Special Topic

Fund Utilization of Insurance Companies and Development of the Insurance Sector

The history of international insurance industry development suggests that with advanced financial innovation and increased market competition, the insurance sector has shifted from solely relying on underwriting to focusing both on underwriting and fund utilization, with the latter becoming an increasingly important pillar of the development of the insurance sector.

Fund Utilization Serves as a Major Profit Source of the Insurance Industry

Insurers rely on both underwriting and fund utilization as their sources of profits. The last two to three decades have witnessed accelerated economic and financial globalization, financial deregulation, interest rate liberalization and diversified operation modes. Against this backdrop, insurers are facing intensified market and price competition. To stay on business, insurers cut premium rates in succession, leading to underwriting losses. Under such circumstances, it has become a trend for insurers to rely on investment gains to offset underwriting losses (Table 1). Thus the capability in fund utilization has become vital for insurers to compete and even survive.

Table 1 Underwriting Profits and Investment Incomes (as a Percentage of Net Premium) of Top 5 Non-life Insurance Companies, Life Insurance Companies and Reinsurance Companies by Premiums in 2006

(*percent*)

Type	No.	Company	Underwriting profit margin	Rate of return on investment	Rate of other expenses	Gross profit margin
Non-life insurance companies	1	Berkshire Hathaway Inc.	-202.82	27.13	247.24	74.87
	2	Allstate Corporation	11.64	23.48	-1	26.08
	3	Millea Holdings Inc.	-68.37	19.75	-1.82	6.01
	4	Travellers Companies Inc.	6.6	19.48	1	27.07
	5	State Farm Mutual Automobile Insurance Company	5.27	9	-3.27	11
Life insurance companies	1	Japan Postal Life Insurance Service	-53.01	25.9	29.03	1.92
	2	Metlife Inc.	-67.25	59.98	35.32	28.05
	3	Nippon Life Insurance Company	-2.38	23.56	6.02	7.07
	4	Prudential Plc	-104.13	118.4	-1.31	12.96
	5	Dai-Ichi Mutual Life Insurance Company	0.53	24.12	8.17	6.36
Reinsurance companies	1	Allianz SE	-35.59	56.95	-3.9	17.46
	2	Munich Re Group	-7.85	23.95	-1.51	14.6
	3	Swiss Re Company	-3.2	30.67	-1.56	20.09
	4	Tokyo Marine & Nichido Fire Insurance	-5.89	14.65	-2.43	6.33
	5	Hannover Rückversicherungs-Aktiengesellschaft	-0.4	12.43	-0.36	11.68

Note: ① Top five companies by premium are included in the order of descending rankings.
② The rate of other expenses is the ratio of other income or expenses to net premium of the insurer. A positive sign means net income, while a negative sign means net expenses.

Source: ISIS Database.

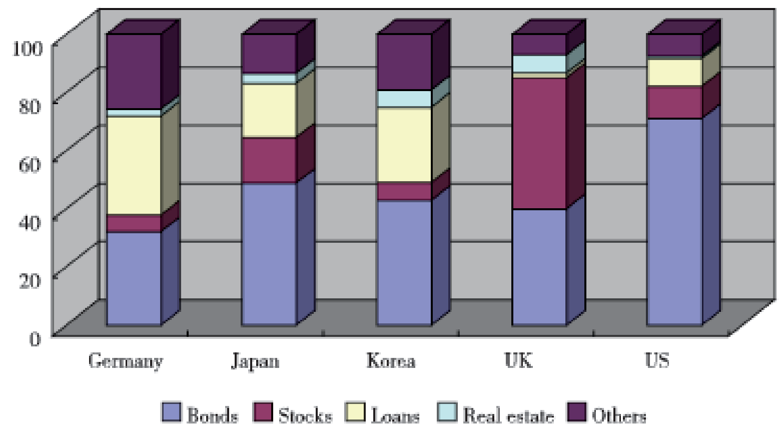
International Experience of Insurance Fund Utilization

