Introduction

Insurance Australia Group (IAG) is pleased to provide this submission to DFAT on the Australia – China free trade agreement (FTA).

IAG is the leading general insurer in Australia and New Zealand. IAG has a presence in China through China Automobile Association (CAA), a wholly owned subsidiary of IAG. CAA is China's largest and oldest automobile association, with an established customer base in Beijing.

IAG has a well publicised interest in entry to the insurance market and takes the view that development of relationships with peak government bodies and input on the development of a sustainable regulatory environment is important to achieving this.

IAG welcomes the opportunity that formal negotiations with China present for the economies of Australia and China. In the case of general insurance, IAG believes that there is much that IAG and the Australian insurance community (public and private) can do to implement world leading regulation and reform that will benefit China's economy, insurance sector and consumers. In this submission we have commented on the Australian prudential regulatory environment in a global context.

IAG has been working with the Chinese insurance regulator, China Insurance Regulatory Commission (CIRC), for several years with the objective of achieving a sustainable regulatory environment. An IAG representative is Chairman of the CIRC International Actuarial Advisory Committee advising CIRC Non-Life Department on non-life matters, and is appointed to three separate committees set up by CIRC for 2005 aimed at developing new requirements for the non-life industry in reserving standards, pricing standards for motor, and data and reporting standards.

In February this year IAG provided a submission on the draft of the *Regulations on Compulsory Third Party Liabilities Motor Insurance* published by the Legislative Affairs Office of the State Council for public comment. Recently we provided follow up information in response to further questions about the Australian regulatory environment and we intend to continue to provide input and support into this process.

As the largest underwriter of compulsory third party motor liability (CTP) insurance in Australia, IAG has worked with government bodies for a number of years to develop a sustainable personal injury scheme. IAG has spent a considerable period investigating a design of the model scheme for dealing with bodily injury. In addition to its work with government, IAG is a major participant in safety and injury prevention programmes in Australia and we consider it a part of our role in the communities in which we operate.

IAG's capability and interest in CTP insurance is of relevance to this submission as this is an area in which foreign insurers are not permitted. As 'foreign insurer' includes any insurer with 25% or more foreign shareholding, this is a critical limitation on any investment in the Chinese market. For reasons that are explained later this submission, the CTP limitation also excludes the ability to participate in motor insurance, an area in which IAG has international leading edge capabilities and which represents approximately 68% of the entire Chinese insurance market.

This limitation is the key barrier for foreign insurers wishing to enter the Chinese insurance market. It is at odds with the reduction of barriers to entry for this and other markets that is an essential part of China's commitment to becoming part of the global economy. Further we believe that the barrier impedes the injection of foreign capital and expertise into the Chinese insurance market, denying these, and their attendant benefits to the insurance consumers of China. The levels of permissible equity do not provide sufficient incentive for significant management focus and capability transfer by potential entrants.

The service sector is a critical part of any modern economy. As China continues its rapid development the emergence of an efficient service sector, especially in financial services, will be critical to sustaining its growth rate.

In general insurance, the China market has seen access considerably improved, other than in the important areas of motor and motor liability. What this process has highlighted is that the regulations underpinning the general insurance sector are just as important as market access issues.

It is not possible to exclude the service sector from FTA discussions with China. Equally, it is not possible to have a discussion about the service sector without talking about the regulations that support that sector, which can create artificial barriers to entry. Our contention is that, although considerable progress has been made in other areas of trade and, indeed, the China insurance industry is reducing some barriers, there are still major issues for motor insurers in the China market.

This submission is in 4 parts:

1. A brief description of the Australian general insurance environment and a short background to IAG and CAA

2. A specific commentary on areas within general insurance that we believe the FTA negotiations should deal with, in particular those that provide barriers to entry of Australian general insurers to the Chinese insurance market

3. An outline of IAG's submission on the draft of the *Regulations on Compulsory Third Party Liabilities Motor Insurance*

4. A commentary on the Australian regulatory and accounting regimes for general insurance business in a global context

IAG would be delighted to engage in further discussion to expand on any of the details and comments provided here. Contact details are as follows:

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We look forward to engaging further in regard to FTA and thank you for the opportunity to participate in the process.

