P.R.C's First Comprehensive Insurance Law — Major Step toward International Standards*

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The first comprehensive insurance law in China since 1949 was promulgated on June 30, 1995, at the fourteenth Session of the Standing Committee of the 8th National People's Congress, and became effective on October 1, 1995.

The law is the culmination of about five years of work by various committees, involving liaison, in depth observations, and visits to some 13 countries to study various approaches to insurance legislation in both the West and Asia.

Over the period, revised drafts circulated both officially and unofficially, reflecting changes prompted by increased knowledge and understanding of the Chinese involved, and a change from the People's Insurance Company of China (PICC) to the People's Bank of China (PBOC) as the major source of control.

Overall, the law is a good start in implementing an internationally acceptable standard of insurance regulation, especially in view of the effective elimination of the industry in China between 1949 and 1978. Most of those who have studied the final result give it high marks as a major step in moving insurance regulation in China toward international standards of management accountability, and balance in protecting insured and

* sent in by our editorial panelist Mr. William Rogers, with the author's permission for publishing the article, which first appeared in Capital Views Magazine sometime ago.

insurer rights, and in defining the role of the regulator.

The process will not be finished until the implementing regulations that the law frequently refers to have been circulated and issued, and this is still some months away, as discussed below.

Nevertheless, it is possible to make a few predictions. In the short term (the next three years), the focus will be on compliance with the new Law and on solvency. There will probably be a few new insurers and few new products.

In the long term (from 2000 A.D. on), there will emerge a financially strong industry with increasing numbers of domestic and foreign insurers operating throughout the country.

Innovation, however, will depend on the availability of skilled people, reinsurance capacity, and a detailed knowledge of the operating environment in China.

It is worth noting that the official English translation, for the first time in China's financial services legislation, was a cooperative effort between the foreign insurance community and the PBOC. A task force of eight people, four from the PBOC and four from the foreign community, consulted to ensure that the translation was accurate, yet using internationally accepted terminology.

Insurance Law Development

This year, China has taken several key steps toward establishing an internationalized legislative framework for its financial services industry. Previously, this area was a lower priority, but it has become important if China is to continue to grow with foreign investment as a key part of the engine driving its growth. Legislation enacted during 1995 includes:

- the law of the People's Bank of China, passed on March 18;
- Law of Commercial Banks, passed on May 10;
- Law of Negotiable Instruments, also passed in May;
- Insurance Law, passed on June 30; and
- Guarantee Law, also passed on June 30.

China had an advanced insurance industry in the early part of this century, especially from 1920 until about 1940, but great change followed the end of the civil war in 1949, leading to nationalization of the industry in the early 1950s. The sole surviving company, PICC, had a limited role until 1978.

As a monopoly, PICC became both the industry and the regulator. In 1978, PICC had only about 3,000 employees and a premium income of approximately $ 200 million - remarkably small for a country of around a billion people.

The industry has grown at a compound rate of almost 40% a year and now employs some 130,000 people (with about as many part-time agents) and is expected to generate about $ 8 billion in premiums in 1995. But per capita spending on insurance in China is still among the lowest in the world, at about $ 7.00 per year.

The key steps in insurance regulation in China have been:

- 1981 Economic Contract Law, amended in 1993;
- 1983 Regulation of Contracts on Property Insurance;
- 1985 Interim Regulations on Management of Insurance Enterprises;
- 1992 China Maritime Law; and
- 1992 Provisional Measures to Administer Foreign Invested Insurance Companies in Shanghai.

Overview of the New Law

The Insurance Law is simply the first step in a long process. In many ways, it is only the skeleton awaiting flesh. The full extent of the Law or the direction the regulators will take will not be defined in detail until the Regulations are issued, which is expected to occur gradually. The PBOC has already completed drafts, but they are being constantly revised as feedback is received from other interested areas of government;

The new law has 152 articles divided into eight sections, as follows;

1. General Provisions
2. Insurance Contracts
   a. General Provisions
   b. Contract of Property Insurance
   c. Contract of Insurance of Persons
3. Insurance Company
4. Insurance Operation Rules
5. Insurance Supervision and Regulation
6. Insurance Agents and Brokers
7. Legal Liability
8. Supplementary Provisions.

