–liability insurance, with private health insurance and short-term casualty insurance counted among the life insurance sector. Initially, the private market was dominated by property insurance for business enterprises (Sun et al., 2007). Over time, life insurance markets have developed, and by 2010 the life insurance market was nearly three times as large as the property insurance market. Auto insurance contributed 77.12 percent of the total property–liability insurance premiums in 2010. In the life insurance market, participating life insurance is the most popular, contributing over 80 percent of premiums in 2010. Private health insurance is a relatively small portion of the insurance market, contributing only about 5 percent of life insurance premiums.[4]

The Chinese government also provides a range of social insurance protections that are separate from the private insurance market. Social insurance consists of five parts: *Basic Old-Age Insurance*, *Basic Medical Insurance*, *Occupational Injury Insurance*, *Unemployment Insurance*, and *Maternity Insurance*. These social insurance programs are considered an important part of employees' compensation and provide basic protections for the Chinese people.[5] Social insurance covers a broad spectrum of the population, reaching over 1.1 billion people in 2010. The income of the social insurance fund in 2010 was 1.88 trillion yuan, and compensation paid out was 1.48 trillion yuan.[6]

In comparison, the private insurance sector was initially much smaller but by 2010 was similar in size to the social insurance sector. Figure 1 displays annual premium revenue of the insurance industry from 1980 to 2010, along with annual insurance premium growth rates and GDP growth rates over the same period. As displayed in the figure, nominal insurance premiums increased from 460 million yuan in 1980 to 1.45 trillion yuan in 2010, an average annual premium growth rate of over 30 percent, compared to a nominal GDP growth rate of 16 percent.

Measures of insurance market maturity have grown along with the rapid growth in the market. As depicted in Figure 2, China's insurance density, measured as insurance premiums per capita, rose from less than 1 yuan in 1980 to over 1,000 yuan ($158.50 in U.S. dollars) in 2010. Insurance penetration, measured as premiums relative to GDP, increased from 0.1 percent in 1980 to 3.65 percent in 2010.

Nonetheless, China's insurance market is far from mature when compared to other countries. China's insurance penetration and insurance density relative to other world

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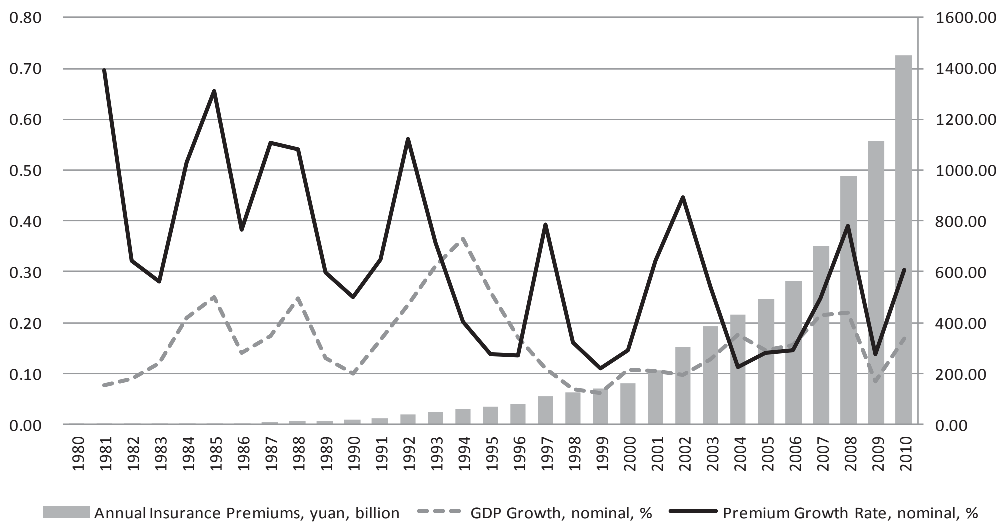
[3] We provide only a brief overview of China's insurance market development for background purposes; see Sun et al. (2007) for a more detailed discussion of the development and structure of the insurance industry.

[4] Data are from *China's Insurance Yearbook 2011*.

[5] There is also a Public Reserve Fund for Housing. The five components of the social insurance program and the housing reserve fund are together described as the "Five Insurances and One Fund" and constitute the social safety net provided to workers.

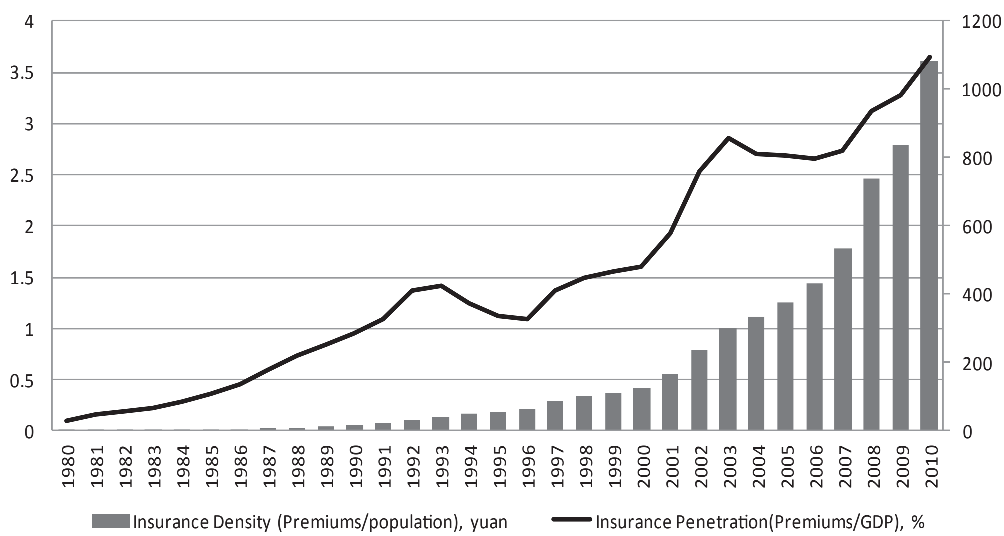
[6] Data on social insurance are from the Statistical Bulletin of human resources and social security development (2010); see http://www.molss.gov.cn/gb/zwxx/2011-05/24/content_391125.htm.