Globally, insurance funds are invested in a broad range of assets, mainly comprising bonds, stocks, loans and real estate, with characteristics varying across countries. In summary, there are several features as follows: first, bonds account for a dominant share of investment portfolio for their low risk and stable returns, while stocks usually take a secondary role for their high risk and high returns. Second, the financing structure in the economy has direct impact on investment portfolio of insurance companies. In economies with developed direct financing such as in the US and the UK, insurance companies invest a large amount of assets in bonds and stocks; in contrast, in economies with developed indirect financing such as in Japan, Germany and Korea, loans account for a substantial portion of assets of insurance companies. Third, regulations have direct impact on investment portfolio of insurance companies. For instance, in the UK insurance regulations set no restrictions on percentages of financial instruments holdings, where insurance companies see a high proportion of stock investments. Fourth, property insurance companies pay more attention to liquidity than life insurance companies, thus holding more liquid assets including bank deposits.

With the US securities market being the largest in the world, the share of bonds in the US insurers' assets has averaged above 50% since 1990, with that of stocks rising to 11% in 2004. The UK also boasts mature financial markets, but insurance regulations in the UK set no restrictions on investment of insurance companies, which is different from the practice in the US. Therefore life and health insurance companies in the UK invest the largest share of assets in common stocks, which once exceeded 50% of total assets in 1990s, and declined somewhat since 2000, still remaining the largest holdings. Non-life insurance companies usually list government bonds as their most important investment, with the share of government bonds in total assets kept at around 20% for many years and the share of cash and other short-term assets at above 10%. Indirect finance has a more dominant role in Germany, Japan and Korea than in the US and the UK, hence insurance fund utilization witnesses more loans, with bonds investment holding a key position as well (Figure 1). In addition, insurance companies in the UK and Japan put more emphasis on overseas investment, with the share in total assets accounting for around 10% for many years.

Figure 1 Investment Portfolios of Insurance Funds in Selected Countries in 2004

(*percent*)



Source: *OECD Insurance Sector Statistical Year Book* (1994 –2004).

Insurance Fund Utilization in China

As the insurance sector has grown rapidly since the reform and opening up in China, total assets of the insurance sector has surged, exceeding RMB 1 trillion yuan at the end of 2004, reaching near RMB 2 trillion yuan at the end of 2006 and exceeding RMB 2.9 trillion yuan at the end of 2007. The outstanding balance of insurance fund utilization stood at around RMB 2.7 trillion yuan, accounting for 92% of total assets, with the scope of investment covering a variety of instruments including bank deposits, bonds and stocks. Looking back to the development process of China's insurance sector, the insurance fund utilization has experienced the following stages[1]:

Start-up stage (1980 –1987): During the stage, total annual premiums of the sector were less than RMB 10 billon yuan and asset accumulation was low. With insurance funds all deposited in banks, fund utilization was not an important factor affecting insurance business.

Full liberalization stage (1987 –1995): In the 1980s China launched an experiment on diversified operation of the financial industry. In early 1990s problems such as overheated economy and poor financial orders were acute. Under such circumstances, the insurance sector suffered great losses due to weak risk control and decentralized decision making, with the non-performing assets built up during the period of 1992 –1993 exceeding RMB 10 billion yuan.

Strict control stage (1995 –1997): In response to financial industry's failure in controlling risks of diversified operation and un-

1 Wu Dingfu, *China's Insurance Sector Development and Reform Report* (1979 –2003), Chapter 9, China Economics Publishing House, 2004.

winding of some deep-rooted problems in the previous stage, the authorities adopted a segmentalized pattern of the financial industry, and the insurance sector entered into a stage of strict control. The Article 104 of the *Insurance Law*, which was promulgated in 1995, provided that funds of insurance companies are restricted to invest in bank deposits, government bonds, financial bonds and other forms of investment approved by the State Council, and will not be used to set up securities institutions and invest in enterprises. The rule greatly contributed to rectifying the disorder in insurance fund utilization and controlling investment risk.