Essentially, the Law focuses on two prime areas;

- contract law, involving the rights and privileges of both the consumer (insured or policyholder) and the insurer and agent or broker;
- regulatory control, which outlines the responsibilities, accountability, and powers of the management of insurance

companies as well as the regulators.

Major Implications of the New Law

Instead of examining the Law clause by clause, it will, perhaps, provide a better understanding of the Law to look at some of its major implications for the insurance industry in China.

Industry Structure

Article 8 of the Law states that the financial supervision and regulation department (FSRD) under the State Council is responsible for supervision and regulation of the insurance industry. Currently, this is taken to be the PBOC, but the Law does not specifically mention the PBOC.

According to Article 69, an insurance company can be either a shareholding company with limited liability, or a wholly state-owned enterprise.

Article 91 states that the scope of business of an insurance company can be either property and casualty insurance or life insurance.

Under article 92, insurers are allowed, with the approval of the FSRD, to engage in reinsurance.

Articles 122 and 123 clearly provide for agents and brokers.

Consumerism

The number of references the Law contains to familiar Western concepts of insurance may be surprising to many. Often, these references are the result of the interaction of the Chinese with regulators around the world.

The intent of the drafters of the Law obviously is to create balance and fairness in the insurance contract, as can be seen from some key phrases:

- in Article 4, utmost good faith".
- in Article 7, "fair competition"
- in Article 10, "fair, voluntary and mutually beneficial." and "never force";
- in Article 30, "interpret disputed clauses in favor of the insured."

Claims

The fair and prompt settlement of claims is a major cornerstone of sophisticated insurance markets worldwide. In the less developed countries, or where regulation is poor, claims settlement is the area most often abused by insurers. Insurers often "negotiate" claims by taking a long time with settlement, speeding up the process only if a discount is agreed to. This happens especially where the profitability of insurers is being squeezed.

Currently in China, fraudulent claims have been increasing: heavy premiums discounting is underway as competition among new domestic companies increases, and there certainly has been evidence in the past of "negotiated settlements." However, this is addressed in the new Law:

Article 23, The Insurer shall... ascertain and determine whether to make the indemnity or effect the payment of the insurance benefits... Within 10 days after an agreement is reached with the insured or the beneficiary on the amount agreed upon.

It may take time before this provision becomes truly effective and clients could expect fair and prompt settlements from all insurers but this is the way it is worldwide.

Insured's Obligations

Article 35 imposes an obligation on the insured to observe all state regulations with respect to fire prevention, safety, production, operations and labor protection. An insurer can make recommendations, and if these are not followed, the premium can be increased or the policy terminated.

This provision will create a need for insurance companies to develop loss control or risk management skills within China.

Solvency

Perhaps the biggest challenge is to move the Chinese insurance industry away from cash flow accounting towards internationally accepted accounting practices and ensure that adequate reserves are established and maintained. Following is a list of the major areas covered in the Law:

- Article 93 requires an unearned premium reserve of 50%;
- Article 94 requires IBNR and RBU reserves (respectively, incurred but not reported claims and reported but unpaid claims);
- Article 95 requires an accumulated reserve fund;
- Article 96 requires contributions to an insurance guaranty fund;
- Article 97 deals with minimum solvency;
- Article 98 requires that net premiums be less than four times the combined total of paid-up capital plus accumulated shareholder funds;
- Article 99 requires that net retained risk be less than 10% of the combined total paid-up capital plus accumulated shareholder funds.

Non-Admitted Insurance

Currently, there are many non-admitted covers in China. Non-admitted means a policy covering a risk in China but the policy is issued outside China and therefore does not officially fall within the control of China's regulations. Many of these are placed in Hong Kong. However, the new Law could have an effect here:

Article 6, Any person or entity within the territory of P.R.C. that needs insurance coverage within the P.R.C. territory shall insure himself with insurance companies established within the territory of the P.R.C.

