

# Industry Outlook

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## China's Life Insurance Industry Outlook 2017: sustained business growth with an improved structure and greater difficulty in liquidity management

**The life insurance industry transformation and the market-based regulatory reform begin to bear fruits. Premiums from new insurance grow faster and cash flows from renewals are ample. Business quality continues to improve and investment income grows with fluctuations. Profitability keeps improving. The industry-wide solvency under C-ROSS remains good to provide a strong cushion against risks. The industry outlook remains stable.**

*The outlook for China's P&C insurance industry is stable. The outlook represents CCXI's forecast for the industry's basic credit status in the next 12-18 months.*

## Abstract

- The life insurance industry experienced strong growth in 2015 and 2016 in the context of value transformation and market-oriented supervision. The supportive industry policies such as the 13th Five-Year Plan for the insurance industry and tax rebate for private health insurance have created a favorable atmosphere for industry growth, indicating the country's great attention to elder care and health insurance and revealing the additional room for insurance development in the field of elder care and health.
- The premium growth in the life insurance industry has accelerated greatly on new single-premium policies. The overall business structure of the industry continues to be improved, with protection business taking up a bigger share. With the short- and medium-term products standardized and the universal insurance supervision upgraded, the overall structure of insurance covers and terms is expected to be adjusted and the business quality will be further improved. Some companies may face the pressure of business growth caused by non-sustainability of short- and medium-term products and investment and wealth management products.
- The asset allocations of life insurers continue to be diversified, with traditional fixed income assets taking up an increasingly smaller share and the equity investment supervision toughened gradually. Therefore, quasi-fixed income products as an alternative investment instrument have become a major category of additional allocations, which imposes higher requirements on insurers' risk prevention and asset-liability matching.
- The industry profit keeps growing fast on sharp acceleration in premium growth and significant increase in investment income. Thanks to shareholders' stronger capital injections into insurance companies and the progressive improvements in new capital replenishment mechanisms, the overall solvency of the industry remains adequate and stable. High-risk assets, mainly equity investment, account for a large percentage and risks build up in the capital market. Moreover, more allocations to long-term assets and the pressure on payment and surrender upon maturity weigh on the liquidity management across the industry.

## Regulatory Environment

**The Outline of the 13th Five-Year Development Plan for Chinese Insurance Industry promulgated provides an action plan for the insurance industry development setting out the goals and supports for key work items for stable industry growth.**

- In August 2016, the CIRC issued the *Outline of the 13th Five-Year Development Plan for Chinese Insurance Industry* (the “Outline”). The Outline follows the guiding principles prescribed in the State Council's *Guidelines on Accelerating Development of the Modern Insurance Service Industry*, including vigorously developing the modern insurance service industry, promoting the industry transformation and upgrading and shifting China from a big insurance market to a strong one. The Outline systematically elaborates on the development goals and measures of China's insurance industry in every respect during the 13th Five-Year Plan period, including: accelerating development of the modern insurance service industry; deepening reforms and enhancing the driving force for sustainable development of the industry; improving the ability to serve eco-social development in a pioneering and innovative spirit; building an insurance-based safety net for the people's wellbeing; unleashing the role of insurance funds in supporting economic growth with upgrades and efficiency enhancements; opening wider to enhance the international competitiveness of the insurance industry; strengthening supervision to forestall risks; fortifying the foundation and continuously improving the environment of the insurance industry development; Talent-oriented, building high-quality talent team; and maintaining scientific coordination to smoothen implementation of the Outline. In addition, the Outline reiterates the growth requirements for the insurance industry in the next few years: By 2020, the national insurance premium revenue will reach about RMB4.5 trillion, the insurance depth (premium revenue/GDP) will reach 5%, the insurance density (premium revenue/total population) will reach RMB3,500/person and the total assets of the insurance industry will reach about RMB25 trillion. With regard to life insurance, the Outline puts forward the following requirements: deepen the market-based reform of life insurance rates and improve the supporting system for the formation mechanism of life insurance rates; innovatively develop various forms of commercial pension insurance products and develop multi-level pension insurance services; improve the top-level design of commercial health insurance, diversify health insurance and promote the steady operation of serious illness insurance.
- In general, the Outline as the action plan for China's insurance industry clearly sets out the goals and priorities for insurance industry development during the 13th Five-Year Plan period based on a comprehensive analysis of the internal and external environments, development status and opportunities and challenges for China's insurance industry. In addition, as the innovation in life insurance achievements in pension insurance, health insurance and corporate annuities are closely related to the social security and pension system reform, healthcare system reform, urbanization and other hot areas of reform, the industry is embracing new room of development while still facing such practical issues as specific ways of implementation.

**The private health insurance with tax rebate implemented officially has a long-term positive influence on the industry development, providing experience for piloting the tax-deferred pension insurance. However, the industry still faces such challenges as breaking the government-oriented way of thinking, defining the division of labor and establishing incentive mechanisms.**

- The Ministry of Finance, the State Administration of Taxation and the CIRC issued the Notice on Launching the Pilot Program on the Individual Income Tax Policy for Commercial Health Insurance, the Interim Measures for the Administration of Tax-deferred Private Health Insurance Business and the Notice on Implementing the Pilot Program on the Individual Income Tax Policy for Commercial Health Insurance successively in 2015 to clear policy and operational barriers to the private health insurance (PHI) tax rebate. The PHI tax rebate program began piloting in 31 major cities across the country, including Beijing and Shanghai, on January 1, 2016. By the end of 2016, a total of 23 insurers were licensed to operate the business. According to statistics, as of November 20, 2016, tax-rebate PHI covered 44,035 people with an aggregate premium of RMB71.24 million, averaging RMB1,618 per capita.
- The PHI tax rebate has gone beyond the ordinary rules and advantages of commercial health insurance. In addition to the benefit that the insured can claim up to RMB2,400 per annum as individual income tax (IIT) deductions, the insurer is not allowed to decline applications on account of the insured's medical history (i.e. “application with illness”) and should undertake to renew the policy without imposing any deductible or waiting period. In addition, the product takes the form of universal insurance with a combination of “mid-range health insurance + individual account reserve”. On the one hand, it is conducive to attracting more young people to take out insurance; on the other hand, it can provide a medical expense reserve for the insured so as to reduce their medical burden after retirement. In addition, the rule that simple payout ratio of medical insurance shall not be less than 80%, among

others, also urges insurers to strengthen payout management. However, on the other hand, the weak sales of private health insurance with tax rebate reflect the problems and difficulties existing in the pilot program, including: low level of publicity; unattractive policy preferences; insurers lacking sales motivation and showing absence of product innovation/personalization and additional services; problematic business support system; sales channels focusing on group insurance and complicated purchase process for individual applicants.

- CCXI believes that private health insurance with tax rebate as a form of policy-oriented commercial health insurance will, if properly implemented, have positive significance in stimulating the national insurance demand, promoting the transformation and upgrading of the insurance industry and building a multi-level social security system. Meanwhile, the private health insurance with tax rebate will also provide experience for the tax-deferred pension insurance to be piloted soon. At present, increasing product publicity, improving the underwriting techniques and channels and increasing the tax rebate quota are still urgent problems to be solved in promoting this type of insurance. In this process, it is difficult to correctly define the functions of the government and the insurer, establish an incentive mechanism for market players and remove the essential problems such as government-oriented way of thinking.

