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THE WTO AND INSURANCE IN GREATER CHINA:

THE PEOPLES REPUBLIC OF CHINA, HONG KONG, MACAU, AND TAIWAN

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Introduction

With the entry of the Peoples Republic of China and of Taiwan into the World Trade Organization, the potential business opportunities in these countries have attracted considerable interest. This study examines the insurance markets of Greater China with a specific focus on the latest developments in insurance regulation and supervision. For the purpose of this study, Greater China refers to the People's Republic of China—including its two special administrative regions of Hong Kong and Macau—and Taiwan. The separate administrations of these areas reflect China's turbulent political history.

China is one of the four origins of human culture. Its history dates from the time people began to settle in the Huang River basin more than five thousand years ago. A succession of dynasties preserved Chinese culture, religion, and language. The great emperors of the Qing [or Manchu] Dynasty (1644-1911) saw themselves as protectors of Chinese traditions in literature and art, religion, and bureaucracy. During the 18th century China was the largest, richest, and most effectively governed state of the world. In the 19th century, however, internal problems and external conflicts led to the decay of this once glorious empire.

During this era of weak central authority, foreign powers sporadically threatened China's sovereignty. China had to cede the Hong Kong Island to Britain in perpetuity according to the Treaty of Nanking in 1842. In 1860 Britain secured Kowloon Peninsula as a part of Hong Kong, and in 1898 it leased the New Territories from China for 99 years.

Portugal began to use Macau as a trading colony in 1557, and in 1849 claimed sovereignty over Macau. China officially accepted Portugal's claim in an 1887 treaty. France, Germany, Russia, and especially Japan also intruded into Chinese territory to establish trading depots.

The Wuchang Uprising led to the abdication of the last Emperor, ending the dynasty era in China. In 1912, China became a republic led by the Kuomintang (Nationalist) Party, but local warlords usurped political power. For the next several decades, China continued to suffer not only from a civil war between the followers of the Kuomintang Party and Communists, but also from the Sino-Japanese War (1937-1945). After Japan's defeat in World War II, the internal conflict between the Chinese Communist Party led by Mao Zedong and the Kuomintang Party led by Chiang Kai-shek intensified. Following its defeat in the civil war, the Kuomintang government moved to Taiwan, and the Communist Party proclaimed the People's Republic of China (PRC) on the mainland.

The economies of both the PRC and Taiwan developed in relative isolation. Being export-oriented and limiting the access of foreign firms to their local markets, both countries generated large trade surpluses. Neither regime was a full participant in the global trading system. Under the Kuomintang Party's administration China was an original signatory to the General Agreement on Tariffs and Trade (GATT), but the Kuomintang government, by then in Taiwan, withdrew its GATT membership in 1950. The GATT granted Taiwan observer status in 1965, but rescinded that status in 1971 after the United Nations recognized the PRC as the sole legal Chinese representative in the UN. The PRC became a GATT observer in 1982. The trade surpluses became a searing issue with other countries, especially when the PRC and Taiwan expressed the desire to join the World Trade Organization

(WTO).[1] Responding to the call for restoring trade balance by foreign governments and also to meet WTO criteria, the PRC and Taiwan have made some regulatory changes. The PRC and Taiwan became WTO members as of December 11, 2001 and January 1, 2002, respectively.

The commitments that the PRC and Taiwan have made to the WTO are based on numerous bilateral agreements with foreign governments, the U.S. in particular. For example, the PRC government, which had already partially opened its domestic insurance market, agreed with the U.S. in 1999 to allow foreign insurers to underwrite large commercial risks, eventually to eliminate a compulsory 20-percent cession to the national reinsurer, and to limit in due course its exemption of national treatment to some statutory lines of insurance business.[2] The PRC also agreed, as a condition to its entry to the WTO, eventually to allow foreign-owned subsidiaries to the local market and to open more cities and provinces for foreign insurer operations.

Taiwan was equally subject to pressure from foreign governments wishing to reduce their deficits with Taiwan. Responding to this pressure, especially from the U.S., it permitted branch operations by U.S. insurers in 1987 and by insurers from other countries in 1994. In 1995, the Taiwanese government not only permitted foreign insurers to establish wholly owned subsidiaries but also removed its prohibition against mutual company ownership structure in insurance business.

As British and Portuguese dependencies, respectively, Hong Kong and Macau maintained relatively liberal insurance markets. However, Britain agreed in 1984 to return all parts of Hong Kong to China on July 1, 1997. Portugal agreed in 1987 to return Macau to China as of December 20, 1999. Both territories will remain independent of the PRC in managing their economies for 50 years from the date they became part of the PRC. Nevertheless, the administrators of these two regions continue to introduce new guidelines that can enhance the competitiveness of the local insurance markets.

The next part of this paper describes the current regulatory and supervisory environment in each of the countries and special administrative regions. It particular it examines how the PRC and Taiwan have responded to WTO protocols and moved toward *ex post* rather than *ex ante* regulatory measures.[3] Whenever possible, this examination falls into four segments. The first segment deals with regulation related to market access. Openness of the market to local private firms and foreign insurers, licensing requirements including initial capital requirement, and other conditions warranting some elaboration are discussed in this segment. The next segment discusses the solvency regulation that licensed insurers in the country must abide by. The third segment describes investment guidelines, including accounting principles, applied to insurers operating in the country or special administrative region. The last segment

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[1]Grimmett, Jeanne J., "China's Accession to the World Trade Organization: Legal Issues," *Congressional Research Service Reports*, June 2, 2000.

[2]Office of the US Trade Representative, "USTR Releases Details in US-China Consensus on China's WTO Accession" [http://www.ustr.gov/ releases/2001/06/01-38.htm], June 14, 2001.

[3]For a discussion about differences in *ex ante* and *ex post* regulatory measures, see W. Jean Kwon, *Toward Free Trade in Services: the ASEAN Insurance Market* (Washington: International Insurance Foundation, 2001).

summarizes market conduct regulation with respect to insurers' pricing, product designs, reinsurance arrangement, and policyholder protection. Finally, the study summarizes its findings and presents the author's conclusions and recommendations.

Discussion in this study is based on various sources including local government publications, online information available from the agencies of those governments, supranational organizations, and other reliable research organizations and journals. Although it is the author's intention to provide as much up-to-date and accurate information as possible, the information at the time of publication of this study might not reflect the current insurance regulatory environments of the countries examined.

The People's Republic of China

With an estimated 1.3 billion people, the People's Republic of China (PRC) is the world's most populous country. Only Russia and Canada have more land area. It has 22 provinces, five autonomous regions, four municipalities, and two special administration regions, Hong Kong and Macau.

The PRC is still a communist party-led, socialist state. Nevertheless, the government has implemented, especially after adopting the open door policy in 1978, extensive economic reforms, adopted market-oriented policies, and encouraged entrepreneurship in numerous economic sectors. A number of domestic and foreign financial institutions, including insurance companies, now operate in the PRC. Securities are traded on the Shanghai Stock Exchange and Shenzhen Stock Exchange.

The PRC insurance market has also grown remarkably, especially after the repeal of government monopoly in the market. In 2000, the market generated premiums amounting to 160 billion yuan (or renminbi, and approximately US $19 billion). This includes premiums of 60 billion yuan from non-life insurance. The aggregate assets of the industry totaled 338 billion yuan (US $41 billion), an increase of 65 billion yuan from the previous year.[4]

Nevertheless, per capita premium, also known as the premium density, still remains low. Mainland Chinese spent, on per-person average, about 80 yuan (US $9.5) for life insurance and 48 yuan (US $5.7) for non-life insurance in 2000. The world average for the year was US $385.4, inclusive of per capita consumption of life insurance of US $239.9.[5] The insurance industry's contribution to the national economy, as measured by the ratio of gross premiums to GDP, is also extremely low. For 2000, this insurance penetration ratio was only 1.79, inclusive of 0.67 from the non-life insurance market, in the PRC. The average penetration ratio was 7.84 globally or 7.72 for Asian countries for the same year.[6] These low insurance consumption rates, with contrastingly high market growth in the PRC, indicate a great market potential to incumbent insurers and others planning to operate in the country.

History of Insurance in PR China

Insurance business was prosperous in major cities in China, especially in Shanghai, in the early 20th century. However, this private-sector-driven insurance industry could not survive the long years of war followed by the PRC's centralized economy system. Its contribution to the national economy became negligible by 1960.

The insurance industry was reborn when Deng Xiaoping introduced the "Open Door Policy" to reform the country's economy. A subsequent order of the State Council in 1979 called for the resumption of insurance business. At this initial stage, insurance was available only through the People's Insurance Company of China (the PICC), and insurance business was subject to the Economic Contract Law of 1981 and the Regulation of Contracts on Property

[4] Swiss Re, "World Insurance in 2000," *Sigma*, No. 6 (2001).

[5] *Ibid.*

[6] *Ibid.*

Insurance of 1983.[7]

In 1985, the State Council issued the Interim Regulations on Management of Insurance Enterprises. These regulations named the People's Bank of China—the central bank of the country—as the regulatory authority of the insurance industry, and ended the PICC's monopoly in insurance business. The central bank subsequently licensed five new national insurers: Ping An Insurance Company, China Pacific Insurance Company, the New China Life Insurance Company, Tai Kang Life Insurance Company, and Hua Tai Assurance Company. These national insurers were affiliated to the PICC. There were also four new regional insurers: Da Zhong Insurance Company, Hua An Property Company, Insurance Company of Xinjiang Production and Construction Corporations, and Tian An Insurance Company.[8] Although those regional insurers were operating independently of the PICC or a local government, they had much smaller shares in the insurance market than the national insurers. The initial privatization policy did not generate much meaningful competition in the insurance market.

Foreign insurers, in any form of business, were not admitted until the PRC government issued the Interim Management Regulation for Foreign Insurance Institutions in 1992. Under these experimental measures, AIG (AIU) was first admitted in 1992, followed by Tokyo Fire and Marine Insurance Company in 1994. Both opened a branch in Shanghai. Sedgwick Insurance Risk Management Consultants (China), Limited, became in 1993 the first authorized insurance brokerage firm in China. China's first domestic insurance brokerage firm, Jiangtai Insurance Brokerage Company, was established in 2000. By December 31, 2001, the government had granted approval for business licenses to 18 domestic insurers and 29 foreign insurers. Not all firms are operating yet. Some newly licensed firms must create joint ventures with local Chinese firms and submit their business plans before they are granted *bona fide* licenses.

In the midst of these changes to the insurance market, the government introduced the Insurance Law of the People's Republic of China on June 30, 1995. The purposes of this law are to protect the rights and interests of parties involved in insurance transactions, to strengthen supervision and regulation of the insurance industry, and to promote the healthy development of the industry. This law covers, as further discussed later, all key regulatory issues, but falls short of providing unequivocal, or transparent, guidelines for specific operational matters of the insurance business. The government clarified some of the gray areas in the protocol for China's accession to the WTO and through issuing additional regulations.

A number of regulations and decrees related to insurance operations now apply in the PRC. Among them, the Measures on Temporary Licensing Administration for the Conduct of Auditing Business by Foreign Accounting Firms for Financial-type Listed Companies, which was issued and became effective on January 12, 2001, requires registered insurance companies to hire both a Chinese accounting firm and a foreign accounting firm for auditing services. The New Insurance Company Regulations, which became effective as of March 1, 2000, complement the existing insurance law and

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[7]Jeffrey Thomas, "Administration of Chinese Insurance Law: An Assessment and a Case Study," *Geneva Association Journal of Insurance Practices* (forthcoming).

[8]Pricewaterhouse Coopers, *Asian Pacific Insurance Handbook* (Melbourne, Australia: Pricewaterhouse Coopers, 1999), pp. 237-238.

clarify a number of provisions in the insurance law, especially those related to the establishment of insurance firms (including foreign-invested insurance companies), insurer operations, insurance policies, premiums, and the use of premium income and reinsurance. Probably most importantly, the State Council adopted new regulations consistent with the country's WTO agreement specifically addressing requirements for foreign insurance firms. This new law, the Regulations on Administration of Foreign-invested Insurance Companies of 2001, came into force on February 1, 2002.