FIGURE 1
Size (Billions of Yuan) and Growth Rate of China's Insurance Market



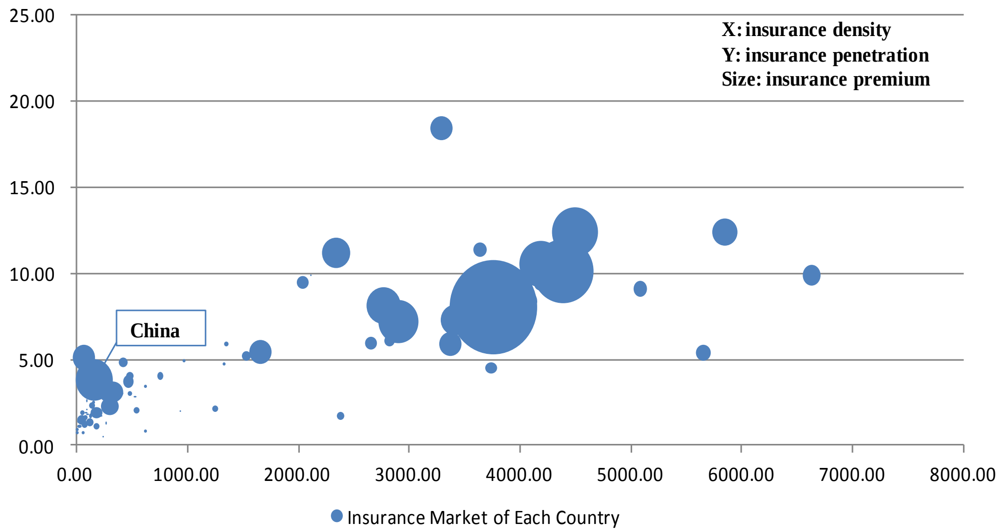
Source: Authors' calculations based on *China Insurance Yearbook* and *China Statistical Yearbook*.

FIGURE 2
China's Insurance Density and Penetration Over Time



Source: Authors' calculations based on *China Insurance Yearbook* and *China Statistical Yearbook*.

FIGURE 3
China's Insurance Density and Penetration Relative to Other Countries, 2010



Source: Authors' calculations based on World Insurance in 2010, Swiss Re Sigma, 2011(2).

economies is displayed in Figure 3. The figure shows that measures of insurance density and insurance penetration are far below worldwide averages ($627.30 for insurance density and 6.90 percent for insurance penetration in 2010, respectively). China ranked 61st in insurance density and 39th in insurance penetration among world economies in 2010.

Insurance Market Structure

The number of insurance sellers in China has increased along with the size of the private insurance market. In 1980, the market was served only by the People's Insurance Company of China (PICC), which was directly controlled by the government (Sun et al., 2007). In 1996, only 21 insurance firms operated in the market. By 2010, 126 insurance firms were doing business in China. Table 1 reports the number of insurance companies, subsidiaries and branch offices, and the Herfindahl–Hirschman Index (HHI) of competitiveness for life and nonlife insurance for selected years. The data show that the competitiveness of the market has increased with the growing numbers of market players. Nonetheless, the markets remain relatively concentrated. In 2010, the nonlife insurance HHI was 1850 and the HHI for life insurance was 1800. To provide a benchmark, U.S. Department of Justice merger guidelines categorize markets with HHI greater than 1800 as "concentrated" (DOJ/FTC, 1997).

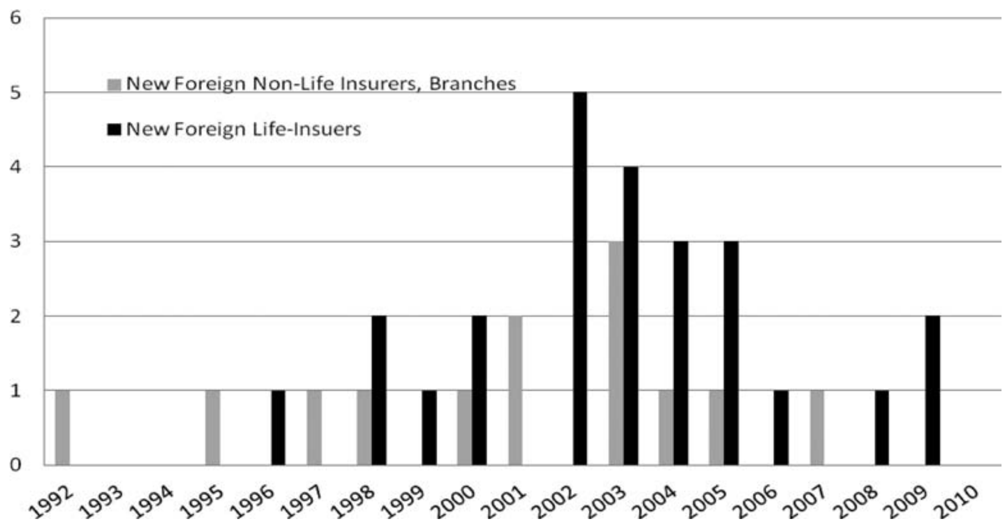
Some of the growth in number of firms is due to the entry of foreign insurers into China. As part of China's entry into the WTO in 2001, China's insurance market was among the very first industries opened to foreign investors. Figure 4 shows the entry of foreign insurers in each year 1992–2010. Foreign entry accelerated after 2001, especially the entry

TABLE 1
Concentration in China's Life and Nonlife Insurance Markets

Year	Insurance Companies	Provincial Subsidiaries	Branches	HHI of China's Nonlife Insurance Market	HHI of China's Life Insurance Market
2001	36	–	–	5,700	4,150
2004	60	–	–	3,900	3,200
2007	102	941	57,191	2,400	2,400
2010	126	1,294	68,061	1,850	1,800

Source: Authors' calculations based on *China Insurance Yearbooks* for selected years.