Gradual liberalization stage (1998-now): Strict restrictions on channels of insurance fund utilization could help control investment risk, but are not good for improving returns of fund utilization of insurance companies. With the insurance sector's overall strength rising and risk control capability improving, financial regulators started to relax controls on investment channels of insurance funds while stressing risk management.

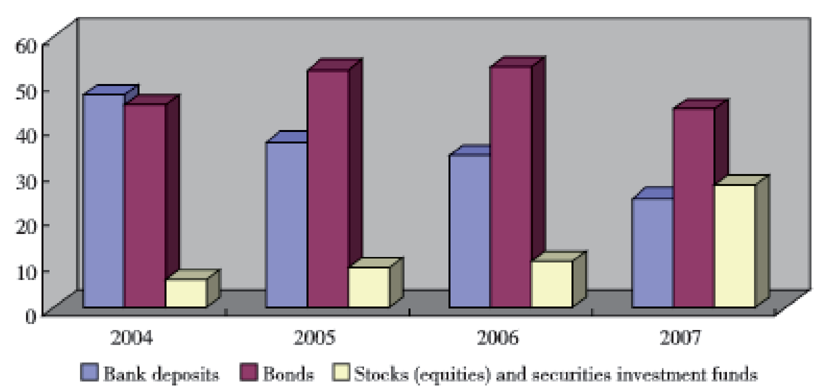
In terms of bond investment, insurance companies were allowed to conduct repo and spot transactions in the inter-bank market in 1998, invest in bonds of central enterprises in 1999, and invest in all corporate bonds rated above AA in 2003. The *Provisional Administrative Rules on Bond Investment by Insurance Institutional Investors* promulgated in 2005 further expanded the scope of bond investment of insurance companies and raised the percentage ceiling of corporate bonds in investment portfolio of insurance companies. In terms of stock investment, the *Provisional Administrative Rules on Investing in Securities Investment Funds by Insurance Companies* promulgated in 1999 allowed insurance companies to indirectly invest in the stock market, and the *Provisional Administrative Rules on Stock Investment by Insurance Institutional Investors* promulgated in 2004 allowed insurance funds direct access to the stock market. In terms of overseas investment, the *Provisional Administrative Rules on Overseas Investment of Insurance Funds* promulgated in 2007 expanded the scope of overseas investment and raised the percentage limit in total assets. In addition, progress was made in investment in large projects and bank equities of insurance funds as the *Administrative Rules on Pilot Indirect Investment in Infrastructure Projects of Insurance Funds* and the *Notice on Investment in Commercial Banks' Equities by Insurance Institutions* were issued in 2006.

In light of broadening investment channels of insurance funds, regulators issued a series of documents such as the *Guidelines on Risk Control of Insurance Fund Utilization*, the *Guideline on Custody of Stock Assets of Insurance Companies*, the *Opinions on Strengthening Risk Management of Insurance Funds*, the *Guidelines on Counterparty Risk Management of Insurance Institutional Investors*, and the *Guidelines on Credit Rating for Insurance Institutional Bond Investors*, to advance the concept of comprehensive risk management so as to effectively prevent investment risks.

Thanks to the guidance of regulators, fund utilization in the insurance sector has improved significantly. First, great progress was registered in improving standardized and professional approach in fund utilization. Insurance asset management companies were introduced, with the number of which reached 9 at the end of 2007, managing over 87% of total assets of the insurance sector. Second, the investment portfolio was more diversified, experiencing a shift from concentrating on bank deposits to mainly investing in bonds, supplemented by bank deposits, equities and other assets. As of the end of 2007, the shares of bank deposits, bonds, and stocks (equities) and securities investment funds in investment portfolio were 24.3%, 44% and 27.1% respectively (Figure 2). Third, the rate of return on invested assets was boosted considerably as a result of the increase in holdings of stocks, which was achieved by taking advantage of the good opportunity of the stock market reform and based on the principle of sound and safe investment. In 2007, the rate of return on investment of insurance funds reached 12.17% (Figure 3).