The current regulatory authority of the insurance industry is the China Insurance Regulatory Commission (CIRC), which was created in November 1998. The CIRC continues to regulate the industry, and has recently formed a nationwide supervision network by establishing offices in its 30 regions.

Market Access Regulation

The Insurance Law of 1995, as well as its related regulations, prescribes authorization requirements for insurance business. According to the law, a new domestic insurer must be a solely state-owned firm or a stock company with limited liability. The applicant must show evidence of qualified management, a sound organizational structure, and sufficient facilities. It must submit a feasibility study report of its proposed business plan. The insurance law states that the regulatory authority may use additional factors related to the development of the insurance industry and fair competition in the market when reviewing each application. However, from the date the PRC becomes a WTO member, this economic needs test is no longer used, and the regulator sets no quantitative limits on the number of licenses issued.

The insurance law requires the regulator to make a decision within six months from the date of receipt of the application. Once approved, the applicant receives an Institution Legal Person Permit that can be used to obtain a business license. A successful applicant is commonly required to complete its preparatory work within six months; otherwise, the approval can be void according to the provisions found in the New Insurance Company Regulations of 2000. An applicant whose application is denied is barred from making a new application for one year.

A licensed direct insurer may also engage in reinsurance business and, upon securing approval from the CIRC and the state government, foreign exchange business. However, no direct insurers are allowed to hold licenses for both life and non-life insurance businesses. The existing composite insurers were required to divide their operations under this provision. In fact, this regulation resulted in restructuring the PICC as a holding company for the newly created China Life Insurance Company, People's Insurance Company of China (for non-life business), and China Reinsurance Company.

According to the Regulations on the Administration of Insurance Companies, an applicant of insurance business is required to raise a minimum initial (registered) capital of 500 million yuan to carry on insurance business on a nationwide basis or 200 million yuan (renminbi) to operate within a designated territory. (This is a change from the Insurance Law of 1995 that merely stipulates the minimum capital of 200 million yuan.) The capital, which must be actually paid in, can be paid up in yuan or the equivalent in a freely convertible currency

Exclusions to Territory-Based Insurance Operation in the PRC

As stipulated in the Regulations for the Administration of Insurance Companies of 2000, an insurer, whether domestic or foreign-invested, may choose to operate within a territory and become subject to a lower initial capital requirement. Several exceptions to this rule exist.

Where two or more insurance companies participate in special risks (such as large-scale projects or satellites) and jointly provide insurance for one object, the insurance companies will not be subject to territorial restrictions as long as one of them is licensed to do business in the place where the object of insurance is situated.

A single insurer can be permitted to provide coverage outside its territory for large industrial or commercial enterprises or large construction projects that meet one of the following conditions:

- The total sum of the insurance for the enterprise's or project's various items of property insurance exceeds RMB 500 million; or
- The total sum of premium income for the above items of property insurance exceeds RMB 1 million.

An individual insurer may be allowed to offer insurance under a blanket policy for risks situated outside its territory, subject to one of the following conditions:

- For key state construction projects, an insurance company operating in the territory where the legal person unit that has invested in the project is located may use a blanket policy to underwrite the relevant insurance business in other places.
- Where the legal person organization purchasing insurance and 50 percent or more of the objects of insurance are located inside the insurance company's territory of operations, but a part of the project or a part of the business not having separate accounting is in a different territory, the insurance company may use a blanket policy to underwrite the objects of

(approximately US $25 million).[9] (See the box above for exclusions to territory-based operations in the PRC.) This minimum capital must be actually paid in. The insurer must deposit 20 percent of its capital, as a guarantee fund, with an approved bank.

Regarding insurance agency/brokerage operations in the PRC, the CIRC issued the Regulations on the Administration Insurance Agencies in 2001. These regulations, which became effective on January 1, 2002, stipulate that an insurance agency can be established in the form of partnership, limited liability firm, or a joint stock company. The paid-in fund for the partnership or limited liability firm must be at least 500,000 yuan. The registered capital for joint-stock company must be at minimum $10 million yuan. The insurance agency must deposit five percent of its registered capital or capital contributions with an approved bank. The regulations also require insurance agencies to purchase compulsory professional liability insurance.

The insurance law separately prescribes rules applicable to foreign insurer operations in the PRC. As the PRC is bound to the WTO Protocol of Accession of China, foreign insurers wishing to do business in the country are now subject to somewhat different rules

[9]The phrase "or the equivalent in a freely convertible currency" is found in the Regulations on the Administration of Foreign-invested Insurance Companies.

from the law. To meet the minimum licensing qualifications, the foreign applicant must have been in insurance business for more than 30 years at the time of application. (The WTO Protocol of Accession of China adds that the country where the applicant has operated must be a WTO member.) Its total assets at year-end prior to submission of the application must be greater than US $5 billion, or US $500 million for insurance brokerage business applicants. The minimum total asset requirement for applicants to do insurance brokerage business will be reduced to US $400 within one year, to US $300 million within two years, and to US $200 within four years after the PRC's entry to the WTO. The applicant must have had a representative office in the PRC for consecutive two years.[10]

As a WTO member, the PRC does not limit cross-border supply of insurance except for the areas listed in the WTO protocol. The exempted areas are: reinsurance; international marine, aviation and transportation insurance; and brokerage for large-scale commercial risks, international marine, aviation and transportation insurance, and reinsurance.[11]

From the year 2002, foreign non-life insurers are permitted to provide insurance of businesses abroad as well as property insurance, liability insurance, and credit insurance of foreign-invested firms in the PRC. They can also be permitted to provide a full range of non-life insurance services—except for statutory insurance such as personal and commercial automobile liability insurance—to both foreign and domestic clients by year-end 2003. At present, foreign insurers are permitted to provide insurance coverage to foreign individuals and to Chinese citizens. Access to health insurance, group insurance, pensions, and annuity insurance will be granted to foreign insurers within three years after the PRC's accession to the WTO.[12]

The WTO Protocol of Accession of China specifies forms of foreign insurer establishment in the PRC. In the case of non-life insurance business, qualified foreign insurers are permitted to establish a branch or create a joint venture with up to 51 per cent ownership. This restriction will be removed within two years after the PRC's accession, and foreign insurers will then be permitted to operate through their wholly owned subsidiaries. For life insurance business, foreign insurers can operate only as a joint venture with up to 50 percent equity ownership of the joint venture. Foreign life insurers may be allowed to operate through wholly owned subsidiaries within five years after the PRC's accession to the WTO.

The ownership-related restriction no longer applies to insurance brokerage services except for the following areas. For brokerage for insurance of large-scale commercial risks, for reinsurance, and for international marine, aviation, and transport insurance, the PRC permits joint ventures with foreign equity no more than 50 percent. This percentage allowance is expected to increase to 51 percent within three years after the PRC's accession. The government is also expected to

[10]The CIRC initially had a three-year restriction for the third condition. Besides, the insurance law states "for more than two years" instead of "two consecutive years." Currently, more than 200 foreign insurers maintain a branch in PR China, particularly in Beijing.

[11]For the full agreement that the PRC made with the WTO, see *Report of the Working Party on the Accession of China*, World Trade Organization, October 1, 2001.

[12]Pension programs in the PRC are pay-as-you-go, defined benefit systems that cover primarily the state sector in urban areas.

remove this restriction on the form of ownership within five years after its accession to the WTO.

The PRC government imposes a geographic restriction on foreign insurer operations, but exceptions exist. At present, there is no geographic restriction on foreign insurers' providing large-scale commercial risks. In addition, the government permits foreign insurers to provide, without being subject to geographic restrictions, reinsurance services for life and non-life insurance as a branch, joint venture, or wholly foreign-owned subsidiary.

This geographic restriction will also phase out over time. Until 2001 foreign insurers were allowed to operate only in Shanghai. With WTO accession, in 2002 China opens Guangzhou, Dalian, Shenzhen, and Foshan to foreign life and non-life insurers as well as insurance brokerage firms. Within two years after its accession, the government is expected to open ten more cities: Beijing, Chengdu, Chongqing, Fuzhou, Suzhou, Xiamen, Ningbo, Shenyang, Wuhan, and Tianjin. This geographic restriction is expected to be removed by the end of the year 2004.

Chinese Cities Allowing Insurance Branches by December 2003

Solvency Regulation

A licensed insurer in China must maintain a minimum solvency margin commensurate with the size of its business. The insurance law prescribes that the "balance of its actual assets after deducting its actual liabilities" must not be less than the solvency margin set by the regulatory authority. The "actual" assets here do not include the following types of assets: advanced payments other than indemnity prepayments, deferred assets, intangible assets, bad debts, the excess of cost of negotiable securities over their current market value, and other assets—as identified by the regulator—that cannot be realized within a stipulated time or the proportion of the value of any assets that may not be realized on disposal.[13]

Specific solvency margins are as follows. For property insurance business and short-term personal insurance business, the solvency margin must be the greater of:

- 18 percent of retained premiums, less taxes on premiums, for less than 100 million yuan, plus 16 percent of retained premiums, less taxes on premiums, greater than 100 million yuan, both for a given accounting year; or
- 26 percent of the average annual claims (compensation) payments made in the previous three years that is less than 70 million yuan, plus 23 percent of the same premium basis that is more than 70 million yuan.

Insurers that have not completed three years of operations must use the first formula.

The minimum solvency amount for long-term personal insurance business is the sum of the following two formulae:

- Four percent of liability reserves for ordinary life insurance business plus one percent of liability reserves for investment-linked business, both at the end of the accounting year; and
- 0.1 percent of the amount of insurance for fixed-term life insurance risk with the coverage period less than three years, 0.15 percent of the amount of insurance for fixed-term life insurance risk with the coverage period of three to five years, and 0.3 percent of the amount of insurance for fixed-term life insurance risk with the coverage period greater than five years and for other types of risks.

In the case that the actual solvency amount of an insurer is less than the minimum solvency amount for the insurer, but still greater than 50 percent of the minimum amount, the CIRC requires the insurer to take effective measures to remove the deficiency. If, however, the actual solvency amount is less than 50 percent of the minimum solvency amount, or if an insurer has failed to meet the minimum solvency margin for three consecutive years, the CIRC may subject the insurer to a heightened level of supervision and inspection for a certain period. During that period, the insurer may not be permitted to establish any branch offices, or pay any bonuses or dividends. The regulator may also order the insurer to purchase (additional) reinsurance, transfer business, stop accepting new business, increase capital and enlarge the number of shares, adjust its assets structure, or use other appropriate methods to improve its solvency situation. If the actual solvency amount of an insurer is less than 30 percent of the minimum solvency amount for the insurer, or if the financial condition of an insurer

[13]Pricewaterhouse Coopers, *Asian Pacific Insurance Handbook* (Melbourne, Australia: Pricewaterhouse Coopers), p. 242.

subject to a heightened level of supervision and inspection worsens to a situation that may jeopardize the interests of its policyholders or the public interest, the CIRC may take over management of the insurer.

Financial and Accounting Regulation

All insurers must maintain an outstanding loss reserve for the amount of insurance indemnity or the amount of the insurance benefits for reported-but-not-yet-settled claims as well as incurred-but-not-reported claims, subject to four-percent limit based on the actual claims payments made during the relevant year.[14] Additionally, all non-life insurers must set aside 50 percent of the premiums retained for the current year as a reserve for future claims. Life insurers must set aside to its policy reserve an amount equaling the total net value, determined actuarially, of the total life insurance policies in force.

All insurers in the PRC must submit their business reports, balance sheet, income statement (profit and loss appropriation account), cash flow statement, and notes to the accounts to the CIRC within three months after the end of each financial year (which is also the calendar year). Insurers must also submit insurance statistics for the preceding month by the end of each month.

In preparing financial statements, insurers may use generally accepted accounting principles. For example, they can record the historical cost for equity investments, or amortize—using a straight-line method or an effective interest rate method over the period to maturity—the difference between the cost and the face value of debentures.

[14] *The Regulations on the Administration of Insurance Companies of 2001*, the China Insurance Regulatory Commission.