FIGURE 4
Entry of Foreign Insurers Into China's Life and Nonlife Insurance Markets

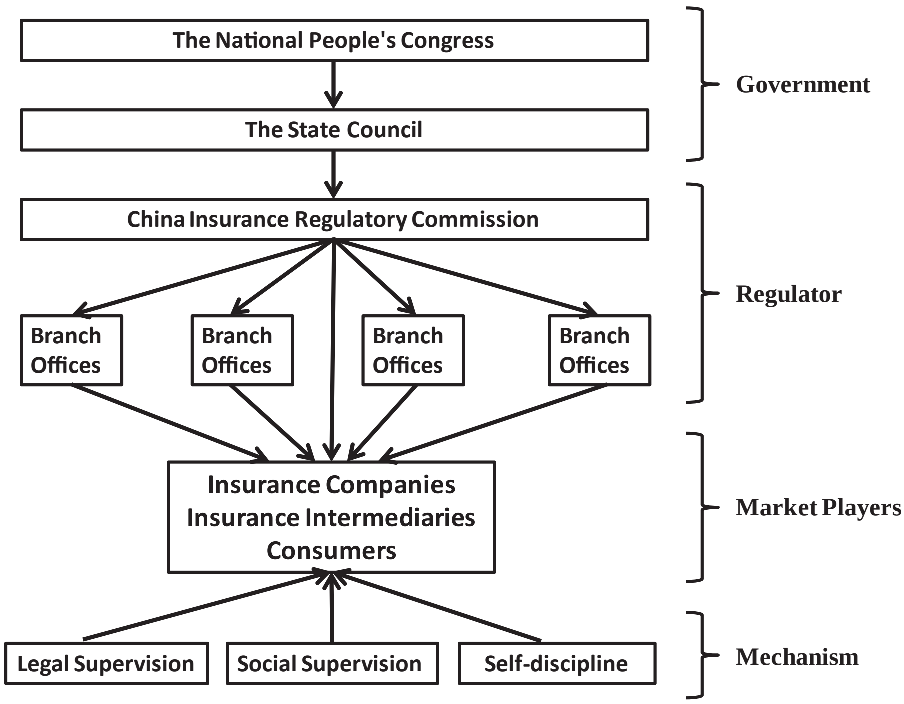


Source: Authors' calculations based on *China Insurance Yearbook* and companies' websites.

of life insurers. Overall, entry of foreign life insurers has been more robust than that of nonlife insurers.[7]

[7] This may be due to the greater differences in China's regulation of foreign and domestic nonlife insurers as compared to regulations for foreign and domestic life insurers. For example, until 2004 foreign nonlife insurers were forced to operate as branches rather than subsidiaries (Zhao, 2009), and foreign insurers are still excluded from offering compulsory insurances such as automobile liability coverage (Huang and Query, 2007). Nonetheless, China's regulations are more restrictive for foreign insurers than for domestic insurers, even in life insurance. This difference may be an important determining factor in insurance market structure, competition, and efficiency (Zhao, 2009).

FIGURE 5
The Structure of China's Insurance Regulatory System



Source: Authors' construction.

CHINA'S INSURANCE REGULATORY SYSTEM

As discussed by Zheng (2011), insurance regulation in China is governed by laws (the Insurance Law and other laws) passed by the National People's Congress (NPC), administrative regulations developed by the State Council, and department rules issued by the CIRC.[8] Industry self-regulation occurs through an insurance industry association, and less formally, legal supervision occurs through the actions of the courts, and social supervision through the media and private citizens. Figure 5 displays the relationships between regulatory governance structures, and the important functions of the regulatory institutions are described below.

The NPC and the Insurance Law

As defined in China's Constitution, the NPC is the most powerful authority in the country: it determines national priorities, names the leaders of governmental institutions, and passes laws. The Insurance Law,[9] the first law put into place regarding the operation

[8] In addition, international treaties such as the WTO and judicial interpretations of laws affect the industry's regulatory and operating environment.

[9] In addition to the Insurance Law, some provisions in China's Maritime Law and Criminal Law relate to insurance. Apart from specific legislation, the insurance business and insurance

TABLE 2
The Insurance Law and Its Modifications

	First Edition	First Modification	Second Modification
Time of modification	June 1995	October 2002	February 2009
Time of coming into effect	October 1995	October 2002	October 2009
Chapters and provisions	8 chapters, 152 provisions	8 chapters, 158 provisions	8 chapters, 187 provisions
Provisions modified		33	145
Provisions added		6	48
Provisions deleted or merged		2	19

Source: Insurance Law chapters, tabulated by author.

and supervision of insurance markets, was approved and implemented in 1995. With 152 articles in 8 chapters, this law provided detailed and systematic rules for insurance contracts, insurance companies, insurance activities, and insurance supervision in China.

Table 2 chronicles the development of the Insurance Law over time. In 2002, the NPC approved the first modification of the Insurance Law. Modifications were aimed primarily at fulfilling China's commitment of opening its insurance market upon joining the WTO. Almost immediately (beginning in October 2004), work began on developing yet more substantial revisions to the Insurance Law. This second modification expanded the number of provisions in the law from 158 to 187, and revised or replaced nearly every provision in the earlier law. This new Insurance Law came into effect in October 2009, and is more complete on important facets of industry oversight such as legal standards in the insurance contract, institutional arrangements among insurance market participants, and insurance supervision. Notably, the new law increases the CIRC's enforcement and supervisory authority.

The State Council

The State Council is the representative of NPC and performs the executive functions of government. Administrative regulations are developed by the State Council as authorized by the constitution and laws of the Republic. The State Council delegates active regulatory oversight to the specific regulatory departments of each sector of the economy. As a result, the CIRC performs most of the active regulation of the insurance sector, and NPC administrative regulations are established only for large issues or issues that affect more than just the insurance sector. Examples include regulations regarding foreign insurers (Foreign Insurance Administrative Regulation, 2001) and regulations regarding

supervision are also regulated by other related legal norms. For example, as in many other countries, contract law can be applied to regulate the insurance contract and corporate law can put constraints on insurance companies. Laws regarding government administrative review, administrative penalty, or administrative licensing apply to the activities of insurance supervisors.

liability for motor vehicle accidents (Administrative Regulation on Compulsory Motor Vehicle Accident Liability Insurance, 2006).

The CIRC

The CIRC is the primary regulator of private insurance in China, conducting direct supervision of the insurance industry according to the authority granted to it by the State Council. The CIRC is considered to be a functional department of the State Council. All functional departments of the State Council, including the CIRC, have independent rule-making authority and CIRC has been very active in rule making.[10] While administrative regulations of the State Council take legal precedence over department rules, CIRC usually works in cooperation with the State Council to develop those regulations. For example, CIRC worked with the State Council on the administrative regulations regarding foreign insurance companies and motor vehicle insurance regulations that were mentioned above.

CIRC shoulders much of the insurance regulatory duties and its regulatory independence and impact have increased over time. The regulatory responsibilities of CIRC are broadly defined and are comparable to those of insurance regulators in many countries. Table 3 compares CIRC responsibilities[11] with those of insurance regulators in 78 countries who reported information to the Insurance Laws Database of International Association of Insurance Supervisors (IAIS) in 2009; the comparison shows that CIRC performs the usual set of regulatory functions.