**The upgraded supervision over universal insurance will bring about business impact and cash flow pressure on life insurers in the short term, especially those with a high proportion of short- and medium-term products. In the long term, it is expected to boost the life insurance industry's supply-side structural reform and its return to protection functions. The overall risk exposure of the industry will shrink and business fluctuations will tend to stabilize.**

- 2016 witnessed a stronger trend that some small and medium-sized insurers made aggressive moves to grow universal insurance, causing risks to their own operations and also seriously deviating from the protection function of insurance. In order to regulate universal insurance development and implement the guiding principle that insurance is to protect”, the CIRC has issued a number of regulatory rules to restrict and standardize the scale and management of universal insurance, including the Notice on Regulating Short- and Medium-term Personal Insurance Products, the Notice on Further Improving the Actuarial System of Personal Insurance, the Notice on Strengthening Supervision of Life Insurance Products and the Notice on Further Strengthening Supervision of Life Insurance. Insurers are required not to design whole life insurance, annuity insurance and nursing insurance as products of medium or short duration. The minimum ratio of insured amount to premium or account value is increased from 105% to 120%. The ratio of death benefit for major age brackets of personal insurance products is increased from 120% to 160%. Starting from 2019, short- and medium-term businesses shall account for no more than 50%, which will further drop to 40% and 30% in 2020 and 2021 respectively. The ceiling of interest rate for universal insurance liability reserve assessment is lowered by 0.5 ppt to 3% to prevent the interest spread risk. The proportion of short- and medium-term insurance premium is linked to the hierarchical supervision of life insurers and the opening of branches, etc. In addition, CIRC issued risk alerts to 27 companies with a large scale and a high proportion of short- and medium-term businesses in 2016, requiring these insurers to strictly control the scale of short- and medium-term products. Seven local CIRC offices have been organized to conduct special inspections on the universal insurance of nine companies (including Qianhai Life and Evergrande Life) with a large volume of universal insurance and especially a large proportion of short- and medium-term products. These local CIRC offices issued regulatory letters to companies showing problems and took regulatory actions to suspend the single premium business in the bancassurance channel of two companies that breached regulatory limit on short- and medium-term businesses. To solve the problems of misleading marketing and cut-throat competition in settlement interest rates of universal insurance products in the Internet-based channel, CIRC has stopped the Internet-based insurance business of six companies successively, including Qianhai Life and Evergrande Life.
- CCXI believes that the toughening supervision over universal insurance since 2016 focuses on the supply-side structural reform of insurance and imposes more detailed and stringent restrictions on the scale and structure of insurance revenue, which will have a mixed impact on insurers. In the short term, the business impact is significant on insurers, especially small and medium-sized insurers that mainly rely on short- and medium-term products to expand the premium revenue. Some companies may face the pressure of cash flows and have a demand for capital increase. In the longer run, it will help to guide insurers to optimize the mix of insurance covers and terms and shift to medium- and long-term regular premium products and risk protection products, thus bringing the entire industry back to the protection function. In addition, under the total capital control framework and the progressive regulation, the industry exposure will be gradually reduced, with business fluctuations expected to smooth out and the business structure to be improved.

**The supervision over insurance fund utilization has been increasingly strengthened and risk control has become the guiding principle. The regulatory measures of “reining in the back end” will be more specific, with the growth rate and structure of fund utilization to be adjusted.**

- In the context of “asset shortage”, insurance companies frequently bought into listed companies in the secondary stock market in 2016, becoming major institutional investors in the capital market. The expansion of scale and yield

of capital utilization is accompanied by the buildup in risks. Various debt risks have come into sight, making it more difficult for insurers to reallocate assets. Some life insurers have found themselves exposed the risk of asset-liability mismatches and liquidity risks and seen their profits fluctuate widely. Against such a backdrop, CIRC has strengthened the market behavior supervision over fund utilization. In November 2016, CIRC conducted a disciplinary interview with chief officers of Evergrande Life in response to the insurer's short-swing trading in the stock market, voicing its stance in Evergrande Life's stock investment, the CIRC interviewed the principal leaders of Evergrande Life, stating that it would not support the frequent, massive stock speculation by insurance funds in a short period of time. CIRC also ordered suspension of trading for irregularities in its entrusted stock investment. In December 2016, CIRC held a special meeting to emphasize that insurance funds must be used in a prudent and stable manner and serve the principal business of insurers. CIRC also set out three principles to be followed: the investment should mainly target fixed income products, supplemented by non-fixed income products such as equities; equity investment should focus on financial investment, supplemented by strategic investment, and a small portion of strategic investment should focus on equity participation. CIRC required efforts to be a friendly investor in the capital market rather than a "barbarian" against the public, nor should insurance funds become "mudslides" in the capital market. In the next step, specific regulatory measures will focus on improving the system of real-time and after-event supervision, strengthening on-site inspection of irregularities and potential risks, strengthening supervision of asset-liability matching for underwriting and investment coordination, strengthening supervision of offshore financing against onshore guarantees, overseas debt financing, major equity investments and other overseas investments and strengthening regulatory coordination with the PBOC, CBRC and CSRC.