Insurance Australia Group
28 June 2005

PART I

OUTLINE OF AUSTRALIAN GENERAL INSURANCE

INTRODUCTION TO IAG AND CAA

Outline of Australian General Insurance

Australia has a very advanced, sophisticated and large general insurance sector. Our market is widely considered one of the most competitive in the world because the majority of insurance is bought directly from companies. This has encouraged product innovation and price competition.

Australia represents some two per cent of the world's insurance market – about twice its share of world gross domestic product. The Australian industry is ranked 11 in the world and second in our region after Japan.

There are around 150 private general insurers and reinsurers operating in the Australian market, employing around 35,000 people. Net premium revenue for the year ended 30 September 2004 was A$20.8 billion, of which A$19.1 billion (92.0 percent) was written by direct insurers.

For the 12 months to September, the Australian general insurance industry paid out A$12.5 billion in claims incurring underwriting expenses of A$5.0 billion.

Introduction to Insurance Australia Group

IAG is the largest general insurance group in Australia and New Zealand (by reference to premium written in these countries). It provides personal and commercial insurance products under some of the most respected and trusted retail brands in the country.

IAG's core lines of business include home insurance, motor vehicle insurance, business insurance, consumer credit insurance, product liability insurance, compulsory motor liability insurance, workers compensation insurance and professional risk insurance.

IAG has a crucial interest in the long-term viability of insurance as a product valued by the community. IAG believes that there are 5 principle ways in which the insurance industry can best meet these objectives. These are:

- Investing in robust risk control frameworks and mechanisms that protect policyholders and provide certainty to shareholders;
- Pricing products realistically;
- Paying the legitimate claims of policyholders;
- Ensuring that customers understand what they are buying when they purchase a policy, and that products do not arbitrarily advantage or penalise particular individuals or groups; and

- Committing to, and supporting, on a continuing basis, a comprehensive and clearly defined regulatory framework that facilitates more affordable premiums and more predictable claims costs.

IAG has, for many years, been a leader in the reform of a number of insurance related schemes throughout Australia. Of particular relevance was the development of the New South Wales CTP scheme and the Western Australian workers' compensation scheme.

In both these instances, IAG has taken a leading role in working with Government and other parties to develop and structure insurance schemes that have generated a sustainable and affordable insurance market, as well as meeting the legitimate aspirations of the community for fair compensation to injured persons.

The success of the reform process and initiatives arising from it are best evidenced in the New South Wales CTP scheme, which is showing significant improvements having had a history of government control and some problems in the administration of the scheme. The reforms have produced benefits for consumers in significant reductions in premiums while insurers are benefiting from improved predictability and stability.

Further, IAG has, as a major part of the development and participation in reform processes, developed (and continues to develop) a 'model' scheme design for both domestic and international personal injury insurance – outlined in Part 3.

In support of all the measures that have been undertaken to drive development of sustainable schemes, IAG plays a major role in the development of safety and injury prevention in the Australian community.

Introduction to China Automobile Association

In addition to insurance-related activities, IAG aspires to make a significant contribution to the development of China's motoring and automotive industry through its wholly-owned subsidiary, CAA.

CAA is China's oldest and largest motoring association and road-side assistance provider. CAA's core operations are in Beijing, but CAA has national aspirations which it intends to achieve through a combination of acquisition, franchise and affiliation with other organisations. IAG acquired a minority stake in CAA in 1999 and assumed full ownership in 2003.

IAG, through CAA, aspires to make the following contribution to the development of China's auto industry:

- Supporting car sales and rapidly increasing car ownership in China through the provision of road-side assistance, motoring knowledge and advocacy on behalf of motorists' interests.