Consistent with its independence and broad authority, CIRC has been active in rule making since its establishment. Figure 6 shows CIRC rule-making activity by year for 2002–2010; during that period CIRC promulgated 56 rules covering wide-ranging aspects of insurance operations.

Within the CIRC itself there are currently 16 operational departments, which can be divided into market regulatory departments (Life Insurance Department, P&C Insurance Department, Insurance Intermediary Department, etc.) and functional departments (Development and Reform Department, International Department, Statistics Department, etc.). To improve local enforcement, the CIRC has also established 35 branch offices ("dispatched institutions") in 22 provinces, 4 municipalities, 4 autonomous regions, and 5 cities throughout China. Since 2010, the CIRC has been building regulatory bureaus in secondary cities. So far there are five such bureaus in the cities of Suzhou, Tangshan, Yantai, Wenzhou, and Shantou.

The central departments of CIRC are responsible for regulatory policymaking, and industry-level issues such as licensing of insurance companies are handled by these departments. The branch offices of CIRC do not have rule-making authority but are responsible for and largely determine the local enforcement of insurance regulations. Due to differences in enforcement activities, Zhao (2009) emphasizes that there are many regional differences in insurance regulation and supervision in China, with the more

[10] This authority is granted by the Legislative Law of the People's Republic of China; rules issued by the departments are called "department rules."

[11] Obtained from the website of CIRC.

TABLE 3
CIRC's Regulatory Duties Compared to Other Nations

Duty or Function	Number of Nations With Function	Proportion With Function(%)	CIRC Function?
Participate in drafting insurance legislation	73	93.6	Yes
Issue insurance regulations	67	85.9	Yes
Issue binding guidelines	64	82.1	Yes
Issue nonbinding guidelines	58	74.4	Yes
Licensing	74	94.9	Yes
Control of premium rates	36	46.2	Yes
Control of policy conditions	49	62.8	Yes
Control of insurance companies' owners	70	89.7	Yes
Control of insurance companies' investments	69	88.5	Yes
Control of solvency/capital requirements	77	98.7	Yes
Monitor annual/shareholders' accounts	63	80.8	Yes
Examine supervisory/financial returns	72	92.3	Yes
Carry out on-site inspections	76	97.4	Yes
Take actions in case of financial difficulty	76	97.4	Yes
Withdrawal of a license	74	94.9	Yes
Wind up insurance companies	57	73.1	Yes
Prevent money laundering	62	79.5	No
Publish statistical information on the insurance market	71	91.0	Yes
Deal with complaints	66	84.6	Yes
Collect taxes	9	11.5	No

Source: IAIS Law Database and CIRC website, tabulated by authors.

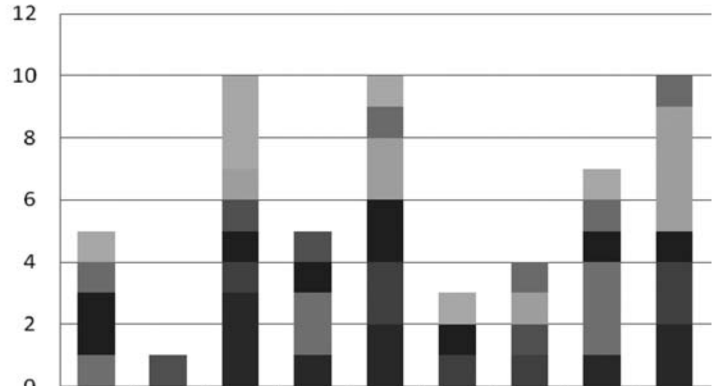
developed provinces in the East taking the lead in modernizing insurance regulatory practices.

Industry Self-Regulation

The industry's self-regulatory organization is the Insurance Association of China (IAC), founded March 12, 2001. The Association is authorized by the CIRC and registered by the National Ministry of Civil Affairs as the self-regulatory organization of the Chinese insurance industry. It is a voluntary, not-for-profit organization. At present the IAC has 176 members, including 105 insurance companies, 36 insurance intermediary firms, and 35 local insurance industry associations.

In addition to the IAC, there are also self-disciplinary "Intermediary Associations" for insurance intermediaries on the provincial and city levels (Zhao, 2009). First established in Shenzhen in 2004, an Intermediary Association takes responsibility for setting up self-disciplinary standards for its members. Although usually supervised by local CIRC

FIGURE 6
Number of CIRC Department Rules Promulgated by Year



	2002	2003	2004	2005	2006	2007	2008	2009	2010
access of insurance companies	1		3		1	1		1	
senior managers	1				1		1	1	1
insurance products			1		2		1		4
solvency		1	1	1			1		
market behavior	2		1	1	2	1		1	1
capital utilization			1		2	1	1		2
insurance intermidiaries	1			2				3	
insurance supervision			3	1	2			1	2

Source: CIRC website, tabulated by the authors.

branch offices, these local associations are not officially recognized by the Insurance Law.

Self-regulatory organizations strengthen self-discipline within an industry by putting constraints on the business activities of its members. The IAC regards this as its primary mission and declares the following specific aims:

- To constrain unfair activities by formulating industry standards and professional industry guidance.
- To promote honesty in professional ethics and to establish a complete system of accountability in the insurance industry.
- To strengthen the self-discipline management of insurance professionals and intermediary agencies by supervising business activities and enforcing compliance through penalties.

In developed market economies, industry self-regulatory organizations often play a very important role in promoting market self-discipline. These organizations provide strong professional services and education, participate in the development of legislation, formulate industry standards of conduct, and enforce adherence to laws, regulations, and industry standards. In contrast, the IAC has a very short history, is relatively small in size, and lacks real independence from the CIRC. For example, the IAC has no enforcement authority, but may only warn, condemn publicly, or ask the CIRC to impose a punishment.[12] Thus, in China the role of industry self-regulation is less important.

Legal and Social Supervision

The Supreme People's Court serves to provide judicial interpretation of laws and has issued a number of rulings regarding application of the Insurance Law (Zheng, 2011). One important example is a decision in 2004 that established benchmarks for compensating personal injury claims in automobile accidents (Huang and Query, 2007). However, the role of China's judicial system in enforcing insurance contracts and promoting market discipline is relatively undeveloped and is still evolving. The courts in China are not independent of the state and are funded and managed by local governments. China does not have a strong history of commerce being governed by contract and liability norms, and there is not a well-developed case law system (van Rooij, 2011). Lack of well-trained judges in insurance law and inconsistency of judgments across similar cases seem to be obstacles in efficient judicial supervision.

