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Deregulation of Chinese insurers' investment activities

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Executive Summary

In 2012, the Chinese insurance industry experienced a slowdown in premium revenue growth and downturn in investment returns. Against such a backdrop, regulatory restrictions on their investment activities were eased. The deregulatory measures are expected to have an impact on insurers' operations.

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Earnings deterioration in 1–3Q 2012

The Chinese insurance industry's profitability worsened in 2011 as insurance benefits and policy dividends grew while investment returns fell, leading to an increase in policy redemptions. Such conditions did not improve much in the first three quarters of 2012.

Among listed Chinese insurers, Ping An Insurance saw net profit growth of 31.6% in 1–3Q 2012, but New China Life Insurance's 1–3Q net profit increased only 2.42% while China Life Insurance and China Pacific Insurance's 1–3Q net profits were down 55.0% and 55.3%, respectively, all on a year-on-year basis. Ping An's earnings growth largely reflects that its banking segment's revenues doubled. Its insurance segment's performance was lackluster.

The first three quarters of 2012 in China's insurance industry were distinguished by three trends. First, growth in insurance premium revenues slowed. Life insurance sales via the bank channel were affected by regulations adopted in 2010–11. To clampdown on misselling of insurance by banks, these new regulations mandated that bank sales personnel who sell insurance products directly to customers must be a licensed insurance agent. They also stipulated that commercial bank branches generally may not form business alliances with more than three insurers[1].

Life insurers' premium revenues from the bank sales channel have fallen due to these regulations. In the first half of 2012[2], China Life's premium revenues fell 5.1% year on year while its premium revenues from the bank sales channel (new policies) declined 33.7%. For Ping An, New China Life, and China Pacific Insurance, the corresponding for first-half growth rates were respectively +5.0, +10.4% and +1.2% for total premium revenues and -35.7%, -12.9% and -39.3% for premium revenues from the bank sales channel.

NOTE
1) See "Recent developments in China's bancassurance market," September 2011 (http://www.nri.co.jp/english/opinion/lakyara/2011/pdf/lkr2011117.pdf).

2) The first half of 2012 is the latest period for which sales data disaggregated by sales channel are available.

Premium revenue growth rates thus turned sluggish and tracked below growth in policy redemptions and insurance benefits, both of which have recently been on the rise.

Exhibit: Recent deregulation of insurers' investment activities

Investment products	New regulations
Government and quasi-government bonds	No limit on total investment.
Corporate bonds	No limit on total investment in secured corporate bonds. Unsecured nonfinancial corporate bonds may not exceed 50% of total assets at quarter-end.
Financial institution bonds	Commercial bank bonds must have a domestic long-term rating of A or above. Internationally rated issuers must have a long-term rating of BB or above. Commercial bank hybrid bonds must have a domestic rating of AA or above. Securities firms' bonds must have a domestic long-term rating of AA or above. Internationally rated issuers must have a long-term rating of BBB or above. Investments in insurers' convertible bonds, hybrid bonds, and subordinated term bonds are limited to bonds issued with the approval of the regulatory authorities. International development institutions' renminbi bonds must have a domestic rating of AA or above. Internationally rated issuers must have a long-term rating of BBB or above.
Nonfinancial corporate bonds (corporate bonds, medium-term notes, short-term and ultra-short-term commercial paper, convertible bonds, other CIRC-sanctioned investment products)	(1) Issuers must have net assets of at least RMB2 billion and a domestic long-term rating of AA or above or, if internationally rated, a long-term rating of BB or above. (2) Secured debt must have a domestic long-term rating of AA or above. (3) Unsecured debt must likewise have a domestic long-term rating of AA or above (A-1 or above for short-term commercial paper).
Financial products Commercial bank wealth management products, bank loan securitization products, pooled trust products, securities firms' asset management products, infrastructure investment deals, real estate investment deals	Aggregate investments in commercial bank wealth management products (domestic rating of A or above; international rating of BB or above), bank loan securitization products (domestic rating of A or above), pooled trust products (domestic rating of A or above if a fixed-return product), and securities firms' asset management products (domestic rating of A or above) may not exceed 30% of total assets at quarter-end. Aggregate investments (book value) in infrastructure investment deals (domestic rating of A or above) and real estate investment deals (domestic rating of A or above), may not exceed 20% of total assets at quarter-end. No investment (book value) in any single commercial bank wealth management product, bank loan securitization product, pooled trust product, or asset management product may exceed 20% of the product's total issuance. No investment in any single infrastructure investment deal or real estate investment deal may exceed a 50% ownership interest in the deal. Within a single insurance group, total investments may not exceed a 60% ownership interest.
Financial derivativess Forwards, futures, options, swaps etc.	May be used only for hedging or risk avoidance. May not be traded for speculative purposes. May be used (1) for hedging or risk avoidance with respect to currently owned assets, existing liabilities, or company as a whole; or (2) to hedge the risk of an asset to be purchased within one month or to fix an asset's future purchase/sale price.
Equity index futures	May be used as risk hedges pursuant to derivative regulations.
Equities (equity interests in companies not listed on a domestic exchange)	Aggregate investments (face value) in equity of unlisted companies, unlisted equity investment funds, or related products may not exceed 10% of total assets at quarter-end. (Old rule) Investments (face value) in equity of unlisted companies may not exceed 5% of total assets at quarter-end. Investments (face value) in equity investment funds or related financial products may not exceed 4% of total assets at quarter-end. Aggregate investments in both combined may not exceed 5% of total assets at quarter-end.
	No investment (face value) in any single equity investment fund may exceed a 20% ownership interest in the fund. Within a single insurance group, total investments may not exceed a 60% ownership interest. (Old rule) No investment (face value) in any single equity investment fund may exceed a 20% ownership interest in the fund.
Real estate and related financial products	Aggregate face value of real estate, infrastructure investment deals, or real-estate-related financial products may not exceed 20% of total assets at quarter-end. Real estate alone may not exceed 15%, and infrastructure investment deals and real-estate-related financial products collectively may not exceed 20%, of total assets at quarter-end. (Old rule) Real estate investments (face value) may not exceed 10%, investments (face value) in real-estate-related financial products may not exceed 3%, and both combined may not exceed 10%, of total assets at quarter-end.
	No investment in any single infrastructure investment deal or real estate investment deal may exceed a 50% ownership interest in the deal. For other real-estate-related financial products, the corresponding limit is 20%. Within a single insurance group, total investments in a single deal (product) may not exceed a 60% ownership interest in the deal (or 60% of the product's issuance). (Old rule) Investments (face value) in a single real estate investment deal may not exceed a 50% ownership interest in the deal. Investments in other real-estate-related financial products may not exceed 20% of the product's issuance.