As competition continues among the licensed players, risks that are not insured in China will increasingly be identified, and the insurers licensed in China will increasingly complain to the regulators about placements outside China.

Enforcement, however, probably will not be effective for perhaps another year or two. But when it is, Hong Kong will become less significant as an offshore/non-admitted covers location. This could affect up to 25 percent of the total premiums currently placed in Hong Kong.

Tariff

The Chinese have initially opted for a tariff system to help develop a standard approach to wordings for basic insurance clauses and pricing. This approach is typical of developing markets' and tends to protect the domestic industry, but it slows down innovation.

Article 106. The basic insurance clauses and premium rates for major types of commercial insurance shall be formulated by the FSRD.

The insurance clauses and premiums rates have still not been defined, and it will be interesting to see how far the control extends. (Classes of insurance include, for example, property, motor vehicle and accident insurance)

Agents and Brokers

The Law addresses ethical and professional "practices" and clearly defines accountability for actions of intermediaries.

Article 124. The insurer shall be held liable for the acts of its insurance agents.....

Article 125. An insurance broker shall be liable for damages or losses caused to the applicant or the insured due to the negligence of the insurance broker....

Training, managing and auditing will become key functions of distribution. Building networks of insurance agents and brokers, therefore, could be slow and costly.

Catastrophe and Reinsurance

In view of the escalation in catastrophes worldwide as weather patterns change, and so forth, it is good to see that the new Law addresses this and a conservative long term view prevails. Many other regulators worldwide should take note.

Article 100. The method of calculation of a risk unit and the plan on managing the catastrophe risk of an insurance company shall be approved by the FSRD.

Effective August 1, 1995, PICC ceased to grant automatic extension for catastrophe covers, but until this decision is enforced internally by PICC, coverage will continue to be granted-motivated by competition and desire for growth- without references as to how this could impact the long term viability to insurers.

Currently, most Chinese insurers have not yet purchased reinsurance for their domestic catastrophic risk exposures, and once they start to buy on the global markets, rationing and increased prices are expected for catastrophic exposures. This could affect underlying pricing to consumers.

Implications for Foreign Insurers

The question most asked by foreigners concerns the entry of foreign insurers. This question is only partially addressed in the Law.

Article 148. The establishment of a joint venture insurance company with foreign equity or that of branches within the territory of the P.R.C. by foreign insurance companies shall be governed by this Law, or other laws and administrative regulations if they provide otherwise.

PBOC's Foreign Financial Institution Department is currently redrafting the Shanghai regulations on foreign insurer entry (the 1992 Provisional Measures to Administer Foreign Invested Insurance Companies in Shanghai), and these will eventually be applied to other cities such as Guangzhou as they are opened to foreign insurance companies.

Branching

Most foreign governments seek national treatment, or access to the total

China market, for their companies. However, the precedent established with the entry of foreign banks into China, as well as the new Law, makes this unlikely.

Article 79. An insurance company requires the approval of the FSRD before establishing any branch offices within and outside the territory of the P.R.C. and shall obtain insurance licenses for these branch offices.

Branching will probably be slow, and innovation will be geographically limited in line with this.

Investments

In view of the limited nature of the current financial services market in China, opportunities for creative or innovative investment strategies will be limited. The authorities have initially taken a very conservative approach and will discourage insurers from speculation.

Article 104. An insurance company shall apply its funds in a conservative, sound and safe manner and ensure that the value of its assets is maintained and increased.

The application of funds at an insurance company is limited to bank deposit, trading of government and financial bonds and other forms of fund application stipulated by the State Council.

Investment income will, therefore, be limited, forcing insurers to rely more on underwriting profit.

Solvency tests (Article 97 to 99) and lack of profitability will limit growth. This, in fact, could be good news for foreign insurers as there will be a need for additional capital, and they will be one of the few sources able to provide it over the long term.

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"I do not mind lying, but I hate inaccuracy."

\- Samuel Butler.

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"If is always the season for the old to learn."

\- Aeschylus.

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"Economy is going without something you do want in case you should, someday, want something you probably won't want."

\- Sir Anthony Hope Hawkins.

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