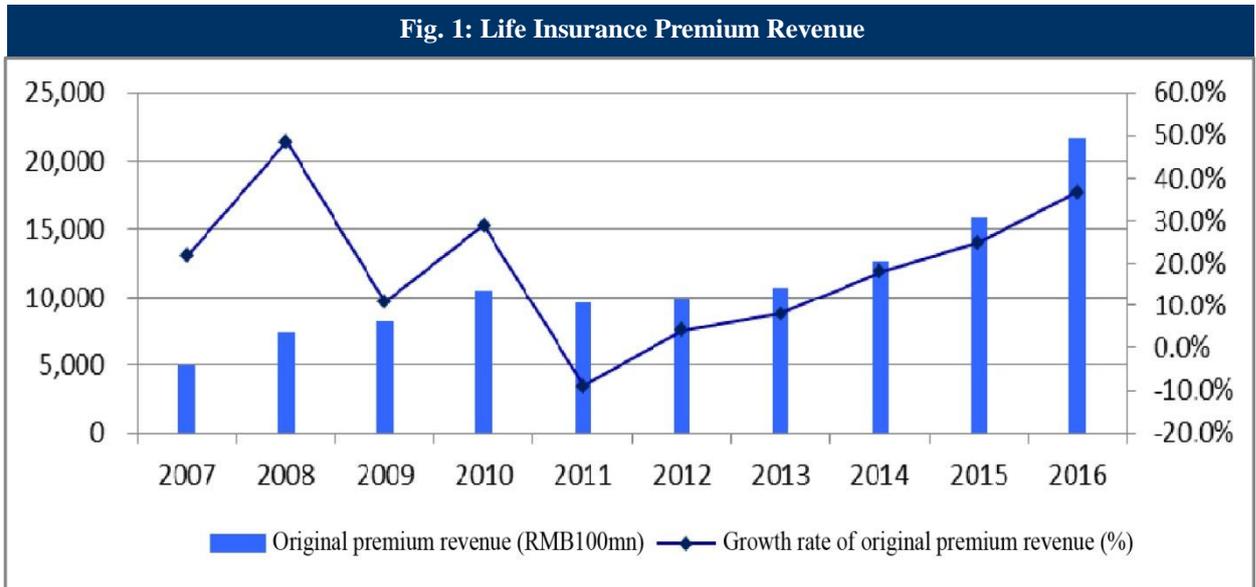
- In fact, the supervision of insurance fund utilization has seeking a balance between "freeing the front end" and "reining in the back end" in recent years. In terms of "freeing the front end", there is greater flexibility in the use of insurance funds. First, insurers are allowed to invest in a broad range of instruments, including such new categories as GEM, GEM funds, blue chips and preferred shares. Second, the regulatory percentage limit on insurance investment has been relaxed, with the ceiling of stock investment raised from 25% to 30% ( or up to 40% if blue chips are included) and the 20% limit on a single collective trusts cancelled. Third, CIRC has further streamlined administration and delegated powers to promote localization and market-oriented management,, authorizing six local CIRC offices (including Beijing and Shanghai) to exercise part of the power to supervise insurance fund utilization. In terms of "reining in the back end", under the C-ROSS system, the solvency risk is comprehensively evaluated using quantitative factors such as the recognized value of assets, minimum capital requirements and qualitative factors such as risk management level and information disclosure, thereby forcing the asset allocations to be restructured. The tightening supervision is to tighten the previously relaxed environment for the use of funds under the regulatory principle of "reining the back end". In the future, in the context of macro-economic downturn, interest rate liberalization, deleveraging and capital market uncertainties, insurance institutions will face a more complicated investment institution. The fund utilization reform will continue to advance in the market-based direction. Risk prevention will become the guiding principle of insurance fund utilization. Regulatory measures will be more specific. The growth of fund utilization scale will slow down, and the asset allocations will be structurally adjusted.

## Business Operations

### **The aging trend and the market-oriented regulatory reform have fueled growth of life insurance, with premium revenue growing significantly faster.**

- In recent years, the New Ten Guidelines for China's insurance industry have created a good environment for insurance industry development. The aging society has also created additional demand for life insurance. According to data available, the population aged 60 and over had reached 222 million at the end of 2015, accounting for 16.1% of China's total population (144 million aged 65 and over). According to the China Population Aging Forecast and Research Report, the total number of elderly people in China will exceed 400 million by 2050. Also, life insurance products have become more attractive in the context of the volatile and down-trending secondary stock markets, interest rate reductions and cancellation of guaranteed minimum interest rates in the life insurance industry. Policy dividends of market-oriented supervision have gradually been released to underpin sustained development of the life insurance industry. The life insurance industry realized a total premium revenue of RMB2.42 trillion in 2015, up 43.13% year on year. Regardless of additional contributions from investment-linked and universal accounts, the original premium revenue was RMB1.59 trillion, up 24.97% year on year, a big increase compared with 7.89% in 2013 and 18.15% in 2014. The life insurance industry continued its growth into 2016, with the annual premium revenue reaching RMB3.45 trillion, up 42.63% year on year. The premium revenue from original insurance stood at RMB2.17 trillion, up 36.78% year on year, representing significantly faster growth. As the social security reform gives a boost to the demand for commercial insurance and the industry's transformation and policy stimulus have begun to bear fruit, the life insurance premium revenue is expected to grow at a good level of more than 20%

through 2017.