Figure 2 Changes in Investment Portfolio of Insurance Funds in China during 2004 – 2007

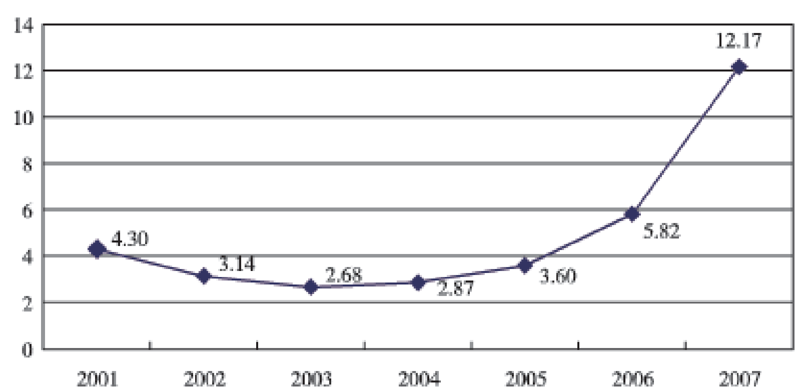
(*percent*)



Source: CIRC.

Figure 3 Changes in the Rate of Return on Investment of Insurance Funds in China

(*percent*)



Source: CIRC.

Challenges Facing Insurance Fund Utilization in China

Both the size and returns of insurance fund utilization in China have been growing rapidly, however, there are still some adverse factors constraining further improvement in fund utilization.

Investment Options of Insurance Funds Are Limited Due to Underdeveloped Direct Financing

The international experience suggests that bonds and stocks are main investment channels of insurance funds. China's social financing structure is characterized by excessively high ratio of indirect financing and low ratio of direct financing (Figure 4), which has affected the depth of the financial markets and thus is not favorable for investment of insurance funds.

Asset Management of Insurance Companies Is Facing Difficulties Because of Limited Bond Products

Bonds are a very important component of investment portfolio of insurance companies, usually accounting for 1/3 or 2/3 of total assets of insurance companies. And life insurance companies play a leading role in insurance fund utilization, which prefer to hold long-term bonds because of their long business terms and stable premium income flows. However, the proportion of long-term bonds issued in China is lower than desired. As of the end of 2007, bonds at maturity of shorter than 1 year accounted for 26.3% of total bond stocks, while bonds at maturity of longer than 10 years only accounted for 17.2%. In this context, insurance companies, though endeavored to increase holdings of long-term bonds, saw relatively short asset terms. Estimated with insurers' custodian bonds with CGSDTC at the end of 2007, the maturity of bonds held by the insurance sector averaged at around 12 years[1], resulting in maturity mismatch risks of assets and liabilities of insurers (Figure 5). Furthermore, the proportion of low-return bonds in total bonds, especially long-term government bonds was overly high, as opposed to a low proportion of high-return corporate bonds, posting challenges to insurers' efforts in increasing returns on fund utilization. For example, out of 10 plus-year bonds, government bonds accounted for 75%, while corporate bonds only took up 6%.