The insurance law has strict investment restrictions, confining the areas of insurer investment to bank deposits, government bonds, financial bonds, central enterprise bonds designated by the CIRC, or other ways of applying the funds as stipulated by the State Council. However, the CIRC has loosened this regulation over years. Since October 1999, insurers have been permitted to invest up to five percent—or, for a few insurers, up to 10 to 15 percent—of their assets in mutual funds. Also, the regulatory authority has since 2000 permitted insurers, including joint ventures with foreign insurers, to invest in shares in the domestic market. At year-end of 2000, insurers invested 13.4 billion yuan in securities, about four percent of the industry's total assets. The insurance law gives the regulator an authority to set the exact percentage of an insurer's total fund allocated to each permitted area.

Market Conduct Regulation

Quite a number of regulatory guidelines related to insurer operations and market conduct exist. The current insurance law states that any licensed insurer must obtain approval and acquire an additional license from the regulator before it can establish and operate a branch. The insurer must secure approval from the regulator whenever it expects a change in the amount of the registered capital or the scope of business. The same requirement applies when an insurer expects changes of shareholders holding more than 10 percent of the company's share.

Regarding insurance policy provisions and premium rates, the insurance law prescribes that the CIRC—or its appointed industry associations or insurance companies —can set the standards for the main types of risks in commercial insurance and that the standards can be revised according to

prevailing market conditions. For other types of risks, insurance companies can set their own policy provisions and premium rates and seek approval from the CIRC. They may use such provisions or rates if the regulator raises no objection within 30 days from filing them for approval. The New Insurance Company Regulations of 2000 list certain circumstances (for example, use of premium rate that is lower than cost or that can induce unfair competition) where the regulatory authority may require an insurer to change its policy provision or premium rate. Insurers are required to implement uniform policy provisions for each type of insurance, but they may charge different rates based on the actual conditions in various areas.

Employment of actuaries recognized by the regulatory authority is also mandatory for life insurers. According to the New Insurance Company Regulations of 2000, life insurers operating nationwide are required to employee a minimum of three actuaries. Life insurers operating in a designated territory may hire as low as one actuary. The PRC introduced its first mortality table, China Life Insurance Mortality Table (1990-1993), in 1996. This table has been used from the following year to calculate premium rates and reserves. If an insurer uses a different mortality table, it must seek approval from the CIRC before offering products priced based on that mortality table.

The law imposes a limit on the volume of insurance business such that, for property insurance business, the premium retained for the current year cannot exceed more than four times the sum of the insurer's paid-up capital plus its accumulated reserve fund. The law also puts a restriction on property insurance business that the maximum amount of insurance for a single insured event cannot exceed ten percent of the sum of the insurer's paid-up capital plus its accumulated reserve fund.[15] However, property insurers may accept large risks over their permitted capacity as long as they cede the excess amount of risk over their capacity to a reinsurer or reinsurers.

The national reinsurer, China Reinsurance Company, was established in 1999 as a subsidiary of the PICC. Until the establishment of this state-owned national reinsurer, reinsurance in the PRC was the responsibility of the PICC. Compulsory cession to China Re will remain in force for the four years after the PRC's accession to the WTO. For this purpose, the direct insurer must submit by November 1 each year its reinsurance program for the following year for CIRC's approval. The required cession rates are as follows. Non-life insurers, domestic and foreign alike, are subject to compulsory reinsurance cession of 20 percent of their direct insurance business in non-life lines, personal accidental insurance, and health insurance to the Chinese Re. (The compulsory cession rate was 30 percent prior to 1996.) The percentage will be reduced to 15 percent in 2003, to 10 percent in 2004, and to five percent in 2005. After January 1, 2006, no compulsory cession will be required. Licensed insurers in the PRC are advised to give priority to insurers established within the PRC when ceding other parts of their risks through reinsurance.[16]

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[15]The law describes the amount of insurance as "each [liability] risk unit," or "the insurer's liability for the maximum loss or damage caused by the occurrence of a single insured event." The law also requires the insurer to get approval from the regulatory authority for the method of calculation of a risk unit and the plan for managing catastrophe risk.

[16]*The New Insurance Company Regulations of 2000*, the China Insurance Regulatory Commission.

Hong Kong, Special Administrative Region

Hong Kong, which includes Hong Kong Island, the Kowloon peninsula, the New Territories, and other 235 small islands, was under British administration from the 19th century until 1997, except for the period from December 1941 to August 1945 when it was occupied by Japanese forces. Its population grew significantly during, as well as immediately after, the Sino-Japanese war and during the 1946-1949 civil war in Mainland China. Over 6.8 million people, mainly Chinese, now live in Hong Kong that has an area of about 1,100 square kilometers. Hong Kong's per capita GDP in 2000 was about US$24,000, over 80% of which came from the service sector. Hong Kong is one of Asia's major centers for trade and financial services. The Hong Kong dollar has been pegged to the US dollar (currently at an approximate rate of US $1 to HK $8).

On July 1, 1997, Hong Kong became a special administrative region of the PRC.[17] Nevertheless, its social and economic structures—including the capital market—remain unchanged and China's socialist system will not be practiced in Hong Kong until year 2047. During the same period, Hong Kong will enjoy a high degree of autonomy, except in foreign and defense affairs. Under this guiding principle of "One China, Two Systems" of the PRC, Hong Kong keeps its own government and constitution, the Basic Law. It also continues to maintain a free market economy under its regulatory philosophy of "maximum support and minimum intervention."

[17]Detailed information about the Sino-British Declaration can be found from Hong Kong government's web page at http://www.info.gov.hk/info/jd-sum.htm.

The classification of insurance products in Hong Kong is rather unique. There are two classes. The long-term class includes life insurance, annuities, marriage and birth insurance, investment-linked long-term insurance, permanent health insurance, tontines, capital redemption policies, and retirement scheme management policies (three types).[18] The general insurance class includes typical property and liability lines of insurance as well as accident and health insurance.

The Hong Kong insurance market is very competitive, in part because of relatively low barriers to entry. As of December 2001, there were 204 insurers, including 104 insurers from 25 countries, operating in Hong Kong in 2000. Among them, 140 were general insurers, 45 were long-term insurers, and the remaining 19 were composite insurers.[19] Foreign insurers dominate both life and non-life insurance markets. Hong Kong hosts branches of a large number of international reinsurers. It is also a host of a number of captive insurers, as the box on the next page suggests.

The industry generated gross premiums amounting to HK $61.5 billion (US $7.9 billion) in 2000. This translates into per capita insurance consumption of HK $6,950 (US $893) including per person non-life insurance consumption of HK $2,093 and an insurance penetration ratio of 4.86 percent

[18]The functions of the Registrar of Occupational Retirement Schemes were transferred in January 2000 to the Mandatory Provident Fund Schemes Authority [http://www.mpfahk.org].

[19]Officer of the Commissioner of Insurance, *Hong Kong Insurance Business Statistics* [http://www. info.gov.hk/oci/statistics/index.htm].

Captive Insurance Operations in Hong Kong

Hong Kong strives to be an attractive domicile for captive insurers. The government amended the Insurance Ordinance in 1997 to add a regulatory framework for captive insurance operations in the territory.

To operate in Hong Kong, a captive insurer must meet the minimum capital requirement of HK $2 million. It must also maintain a solvency margin being the greatest of (1) HK $2 million, (2) five percent of premium income, net of reinsurance, or (3) five percent of claims outstanding, net of reinsurance. An applicant of captive insurance operation is not required to conduct a feasibility study of its business plan. Neither is it subject to the restriction on engaging in fronting operations.

A captive can be managed and operated independently of its group. Neither is it required to maintain assets in Hong Kong to back up its insurance liabilities in the special administrative region. Its assets and liabilities can be valued according to generally accepted accounting principles.

including 1.12 percent for non-life insurance for the year. Five-firm and ten-firm concentration ratios, based on premiums, were about 25 percent and 36.4 percent, respectively, in the Hong Kong insurance market for year 2000.

The Hong Kong government established in 1990 the Office of the Commissioner of Insurance (OCI) as the regulatory body of the insurance industry. The principal functions of the OCI are protecting policyholders' interests and promoting the stability of the insurance industry. Accordingly, it authorizes insurers, supervises insurance activities, and oversees insurance intermediary-related matters. It also works closely with numerous industry associations.

The regulatory framework for the industry is prescribed in the Insurance Companies Ordinance (Chapter 41) of 1983. This ordinance has been amended several times. For instance, the government amended this ordinance in 1999 mainly to introduce a new regulatory framework for Lloyd's, to accelerate insurers' submission of financial information on their Hong Kong general business to the OCI, and to collect statistical claims data for a longer period. It amended the ordinance again in 2000, *inter alia*, to strengthen professional standards of appointed actuaries working for insurers in long-term insurance business.

Market Access Regulation

Only authorized companies, Lloyd's, and associations of underwriters approved by the OCI can carry on insurance business in or from Hong Kong. (A "company" here refers not only to a company formed and registered under the Companies Ordinance (Chapter 32) but also to a company incorporated outside Hong Kong.) The Insurance Companies Ordinance prescribes several conditions that an applicant of insurance business must meet.[20] As the government continues to maintain low entry barriers to the insurance market and supports the policy of minimum regulatory intervention, many of the conditions deal with a proper-and-fit

[20]The Insurance Companies Ordinance also deals with matters related to Lloyd's of London operation in Hong Kong. Rules related to such operation are not discussed in this paper.

person rule and readiness of the applicant for sound financial and operational management of the proposed business. For instance, the applicant is expected to submit a feasibility study for its business plan. If the application is for long-term insurance business, a qualified actuary must certify that prudent actuarial principles are used to construct the business plan. Presence or availability of reinsurance arrangements is also a condition to complete the application. Under the Insurance Companies Ordinance, the regulator may impose other conditions that an applicant of insurance business must meet to secure a license.

A licensed insurer is advised not to destabilize the local insurance market or use the license for any other purposes than authorized. For example, with the exception of the captive insurer, no licensed insurers are permitted to engage in a fronting operation under the disguise of a reinsurance arrangement. Neither does the OCI permit, other than in the case of professional reinsurers, a single application for both long term and general insurance businesses. However, an applicant wishing to do business in both classes may create separate entities, one for each class of business, and submit applications accordingly. The OCI may consider applications for expansion of business into a new class or lines of insurance from existing insurers. Professional reinsurers are exempted from these restrictions, and thus may reinsure both long-term and general insurance.

With respect to applications of branch operation in Hong Kong, the regulatory authority requires that the holding company is, among others, a well-established insurer with international experience and of "undoubted financial standing." Of course, this rule does not apply to those foreign insurers wishing to do business through its local subsidiaries in Hong Kong. There are no limitations on shareholdings or levels of investment for foreign insurers in the territory.

Capital requirements are significant. An insurer engaged in general business or long-term business is required to have a minimum paid-up capital of HK $10 million (approximately US $1.25 million). For an insurer carrying on both general business and long term business or carrying on any statutory insurance business, the minimum amount is HK $20 million. The minimum paid-up capital for a captive insurer is HK $2 million.

Solvency Regulation

Insurers in Hong Kong must maintain an excess of assets over liabilities of not less than the required solvency margin. As summarized in the table on the next page, the solvency margin of the general insurer is expressed in terms of the relevant premium income ("the premium income"), being the greater of the annualized premium income net after reinsurance and 50 percent of the annualized premium income, and the relevant claims outstanding ("the claims outstanding"), being the greater of the claims outstanding net of reinsurance recoverable and 50 percent of the gross claims outstanding plus any additional provision of unexpired risks.