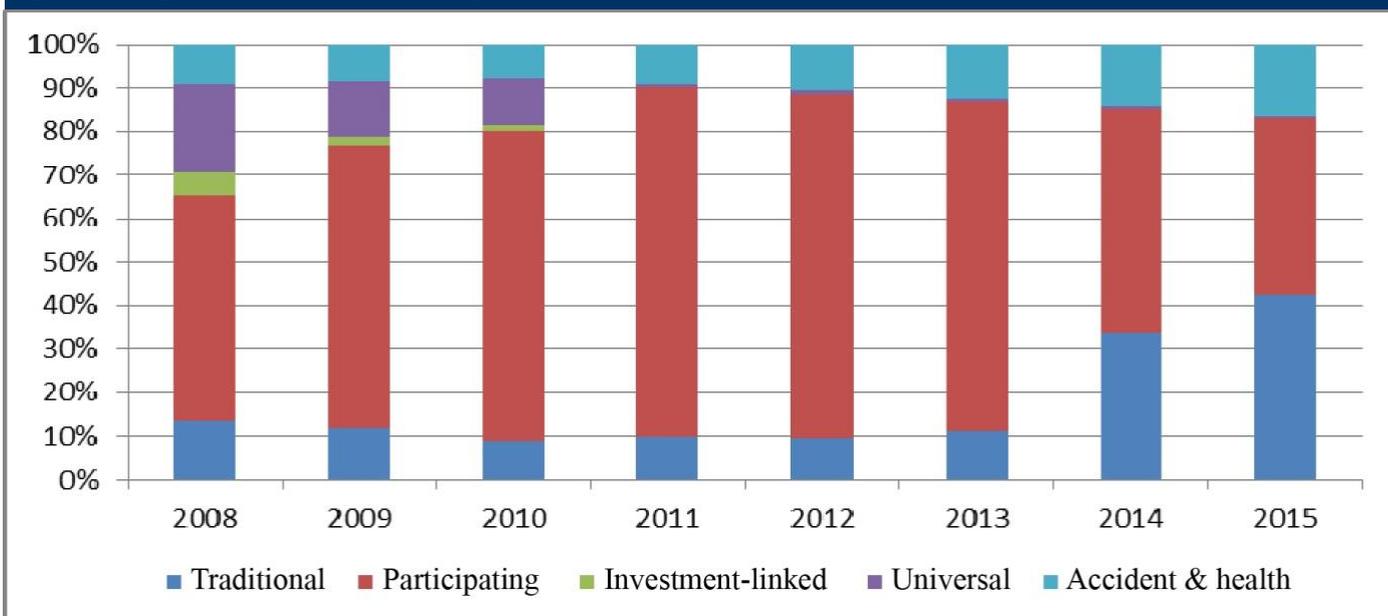


Source: CIRC website, compiled by CCXI

- Market strategies are becoming divergent. Large insurers continue to pursue value-oriented business transformation and offer a rising proportion of protection products and regular-premium products. Under the strategy of asset-driven liabilities, small and medium-sized private insurers have seen a rapid increase in the issuance of scale-oriented short- and medium-term products and wealth management products, but their future development remains to be seen under the tightening supervision. Foreign insurers stand steady with small market shares. Overall, the industry witnesses continuing improvements in overall business quality.
- From the perspective of product strategy, large insurers with a longer history and bigger market share focus on value orientation. They adjust the structure and improve the quality of business as the industry returns to the founding mission of protection. Though large insurers offer some scale-oriented products, it is just a makeshift strategy. Overall, increasing regular-premium and high-value product offerings remain the guiding principle. The earlier transformation efforts have begun to take effect. Protection products and regular-premium products are taking up a bigger share of premium revenue. On the other hand, small and medium-sized insurers are still under a heavy pressure of competition, so the expansion of scale is still a major factor for the management to consider. Moreover, their sales teams are relatively weak. Thus smaller insurers' product offerings focus on investment and wealth management products in a bid to expand business scale and market share rapidly. However, the future development is yet to be further observed due to the stricter supervision of short- and medium-term products and investment-oriented products, coupled by the C-ROSS implementation. By contrast, foreign-funded (joint-ventured) insurers are usually under higher requirements from shareholders in terms of business value, return to shareholder, risk control and decision-making process. Thus foreign insurers adopt a more prudent product and investment strategy, manifesting limited competitiveness and small market share. According to data disclosed by the CIRC, among the top 15 life insurers by gross premium revenue in 2016, state-controlled insurers generally have a larger share of original premium revenue than their share of policy holders' investment funds, while the top-ranking private small and medium-sized insurers show a rising market share of policy holders' investment funds.
- The overall mix of life insurance covers continues to be adjusted and optimized. By structure of original premium revenue, protection products take up a substantially bigger proportion in the industry. Influenced by the market-based rates reform, insurers continued to vigorously promote new products in tune with premium reform in 2015. Premium revenue from traditional life insurance continued to grow fast by 56.59% year on year to reach RMB672,810 million, with its share in the industry's total original premium revenue rising to 42.43% from 33.86% in 2014. In addition, in the context of the insurance industry returning to the founding mission of protection, accident and health insurance increased by 46.44% in 2015 year on year, with its share in the original premium revenue rising from 14.08% in 2014 to 16.50% in 2015. As a major life insurance cover, participating life insurance contributed 40.44% of original premium revenue, down 10.86 bps from the previous year. By structure of gross premium revenue, the industry's overall investment-oriented business grew rapidly in 2015 due to the aggressive marketing of universal, investment-linked and other investment-oriented products by some life insurers riding on the capital market upturn in 1H 2015. The additional contributions to policy holders' investment funds and those to independent accounts for investment-linked insurance stood at RMB764,656 million and RMB67,788 million, up 95.23% and 134.16% year on year respectively, accounting for 31.62% and 2.80% of gross premium revenue, up 8.44 bps and 1.09 bps from the previous year respectively. The original premium

revenue grew by 24.97%, with its share in gross premium revenue dropping to 65.58% from 75.11% in the previous year. In 2016, additional contributions to policy holders' investment funds and those to the independent

**Figure 2: Original Insurance Premium by Insurance Cover**

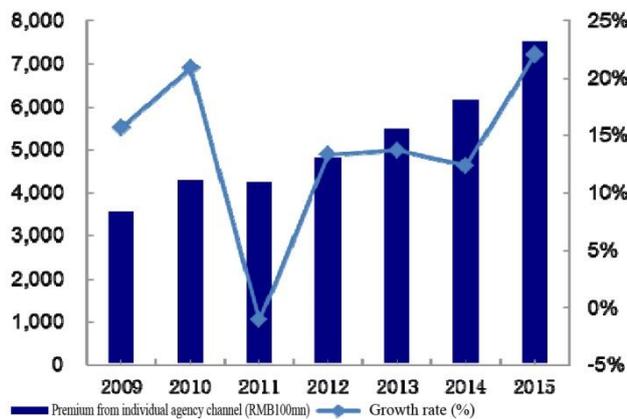


Source: CIRC website, compiled by CCXI

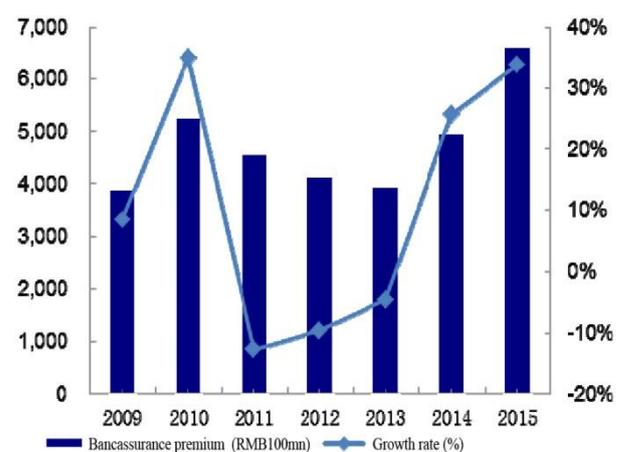
- By payment term structure, the overall premium growth across the industry in 2015 was driven by sustained contribution of renewals and strong growth of premium from new policies. Annual premium revenue from renewals increased by 6.91% to RMB654.44 billion year on year, representing a decrease of 6.97 bps to 41.27% as a share in the original premium revenue. Premium from new policies increased by 41.81% to RMB931.47 billion year on year, with its share in the original premium revenue rising by 6.97 bps to 58.73%. The growth in new policies was driven by single-premium and regular-premium businesses. The single-premium revenue grew by 42.00% year on year, with its share in new policy premium rising by 0.11 ppt to 73.50%. Regular-premium new policies took up a relatively low percentage, yet still maintaining a 41.26% year-on-year growth rate. The regular-premium new life insurance policies continued to grow rapidly in 2016, providing a strong backing for the sustainability of future premium growth in the industry.
- Overall, the market-based reform has gradually unleashed its role in boosting the diversity of life insurance products. Protection products have been taking up a rising share in the product mix. Given the stricter supervision on the use of insurance funds, the ongoing standardization of short and medium-term products and the formal implementation of C-ROSS, the overall business quality are expected to further improve across the industry.
- Driven by manpower and productivity enhancement, the insurance premium from individual agency channels has maintained steady growth. Bancassurance-based premium grew fast to contribute a bigger share thanks to enhanced product competitiveness, in spite of increasingly tougher supervision. Emerging distribution channels (e.g. telemarketing and Internet) have been mushrooming. Channel integration will become a key driver for the rapid expansion of emerging channels.
- As for marketing channels, with the insurance agent qualification examination policy considered and finally promulgated, the number of insurance agents has been growing in a spurt, reaching 4,713,000 in 2015, an increase of 1,460,100 from the beginning of the year, and further arriving at 6,572,800 in 2016. Meanwhile, insurance companies, especially large life insurers, are attaching greater importance to individual agency channels in line with their value transformation and the new bancassurance policy.
- They have strengthened cleanup of low-efficiency personnel and stepped up training efforts. As a result the overall competence of the agent team has been gradually improved, evidenced by the rising per-capital output. The premium revenue from individual agency channels totaled RMB753.25 billion in 2015, up 21.99% year on year, with its share in the total original insurance premium falling to 47.50% by 1.16 bps from the previous year. The rapid expansion of manpower in 2016 has laid a good foundation for growth of individual agency channels. The premium revenue from individual agency channels is expected to maintain rapid growth through 2017.
- The bancassurance channel is under a pressure from the tightening supervision over short- and medium-term products and from the intensifying competition within the channel. However, the increase in investment income after investment restrictions were lifted makes investment/WM products and short- and medium-term products in the channel more attractive, coupled by large insurers' explorations for bancassurance business transformation and the improvement in premium mix within the channel. Bancassurance-based premium revenue reached

RMB661.52 billion in 2015, up 33.72% year on year, with its percentage contribution to premium rising by 2.73 bps to 41.71% over the previous year, mainly driven by single-premium policies. With the bancassurance supervision toughened further, the marketing discipline and business quality are expected to improve. However, the bancassurance channel is suffering weak growth of regular premium and facing big challenges in transformation.