Source: NRI, based on CIRC publications

Second, asset (securities) impairment charges increased due to capital markets' poor performance. In 1–3Q, China Life booked impairment charges of roughly RMB29 billion, a nearly fivefold increase from the year-earlier period. The other three listed insurers' impairment charges also increased.

Third, investment returns also decreased in connection with growth in impairment charges. In the first half of 2012, China Life earned an overall return on its investment portfolio of +2.83% (+4.48% before impairment charges). Ping An, China Pacific, and New China Life's corresponding returns on their investment portfolios were +3.7% (+4.5%), +3.9% (+4.9%), and +1.8% (+2.2%), respectively. By comparison, banks were paying interest of 3.3% and 3.5% on 6-month and 12-month time deposits in the first half of 2012. Even higher yields were available from banks’ wealth management products. Participating insurance accounts for some 70–80% of Chinese life insurers' premium revenues[3]. With investment-type products making up such a large share of the insurance market, the decline in investment returns led to a slowdown in sales of new policies and growth in policy redemptions. One factor behind the decline in investment returns was limitations on the range of assets in which insurers are permitted to invest.

3) Participating insurance's share of life insurers' aggregate premium revenues was 71.0% in 2010 and 80.2% in 2011, according to the 2011 and 2012 China Insurance Market Annual Report.

Deregulation of insurers' investment activities

In response to such difficulties, regulatory authorities have recently been taking action. In June 2012, the authorities convened a conference to discuss investment reforms for the insurance industry. In July, the China Insurance Regulatory Commission (CIRC) announced four reforms, including interim measures related to investment of insurance assets in bonds and a directive on investment of insurance assets in equity and real estate. In October, the CIRC followed up with six additional reforms, including a directive on investment of insurance assets in financial products and new regulations regarding overseas investments and investments in financial products, infrastructure assets, financial derivatives, and equity index futures[4].

By expanding the scope of investment products available to insurers and easing investment restrictions, these reforms aim to boost insurers' investment returns. At the same time, insurers' risk management also should improve. The new regulations explicitly set forth rules for investing in a wide range of financial products, including bank loan securitizations and asset management products originated by banks, trusts, and securities firms (see exhibit). Additionally, the new regulations permit insurers

4) The four July reforms were Provisional Measures Concerning Investment of Insurance Assets in Bonds, Directive on Issues Related to Investment of Insurance Assets in Equity and Real Estate Investments, Provisional Measures Concerning Oversight of Trust Investment of Insurance Assets, and Provisional Measures Concerning Oversight of Insurance Asset Allocations. The six October reforms were Directive Concerning Matters Related to Insurance Asset Management Companies, Directive Concerning Investment of Insurance Assets in Financial Products, Provisional Measures Concerning Oversight of Infrastructure Investment Projects, Detailed Regulations for Implementation of Provisional Measures Concerning Management of Insurers' Overseas Investments, Provisional Measures Concerning Trading of Financial Derivatives by Insurers, and Regulations Concerning Equity Index Futures Trading by Insurers.

to invest in equity index futures and interest-rate, currency, and other derivatives. Speculative investments, however, are not permitted. Also prohibited is investment in physical commodities. In terms of geographic restrictions, insurers were previously permitted to invest only in "mature, developed markets," but they are now expressly permitted to invest in 25 developed markets and 20 emerging markets.

Restrictions on portfolio allocations also were eased. Limits on quarter-end portfolio allocations (based on face value) were raised from 5% to 10% for unlisted equities, from 10% to 20% for real estate, and from 20% to 50% for unsecured nonfinancial corporate bonds. The new regulations also specify minimum credit ratings for bond investments.

Expansion of insurers' investment universe and deregulation of hedging should reduce insurers' investment portfolios' sensitivity to the equity market. In addition to competing with other financial institutions to offer investment products to investors, insurers are likely to also strengthen their cooperative relationships with other financial institutions by investing in their investment products.

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