Accordingly, if the premium income for the last preceding financial year, or the claims outstanding at the end of its last preceding financial year, whichever is the greater, did not exceed HK $50 million or its equivalent, the minimum margin of solvency is HK $10 million (or HK $20 million for insurers in statutory lines of insurance business). For insurers having premium income during or claims outstanding at the end of last preceding year, whichever is the greater, that exceeded HK $50 million but were less than HK $200 million, the

Hong Kong's Minimum Margin of Solvency, General Insurance

If premium income for the last preceding financial year, or the claims outstanding at the end of its last preceding financial year, whichever is the greater, is	*The minimum margin of solvency is*
• less than HK $50 million	HK $10 million (HK $20 million for insurers in statutory lines of insurance business)
• greater than HK $50 million, but less than HK $200 million	20 percent of the applied basis
• greater than HK $200 million	HK $40 million plus 10 percent of the applicable basis that exceeded HK $200 million

minimum margin of solvency is 20 percent of the applicable premium income or claims outstanding. For insurers with premium income or claims outstanding that exceeded HK $200 million from the last preceding year's operation, the minimum margin of solvency is HK $40 million plus 10 percent of the applicable premium income or claims outstanding, whichever is the greater, that exceeded HK $200 million.

For long-term insurers, the margin is determined by the greater of (1) HK $2 million, or (2) an amount specified under the Insurance Companies (Margin of Solvency) Regulation of 1995 (which is generally four percent of the mathematical reserves and 0.3 percent of the capital at risk). If an insurer does business in both general and long-term insurance, its minimum margin of solvency is the sum of the minimum requirements for each class of business described above.

If an insurer fails to meet the minimum margin of solvency, the regulator may initially require the insurer to submit a plan for the restoration of a sound financial position and, subject to approval of the Insurance Authority, to implement the plan.

Financial and Accounting Regulation

All insurers in Hong Kong are required to submit annually to the OCI their financial statements prepared according to the Third Schedule of the Insurance Ordinance. An insurer, other than a professional reinsurer or a captive insurer, carrying on general business is additionally required to submit annually an audited general business return and audited statement of assets and liabilities pertaining to its Hong Kong general business. With the amendment of the Insurance Companies Ordinance in 1999, general insurers are now required to file the said return and statement within four months from the end of the last preceding financial year. An insurer carrying on long-term business is required to submit annually an actuarial investigation report to the regulatory body.

The Insurance Companies (General Business) (Valuation) Regulation governs the valuation of the assets and liabilities of insurers carrying on general business, other than captive insurers. For example, it prescribes the valuation methods for different types of assets commonly found in an insurer's balance sheet. It also prescribes admissibility

limits for different categories of assets. This regulation, according to the OCI, ensures a prudent spread of investments.[21] Besides, the law requires each general insurer, excluding professional reinsurers and captive insurers, to maintain assets in Hong Kong of an amount that is not less than the aggregate of 80 percent of its Hong Kong liabilities, net of reinsurance, plus the relevant amount pertaining to its Hong Kong business. If the insurer's reinsurance premium exceeds 50 percent of the gross premium, it must maintain assets in Hong Kong reflecting 40 percent of its Hong Kong liabilities and the relevant amount pertaining to its Hong Kong business. Exceptions to these rules may be made if an insurer is under a special or unusual circumstance.

The Insurance Companies (Determination of Long Term Liabilities) Regulation sets out the bases for the determination of the amount of long-term business liabilities. An insurer is required to adopt prudent provisions and assumptions, particularly on the rate of interest, when valuing long-term business liabilities. Among others, valuation methods are to be specified for the calculation of the yields on assets and on the amount of future premiums payable. Additionally, the Insurance Companies Ordinance stipulates that insurers offering Classes G and H products—retirement scheme management policies—must maintain a separate fund account each from the funds related to other long-term businesses. Insurers are not allowed to commingle assets and liabilities between the different types of funds.

Hong Kong does not have any specific guidelines related to investment activities of insurers. However, the regulatory authority may require insurers not to invest in certain types of investments. It may also require insurers to realize the whole or part of an investment of a specified class or description before the expiry of a specified period.

Market Conduct Regulation

The structure of Hong Kong insurance law clearly implies the importance of having a fit-and-proper person to run an authorized insurer in the territory.[22] The law also emphasizes that any person entitled to exercise or wishing to control the exercise of 15 percent or more of the voting rights of an authorized insurer—thus the person becoming a "controller"—should secure a notice that the regulator does not object to such a control. All licensed insurers are required to notify the Insurance Authority of an appointment of a new director. Any insurer engaging in long-term insurance business must also appoint a qualified actuary.

Insurers in Hong Kong are required to maintain adequate reinsurance arrangements. However, there are no specific guidelines or regulations related to this provision. Insurers that are members of the Insurance Claims Complaints Bureau (ICCB) are also bound to the decision of an award up to HK $600,000 made by the bureau. This bureau, established in 1990, handles claims-related disputes of personal insurance policies.

Regulation of Insurance Intermediaries

Insurance intermediaries in Hong Kong are subject to a self-regulatory system stipulated in the Insurance Ordinance. The ordinance prohibits any person from working concurrently as an insurance agent and insurance broker. It is an offence under the

[21]The admissibility limits do not apply to assets maintained in Hong Kong pursuant to the local asset requirement.

[22]Refer to *Guidance Note on Fit and Proper Criteria,* available from the Office of the Commissioner of Insurance, Hong Kong [http://www.info. gov.hk/oci].

ordinance for an insurer to issue an insurance contract through, or accept insurance business referred to it by, an insurance intermediary who has not been properly appointed or authorized.

To act as an insurance agent, a person must be appointed by an insurer and registered with the Insurance Agents Registration Board (IARB) established under the Hong Kong Federation of Insurers. An appointed agent cannot simultaneously represent more than four insurers, subject to an additional condition that no more than two of the insurers are in long-term insurance business. An insurer employing insurance agents must comply with the Code of Practice for the Administration of Insurance Agents issued by the Hong Kong Federation of Insurers.

A person wishing to work as an insurance broker must seek authorization from the OCI, or become a member of a body of insurance brokers approved by the OCI. The insurance authority has issued a list of minimum requirements that applicants of insurance brokerage business must meet. The list includes minimum qualifications and experience, minimum capital and net assets (currently HK $100,000), purchase of professional indemnity insurance, keeping of separate client accounts, and maintenance of proper books and accounts. The amount of professional indemnity insurance is determined according to the amount of insurance brokerage income, subject to a minimum of HK $3 million and a usual maximum of HK $75 million. The OCI maintains a register of authorized insurance brokers as well as a register of approved bodies of insurance brokers. In turn, an approved body of insurance brokers is required to maintain a register of its members.

An authorized insurance broker is required to submit to the OCI annual audited financial statements along with an auditor's report certifying the broker's compliance with the minimum requirements. An insurance broker who is a member of an approved body of insurance brokers is required to submit the same information to that body, which then lodges annually with the OCI an auditor’s report on the continued compliance with the minimum requirements by its members.

In the past, a question existed regarding educational and training background of insurance intermediaries. In particular, insurance intermediaries were not required to pass any public qualification examination. Responding to this question, the Insurance Intermediaries Quality Assurance Scheme was introduced on January 1, 2000. Under this scheme, insurance intermediaries are required to pass a qualifying examination and continue to earn 10 core credits and 20 non-core credits each year under the continuing professional development programs (CDP).

As of May 2001, there were 2,723 corporate, 28,857 individual agents, and 381 licensed insurance brokers. Of those brokers, only one was authorized by the Insurance Authority; the others were members of the Hong Kong Confederation of Insurance Brokers or Professional Insurance Brokers Association, Limited.[23]

[23]The Office of the Commissioner of Insurance, [http://www.info.gov.hk/oci].

Macau, Special Administrative Region

Macau, Special Administrative Region, is located on the Southeast coast of Mainland China about 65 kilometers west from Hong Kong. It has an extremely high population density—440,000 residents in 24-square-kilometer territory, or 18,000 persons per square kilometer. Macau was a Portuguese territory, but most people speak Cantonese. Only two percent of the population speak Portuguese primarily.

Macau became a special administrative region of the PRC on December 20, 1999. Like Hong Kong, Macau is protected by the principle of "One China, Two Systems," and the government of Macau maintains a high degree of autonomy for 50 years from the date Macau became a special administrative region of the PRC. This autonomy includes the administrative power, legislative power, and independent judicial power. The Central People's Government of the PRC administers matters related to foreign affairs and defense of Macau. However, Macau, using "Macau, China," may develop relations with foreign states or supranational organizations such as the European Union. The principal officials of the Macau government must be Chinese citizens who are also permanent residents of this special administrative region.

Macau is a small economy, but has well developed infrastructure, highly educated human resources, and a sound financial services sector. The government maintains a free and open market as the main determinant of its economic development. Bank of China and *Banco Nacional Ultramarino* are officially appointed treasury banks of Macau. There are 23 licensed banks, one finance company, one securities firm, and 24 insurers operating in this special administrative region. Macau generated GDP of US $6.2 billion, or per capita GDP of US $14,185, in 2000.[24] Its currency, the Macau pataca, is pegged to the Hong Kong dollar—thus, indirectly to the US dollar—at a fixed rate of 1.03 pataca to one HK dollar.

The history of insurance business in Macau dates to the late 18th century when Portuguese firms wrote marine insurance. However, the first regulatory authority of Macau, the Issuing Institute of Macau (*Instituto Emissor de Macau*, or IEM) was created only in 1980. It was not only the regulator of the financial services sector, but was also a quasi-central bank and currency board of Macau. Macau adopted its first insurance law in 1989 (Decree-Law no. 6/89/M), which was amended several times until the Insurance Ordinance of 1997 was adopted. Also in 1989, the government created the Monetary and Foreign Exchange Authority of Macau (*Autoridade Monetaria e Cambial de Macau*, or AMCM) to regulate the financial services sector. After Macau became a special administrative region of China, this authority was re-named the Monetary Authority of Macau (*Autoridade Monetaria de Macau*) while the acronym AMCM was retained. From April 2000, AMCM assumed the responsibility of managing the reserve fund of the Macau government. As a result, AMCM supervises monetary and financial operations in Macau.

Key roles of AMCM include advising the Chief Executive of Macau in formulating and implementing insurance policies as well as guiding, coordinating, and overseeing insurance operations. To be precise, the chief executive holds supervisory authority over insurance activity in Macau, and the AMCM

[24] AMCM/GEE Newsbrief (November 15, 2001), *Autoridade Monetária de Macau* (AMCM).

—through its Insurance Supervision Department—administers this authority.[25] AMCM is a member of the Association of Portuguese-Speaking Insurance Supervisors.

Currently, 24 insurance companies —including 17 branches of foreign insurers— operate in Macau. Nine of them conduct life insurance business; the other 15 non-life insurance. They are subject to the Macau Insurance Ordinance of 1997 (Decree-Law No. 27/97/M). All authorized insurers, both in life and non-life businesses, are members of the Macau Insurers' Association.

Insurance intermediaries, agents and brokers alike, are subject to the Insurance Agents and Brokers Ordinance of 1989 (Decree-Law No. 38/89/M) and its subsequent amendments in 1991 (Decree-Law No. 45/91/M) and 1994 (Decree-Law No. 51/94/M). Insurers in Macau distribute their products primarily through 1,400 individual agents. The Macau Insurance Agents and Brokers Association represents these intermediaries, as does the Federation of Macau Professional Insurance Intermediaries.

The total assets of the insurance industry in Macau were over 3.3 billion pacatas (US $400 million). This includes the aggregate capital and surplus of all insurers of 769 million pacatas. In 2000, the industry generated gross premiums amounting to 1.1 billion pacatas, which includes gross non-life premiums of 348 million pacatas. These data translate into 2,500 pacatas (US $312) for per capital consumption of insurance, or an insurance penetration ratio of 2.52 percent—comprising 1.73 for life insurance business and 0.79 for non-life insurance business—for the year 2000.

Market Access Regulation

Only licensed insurance companies are permitted to operate in Macau. As prescribed in the Macau Insurance Ordinance of 1997, a licensed insurer can be formed as a locally incorporated company—preferably as a joint-stock company with limited liability—or as a branch of a foreign insurer. When reviewing applications, AMCM considers three criteria: (1) benefits to the local economy, (2) the applicant's ability to meet the minimum capital requirement, and (3) the applicant's willingness to meet other requirements as stipulated in the insurance ordinance. Composite insurers are not permitted in Macau.