**Figure 3: Premium Revenue from the Individual Agency Channel** **Figure 4: Premium Revenue from the Bancassurance Channel**

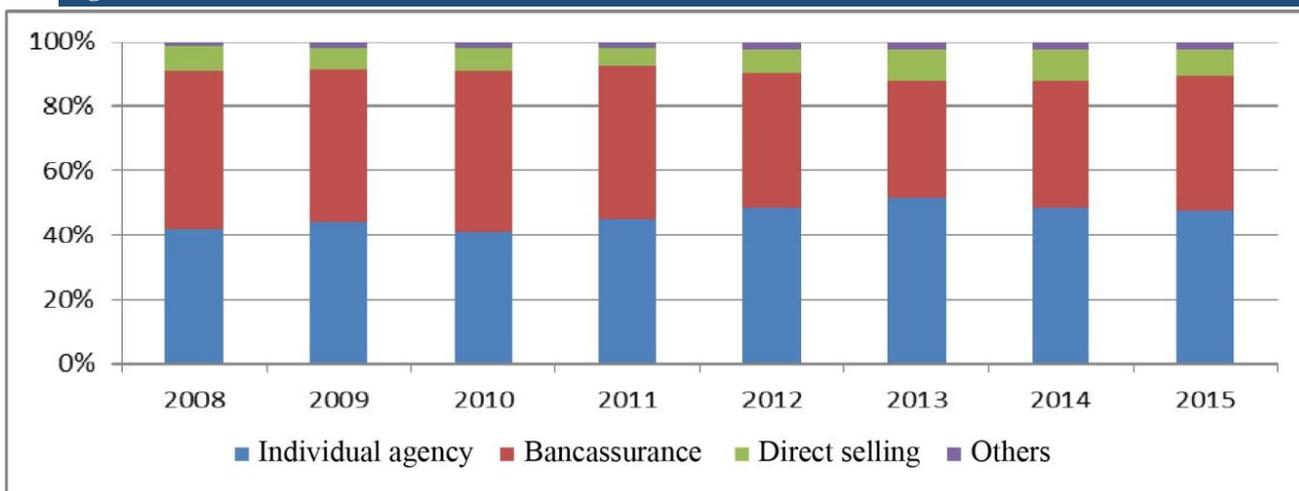


Source: Annual report on China's insurance market, compiled by CCXI



Source: Annual report on China's insurance market, compiled by CCXI

**Figure 5: Mix of Premium Channels**



Source: Annual report on China's insurance market, compiled by CCXI

- In terms of the telemarketing channel, the life insurance telemarketing market showed steady growth in 2015, with the business scale continuing to expand, albeit at a slower pace. In 2015, the number of personal insurance companies using telemarketing dropped from 33 last year to 32, with the annual premium revenue reaching RMB14.2 billion, an increase of 16.4%, down 3.2 bps from the year-on-year growth of 19.6% in 2014. The total number of paid-in insurance policies sold through telemarketing exceeded 2.58 million, up 10% year on year. The number of salespersons was 69,000, up 11% year on year. The monthly output value per capita and the monthly number of policies per capita were RMB18,900 (2014: RMB19,400) and 3.4 respectively. The premium per policy was RMB5,485. All key indicators showed solid performance. In terms of premium revenue breakdown by product in the telemarketing channel, life insurance, health insurance, annuity insurance and accident insurance ranked among the top four in descending order. By profitability, the telemarketing channel features relatively high policy values, but also faces a pressure from heavy investment in the telemarketing infrastructure, high maintenance costs, tough compliance requirements on customer acquisition, rising costs of customer acquisition, declining conversion ratio and rising operating costs such as manpower and rent. Moreover, insurance policies are mostly short-term, small-value protection products with limited diversity, showing rare economies of effect and high cost per policy. Many companies are losing money in the in-house telemarketing business, and some even quit the business. However, on the other hand, the companies having an edge in telemarketing take this opportunity to push for complying and professional precision marketing. In the future, in-depth resource integration and cross-sectoral cooperation and big data-based precision marketing will be the commonly

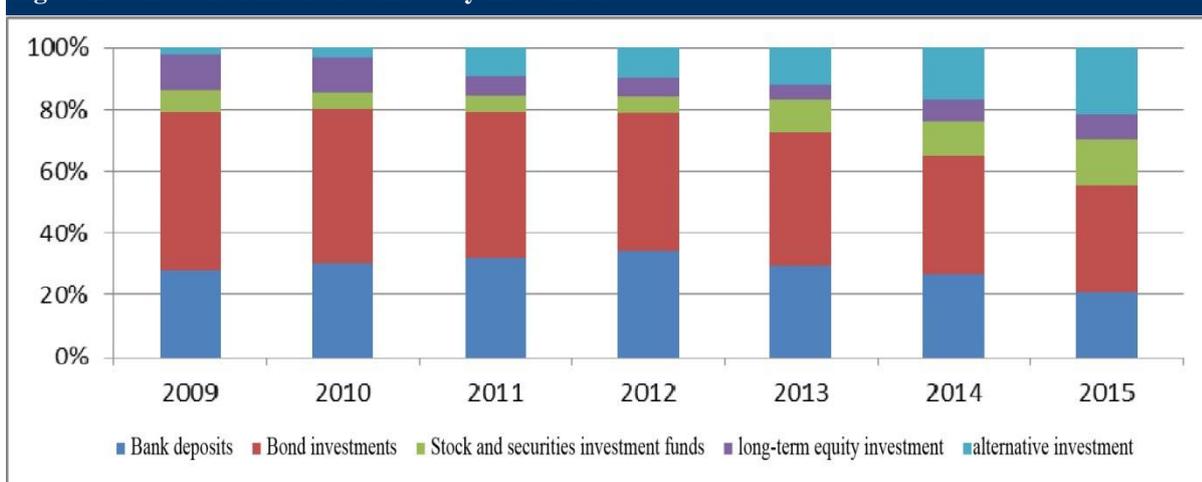
recognized trend in insurance telemarketing. The integration of telemarketing and Internet has become the direction of telemarketing transformation.