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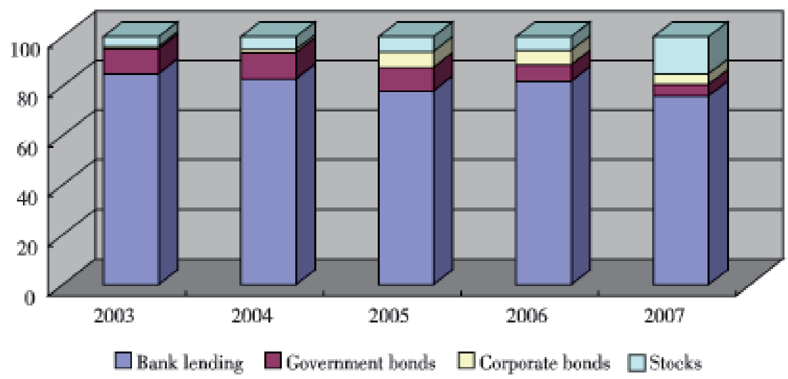
1 The figure is the weighted sum of maturity based on insurers' custodian bonds with CGSDTC at the end of 2007, where the weight is the ratio of value of bonds at a range of maturities to total value of bonds, and the maturity is decided by the median of the range of maturities (e.g., 1.5 for the maturities of 1-3 years).

Figure 4 Social Financing Structure in Recent Years

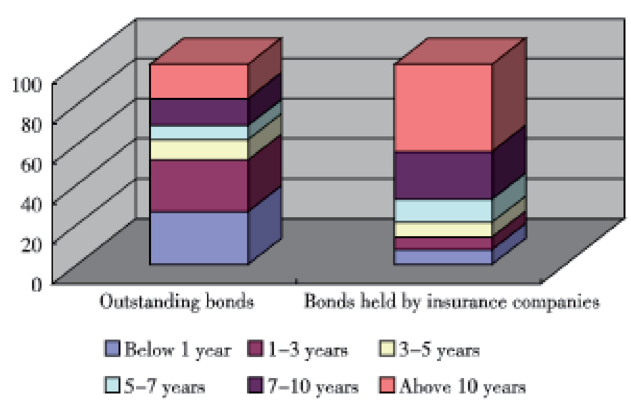
(*percent*)



Source: PBC, CSRC, CGSDTC.

Figure 5 Maturities of Outstanding Bonds and Bonds Held by Insurance Companies

(*percent*)



Source: CGSDTC.

Risks of Stock Price Volatility Warrant Attention Given the Rapid Growth in Stock Investment

Stock prices have surged since 2005, and the insurance sector has taken advantage of the opportunity to increase investment in the stock market, and subsequently witnessed a substantial increase in the rate of return on investment. In 2007, the investment income of insurance funds reached RMB 279.17 billion yuan, exceeding the sum of investment income over the past five years, with the rate of return reaching 12.17%. Funds, stocks and equities in unlisted companies accounted for

27.1% of investment portfolio, with their earnings making up for around 70% of total investment earnings. While bringing handsome investment gains, the surge in equity prices poses challenges for the insurance sector as well. The history of global insurance development shows that risks are easily built up in the insurance sector during the period of asset booms and abruptly unwind during the period of asset slumps. For example, in the 1980s, attracted by high asset prices, Japan's insurance sector launched policies of high assumed rates, investing premiums earned in the stock and property markets for high returns. As asset prices plunged, investment risks and pricing risks in the life insurance sector materialized at the same time, leading to mass bankruptcy of life insurance companies in Japan.

Investment Channels and Proportions of Insurance Fund Utilization Are Still Subject to Various Restrictions

Great efforts were made by regulators in expanding investment channels of insurance funds in recent years, contributing to increasingly diversified investment portfolio. However, in comparision with that of developed economies, insurance fund utilization in China is still subject to more restrictions (Table 2), mainly reflected by the concentration of investment in financial markets and lack of direct investment opportunities[1]. As a result, the insurance sector fails to fully share the benefits of rapid economic growth, and fully play its role in supporting economic growth with its long-term financial resources.

Table 2 Restrictions on Stock and Real Estate Investments of Insurance Funds in Selected Countries

	Government bonds	Corporate bonds	Stocks	Loans	Real estate	Overseas investment
US①	No	No	20%	20%	25%	10%
UK	No	No	No	No	No	No
Japan	No	No	30%	No	20%	30%
China	No	30%	10%②	0	5%③	15%

Note: ① Insurance investment is regulated at state levels in the US, with restrictions varying across states. Here shows the case in the New York State.