To determine whether the applicant will contribute to the local economy, AMCM takes into account the following specific factors, which include a weak form of an economic needs test:

- Possibility of the applicant to improve the variety and quality of insurance service;
- Integrity of the founding members that may have significant influence on the local insurance activity and insurer management;
- Integrity, qualification, and professional experience of the persons that will manage the firm;
- Sufficiency of technical support and financial resources to back up the applicant's activity; and
- Compatibility between the applicant's business plan and the maintenance of healthy competition in the insurance market.

The insurance ordinance specifies the

[25] The AMCM also has, among others, the Banking Supervision Department, Monetary and Foreign Exchange Affairs Department, and Research and Statistics Department.

minimum capital requirement. It is 30 million patacas for applicants in life insurance business or 15 million patacas for non-life insurance. If the application is for reinsurance business, the minimum capital increases to 150 million patacas (approximately US $19 million) for life business, or 100 million patacas (approximately US $12.5 million) for non-life business.

In the case of an application for a branch operation, the ordinance requires a minimum establishment fund of 7.5 million patacas for life insurance business, or 5 million patacas for non-life insurance business. Additionally, the share capital of the applicant's head office should not be less than the minimum capital required for a locally incorporated insurer; that is, 30 million patacas for life insurance, or 15 million patacas for non-life insurance.

At the time of formation, the applicant may deposit 50 percent of the required capital, or the establishment fund in the case of a branch operation, with an authorized credit institution in Macau. The remaining 50 percent must be realized within 180 days from the date of the deed of constitution.

AMCM also licenses representative offices of foreign insurers. Representative offices in Macau are prohibited from conducting insurance business.[26] A foreign insurer's representative office is not required to raise an establishment fund. However, the share capital of the respective head office should meet the required capital for insurance or reinsurance business in the territory.

Finally, the applicant must comply with:

1. the legal requirements (such as the form of business entity, terms and conditions of insurance policies, and insurance specialization),
2. accounting requirements (filing prior-year accounts and three-year business plan),
3. technical requirements (pricing basis and reinsurance programs), and
4. managerial requirements (demonstration of officers being "fit and proper persons").

The Insurance Ordinance of 1997 lists the criteria that the applicant must meet for each of these four requirements. A new insurer must submit to AMCM a detailed report on the execution of its business plan at every sixth month for the first three years.

Solvency Regulation

Authorized insurers and reinsurers must maintain a margin of solvency that is sufficient to meet their insurance obligations arising from underwriting risks in Macau. The calculation of this solvency margin depends on the class of insurance, as well as size.

Solvency margin for non-life insurers

The required margins for non-life insurance and reinsurance businesses depend on the gross premiums written during the preceding year. For insurers writing less than 10 million patacas, the minimum solvency margin is 5 million patacas. This minimum increases for insurers writing more business, as shown in the chart on the next page.

If an insurer or reinsurer experienced abnormal losses during the preceding three consecutive years or during any three years of

[26] The insurance ordinance defines "representative office" as "an office, representing an insurer or a reinsurer with a head office in [Macau or overseas], which is not permitted to conduct, directly in its name, any operations which come within the scope of activity of such insurer or reinsurer." When permitted, a foreign insurer can operate only one representative office in Macau.

Macau's Solvency Margin, Non-Life Insurance

If the annual gross premium during the preceding year, net of returns and cancellations, is	*The minimum margin of solvency is*
• less than 10 million patacas	5 million patacas
• at least 10 million patacas, but less than 20 million patacas	50 percent of the income
• 20 million patacas or more	10 million patacas plus 25 percent of the income in excess of 20 million patacas

the preceding five years, its minimum margin of solvency is twice the amount calculated using the above schedule.[27]

Solvency margin for life insurers

The required margin of solvency for a life insurer is based on the mathematical reserves and the amount of capital at risk—the amount payable on death less mathematical reserves for the coverage. The margin also varies, as summarized below, according to the lines of business the insurer writes.[28]

For Class A (life and annuity policies) and Class B (marriage or birth policies), the minimum solvency margin is the sum of following two calculations:

(1) Four percent of the gross mathematical reserves multiplied by the ratio of mathematical reserves (net of reinsurance cession) to gross mathematical reserves [subject to a minimum 0.85 for the ratio for the insurer or 0.50 for the reinsurer].

(2) 0.3 percent of the capital at risk multiplied by the ratio of capital at risk (net of reinsurance cession) to gross capital at risk [subject to minimum 0.50 for the ratio].

For short-term life insurance products with death benefits only, the insurer may use a reduced percentage in lieu of 0.3 percent in part (2) of the above calculation. The reduced percentage is 0.1 percent for contracts with a maximum period of three years, or 0.15 percent for contracts with a maximum period of five years. In the case of reinsurers, the percentage is fixed at 0.1 percent.

For Class C (linked long-term policies) and Class I (type 3 pension fund management), the minimum solvency margin is the sum of following two calculations:[29]

(1) If the insurer bears investment risk, four percent of the gross mathematical reserves multiplied by the ratio of

[27]The insurance ordinance defines an "abnormal loss ratio" as (1) the gross loss ratio of a non-life insurer being at least 50 percent higher than the (average industry) gross loss ratio for the line of non-life insurance business, or (2) verification of substantial variation in the amounts of mortality tables of any life insurer from the (industry) experience of the line of life insurance business.

[28]Part 2 of the Insurance Ordinance of 1999 lists all the lines of life insurance businesses.

[29]Creation and operation of pension funds in Macau are subject to special legislation such as the Legal Framework for Private Pension Fund of 1999 (Decree Law No. 6/99/M) and Compensation and Valuation of Assets Constituting the Patrimony of Pension Funds of 2001 (AMCM Notice No. 006/2001).

mathematical reserves, net of reinsurance ceded, to gross mathematical reserves [subject to a minimum 0.85 for the ratio]. If the insurer does not bear investment risk, the insurer may use one percent of the gross mathematical reserves for this calculation for policies with a period of five or more years and fixed management expenses for the period exceeding five years.

(2) 0.3 percent of the capital at risk multiplied by the ratio of capital at risk, net of reinsurance ceded, to gross capital at risk [subject to a minimum 0.50 for the ratio].

For Class D.1 (long-term health insurance) and Class F (capital redemption), part (1) of the formula for Classes A and B is used to derive the minimum margin of solvency. For Class D.2 (short-term health insurance), the minimum margin of solvency is calculated using part (2) of the formula for Classes A and B.

For Class E (tontines), the required solvency margin is one percent of the assets of the relevant tontines. For Class J (operations of capitalization), it is four percent of the gross mathematical reserves. The ordinance is silent on the solvency margin requirements for Class G (type 1 pension fund management) and Class H (type 2 pension fund management).

When an insurer fails to meet the minimum solvency margin requirement, AMCM requires the insurer to submit a short-term financial recovery plan. AMCM may effect necessary modifications if such a plan is considered inadequate.

Financial and Accounting Regulation

Authorized insurers and reinsurers must maintain, at minimum, two technical reserves —claims reserve and mathematical reserve (for life business only) or unearned premium reserve (for non-life business only). The claims reserve reflects insurer's foreseeable future claims liability, including incurred but not reported claims. The insurance ordinance prescribes that insurers calculate claims reserves using an individual estimation method for each claim or using an averaging method approved by AMCM.

The life insurance mathematical reserve corresponds to the difference between the actual values of reciprocal liabilities of the insurer and its insureds. This reserve must be certified by an actuary of the insurer. If justified, AMCM may authorize Zilmerization of the mathematical reserve.

For the calculation of unearned premium reserves, non-life insurers may use a pro-rata method for each outstanding individual policy. However, they can be allowed to apply a certain percentage determined by AMCM to gross premiums written, net of returns and cancellations, to estimate the unearned premium reserves for each line of non-life insurance.

If an insurer carries on credit insurance (commercial risks), it must additionally maintain a loss ratio variation reserve. AMCM is empowered to determine the estimation method for this reserve.

Life and non-life insurers must guarantee the amounts for their technical reserves with assets located in Macau. AMCM publishes the types and percentages of insurers' assets that can be used for this purpose.

AMCM mandates insurers and reinsurers submission of quarterly and yearly accounts—trial balance, profit and loss accounts, balance sheet, and other statistical information. There are two other key rules that AMCM imposes on insurer accounting. The first is maintenance of so-called "financial provisions" that are considered necessary for insurers to meet risks of depreciation or losses to which certain types of securities or transactions are especially subject.

The other requirement is maintenance of a legal reserve fund. This fund can offset the losses accumulated during the year or over several years that cannot be covered by other reserves. To comply with this requirement, affected insurers should set aside 20 percent of their net profits of each financial year until the amount of the reserve equals one-half of the minimum share capital. Thereafter, they must set aside 10 percent of their net profits until the amount of the reserve equals the applicable minimum share capital.

Market Conduct Regulation

There are five lines of compulsory insurance in Macau:

- third-party motor vehicle insurance,
- employees' compensation insurance,
- professional liability insurance for travel agents,
- public liability insurance relating to the fixing of propaganda and publicity material, and
- third-party liability for pleasure boats.

These lines are subject to stringent regulation, especially regarding policy wordings and rates that insurers can use. AMCM also regulates the commission rates for intermediaries.

Authorized insurers in Macau are free to assume reinsured risks from or cede their risks to—as long as such risks are within the class of business they are licensed—insurers or reinsurers licensed in Macau or elsewhere.

No person, individual or corporate body, is permitted to hold a qualified shareholding —10 percent, or more, of the share capital or voting rights—or increase any shareholding by five percent of the capital or of the voting rights, without AMCM's prior approval. If an unavoidable circumstance prevents prior approval, the shareholder must notify AMCM within 30 days from the date of such acquisition or increase. AMCM may oppose an acquisition or increase that might hinder proper and prudent management of the insurance company. If AMCM does not comment within two months, the approval is deemed granted. Similarly, a person who does not intend to maintain a qualified shareholding, or wants to reduce a shareholding by five percent of the capital or of the voting rights, must communicate this intention in advance to AMCM.

The Insurance Agents and Brokers Ordinance empowers AMCM to regulate insurance intermediaries and their activities. Under this ordinance, insurance intermediaries fall into three categories:

- Insurance agents (individuals or corporations acting in the name of and on behalf of one or more insurers);
- Insurance salesmen (individuals who are simultaneously an employee of insurance companies or insurance brokers and act in the name of and on behalf of the representative insurance company or broker); and
- Insurance brokers (corporate entities, formed with the exclusive object of conducting business as an insurance intermediary, who act in the name of and on behalf of the insured).

The ordinance also prescribes licensing procedures, intermediaries' rights and obligations, and the sanctions applicable in case of noncompliance of an intermediary and the regulator's power of intervention.

Taiwan, the Republic of China

The island of Taiwan has long been influenced by Chinese culture and tradition, although it was briefly under Dutch rule from 1620 to 1662. The Qing dynasty officially declared it a province in 1887 but had to cede Taiwan to Japan in perpetuity according to the Treaty of Shimonoseki in 1896. The Kuomintang Party took control of Taiwan after Japan's defeat in World War II, and moved there following its defeat in Mainland China's civil war, declaring it the new home for the Republic of China. The Kuomintang Party continued to lead the government of Taiwan until it was defeated in 1999 by the pro-independence Democratic Progressive Party. Although Taiwan and the PRC have not agreed on the terms and conditions for reunification, economic ties between these two states have expanded since the early 1990s. Taiwan has a strong economy, and it is a one of the leading capital exporters in the world.

The Insurance Law of the Republic of China dates back to the era of Kuomintang's administration in Mainland China. It was first introduced in 1929, and has been amended numerous times in 1937, 1963, 1974, 1992, 1997, and 2001. The latest amendment particularly deals with Chapter V of Insurance Business of the law. The law is very specific about the terms and conditions of the insurance contract as well as the policy administration procedures that licensed insurers must abide by. It also covers matters related to insurer and insurance intermediary operations.