- In terms of the Internet channel, third-party websites have gradually matured. Insurance products are sold through many major e-commerce platforms, including Tmall, Netease, Tencent, Suning, JD Mall and Ctrip. With a huge customer base and strong big data analysis capabilities, e-commerce platforms have a great advantage over self-run websites, serving as crucial vehicles for all major companies to sell products online. Meanwhile, more and more Internet platform companies have begun to set up specialized Internet insurance subsidiaries. After the approval of China's first Internet insurer ZhongAn Online P&C Insurance in 2013, a number of specialized Internet insurers have been approved in succession in recent years, such as Yi An P&C insurance, Anxin P&C Insurance, BaiAn Insurance and Hetai Life Insurance. Traditional insurers, in addition to running their own websites, have also set up an Internet insurance division or e-commerce platform to strengthen in-depth cooperation with third-party e-commerce platforms. A variety of innovative mobile APPs catering to Internet users are also emerging. The number of domestic Internet insurers rose to 119 in 2015, with their written premium totaling RMB246.97 billion, up 1.8 times year on year. RMB174.72 billion of written premium came from personal insurance, up 3.6 times year on year and accounting for 70.7%. In 2016, a total of 117 insurance organizations ran the Internet insurance business and realized RMB234.8 billion of written premium. Among them there were 61 personal insurers with an aggregate written premium of RMB194.49 billion. Compared with large life insurers with leading market share and mature channels, small and medium-sized life insurers are relatively weak in marketing team and bear less burden, and are more active in the strategic setup of online marketing channels. From the perspective of products, the Internet channel focuses on universal and investment-linked insurance products that are oriented to investment and wealth management. In addition, tourism accident insurance and medical/health insurance are also favored by third-party platforms, representing major protection projects. At present, however, protection products sold on Internet have their weaknesses in the absence of complicated procedures such as physical examination in the underwriting process. For insurance risk considerations, online product offerings have lower insured amounts and lack of exclusive products in the short term when compared with offline products. The business model, product strategy, service rendering and supervision methods still need to be explored. In the long run, Internet-based insurance still has great development potential as Internet finance is advancing.
- In addition, the diversification channels have become an important choice for many insurers in their strategic planning. The preexisting cross-selling methods, i.e. selling individual insurance products through group insurance channels or individual insurance salespersons developing group insurance customers, have long been an important selling method for insurers to integrate channel resources, provide comprehensive services, reduce customer acquisition costs, increase customer stickiness and enhance competitiveness. In recent years, the cross-selling between telemarketing and bancassurance, telemarketing and online selling as well as telemarketing and direct selling has blurred the boundaries of the internal sales channels of insurers, and channels have been increasingly integrated. With integrated finance evolving, more and more integrated insurers cross-sell their products between P&C and life insurance, between insurance and banking, and between insurance and other business lines of the common owner. Cross-selling and horizontal alliances will become new poles of growth for insurers in the future in the context of integrated operation.
- Life insurers have increasingly diversified asset allocations, undergoing a declining share of traditional fixed income assets and a rising percentage of fixed income products as part of alternative investment. Against the backdrop of volatile interest rates and exchange rates, non-standard assets, overseas assets and fund products that can be encashed flexibly will become the major categories of additional allocations.
- The expanding premium revenue has been driving up the scale of fund utilization, with the efficiency of fund utilization staying above 90%. The funds used in the insurance industry reached RMB11.2 trillion in 2015, up 19.8% from the previous year, and the utilization rate of insurance funds was 91.06%. In 2016, the insurance industry registered RMB15.1 trillion in assets and RMB13.4 trillion in fund utilization, up 19.8% from the previous year.
- From the perspective of capital market fundamentals and investment strategy, PBOC lowered the benchmark interest rate several times from 2015 through the first three quarters of 2016. The interest rate of market funds trended down obviously. Banks' negotiated deposit rate also showed a downtrend. Insurers continued to broaden investment channels to reduce the dependence of insurance assets on interest rates. At the same time, the return on investment in non-standard assets is around 6% to 7%. Insurers have increased their investment in non-standard assets to improve the overall investment income. The infrastructure debt investment plans feature longer terms, high rate of return and large amount of fundraising, catering for the long-term nature of insurance funds and thus becoming the main category of insurers' non-standard investments. In addition, fixed income products such as portfolio management products, trust and banker's wealth management are also favored by insurers, taking up an increasing share. After the New Ten Guidelines granted go-ahead for the establishment of specialized asset management organizations, private equity funds and asset securitization, the non-standard investment is expected to further diversify in form and expand in size. In addition, the stock market upswing in 1H 2015 led to an increase in the overall equity investment positions of insurers. In spite of the subsequent wide swings in the capital market,

there were still insurers buying into blue chips with low valuations and good growth potential in the secondary market. However, the tightening supervision over the use of insurance funds will curtail insurers' equity investments in the secondary market.

- From the perspective of asset portfolio structure, traditional fixed income assets are still the main allocation for insurance funds, but their share continues to decline. In terms of bank deposits and bond investment, the banks' negotiated deposit interest rate and bond yield rate are also on the decline within the downward cycle of interest rates, becoming less attractive and taking up shrinking shares. By the end of 2015, the balance of banks' deposits fell by 5.18% to RMB2,434.97 billion year on year, with its percentage share down 5.34 pts from the end of the previous year to reach 21.78%. Bond investment increased by 6.74% year on year to RMB3,844.64 billion, with its share falling to 34.39% by 3.76 pts from the end of the previous year. Equity investment continued to grow on the bullish stock market in 1H 2015. The balance of stock and securities investment funds reached RMB1,696.9 billion, up 64.34% year on year, with its share in total investment rising by 4.1 pts from 2014 to 15.18%. The balance of long-term equity investment was RMB890.91 billion, up 39.23% year on year, with its share in total investment rising by 1.1 pts from 2014 to 8.0%. In addition, alternative investments such as infrastructure plans, real estate investments, policy pledge loans, portfolio management products, trust, banker's wealth management, etc. have also become the major categories of allocations. As at the end of 2015, investment real estate and infrastructure plans combined increased by 16.72% year on year to RMB945.62 billion, with their combined share falling by 0.3 ppt from 2014 to 8.4%. Policy pledge loans increased by 27.7% year on year to RMB229.81 billion. The portfolio asset management products increased by 208.1% year on year to RMB249.06 billion. Investment in financial products such as trusts and banker's wealth management increased by 18.6% year on year to RMB550.23 billion. Since 2016, bank deposits and bond investments have been taking up a declining share of total investment assets. The proportion of stock and securities investment funds has also shown a downtrend due to the bearish secondary stock market. As of the end of 2016, the balance of bank deposits was RMB 2,484.42 billion, accounting for 18.55%. The balance of bonds was RMB4,305.03 billion, accounting for 32.15%. The balance of stock and securities investment funds was RMB1,778.81 billion, accounting for 13.28%. The balance of other investments was RMB4,822.81 billion, accounting for 36.02%. At present, in spite of the still-existing risk of macro-economic downturn, the tight monetary policy of the central bank and the short-term pickup of interest rates, coupled by the regulatory efforts to guard against the systemic financial risk and deleverage, provide a good opportunity for life insurers to create a position in bond investments. Meanwhile, higher-yield non-standard assets and overseas assets will become insurers' hedging tools against interest rate risk and exchange rate risk. The equity investment position is expected to shrink due to secondary market fluctuations and tighter regulation. In addition, some fund products with controllable risks, higher returns and good liquidity will still remain hotspots for allocation.
- Overall, insurers' asset allocations are increasingly diversified, with high-yield and long-term products rising rapidly as a percentage of total portfolio. The effects of increasing investment return and improving asset-liability mismatches are gradually showing up. The gradual relaxing of investment scope restrictions has eased the embarrassing situation of unattractive investment-oriented insurance products to a certain extent, providing insurers with bigger flexibility in exercising their product strategies. On the other hand, however, new investment instruments and volatile capital markets pose greater challenges to the risk control ability of insurers and the effectiveness of regulators' supervision. Specifically, credit risk and market risk are major exposures. In terms of credit risk, as insurers have a short history of credit investments in non-capital markets and it takes time to build a professional risk control team and mechanism, currently credit risk is rising with the rapid expansion of high-income fixed income investment. In particular, given the lack of unified credit management of a single obligor, special attention should be paid to the risk of concentration on a single entity. The platform risk deserves special attention as the scale of planned investments in financing platforms has increased rapidly. In addition, potential credit risks also deserve special attention as the implicit guarantees for banker's wealth management, trust plans and bond market have been tapered off. In terms of market risk, given the large share of bond investment holdings, the sharp decline in bond prices starting from 2016 has had a great impact on the investment income of insurers. Also, the rising share of equity investment exposes investment income to the secondary market turmoil. Moreover, the tightening supervision over equity investment will put such investments under stiffer restrictions.