Less formal aspects of social supervision of industries include attention from consumers, the news media, and public opinion. In recent years, insurance regulators have begun to pay more attention to this mechanism of disciplining the insurance market. For example, in 2009 the CIRC issued opinions on professional norms for insurance regulators and insurance professionals, and emphasized that insurance consumers—not just regulators, companies, and intermediaries—should become informed about them in order to strengthen supervision by society.[13]

Nonetheless, effective social supervision is difficult in an area such as insurance due to its complexity and the lack of easily visible signs of regulatory violations. van Rooij (2011) argues that "people's regulation" is most effective when the regulated behavior is simple and violations are easily visible. Moreover, behavioral norms for insurance dealings are not well developed on the customer side of the market either. Fraud in insurance applications, and in insurance claiming by consumers and by consumers in collusion with agents, is perceived to be a large problem (Huang and Query, 2007; Zhao, 2009). For example, news articles report that more than 70 insurance fraud cases were detected in Jiangsu Province alone since 2008, resulting in over 100 million yuan in losses to insurance companies.[14]

Evolution of Insurance Regulation and Supervision

The evolution of China's approaches to insurance supervision and regulation has been shaped by many forces, including the progress of domestic insurance markets, the increasing international connectedness of the markets, and international developments in insurance supervision. Entry into the WTO in 2001 marked a new era not just for China's insurance industry but also for its regulation and supervision.

[12] The information is taken from the Constitution of the Insurance Association of China (2001).

[13] "The Circular of Understanding and Carrying out 'The Norms of Insurance Regulators' and 'The Norms of Insurance Professionals,'" 2009.

[14] In response, China's first Anti-Fraud Center was established in Jiangsu Province in 2011.

Opening up of the market strengthened connections and cooperation with international organizations and other insurance regulators. In many areas, the CIRC has been active in monitoring and adopting the common global standards promulgated by such bodies as the IAIS and the European Union (EU). In 2005 the IAIS articulated the "three pillars" of insurance supervision as consisting of regulation of corporate governance structure, regulation of market behavior, and regulation of solvency. China adopted the "three pillars" as the basis for insurance supervision in 2006.[15] China is also closely following the implementation of Solvency II in Europe, and studying the management of systemic risk as an important part of future insurance regulation.

More generally, over the past decade China has modernized its insurance regulation and supervision in a variety of dimensions, including both regulatory process and content. Some of the major developments are described below.

Asset Management Regulation

Asset management in insurance companies has traditionally been strictly regulated in China. The Insurance Law of 1995 restricted insurance companies' assets to be invested only in bank deposits, government bonds, corporate bonds, and other funds stipulated by the State Council. The restrictions have been relaxed gradually over time, beginning in 1998 when a certain proportion of insurance assets were permitted to be invested in securities. During the succeeding years, the nature of allowable investments has been gradually expanded.[16] Nonetheless, asset management regulations remain restrictive in comparison to those in other countries.

Table 4 presents a comparison of investment limitations for China's insurance companies relative to other jurisdictions in 2010. Chinese insurance companies face significant restrictions on investing in risky assets, with no more than 20 percent of assets permitted to be invested in stocks or in corporate bonds, respectively, and no more than 10 percent of assets permitted to be invested in real estate and mortgages. Overall, nearly half of insurance company assets must be invested in government bonds and bank deposits. China's Central Bank reports that in 2011, 32 percent of insurance companies' assets were invested in bank deposits, while bonds (both government and corporate) contributed 47 percent.[17]

Solvency Regulation and Supervision

The Insurance Law of 1995 provided only basic guidelines regarding minimum solvency requirements for insurance companies. The first comprehensive and systematic regulation regarding solvency supervision came about in January 2001 in conjunction with requirements for China's entry into the WTO. This regulation developed a ratio-based solvency monitoring system, specifying the calculation of ratios, and standards for recognizing assets. It also established measures for dealing with distressed or insolvent insurance companies.

[15] "Several Opinions on the Reform and Development of Insurance Industry from the State Council," June 16, 2006.

[16] A detailed list of specific rule changes over time is available from the authors.

[17] Bank of China, China Financial Stability Report 2012.

TABLE 4
Investment Limitations in China and Other Countries, 2010

	Maximum Limit, %, Average Among All IAIS Reporting Jurisdictions		Maximum Limit, China (%)
	Life	Nonlife	
Corporate bonds	37	37.4	20
Government bonds	72.8	72	
Stock shares	26.9	27.8	20
Mortgages	30.8	30.9	10
Real estate	30.1	28.9	
Loans	19.1	19.3	
Cash	26.7	26.9	
Derivatives—traded	13.6	14.2	
Derivatives—OTC	5	5	
Hedge funds	30.7	30.7	
Unit trust	32.4	32.2	

Source: IAIS Insurance Laws Database, the Temporary Administrative Measures of Utilization of Insurance Capital by CIRC.

The Insurance Law modification of 2002 led to additional strengthening of this system by revising the solvency ratios and requiring insurers to submit periodic reports on the solvency measures. CIRC started to build a modern solvency regulation system in 2003. With the establishment of the China Insurance Solvency Standards Committee in 2007 and the first complete solvency regulation provision in 2008, CIRC established a dynamic risk-based solvency regulatory framework consistent with international standards, indicating the establishment of "the first-generation insurance solvency regulation system in China."[18] After the financial crisis, and in the wake of the evolution of the global financial regulatory system, CIRC began development of a new solvency monitoring system better suited to the new market environment and global situation. CIRC issued a planning document in 2012 that announced plans to draft a "second-generation system" by the end of 2014.[19]

The growing concern with solvency regulation from the CIRC has led directly to an increase in required capital injections from insurance shareholders. Table 5 shows the number of insurance companies whose shareholders injected capital and the total amount injected (RMB yuan), in each year 2005 through 2011. Even prior to the global financial

[18] According to the "planning of the second-generation insurance solvency regulation system," the first-generation system was finished in 2007–2008. See http://www.circ.gov.cn/tabid/106/InfoID/197933/frtid/3871/Default.aspx.

[19] See http://www.circ.gov.cn/web/site0/tab4566/i203919.htm.