Chung Kuo Insurance Company, a non-life insurer, is the oldest insurer in Taiwan. It was founded in Mainland China and, following the Kuomintang Party's move to Taiwan, has continued to operate in the island. The other insurers established before the declaration of the Republic of China include Taiwan Fire and Marine Insurance Company created in 1946 and Taiwan Life Insurance Company created in 1947. Later the government established the Central Reinsurance Corporation as the monopoly reinsurer for both life and non-life business in Taiwan. All these companies were state-owned.

The government partially liberalized the insurance market during 1961-1963 by admitting eight private life insurers—including Prudential Life Assurance Company —and 14 non-life insurers—including Zurich Insurance (Taiwan) Limited. This liberalization policy was short lived, and few insurers were admitted for almost a quarter century thereafter.

In 1987, the Taiwanese government, in an attempt to balance its trade surplus with the U.S., gave U.S. insurers exclusive access to the Taiwanese insurance market through branch operations. As a result, a number of U.S. life and non-life insurers established branches during the next several years. In 1992, the government issued Guidelines for Establishing New Insurance Companies, and lifted the moratorium on the establishment of local insurers. In 1994, the government issued another guideline, the Regulation Governing the Standards of Incorporation and Administration of Foreign Insurance Companies, explicitly authorizing branch operation by all qualified foreign insurers. The government permitted in 1995 foreign insurers to establish a wholly owned subsidiary in Taiwan.[30] It removed its prohibition against mutual insurance

[30]Bureau of Monetary Affairs, *the Financial Systems in the Republic of China*, Ministry of Finance.

companies in July 1995. The Taiwan government currently reviews plans to allow Taiwanese insurance companies to set up liaison offices in the PRC, the activities of which can be limited to gathering market information and providing services to Taiwanese firms in the PRC.

At the end of 2000, there were 32 life insurers (including 16 branches of foreign companies) and 29 non-life insurers (including 11 branches of foreign insurers and one insurance cooperative) in Taiwan. Although six foreign professional reinsurers maintain liaison offices in Taipei, Central Reinsurance Corporation remains, at least until the end of 2001, as the sole provider of reinsurance in the country.

The Taiwan insurance market generated gross premiums of NT $651 billion (US $22.9 billion), including non-life insurance premiums of NT $429 billion, in 2000, an increase of 9.6 percent (inflation-adjusted) from the previous year.[31] During the same year, Taiwanese spent, on per-capita average, NT $20,270 (US $710) for life insurance and NT $9,140 (US $320) for non-life insurance protections. Insurance penetration ratios for 2000 were 5.10 for life insurance and 2.29 for non-life insurance.[32]

Taiwan became a WTO member in January 2002. The protocol for Taiwan's accession to the WTO addressed issues related to amendment of the insurance law—particularly regarding insurance company establishment criteria, criteria for approving foreign insurance enterprises, and the governing regulation—and revision of the Central Reinsurance Corporation Act to end the government monopoly in reinsurance. Answering the call for these changes and to make available free trade in insurance services, the government has already privatized four state-owned insurance firms: Chung Kuo Insurance Company in 1994, Taiwan Fire and Marine Insurance Company in 1998; Taiwan Life Insurance Company in 1998, and Central Reinsurance Corporation in 2001. According to 2000 data, the Taiwanese government was still a major shareholder of the three primary companies. It had 30.60 percent of share of Chung Kuo Insurance Company, 29.03 percent of Taiwan Fire and Marine Insurance Company, and 28.92 percent Taiwan Life Insurance Company.[33] As for the reinsurer, at the end of 1999, the Ministry of Finance owned 87.04 percent of the paid-up capital of over NT $3 billion. State-owned insurers and private domestic insurers owned the remaining 0.11 percent and 12.85 percent, respectively.[34]

The Legislative Yuan supports this liberalization plan, and it has already passed several bills. Among them was an amendment of the insurance law in 2001, which is discussed extensively later in this study. This legislative body of Taiwan also passed the Financial Institutions Merger Law at the end of 2000, and enacted the Financial

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[31]Swiss Re, *World Insurance in 2000*, Sigma No. 06/2001.

[32]The information available from the Taiwanese government is slightly different from Swiss Re data, and is as follows. During 2000, Taiwanese spent, on per-capita average, US $900 for life insurance and US $126 for non-life insurance protections. Insurance penetration ratios for 2000 were 6.47 percent for life insurance and 0.91 percent for non-life insurance.

[33]World Trade Organization, *Report of the Working Party on the Accession of the Separate Customs Territory of Taiwan, Penghu, Kinmen and Matsu: Addendum*. WTO Ministerial Conference in Doha (November 9-13, 2001), pp. 46-47.

[34]Department of Insurance, *1999 Annual Report*, Ministry of Finance of the Republic of China.

Holding Company Law and the Financial Supervisory Board Law in 2001. Other bills passed in 2001 include the Securities Finance Management Law, the Business Tax Law, and an amendment of the Statute of Deposit Insurance. The Securities Finance Management Law allows, among others, bill finance companies to expand into brokerage activities. The Business Tax Law is to create a super fund to help address the nation's bad loan problems, but it will phase out by January 2006.

Under the Financial Supervisory Board Law, a single supervisory authority oversees operations in the banking, insurance, securities, and futures markets. Accordingly, the board assumes the regulatory duties of the Department of Insurance of the Ministry of Finance, the Bureau of Monetary Affairs (for the banking industry), and the Securities and Futures Commission. The board, members of which include a deputy finance minister and a deputy governor of the Central Bank of China, operates directly under the Executive Yuan. It is also subject to the oversight of the Legislative Yuan.

The Financial Holding Company Law offers a legal basis for the creation of financial holding companies that can offer banking, insurance, securities and finance services through their subsidiaries. This law went into effect on November 1, 2001. This law also permits joint-marketing efforts among the subsidiaries of a financial holding company.

The industry responded quickly to this reform. More than ten financial institutions, including the Fubon Group and the Cathay Life Insurance Company, applied to set up financial holding companies. Naturally, a number of mergers and acquisitions have been completed, or are under discussion. Consolidation is also likely in the insurance industry, especially among those eight firms that have yet to meet the minimum capital requirement of NT $2 billion.[35]

Market Access Regulation

According to WTO protocol to accession of Taiwan, the local government will not restrict cross-border supply of insurance except for maritime shipping and commercial aviation as well as goods in international transit.

Regarding insurance supply within the country, the current insurance law states that only authorized insurers may engage in insurance business or a business similar to insurance. The WTO protocol also states that the government does not allow solicitation and marketing activities by non-resident financial service suppliers in Taiwan. An authorized insurer can be structured as a stock company or as a cooperative (mutual) company, both with limited liability.[36]

A newly established insurer must have a paid-up capital of NT $2 billion (approximately US $45 million), an amount set by an order of 1992. Insurers that were licensed prior to 1992 amendment are subject to this requirement by the end of 2002. The Insurance Law of 2001, *inter alia*, Article 139, empowers the regulatory authority to

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[35]The Taiwan government passed the Company Law, the Civil Code, Equitable Trading Act, and other relevant regulations to facilitate liquidation of a problem-ridden insurer or its merger with other insurers in year 2001. Ministry of Finance, *Press Release: Amendments to the Insurance Law Passed by the Legislative Yuan on June 26, 2001.*

[36]Stock insurers are additionally subject to the Company Law and cooperative companies are subject to the Cooperative Law. Ministry of Finance, Article 151, 156 of *Insurance Law (2001).*

increase the minimum capital requirement based on the prevailing social and economic conditions. Such an increase can also be ordered to a specific insurer based on the insurer's operating and financial conditions. Foreign insurers that have earned an A-rating from an approved international rating agency may apply for license for insurance business in Taiwan.[37] The minimum paid-up capital—to be earmarked by the holding company using its working capital—is now NT $50 million for foreign branch operation in the Taiwanese market. If the application is for branch operation by a foreign mutual insurance company, the parent company must have net worth at least NT $2 billion.

A licensed insurer, including a foreign holding company of a branch—must post a guarantee bond at the national treasury in the amount of 15 percent of its total paid-in capital or fund, depending on the structure of the company. The guarantee bond must be in cash or, upon approval of the regulatory authority, government bonds or treasury notes. The guarantee bond, including any interest income accrued, will not be returned to the insurer until it has declared cessation of business, or has completed liquidation. A licensed insurer is usually required to begin its operation within six months from the date it is licensed.

A direct insurer may engage in reinsurance business. However, it cannot hold licenses concurrently in both life and non-life classes, and is permitted to underwrite risks only in the class the insurer is licensed. Although the underlying principle of this class-wise restriction is retained in the revised law, a few major changes are expected in the insurance market. First, the revised law has a special provision that non-life insurers may sell accidental insurance, which was under the domain of life insurers, upon securing regulatory approval.[38] Second, life insurers and non-life insurers are now permitted to invest in each other. Third and probably more importantly, under the Financial Holding Company Law, financial holding companies can offer banking, insurance, securities, and other financial services through their subsidiaries. As such, heightened competition not only in the insurance market but also across industries within the financial services sector is expected in Taiwan.

Solvency Regulation

The insurance law is silent about the minimum solvency margin requirement per se, but has at least three relevant provisions. First, the maximum amount of insurance, net of reinsurance, of an exposure cannot exceed 10 percent of the insurer's policyholder's surplus—that is, the sum of the insurer's own capital, surplus, special reserves, and retained earnings. Second, the insurer must maintain its excess of admitted assets over liabilities at three times the amount of the guarantee fund it has posted with the national treasury. Third, the 2001 revision of the insurance law mandates regulatory use of a risk-based capital system as a tool to measure capital adequacy of insurers—an insurer's ratio of equity capital to risk-based capital not being lower than 200 percent. This risk-based

[37]The Regulations on Granting Special Approval and Administration on Foreign Insurance Companies (amended in May 2001) states this requirement as "[applicant's] having a record of healthy business operations and safe financial ability over the past three years; and having no record of being punished for major violations in the past five years. . . ."

[38]The Insurance Law defines accidental insurance as an indemnity insurance protection against the insured's injury, disability or death resulting from an accident.

capital system is expected to be in place in about two years after implementing the revised insurance law.

An insurer that fails to meet either of the last two requirements will initially be asked to raise its capital in cash within a period prescribed by the regulatory authority, to restrict the scope of its business or the amount of its new contracts, or both. If the insurer fall short of raising required cash, the regulatory authority may take one or more of the following actions: (1) Withdraw the decision of statutory meeting, (2) removal or replacement of a responsible officer, (3) removal of the duty of directors or suspend the directors' duty, or (4) other necessary action.

Financial and Accounting Regulation

The Enforcement Rules of the Insurance Law, last amended in 2000, illustrate minimum statutory reserves for unearned premiums that property insurers must abide by. The minimum reserve for fire insurance business is 40 percent of the insurer's retained premium during the year of business. It is 20 percent of the entire premium income for marine cargo insurance.[39] For marine hull insurance including fishing vessel insurance, the minimum is 60 percent of the entire premium income retained. Insurers operating in automobile damage insurance, liability insurance, guarantee insurance, and other types of property insurance must maintain a minimum statutory reserve of 50 percent of their entire premium income retained. These minimum reserve requirements apply only to insurance policies having a term of one year or less. For policies having a longer policy period, the regulatory authority may impose different reserve requirements.

Property insurers must maintain loss reserves according to the following guidelines. If the actual loss is less than the expected (anticipated) loss, the insurer must set aside 50 percent of the difference into a special reserve. If, however, the actual loss exceeds the expected, the excess may be used to offset the already reserved amount. If the reserve for each line of insurance exceeds the premium earned by the insurer for that year, the insurer may treat the excess as income. Finally, the property insurer may set aside an additional amount to the reserve based on the special nature of the line of insurance. The methods that insurers use to set aside or offset this additional amount as well as the maximum cumulative amount for the reserve is subject to approval of the regulatory authority.