**Fig. 6: Breakdown of Insurance Industry Investment**



## Financial Position

**Driven by the continuous increase in premium revenue and investment income, the industry-wide profits have increased substantially. Long-term attention should be paid to stability of the industry profits in the context of more volatile capital market and elevated payouts and surrenders.**

- Thanks to people’s stronger awareness of insurance and the increased attractiveness of insurance products in a low interest rate environment, the premium from new life insurance policies increased significantly in 2015, driving the continuous growth of premium revenue at an increasingly faster pace. In 2015, the original premium revenue reached RMB1,585,913 million, up 24.97% year on year, 6.82 ppts faster than one year ago. In 2016, the original premium revenue reached RMB2,169,281 million in the industry, up 36.78% year on year, 11.81 ppts faster than one year ago. In the short term, the more fierce competition and tighter regulatory policies weigh on the rapid growth of premium revenue in the life insurance industry. In the long run, however, industry profits will be boosted by the innovation in insurance products, improvements in the mix of insurance covers, expansion of Internet and other marketing channels, policy dividends created by market-based reforms and the return of value under tighter regulation. The industry’s original insurance premium will still keep growing, albeit at a slower pace.
- As for underwriting expenses, , the industry’s payouts naturally increase as business scale expands. In addition, some companies’ participating insurance policies sold well in previous years entered the peak of payouts upon maturity. The life insurance payouts totaled RMB447,998 million industry-wide in 2015, an increase of 30.69%, faster than premium revenue growth. In addition, the problem of high surrender rate will continue to a certain extent due to the hot selling of short- and medium-term products. The industry-wide annual surrender spending reached RMB396.79 billion, up 22.8% year on year. The surrender rate was 6.12%, up 0.41 ppt year on year. In 2016, the life insurance payouts (including health insurance and accident insurance) reached RMB578,671 million, an increase of 29.17%.
- In terms of investment income, thanks to the deregulation, diversification of insurance fund allocations and improved efficiency of fund utilization, the investment income of life insurance funds increased steadily in 2015. Interest income from fixed income investment is still the main contributor to investment income. Interest income from equity investment is high but volatile, while alternative investments such as asset management products and infrastructure investment plans has grown rapidly to become a new growth pole for investment income. In 2015, the industry as a whole realized investment income of RMB7830.36 billion, up 45.6% year on year. The return on investment reached 7.56%, up 1.26 ppts from the previous year, a relatively high level in recent years. After experiencing bullish stock and bond markets 2015, the return on investment in 2016 dropped significantly, with the overall return on investment falling to 5.66% across the industry. In the future, the return on investment is expected to pick up on rising interest rates and higher-yield asset allocations.

**Fig. 7: Investment Income in the Insurance Industry**



Source: Websites of life insurers, compiled by CCXI

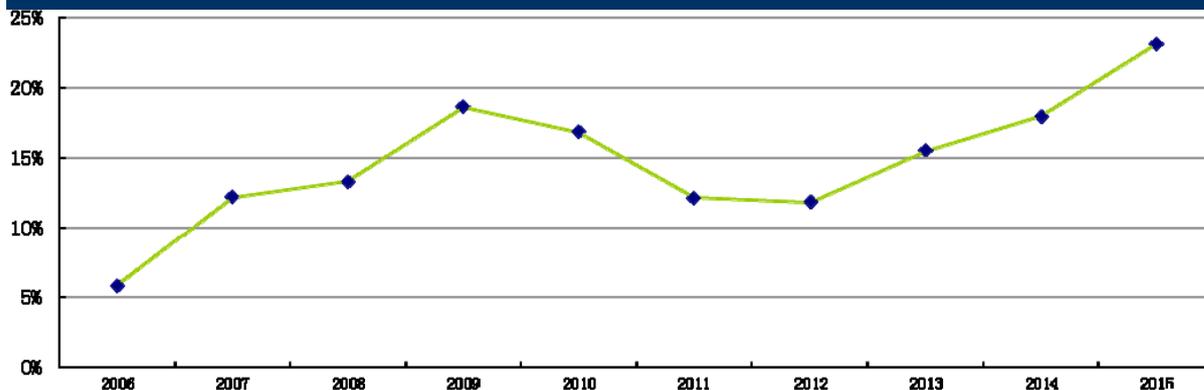
- Overall, overall profits of the life insurance industry continued to improve due to faster premium growth, higher investment income and rapid growth in payouts and surrenders. But the growth slowed down. The life insurance industry realized a total profit of RMB174.32 billion in 2015, up 59.5% year on year. In 2016, the insurance premium of life insurers continued to grow rapidly, but the overall profitability weakened across the industry due to the depressed capital market, declining interest rates and the still-high payouts upon maturity and surrenders across the industry. More than half of life insurers saw their profits declining year on year. In the future, the

factors adverse to overall profitability of the life insurance industry still exist. First, the allocation of insurance funds will be more difficult, duration mismatches of assets and liabilities will remain a prominent problem and the volatility of investment returns will be aggravated by capital market shocks. Also, the rising number of industry players has been intensifying competition and pushing up the cost of customer acquisition. In addition, the high-price products sold in recent years are facing a greater pressure of surrenders, casting uncertainty over the steady growth of underwriting profits.