TABLE 5
Capital Injections, 2005–2011

	Number of Injections		Amount of Capital Injections (Yuan)	
	Life	Nonlife	Life	Nonlife
2005	0	1		40,000,000
2006	3	0	775,000,000	
2007	8	0	1,890,000,000	
2008	5	1	1,270,000,000	20,000,000
2009	2	0	250,000,000	
2010	12	0	2,935,000,000	
2011	14	5	3,248,000,000	572,900,000

Source: News Release from CIRC website, calculated by the authors.

crisis, capital injections to life insurers were substantial in some years, and the number and amount of capital injections increased dramatically following the crisis. In 2011, 14 life insurers and 5 nonlife insurers required capital injections totaling nearly 4 billion (RMB).

On-site and off-site examinations (inspection of insurance company statements and materials) are important supervisory methods used by insurance regulators worldwide (e.g., Klein and Schacht, 2001) and are an important tool for China's insurance regulators. In the past decade, the CIRC has expanded requirements for insurance company reporting, broadened the focus of off-site examinations, and improved its risk-monitoring measures. It has also inaugurated a program of on-site spot-inspections to directly examine the operations, activities, and financial situations of insurance companies.

The CIRC carried out nationwide spot-inspections for the first time in 2006. These inspections were broadly focused and included examination for irregular operations in auto insurance and large property insurance, irregularities in fee collections from the bank and postal agency life insurance business, the accuracy of financial data, other business fraud, and problems regarding insurance capital utilization and statistical data. The use of on-site examinations has continued as an important focus of supervision since that time. By 2008 the CIRC sent out 2,052 examination groups to carry out spot-inspection of six insurance companies, 1,407 insurance branches, and 740 insurance intermediaries in the property–liability and life insurance sectors.[20]

The Insurance Protection Fund

China established an insurance guaranty fund (the Insurance Protection Fund, IPF) in January 2005. The fund was initially managed by CIRC under the oversight of an IPF Council consisting of representatives of insurance companies, the Legislative Affairs

[20] Dingfu Wu, *China Insurance Industry Development Blue Book*, 2009.

Office of the State Council, Ministry of Finance, the People's Bank of China, and others.[21] In October 2007, responsibility was transferred to a new entity, the China Insurance Protection Fund Ltd. Co. New administrative regulations were put into place in September 2008, which established rules for the business operations, governance structure, financing, and information-sharing activities of the Protection Fund management company.

The IPF provides full compensation of losses up to 50,000 yuan for policyholders of insolvent nonlife insurers; individual policyholders receive 90 percent of losses over 50,000 yuan and institutional policyholders receive 80 percent of losses. The policies of insolvent life insurers are transferred to another life insurer and the accepting insurance companies receive compensation from the fund for losses associated with the transferred polices. Insurer compensation is limited to 90 percent of losses for individual policies and 80 percent of losses for institutional policies.

There have been no instances of bankruptcies for insurance companies in China. However, the IPF has injected capital into two companies in financial distress. Xinhua Life Insurance Company, the fourth largest life insurance company in China at that time, reported that its CEO misappropriated company assets in 2007.[22] To protect the policyholders and help the company through the distress, the IPF began purchasing company shares. The IPF initially purchased 22.53 percent of the company's shares by injecting over 1.619 billion yuan into the company;[23] by 2008 the IPF held 38.82 percent of shares and was the largest single shareholder of the company. In November 2009, the IPF transferred its total shareholding of Xinhua Life to Central Huijin Investment Ltd., a state-owned investment company.

The second IPF rescue operation occurred in 2011 when China United Insurance Company, an insurance group with a long history, fell into financial distress due to improper management. The IPF purchased 57.43 percent of the company's shares in November 2011[24] and injected another 6 billion RMB in March 2012, which left the IPF with a 91.49 percent stake in the company. After receiving a further 7.81 billion RMB in capital from another large investor in October 2012, China United Insurance moved beyond the insolvency problem. The IPF remains the second largest shareholder in the company, but is now looking for a means of exit.

Insurance Rate Regulation

In the initial phase of the private insurance market, in which there was only a single government-owned insurer, government-set rates were quite natural. At that time, private insurance was more like a public service provided by the government's agent, the People's Insurance Group. As new entrants led to competition in the market, the

[21] "Administrative Measures of Insurance Protection Fund," 2005, http://www.circ.gov.cn/tabid/106/InfoID/19966/frtid/3871/Default.aspx.

[22] Xinhua Life insurance company reported 26 billion RMB premium revenue in 2006, which made it the fourth largest life insurance company in China. Data are from CIRC's statistics.

[23] See CIRC's report on this equity transaction approval, http://www.circ.gov.cn/tabid/106/InfoID/47341/frtid/3871/Default.aspx.

[24] See CIRC's report on this equity transaction approval, http://www.circ.gov.cn/tabid/106/InfoID/185242/frtid/3871/Default.aspx.

government has experimented with relaxation of rate regulation. Currently, however, most insurance product lines are still under strict rate regulation.[25]

There are two basic objectives that may be pursued in regulated insurance rates: regulations can try to control the upper limit of premium rates to prevent monopoly pricing, or regulations can set lower limits on premium rates to prevent vicious price competition, which could lead to insolvencies. In the Chinese insurance market, due to concerns that insurers will blindly pursue market share in selling relatively homogeneous products, insurance rate regulation has primarily focused on the second objective.

In some countries, insurance rate regulation may also place limits on the differences in premiums paid by different groups of consumers, in an attempt to improve insurance affordability for high-risk or low-income consumers. In China, rate regulation serves this purpose for certain kinds of insurance, such as agricultural insurance, but is not a focus of rate regulation in general.