The rules regarding policy reserves, which apply to personal insurers, are a little more complex, and can be summarized as follows. First, personal insurers are bound to the rule that the annual interest rates used in calculating policy reserves must be greater than 4 percent but less than 10 percent. Second, they are subject to different policy reserve valuations rules depending on the inception date of personal life insurance policies. For example, for policies incepting after January 1, 2003, with a pure premium exceeding that of a 20-year premium payment whole life insurance, insurers should use the modified 20-year premium payment whole life insurance method that the regulator specifies. Third, the minimum policy reserve for pure endowment and annuity should be based in principle on the level premium reserve method that the regulatory authority separately prescribes. Fourth, in the case of reserves for accident insurance and health insurance with a term

[39]The entire retained premium income here refers to gross insurance premium income (without deducting commissions) plus reinsurance premium income (without deducting reinsurance commissions), minus reinsurance premium expense.

less than one year, insurers—now including property insurers writing accident insurance—must set aside an amount as unearned premium reserve not less than 50 percent of the entire premium income they have retained for that year. This rule also applies to one-year term life insurance that the personal insurer writes. Finally, the minimum policy reserve for health insurance policies must be based on the modified one-year term system, unless the regulatory authority has imposed a different rule for certain special types of health insurance policies.

Personal insurers are additionally subject to statutory reserve requirement rules based on their claims experience. If the actual claim is less than the expected claim for one-year term life insurance, health insurance, and accident insurance, the insurer must set aside 50 percent of the difference into a special reserve. Similar to the rule applied to property insurers, the insurer may offset the excess of the actual claim over the expected from the reserve that it has already accumulated. If the amount for the special reserve with respect to each of the aforementioned lines of insurance exceeds 70 percent of the gross earned premium, the insurer may treat the excess as income. Finally, the insurer may set aside an additional amount to the reserve based on the special nature of the line of insurance. The methods that the insurer uses to set aside or offset this additional amount as well as the maximum cumulative amount for the reserve is subject to approval of the regulatory authority.

The regulatory authority may prescribe a different set of rules regarding policy reserves, unearned reinsurance premium reserves, special reserves, and claim reserves for reinsurers. The authority may prescribe separate criteria for nuclear insurance.

An actuary appointed by an insurer must authenticate the reserving methods, premium rating methods (discussed below), and other matters that the regulatory authority has designated. The Insurance Law is silent regarding accounting principles that insurers may use.

In Taiwan, insurers are permitted to invest their funds—referring to owner's equity and various policy reserves—in marketable securities, real estate, lending, and foreign investments, as well as special projects and public investment (subject to the approval of the regulatory authority). Qualified marketable securities include:

- Government bonds, treasury notes, savings bonds;
- Financial bonds, transferable certificates of deposit, banker's acceptances, commercial promissory notes guaranteed by banks, and other marketable securities permitted by the regulatory authority, subject to a 35-percent limit of the aggregate investment in this category to the insurer's funds;[40]
- Publicly issued corporate stocks and bonds, subject to the conditions that (1) the aggregate amount of investment in this category by an insurer does not exceed 35 percent of the insurer's funds, and (2) the aggregate amount of the stocks and bonds issued by one company does not exceed five percent of the insurer's funds or of the capital of the issuing company;[41] and

[40]Prior to 2001 amendment of the law, insurers' investment in promissory notes were limited to those guaranteed by banks only.

[41]Prior to 2001 amendment of the law, insurers could invest in only those issuing companies that generated an average ratio of net profits, after taxes, greater than six percent during the most recent three years.

- Publicly issued beneficiary certificates—now including approved mutual fund beneficiary certificates—of securities investment trust funds, provided that the aggregate investment amount in this category does not exceed 10 percent—an increase from the previous five-percent limit—of the insurer's funds or of the trust fund.

With the revision of the law in 2001, insurers are permitted, upon securing regulatory approval, to invest their funds additionally in insurance-related business, derivatives, and other areas. As a result, life insurers may invest in property insurers, and vice versa. Insurers may also invest, subject to a 10-percent limit on each, in banks, securities firms, securities houses, and bills finance.

Investment in real estate is limited to the real estate that can be used immediately and from which benefit may be derived. The total amount of such investment, excluding the real estate held for the insurer's own use, is limited to 30 percent—an increase from the 19-percent limit before 2001 amendment of the law—of the insurer's funds. The total amount of real estate for the insurer's own use cannot exceed the total amount of its owner's equity.

No insurer is permitted by law to borrow money for any other purposes than paying for major claims. Neither is any insurer permitted, unless approved by the regulatory authority, to use its assets as collateral for the loan. An outstanding loan that an insurer owes must be repaid within five months.

Loans made by an insurer are limited to loans guaranteed by banks, secured by qualified marketable securities, secured by real estate, or, in the case of a life insurer, secured by life insurance policies. With the 2001 amendment of the insurance law, insurers may now accept movable property as collateral for loans. A restriction exists on loans extended by insurers. With an exception of policy loans, the amount of loan to each borrower must be less than five percent of the insurer's funds, and the total amount of all loans—not defined—cannot exceed 35 percent of the insurer's funds.

The law specifies that the total amount of an insurer's foreign investment in permitted areas is limited to five percent of the insurer's funds. The regulatory authority may adjust the percentage limit and eventually permit an insurer, after factoring in its operating conditions, gradually to invest up to 20 percent of its funds in foreign investment.

Finally, insurers may use their funds, subject to prior approval of the regulatory authority, for an investment in special projects or public investment. Investment using the money from offering investment-linked insurance is subject to a separate ordinance sanctioned by the regulatory authority.

Market Conduct Regulation

The insurance law amended in 2001 and related regulations lay down guidelines relating to insurers' market conduct. Above all, insurers can now file for approval for premium rate formulas, policy clauses, insurance application forms, and other relevant materials prescribed by the Ministry of Finance.[42] This rule is also found in the WTO protocol to Taiwan's accession. The authority is expected to review and respond to the application—in Chinese or in English with Chinese translation—within 90 days if the petition is for a new product or within 15 days for an existing product that has

[42] Exceptions to this rule may exist for insurance contracts that are international in nature. *Regulations Governing the Administration of Insurance Enterprise* (amended on May 21, 1997).

approved for another financial institution.[43] The applicant may use the new rate, clause, form or other materials subject to this policy when the regulator has not responded within the given time period. Unless explicitly excluded in the protocol, this policy applies to all applications for all financial services products including those in banking and investment services industries.[44]

Insurers must participate in several funds. The government requires insurers writing third-party automobile liability insurance to participate in the fund set to expedite claims settlements involving uninsured motorists. The Motor Vehicle Accident Compensation Fund currently manages this fund. All insurers also contribute to the stabilization funds for property and personal classes of insurance. These funds are similar to U.S. guaranty fund systems, used to protect policyholder's rights from insurers having financial difficulty. Accordingly, use of the stabilization fund is limited to: loans to insurers suffering from operational difficulties; low interest loans to an insurer suffering losses arising from purchase of valid contracts of an ill-operated insurer or from merger or change of organization; compensation to the policyholders and claimants of an insolvent insurer; and other purposes approved by the authority for the protection of policyholders' rights and benefits.

With the amendment of the insurance law in 2001, homeowners with an outstanding mortgage must purchase earthquake coverage, which is offered as part of homeowner's insurance policy. The amended law also includes a provision for the establishment of the residential earthquake insurance fund. This fund functions like a reinsurance pool with participation of domestic insurers and the government. The fund administrator may place excess exposure over the fund's retention with overseas reinsurers.

The WTO protocol states that except marine adjusters, all foreign agents, brokers, and adjusters who have set up branch offices in Taiwan must employ at least one individual who has secured a Taiwanese agent, broker, or adjuster license. Further, a professional who has obtained an agent, broker, and adjuster qualification certificate may not practice business in the name of an individual.

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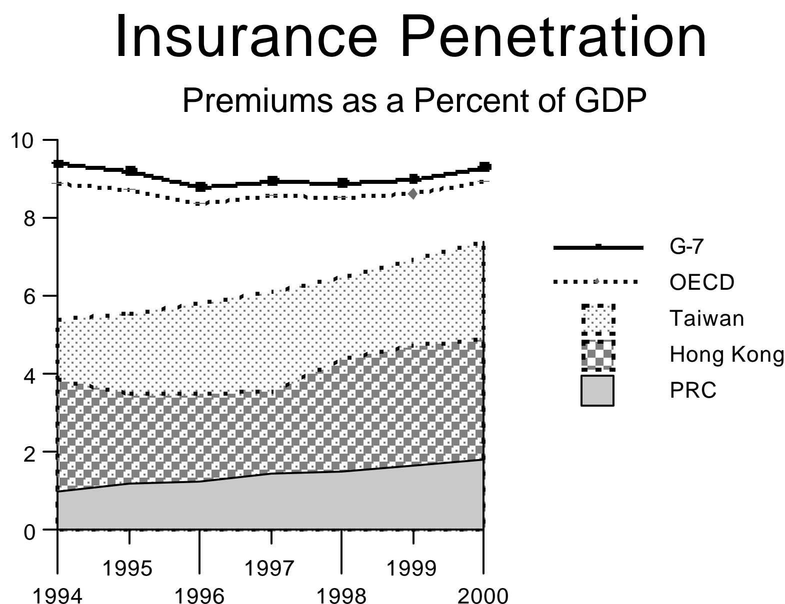
[43]The insurance law prescribes that the percentage of profit rates used to calculate health insurance and personal injury insurance premiums must be lower than that of all other kinds of insurance.

[44]World Trade Organization, *Report of the Working Party on the Accession of the Separate Customs Territory of Taiwan, Penghu, Kinmen and Matsu: Addendum,* WTO Ministerial Conference in Doha (November 9-13), pp. 46-47.

Summary

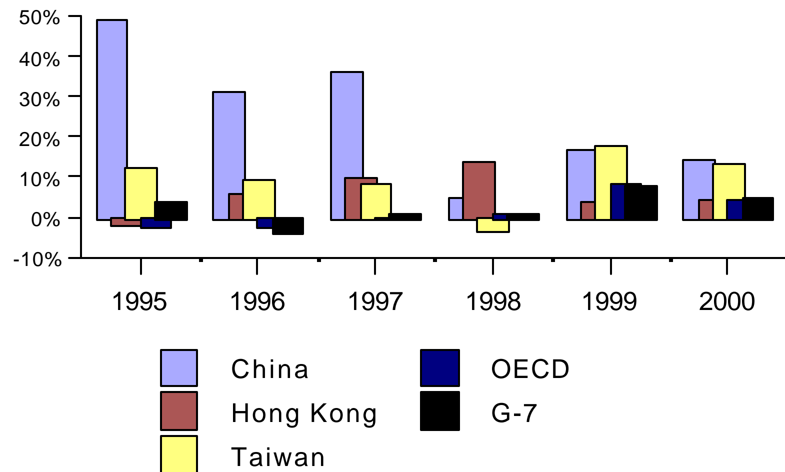
The insurance regulatory environment in Greater China continues to change, at an accelerating pace as the PRC's and Taiwan's entry to the WTO drew near, and changes will probably continue for many years to come. With wider access to the insurance markets in Greater China, numerous global insurance firms—direct insurers, reinsurers, and insurance intermediaries alike—show a keen interest in entering these markets, as do a number of local non-insurance firms. By entering Chinese markets foreign firms can further diversify their risk and investment portfolios, benefit from scale and scope economies, and find room for further growth. They can contribute to the local industry by making available sophisticated risk coverages, underwriting large risks, and transferring insurance expertise to their local partners. A competitive insurance market, compared to a tightly regulated market, can make more insurance products affordable and available to an increasing number of individuals and businesses, subsequently increasing the contribution of the insurance industry to the local economy. A competitive environment also makes the market more vulnerable to market distortion and insurer failure. Hence, it seems critically important at this juncture to investigate whether the insurance markets in Greater China are ready for competition and what additional measures the local governments should implement for the healthy growth of the markets.



Growth Potential

The growth potential of an insurance market can be measured using changes in insurance consumption and the insurance penetration ratio. Insurance penetration compares insurance premium volume to a country's gross domestic product (GDP). This measure is a rough indicator of the importance of insurance in the overall economy. The chart at the left, for example, shows insurance penetration ratios for Greater China from 1994 to 2000. (Macau is omitted because of its small size and the scarcity of data.) For comparison purposes, the chart also gives insurance penetration ratios for the OECD member countries in aggregate and the G-7 countries. This chart shows that the insurance penetration ratio has grown rapidly in Taiwan and Hong Kong while remaining nearly level in the OECD and G-7 countries during these years. Insurance penetration has also increased rapidly in the PRC, although from a much smaller base.