- Significantly improving road-safety in China by leveraging IAG's successful history of road-safety research and advocacy programs conducted through the media and community engagement. Specifically, IAG aims to commence specific road-safety and vehicle safety research activities in co-operation with a high-profile, credible Chinese research or academic institution, together with joint-sponsored road-safety advocacy activities leveraging China-based research and international research adapted for Chinese conditions. This research will be centred around reducing the number of fatalities and serious injuries on China's road through awareness, educational and attitudinal change campaigns about the basic topics of seat-belts use, speeding and drink-driving.

- Collaborating with Chinese traffic and commercial regulatory authorities in designing and promulgating regulations to govern the development and operation of the road-side assistance, towing and repair industries that ensure transparency, fairness, propriety, efficiency and the long-term sustainability of these industries.

CAA is also an insurance agency for China's 3 largest non-life insurers, PICC, China Pacific and Ping An, and through this agency we have been learning about the insurance market for over 4 years.

PART II

COMMENTARY ON AREAS TO BE INCLUDED

IN GENERAL INSURANCE SECTOR NEGOTIATIONS

Issues for an Australia – China FTA

IAG has a number of issues relating to the insurance sector it would like included in FTA discussions with China. Whilst it is true that China has made it easier for foreign insurers to enter the Chinese general insurance market, the Accession Agreement made no mention of regulatory reforms, capital controls and, critically, excludes "foreign insurance institutions" from having access to statutory insurance business, principally the third party liability market of which compulsory motor insurance is the largest component.

What the WTO process has shown is that it is not possible to talk about meaningful market opening in the insurance sector without also talking about the regulations and prudential controls that underlie that market. It is these underlying issues that IAG would like to focus on.

As is the case with many of these agreements, successful resolution of these issues will have a greater benefit for Chinese consumers and society than any other group.

Foreign Ownership Rules and Market Access

China now permits foreign insurers to apply for licences as wholly owned subsidiaries. There do remain a number of impediments for Australian general insurers gaining meaningful access to this market.

- ***Investment cap of 25% for foreign insurers***

One such regulatory impediment is the definition of what constitutes a Chinese insurer. For the moment, an Australian insurer is limited to an effective investment cap of less than 25 per cent in any current Chinese insurer. If the investment equals or exceeds 25 per cent, then that insurer becomes a "foreign insurance institution". The implications of this are significant.

A foreign insurance institution is prevented from participating in statutory insurance business. This principally means the motor third party liability insurance market. Unlike Australia, where CTP covers personal injury only, compulsory third party liability covers personal injury and property damage.

Critically, consumer behaviour in China for motor insurance means that first party insurance is almost universally taken out with the same insurer, and as part of the same transaction, with compulsory third party insurance.

Based on our experience via CAA as an insurance agent, approximately 85% of motor insurance sold is first party and compulsory third party, approximately 15% is compulsory third party motor insurance, and 0% is non-compulsory first party motor insurance sold on its own.

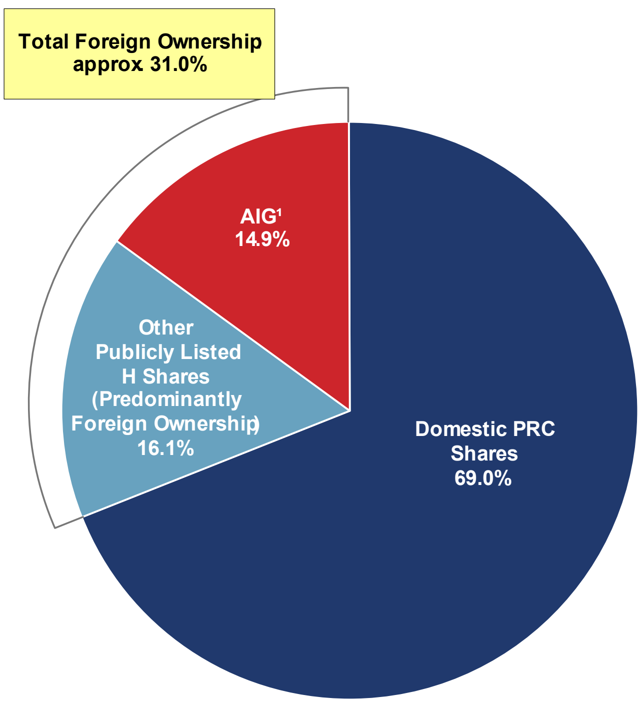
As a result, exclusion of an insurer from "statutory insurance business" effectively excludes that insurer from meaningfully participating in the non-compulsory motor insurance market. This market represents as much as 68 per cent of China's non-life insurance market (source: CIRC data as at 31 December 2004).