Rate regulation of private passenger automobile insurance provides a useful illustration of China's experiences.[26] As one of the most important nonlife insurance products, automobile insurance market remains the most stringently rate-regulated line. However, there have been three waves of market-oriented rate regulation reforms since 1980:

- Wave 1 (1988–1993) was driven by the entry of new market players when the government decided to expand the set of insurers to eliminate the monopoly held by the People's Insurance Group. Along with the entry of China Ping'an Insurance Group and several other insurance companies, rate regulation was relaxed from government rate setting to government prior approval of company rates. With rate flexibility allowed, and facing an entrenched monopoly, the new market players engaged in premium cutting to pursue greater market shares. This period of market-set rates was thought to be a failure and was ended by the regulator (the Central Bank) in 1993, and competition in products and rates was again eliminated. All insurers were required to issue the same contract form, and government-set rates were established for each region of the country. All provisions regarding auto insurance contracts and rates were controlled by the regulator, leaving no room for differentiation across insurers.
- Wave 2 (2001–2006) occurred after the establishment of the CIRC and China's entry into the WTO. Although the WTO did not explicitly require relaxation of rate regulation, it nonetheless put pressure on China to modernize insurance regulation. The CIRC started to relax rate regulation by allowing insurers to implement their own insurance product provisions and rates. This process eventually failed again due to underpricing problems. In response, CIRC set up three universal contract forms (offering different combinations of coverage) along with premium standards

[25] According to Administrative Measures for Life Insurance Provisions and Premium Rates (2011) and Administrative Measures for Non-Life Insurance Provisions and Premium Rates (2010), the premium rates of all major insurance product lines must be approved by CIRC before the companies want to use them.

[26] The rate regulation discussed here does not apply to the Compulsory Third Party Motor Vehicle Liability Insurance, whose rates remain set by the CIRC.

for each form. These three contract forms were the only forms that auto insurers could offer.[27]

- Wave 3 (2011–) began in 2011. This time, the CIRC put certain solvency requirements on insurers who wish to apply for flexible rate-making authority.[28] These requirements are an attempt to prevent insurers with poor financial and solvency performance from engaging in excessive price competition, and thereby to ensure that competitive rate setting will not lead to unstable markets. Insurers who are granted flexible rate-making authority must report contract provisions and rates to CIRC, including basic assumptions in making the rates and actuarial analysis supporting the rate structure.

Disclosure and Consumer Protection

Consumer protection has attracted increasing attention in insurance regulation. Irregularities in insurance contract fulfillment have been a persistent problem for consumers and have hindered the expansion of the insurance market. Numerous (unsubstantiated) reports by consumers on social media sites describe disputes with insurers in areas including contract features, underwriting decisions, and claims. According to a survey of insurance consumers conducted by Shaanxi Consumers Association in 2010,[29] difficulty in claim filing was thought to be the most important concern for the consumers when considering purchasing insurance (49.3 percent). More substantiated reports of consumers' problems with insurers can be found in the Consumer Education section of CIRC's website, which provides examples of selected cases of irregular operations encountered by regulators.[30]

The most significant modification in the new Insurance Law of 2009 was its increased attention to consumer protections, demonstrating the determination of regulators to improve the contracting environment. Observers have noted that the law will put heavy pressures on insurance companies in the short run, due to the substantial new restrictions on market conduct and increased disclosure requirements (Jin, 2009). However, these same observers note that the strengthening of regulation and market transparency should improve the health of the market in the long run (Jin, 2009; Hu, 2009).

The Insurance Law requires formatted provisions in insurance contracts to protect consumers from overlooking important terms and conditions. The rights of insurers to terminate contracts are restricted to situations when the insurer can demonstrate that the insured engaged in improper or fraudulent behavior. Procedures and time limits for claims payment (within 10 days of coming to agreement) were also established in the law.[31]

In the past 3 years, the CIRC has issued major new regulations regarding disclosure requirements for insurance companies. In 2010, seven specific areas in which

[27] See the policy provision by CIRC: http://www.circ.gov.cn/tabid/106/InfoID/34560/frtid/3871/Default.aspx.

[28] See the policy provision by CIRC: http://www.circ.gov.cn/tabid/106/InfoID/194826/frtid/3871/Default.aspx.

[29] See http://www.cqn.com.cn/news/wqpd/gmwq/366934.html.

[30] See http://www.circ.gov.cn/web/site47/tab4339/.

[31] Li and Chongmiao (2009) discuss nine areas in which the law increases consumer protections.

insurance companies must release information to the public were identified.[32] Companies are required to report the relevant information on their website and in a newspaper designated by the CIRC. Reports must be released annually, and the reports of at least the most recent 5 years must be maintained on the company website.

Regulation of Foreign Insurers

Entry into the WTO committed the Chinese government to open its insurance markets to foreign competitors. Since that time, restrictions on location, products, reinsurance, ownership, and other facets of insurance company operations have been gradually loosened. Although insurance should be considered one of the industries that is most open to foreign investors, there are still some very crucial restrictions on foreign insurers.

For example, foreign nonlife insurers are not allowed to underwrite third-party liability insurance for motor vehicles, which has hindered development of their motor vehicles insurance products. Also, foreign investors are still constrained to holding no more than 50 percent of a life insurer's shares. The result is that 10 years after the opening up of the market, foreign insurers are still "struggling" in China's insurance market. The market shares of foreign insurers in China are only about 1 percent in the nonlife sector and 5 percent in the life sector, far below that in other countries' insurance markets.[33] The discriminatory regulation is at least one of the causes of this situation.

PERSPECTIVES ON INSURANCE REGULATION IN CHINA

As the preceding discussion makes clear, China's insurance regulatory system developed rapidly but unevenly, with some areas receiving inadequate regulation and others being overregulated. The speed and direction of regulatory reforms has responded to these imbalances and to developing economic and market conditions in the industry. Along with the blind pursuit of market expansion and development came a number of associated market problems, and this coupled with changes in the international insurance market after the global financial crisis have modified the development objectives for China's insurance industry. In recent years, the financial strength and health of the industry has gained in emphasis, and the need for consumer protections has attracted growing attention.

It is by now well recognized in comparative political and economic analysis that institutional history and context are important determinants of the evolution of institutions in response to pressures for change. With this in mind, the path of China's insurance regulatory development must be viewed in the context of China's more general transition from a planned economy to a socialist market economy. Much has been written about China's unique approach to transition, which included gradual and pragmatic reforms and development of private enterprises operating in parallel with state-owned enterprises (Qian, 1999, 2000; Ahrens, 2007). This approach characterizes the transition in the insurance sector as well as in the economy overall.