The chart showing the insurance penetration ratio, however, fails to capture the real magnitude of market changes in Greater China. The chart on this page illustrates the annual rate of changes in insurance consumption. Not surprisingly, the data for the OECD member and G-7 countries show that their rates of change in insurance consumption over these years have been consistently small and sometimes negative. These markets are largely saturated, leaving little room for future growth. In contrast, except for the year of the Asian Financial Crisis, the annual growth for the PRC, Taiwan, and Hong Kong has usually been in the double digits, thus indicating a much greater potential for insurance market growth.



A related issue is the number of firms operating, or soon to operate, in the market. This issue can be examined using the Herfindahl index—sum of the square of market shares of all insurers. A Herfindahl index below 1000 often indicates that the market is not concentrated. An index between 1000 and 1800 indicates some degree of concentration, and an index greater than 1800 indicates that a single insurer or a group of large insurers have the ability to exercise some control (such as control of prices or distribution channels) in the market. Another proxy measure is the firm concentration ratio: the higher the ratio, the more likely that large insurers exercise some anti-competitive activities in the market.

The table on the next page presents Herfindahl indices and five- and ten-firm concentration ratios in Greater China based on the information for the year 1999 or later. The findings for Hong Kong indicate that the market is relatively competitive and that no insurer would be large enough to exercise control over other insurers in the market. In contrast, the results for the PRC show that its insurance market is highly concentrated, and a few insurers probably control the market. The life insurance market in Taiwan and both the life and non-life insurance markets in Macau display similar characteristics, although to a lesser extent. Those markets need some measures to minimize, if not eliminate, any anti-competitive threats.

Several solutions exist. For example, the government may reduce the scope of business for its state-owned insurers, or it may even privatize them completely. Admitting more financially sound insurers equipped with a strong financial capacity and superb expertise in insurance business can be a solution. Another solution can be encouraging mergers and acquisitions among small insurers or firms in the financial services sector, thus creating additional viable competitors.

Insurance Market Concentration

	Number of firms*			Herfindahl index		5-firm concentration ratio		10-firm concentration ratio	
	Life	Non-life	Composite	Life	Non-life	Life	Non-life	Life	Non-life
PRC	47		N/P	5180	6398	99.1%	98.1%	N/A	
Hong Kong	140	45	19	963	251	61.5%	24.8%	N/A	35.8%
Macau	9	15	N/P	2,019		78.82%		92.90%	
Taiwan	33	29	N/P	1771	805	78.47%	47.63%	91.38%	72.61%

* Based on the latest information available.
N/P (not permitted); N/A (data not available)
Sources: Swiss Re (2001), Office of the Insurance Commissioner of Hong Kong, 1999 Insurance Department Annual Report (Taiwan), Macau Insurance Report 2000.

Requisites for a Competitive Market

Since they expressed the wish to join the WTO, the PRC and Taiwanese governments have prepared for the entries of new domestic and foreign insurance firms. The PRC created the CIRC as the insurance regulatory authority in 1998. It introduced, among others, the Regulations Governing the Administration of Insurance Enterprise of 1997 and the Regulations on the Administration of Foreign-invested Insurance Companies that came to effect in January 2002. Taiwan amended its insurance law in 2001, introduced the Financial Institutions Merger Law in 2000, and both the Financial Holding Company Law and the Financial Supervisory Board Law in 2001. Hong Kong and Macau, which have maintained rather liberalized insurance markets, are not directly affected by the PRC's accession to the WTO, at least for now. Nonetheless, Hong Kong has revised its insurance law several times, the latest amendment in 2000, and continues to focus on corporate governance and self-regulation. Since becoming part of the PRC, Macau also restructured its financial regulatory authority, AMCM.

With respect to insurance business, the WTO protocols deal mainly with liberalizing the local insurance markets according to the principle of most favored nation, deregulating the local industry, and creating a level playing field in the local market according to the principle of national treatment. As such, creating and maintaining a market environment where financially sound and prudent firms with robust insurance expertise offer a wide array of insurance coverages is still a task of the local regulators. The regulators must also enhance their competence in regulating and supervisory the industry. By doing so, the regulators can best protect the interests of policyholders. There are still a few areas that need regulators' close attention.

Solvency Regulation

All the governments in Greater China have solvency margin guidelines. These guidelines share a common element that the margin requirement is basically a function of the insurer's size of business measured by premiums, claims, or both. There are additional, albeit crude, regulatory measures

that control the amount of insurance coverage, per risk or in aggregate of all risks that each insurer assumes, based on the size of the insurer's capital (policyholders' surplus). Nevertheless, the existing solvency margin guidelines fail to reflect fully differences in size among insurers operating in the same class, in risk and investment portfolios of individual insurers, in reinsurance arrangements, and in other insurance business-related risks. This weakness can result in inadequate capital buffers for those insurers that expand rapidly, operate in volatile lines of insurance business, or take excess risks in investment and other activities. Also lacking are well-articulated methods enabling insurers to estimate their unearned premium reserves and loss liabilities, IBNR claims in particular.

To address these issues, the existing formulae need modification to reflect not only underwriting risk and pricing risk, but also asset risk, credit risk, and other business-related risks, including foreign exchange risk. An alternative approach could be adopting risk-based capital models, which the Taiwanese regulator plans to introduce by year-end 2003, or more advanced solvency margin formulae of international standards.

Focus on Ex Post Regulatory Measures

In the new regulatory environment where *ex post* regulatory measures are increasingly emphasized, the importance of prudent financial and accounting regulation cannot be overestimated. Without reliable financial reporting, the supervisor may not be able to monitor in a timely and effective way signs indicating the financial difficulty of insurers. Regularly gathering and analyzing material financial and accounting information from licensed insurers is an essential supervisory tool. Guidelines that allow reasonable, but somewhat conservative, valuation of insurers' assets and liabilities also help monitor solvency. Permitting insurers to invest their assets in an array of investment vehicles matched with their liability exposures is equally important.

Development of Capital Markets

A related issue is whether the local financial sector, especially the capital market, is mature enough to offer a wide range of investment opportunities for insurers. Without the presence of a financially sound and strong capital market, insurers face difficulty in diversifying their investment risks. Neither can they closely relate the duration, risk, and investment return of their assets to those of their liabilities. Limited investment choices on top of stringent investment guidelines can impede further development of the local insurance market. Capital flows freely into and out of Hong Kong and Macau, which function as regional hubs for financial services. Taiwan also has a relatively well-developed financial services sector. In the PRC, however, the investment choices are somewhat limited, despite the government's recent revision of investment guidelines.

Additionally, unless a reasonable justification exists, regulators should consider removing foreign equity ownership limits. Such a limit can reduce insurer underwriting and large-line capacity. This limit, when coupled with a lack of management control by foreign partner, can further discourage foreign direct investment, especially in the financial services sector. A similar issue is allowing insurers to make reinsurance arrangements freely, but with financially sound and authorized, reinsurers.

Human Resources Development

With the exception of Taiwan, there is probably a widespread shortage of qualified insurance professionals—actuaries, underwriters, claims adjusters, investment specialists, and market specialists—in Greater

China. The causes of this shortage are manifold: decade-long national monopoly, use of tariff rating, lack of new product developments, and few training institutes or universities offering insurance programs.[45] As the insurance industry develops, it certainly needs more local insurance expertise. These needs could not be met solely via skills-oriented training programs. The insurance industry, as well as the regulatory authorities, needs well-educated professionals specializing in insurance and actuarial science. A long-term solution would be promoting collegiate insurance and actuarial science education and encouraging academic research in insurance, as well as banking and capital markets.

Public Education

Insurance is probably the lowest-cost and systematic risk management mechanism that protects individuals and businesses from scores of risks. It is also an effective mechanism to preserve or accumulate wealth for holders of life insurance and their beneficiaries. These benefits of insurance and its superiority—in many aspects—over other investment mechanisms as a wealth protection mechanism might not be not widely, or correctly, known to people and firms in Greater China, especially in the PRC. Regulators and insurers should emphasize public education about insurance. An effective education campaign will result in more insurance consumption when the market is served by prudent, competent, and efficient insurers, and when rigorous regulatory mechanisms are in place to protect policyholders' interests. Policyholders should also be discouraged from exercising adverse selection against insurers or committing fraud.

Prognosis

The PRC and Taiwanese insurance markets are now in the midst of privatization, liberalization, and deregulation. This progress toward free trade in insurance not only mirrors other economic reforms, including other sectors in the financial services industry, but it is also in line with the efforts to observe international best practices in insurance regulation and supervision.

Of course, the entire lines of insurance may not be deregulated, as a perfectly competitive market can only be observed in theory. However, the regulator should minimize, unless it can eliminate, any unnecessary constraints in the insurance market, while it closely monitors all the activities in the market, especially those related to financial stability of insurers, for the development of a sound insurance industry.

A liberalized market environment induces insurers to increase their efficiency and be more competitive, while such a competition does not necessarily lead to market distortion. Insurers in a competitive market will focus their *modus operandi* on developing expertise in all areas of insurance operations, thus being able to offer a wide array of insurance products. When the market is liberalized, even if not fully, foreign capital and expertise will flow in to the local market, and all the participants in the market can receive the benefits resulting from scale- and scope-economy effects of insurance operations.

The insurance industry plays an important role in the economy in transition toward a liberalized and competitive economy. The industry is a vital source of capital for economic development. More

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[45] See Kwon (1999a and 1999b) for a discussion about the current status of collegiate insurance and actuarial science education as well as training institutes in Asia.

importantly, it makes indirect, but significant, contributions to the economy in the form of providing effective and low cost means of protecting wealth of individuals as well as letting businesses use their resources to enhance their firm values.

The more open an insurance market, the more the market, as well as the economy, benefits from scope- and scale-economy effects. Liberalization of the market improves financial intermediation and resource allocation in the economy. It also induces inflows of foreign capital and technical expertise, thus increasing productivity and types products available. In fact, numerous studies have found a positive correlation between openness of the financial services market and economic growth in developing countries.

Liberalization, along with deregulation, makes the market more competitive and encourages insurers develop more specialized products to meet policyholders' ever increasing exposures. Competition leads to improved management and service quality, allowing cost-savings to policyholders. A competitive market tends to be stable and is less vulnerable to abnormalities in the market. A competitive market—an open market with national treatment and regulatory transparency—is attractive to both the local private sector and foreign insurers.

Inefficient insurers cannot survive long in a competitive market. However, regulators and other stakeholders in closed markets often misinterpret the causes of the failure of those insurance firms, sometimes even the mere possibility of such a failure, and prefer retaining protectionism or upholding tight regulation. Even when a market in a developing economy is being deregulated or liberalized, the regulatory authority may insist on the needs for safety nets—for example, tight access and exit regulation, price regulation, investment regulation, as well as compulsory reinsurance cession—to minimize the risk of market distortion and insurer insolvency. Such safety nets should not always be avoided and might be working when the market is in transition. However, they should be of short-term measures and be eventually removed. Otherwise, the market continues to operate less efficiently than a fully liberalized, competitive market. The same logic applies when the insurance market is more tightly regulated than other industries. The insurance regulator must do its best to keep the insurance industry, at least, as equally attractive as other industries; otherwise, the capital can be diverted to other industries within the financial services sector or to other sectors with better potential returns.

To improve efficiency and competition in the insurance market, all interested parties must be actively involved. The regulators should impose only the rules and regulations that promote fair competition within the market, and must not attempt to use the insurance industry as a simple means to support another industry or purely as a source of capital for economic development. Insurers in the countries should be financially sound, technically competent in insurance matters, and must remain prudent in management and operation. The people as well as public and private entities in those countries must enhance their understandings about the benefits of insurance, and demand for and consume insurance products that meet their insurance needs. Political stability in Greater China is another prerequisite. When these prerequisites are met, the insurance industry can further benefit the local economies in the region and eventually help those economies continue to advance.

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