As motor is predominantly a retail product, the exclusion of motor insurance excludes insurers seeking to build a retail brand the real ability to do this, and to cross-sell other retail insurances such as home, property etc. What this means for foreign insurers is that they are effectively restricted to the high end, commercial end of the insurance market, principally with corporate clients.

This is an issue for IAG as a start up venture, but more importantly is a critical limitation on IAG's ability to take a meaningful equity stake in a local insurer.

A further dimension to this issue is that the 25 per cent cap does not apply if the insurer is listed. This carve out was introduced under regulations effective in 2002 – the carve out applies for the benefit of the national insurer, PICC, which listed in 2003, and now applies to Ping An, which was listed in 2004. Both of these companies now have foreign investment greater than 25 per cent.

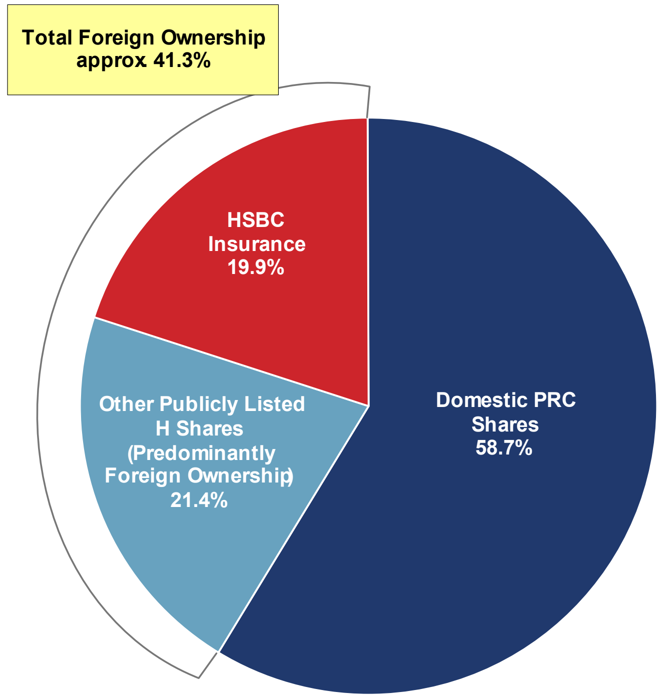
PICC



Source: PICC Annual Report, Bloomberg

[1] *AIG's share includes a holding of 5.05% by Birmingham Fire Insurance Company of Pennsylvania which is ultimately controlled by AIG.*

Ping An



Source: Ping An Annual Report, Bloomberg, PPO Prospectus, Media Releases

Note: Only foreigners or foreign entities can hold H-shares. Although domestic shares can be held by foreign entities, PICC's and Ping An's domestic shares are not held by foreign entities.

We believe there is little equity in this limited carve out. The path to listing is not an easy or predictable one and not suitable for all companies, particularly for many Chinese local insurers which have legacy issues as current or former SOEs, with organisational cultures far from the transparency and discipline required by reputable exchanges.