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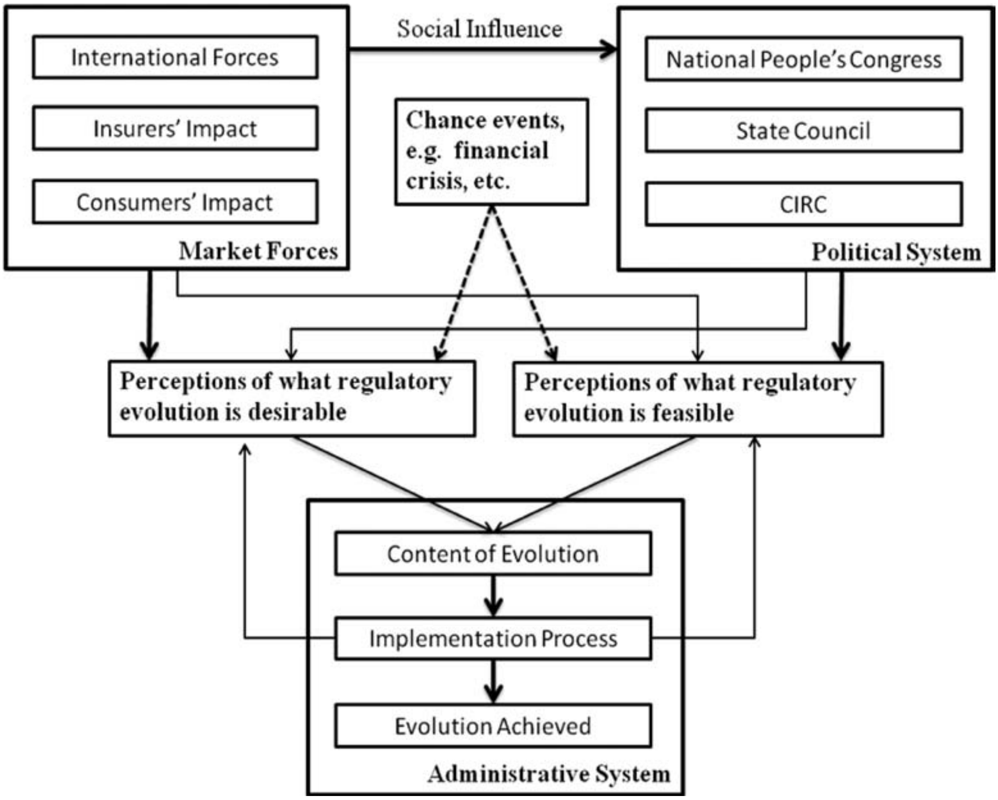
[32] CIRC, "Administrative Measures of Information Releasing of Insurance Companies," 2010.

[33] The premium data are from CIRC's website, and market share is calculated by the authors. For a more detailed analysis of this issue, see Chen et al. (2012).

FIGURE 7
A General Model for China's Insurance Regulatory Evolution



In evaluating changes in public management in 10 countries since 1980, Pollitt and Bouckaert (2000) relate a general model of public management reform, in which they argue that public management reforms are driven by a variety of external forces but are shaped by the political and administrative systems within a country. According to these authors, the political system shapes the perceptions of what evolution is desirable and the administrative system determines what is feasible; together, these determine the speed and direction of reforms. We apply this model more narrowly to the evolution of China's insurance regulatory system, where "evolution" is used to refer to the broad scope of changes including the drift in regulatory philosophy, the modification of the Insurance Law, the increasing focus on solvency and consumer protection, and greater cooperation with international markets and organizations. Figure 7 depicts the interrelationships between the various forces at work in China's insurance regulatory evolution.

China's overall stage of economic development also influences the nature and evolution of insurance regulation. A growing literature considers the special problems that governments in developing countries face when regulating private industries (Laffont, 2005).[34] The primary thesis of this literature is that certain institutional weaknesses in developing countries make effective regulation more difficult and should be accounted for when designing the regulatory system. As outlined by Estache and Lewis (2009), regulators in developing countries are usually subject to one or more of the following institutional weaknesses: limited regulatory capacity, limited commitment, limited accountability, and limited fiscal efficiency.

Qian (1999) rightly notes, however, that on the one hand China is a developing country and on the other hand China is transitioning from a centrally planned economy. This creates special characteristics which must be accounted for in understanding the development of China's insurance regulation. As indicated by van Rooij (2011), China's regulatory capacity and fiscal efficiency are stronger than in many other countries due to its long history of state administration.

China's current market economic system has evolved from a strong planned economy, which, together with the socialistic political system, leaves China with strong bureaucratic actors in almost every economic field. This was initially manifested as strong "top-down" administrative interference in market operations. A perfect example is the initial supervisory priority placed on expanding the market and accelerating its development when the insurance industry was first developing. The strong "top-down" bureaucratic system caused severe neglect of consumer protection in the industry. Through incremental change this has gradually been transformed into promoting the healthy development of the market, as evidenced by the increasing attention to consumer protection in the Insurance Law of 2009.

However, the lack of effective constraints on government actions makes limited commitment and limited accountability issues significant problems in China. As described by Qian (2002), China's 30-year economic growth might be characterized as a miracle given the absence of many conventional institutions such as rule of law and secure private property rights. In the insurance industry, high entry barriers and discriminatory treatment of foreign and privately owned companies (compared to the state-owned companies) have received frequent criticism.[35] How such problems will affect the future development of the insurance market must be considered by anyone wanting to make predictions about these issues.

Nonetheless, regulatory process is gradually evolving along with the continual efforts to modernize regulatory rules and procedures to accord with international standards. Compared to the 2002 Insurance Law modification, which was approved in a single process by the Standing Committee of the Ninth NPC, the Insurance Law of 2009 went through a more rigorous legislative process. CIRC started the modification process as early as 2004, and the first draft approved by the State Council in August 2008 went to the Standing Committee of the Eleventh NPC. After that, three rounds of reviews were

[34] Although this literature has considered almost exclusively the regulation of infrastructure monopolies such as utilities, some principles may be extended to regulation of financial services such as insurance.

[35] Recent investigative journalism reported in the *New York Times* offers a fascinating story of asymmetric treatment and lack of regulatory accountability within the insurance regulatory system as recently as 10 years ago (Barboza, 2012a, 2012b).

adopted before the final version was approved, with more than 60 different entities or organizations involved. Opinions from consumers were collected through a government website during the second round, which contributed more ideas on consumer protection provisions in the new law.[36] This legislative process allowed the interests of many more stakeholders to be considered in developing the law, and wider stakeholder engagement and involvement are important means by which accountability can be increased.

The evolution of China's insurance regulation outlined in this article reflects remarkable progress in institutional development over a short period of time. Rapid development of the market due to global and domestic economic forces has greatly compressed the timeframe for development of regulatory institutions, providing a fascinating case study and a useful example for emerging industries within China and around the developing world.

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