② Insurance companies in China are allowed to invest up to 15% of assets in securities investment funds.

③ Referring to the infrastructure investment ceiling.

Source: International Comparison of Insurance Fund Utilization; China Economic Information Network; Annual Research Report on Insurance; CIRC.

1 The *Administrative Rules on Pilot Indirect Investment in Infrastructure Projects of Insurance Funds* provides that the outstanding balance of investment of life insurers and property insurers should be no more than 5% and 2% of their total assets at the end of the previous quarter respectively based on cost prices, and the outstanding balance of investment in single infrastructure project of life insurers and property insurers should be no more than 20% and 5% of the total budget of the project respectively based on cost prices.

Efforts Should Be Made to Improve Insurance Fund Utilization

The State Council issued the *Opinions of the State Council on the Reform and Development of the Insurance Sector* (hereinafter referred to as the *Opinions*) in June 2006, stressing that insurance companies should increase returns on the basis of risk prevention. Relevant parties should actively carry out the *Opinions* to improve insurance fund utilization in a collaborative manner.

Develop Financial Markets Vigorously so as to Create More Investment Instruments

Both the international experience of financial development and China's reform of the financial sector have showed that insurance fund utilization and its efficiency are closely associated with the development of financial markets, and the development of the insurance sector needs to be underpinned by efficient and well-functioning financial markets. With a view to increasing competitiveness of China's insurance companies and efficiency of insurance fund utilization, efforts should be made in developing a multi-tier financial market system in a step-by-step manner by further expanding market functions, increasing market tiers, boosting the proportion of non-government credit products, and developing a variety of products such as asset-backed securities, corporate bonds and commercial papers. Measures should also be taken to orderly develop derivative products along with underlying products, such as interest rate and exchange rate futures and options, thus can provide more options and risk management means for institutional investors like insurance companies. Meanwhile, as key institutional investors in financial markets, insurance companies should step up innovation and actively take part in developing financial instruments such as long-term bonds to address maturity mismatch of assets and liabilities in the course of financial market development and reform.

Further Expand Channels and Scope of Fund Utilization Based on Sound Risk Control

In line with the needs of national economic development and risk control capacity of the insurance sector, endeavors should be made to continuously expand channels and scope of insurance fund utilization to bring the advantages of long-term and stable insurance funds to full play and thus provide financial support for national economic development. Measures need to be taken in encouraging insurance funds to invest in capital markets in various forms, steadily promote insurance funds to investment in asset-securitized products, facilitate insurance funds to invest in the real estate sector more quickly, and support them to purchase stakes in financial institutions such as commercial banks and to invest overseas.

Accelerate the Reform of Insurance Asset Management System and Strengthen Regulation over Fund Utilization

With the expansion of insurance fund utilization channels, insurance companies are facing increasing investment risks. It is imperative to accelerate the reform of asset management system of insurance companies and strengthen regulation to better fend off risks. Efforts should be made in the following fronts: first, to accelerate the building of a professional, market-based and standardized insurance asset management system and further advance the development of insurance asset management companies by encouraging and supporting them to introduce overseas strategic investors with a view to improving business performance and corporate governance. Second, to put in place an effective risk control mechanism, improve the firewall to separate investment decision-making, trading and custody in the process of insurance fund utilization, and clearly define responsibilities of and legal relationship among trustors, trustees and custodians to establish an operational mechanism characterized by professional division of labor and effective check and balance. Third, to further improve risk management capability of insurance companies. Investment portfolio should be decided on the basis of a sound balance among security, liquidity and profitability. Fourth, to increase information disclosure, strengthen management of related party transactions and enhance standardization and transparency of insurance fund management. Fifth, to strengthen communication among financial regulators and improve the coordination mechanism of financial regulation so as to prevent cross-sector and cross-market financial risks.

(By Wang Shaoqun and Chen Min)