**The quality of assets is at a bigger risk due to the further widening of investment channels and rising proportion of higher-risk assets focused on equity investment. Liquidity management is challenged by the widening duration gap of assets and liabilities and the rise in payouts upon maturity and surrenders**

- In recent years, the fast-growing insurance business has propelled the rapid expansion of insurance investment assets, while insurers have continuously widened investment channels on CIRC’s deregulation of insurance fund utilization. In 2015 when the capital market underwent violent turbulences and the central bank announced a string of interest rate cuts, insurers kept increasing equity asset allocations while still focusing on traditional fixed-income investment and also increased alternative investments including real estate investment, infrastructure investment and asset management products. At the end of 2015, equity investments including securities investment funds, stocks and long-term equity investments with relatively high risks accounted for 23.2%, up 5.3 ppts from 2014. The percentage share of investment plans such as infrastructure, financial products such as banker’s wealth management and portfolio asset management products rose to 7.6%, 4.9% and 2.2% respectively. Since the beginning of 2016, the capital market has continued to fluctuate at low levels and the market interest rate has continued to decline. The allocation of insurance funds faces such problems as declining investment income, mismatched asset-liability durations and inversion of yield curves. These problems, coupled by frequent bond defaults in a spreading trend, have been exposing insurers’ investments to rising market and credit risks.
- From the perspective of liquidity, though the bigger proportion of equity investments such as stocks and funds boots liquidity to some extent, high-quality liquid assets as a percentage of total assets has decreased due to the rising share of long-term asset allocations driven by fast-growing alternative investments (e.g. infrastructure claims, real estate investments and bankers’ wealth management), which have a relatively long maturity and are mainly held to maturity. In addition, the abnormal surrenders have increased in recent years due to the short- and medium-term business that mainly takes the form of universal insurance and ordinary life insurance, while the last two years remained the peak of payouts upon maturity. These factors have quickened cash outflows from operating activities, adding to difficulty in liquidity management. As for asset-liability structure, some of the liability-side transactions feature short terms and high costs, while the asset-side portfolio include a larger proportion of equity, real estate and other investments with poor liquidity. The resulting maturity mismatches pose a greater challenge to the liquidity management of life insurers.

**Fig. 7: High-risk Assets as A Percentage Share of Total Investment Assets**



Source: CIRC website, compiled by CCXI

**The industry-wide solvency remains sufficient, yet still in a downtrend. Business growth has created a pressure from continuous capital replenishment, with the capacity of endogenous capital replenishment susceptible to capital market volatility. New capital replenishment mechanisms need to be improved**

- In 2015, the insurance industry embraced the transition period for C-ROSS in which the CIRC has further strengthened day-to-day supervision of solvency. The industry demonstrates sufficient overall solvency. In 2015, thanks to stronger profitability and bigger investment income, the industry-wide solvency remains adequate and stable. By the end of 2015, only two of all insurers failed to meet the solvency standard (solvency adequacy ratio (SAR) of 100%). The median SAR of life insurers was 296%, up 11 bps year on year. 2016 marked the first year of full-scale C-ROSS implementation. The industry's overall solvency was sufficient and stable, yet showing a downtrend. The median of disclosed SARs of life insurers was 193% in the fourth quarter, with 44 life insurers

showing a decline from the third quarter. Some insurers were approaching the regulatory red line (core SAR of 75% and overall SAR of 100%), while two life insurers recorded negative core and overall SARs. In the future, capital market changes will make risk control a bigger challenge for the life insurance industry, thus weighing on solvency improvement.

- The profitability of life insurers is susceptible to capital market fluctuations. Since 2015, with the life insurance industry entering the boom cycle, insurers has expanding their appetite for capital to accommodate business growth and capital market operations. The shareholders of life insurers have strengthened capital contributions in an effort to expand business scale and market share. According to data disclosed by the CIRC, 23 life insurers, 2 health insurers and 1 pension insurer increased their registered capital 28 times in 2015. These increases totaled RMB64.557 billion. The C-ROSS system was fully implemented across the insurance industry in 2016, imposing higher requirements on the capital base of life insurers, while small and medium-sized life insurers with weaker capital base became the main participants in the new round of capital increase. According to data disclosed by the CIRC, 20 life insurers, 2 health insurers and 1 pension insurer increased their registered capital 27 times in 2016. These increases totaled RMB43.557 billion, a decrease of 32.53% year on year. The capital increase by most small and medium-sized life insurers did not exceed RMB2 billion, except Tian'an Life's capital injection of RMB10 billion. On the other hand, insurers were approved to issue capital replenishment bonds tradable in the interbank bond market in 2015. Many life insurers chose to issue capital replenishment bonds to replenish their capital due to the regulatory cap on subordinated bond issues. According to the CIRC disclosures on approved subordinated fixed-term bond and capital replenishment bond issues, two life insurers were approved to issue subordinated fixed-term bonds in 2015 in an amount of up to RMB1 billion, down 95.79% from 2014. A total of 9 life insurers were approved to issue redeemable capital replenishment bonds in an amount of up to RMB64.8 billion. In 2016, insurers' frequent buying into listed companies caused market fluctuations, while capital replenishment bond issues would make insurers financially stronger for secondary-market equity investments. Therefore, under the guiding principle of strictly strengthening supervision over the use of insurance funds, regulatory authorities are cautious in approving the application for capital supplement bond issues. According to the CIRC disclosures on approved subordinated fixed-term bond and capital replenishment bond issues, one life insurer was approved to issue redeemable capital replenishment bonds in 2016 in an amount of up to RMB8 billion. The subordinated debt issues have also continued to shrink, with only one life insurer approved to issue subordinated bonds in an amount capped at RMB300 million. Overall, despite the sufficient solvency, life insurers still need to replenish their capital base. At present, CIRC is continuously improving the capital replenishment mechanism of insurers, encouraging and regulating the innovation of capital instruments and actively researching and launching new capital replenishment mechanisms and channels such as convertible bonds, hybrid capital bonds, preferred shares, contingent capital, policy liability securitization products, non-traditional reinsurance and New Third Board listing.

## External Supports

### **The systemic support from large state-controlled life insurers, foreign life insurers and bank-controlled life insurers and shareholders' support are factored in rating**

- Life insurers mainly targets individual customers. Their stable operation is closely related to social stability, so the rights of policy holders will be protected first. However, life insurers' subordinated fixed-term debt and capital supplement bonds have a lower property in terms of payment. Life insurers' solvency depends mainly on their own financial strength, while their systemic importance and shareholders' support are also a consideration.
- The life insurance industry is highly concentrated, with the largest life insurers taking up a majority of market shares (the premium revenue of the top five life insurers accounts for 62.45% in 2016). Moreover, large state-controlled insurance companies are systemically important due to their long history of business, nationwide service network and high brand awareness, which turn into a huge customer base and a large number of outstanding insurance policies. It is highly probable for them to receive government support when a crisis occurs.
- The external supports available to life insurers also include the support from shareholders. Foreign insurers (including joint-ventured insurers) and bank-controlled insurers enjoy a strong backing by their shareholders, which are foreign insurers or large state-owned enterprises or banks. The dimensions of support to be considered includes the strategic importance of life insurers to their parent company, the commitments and track record of support of both shareholders of joint venture, the corporate governance mechanism and the financial strength of the parent company.
- In contrast, small and private insurers usually experience frequent shareholding changes. Their shareholders are not financially strong or have no clear intent to hold shares. We believe that their shareholders' and external supports are weaker than those available to state-controlled life insurers and foreign life insurers.

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