Further, the regulations which give effect to the carve out are unusual in that they:

- are located in Interim Provisions, suggesting an ad hoc approach to regulations in this area
- 'deem' the listed PRC insurer as not a foreign insurance institution irrespective of the percentage of foreign equity.

IAG would like to have any such interests that it buys in Chinese insurers to be excluded from the 25% cap. This could occur through a similar 'deeming' regulation.

We do not believe it is in long terms interests of the Chinese CTP insurance market to restrict access to foreign capital and expertise. In Part 3 below we have outlined the written submission provided to the State Council Legislative Affairs Office earlier this year with a detailed description of a model scheme developed by IAG – we would be pleased to provide this to DFAT upon request.

Although we have provided a written submission on this subject, the inability to participate with a meaningful equity level will impair the level of management focus and capability transfer that IAG is prepared to commit to an investment in the Chinese insurance market.

We believe that the scheme is best implemented by committed insurers operating in the market, rather than 'outside' influences. In short, the potential benefits to be realised by implementing international best practice in this segment of the market will not be realised by restricting access.

- ***Investment cap of 20% for single investors***

In addition to the 25% threshold for statutory insurance, there is a 20% cap for single investors. This cap can be addressed through a waiver granted by CIRC, or through holding an investment over 20% among multiple related parties (although this latter approach is not determinative). Any regulation introduced to deal with the 25% statutory business threshold should potentially address this issue.

- ***Investment cap of 50% for commercial insurance and reinsurance***

Finally, we understand that foreign equity ownership in insurance brokerage companies handling large scale commercial risks, marine, aviation and transport insurance, and reinsurance is limited to 50 per cent. We understand that this limit is scheduled to be increased to 51 per cent three years after China's accession to the WTO and completely eliminated after five years. IAG would like to seek some assurance that this timetable is currently being followed and likely to be implemented.

Effective Prudential Regulation

IAG has already noted the importance of proper prudential regulation in any general insurance sector. The benefits flowing from prudential regulatory reform are multifarious. An efficient, well run and transparent general insurance sector allows an economy to reduce risk cost effectively, price risk appropriately, protect consumers and their goods, while promoting economic activity by allowing investors to reduce risk and protect assets.

The Australian Prudential Regulation Authority (APRA) is considered to be leading edge internationally in its prudential regulation. Core elements of this regime include risk based minimum capital requirements, strong actuarial standards for liability valuation, flexible rules around investments and reinsurance arrangements that ensure a assets relate to the risk profile of liabilities, open reporting and disclosure, and effective audits, supervision and oversight. Further commentary on the Australian prudential environment in a global context is included in Part 4 below.

IAG hopes that an FTA with China will be seen as an opportunity to begin work on regulatory reform. The reform could include, but not be limited to:

- Implementing a fit and proper director's test – updating and tightening this requirement has been championed by APRA following the HIH collapse, and IAG supports regulatory oversight of the officers appointed to insurers.

- Removing the 8 per cent commission cap for taxation purposes – what this means is that an insurer is not allowed to deduct from its income any commission expenses paid to agents, brokers or other insurance intermediaries in excess of 8 per cent. However, we understand the entire industry effectively operates based on market pricing for commissions (exceeding this threshold across the board), so the rule results in misreporting. We believe the sector should be moving in favour of fully transparent and accurate accounting, rather than the other way.

Artificial rules such as the 8 per cent cap, which are adverse to market pricing and encourage misreporting, should be abandoned.

- The introduction of a uniform insurance contracts act that makes the rights and obligations of insurers and the insured consistent and transparent.

Actuarial and Accounting Standards

The existence of consistent audited actuarial standards is critical to the stability of the insurance industry. The basis of actuarial standards and approval of the actuary are key elements of prudential oversight and form the basis for effective liability valuation and pricing of risks.

PRC standards for accounting of insurance companies differ from international standards and principally result in improved reporting from what would be allowed under robust international standards. Examples include:-

- Assets of poor quality such as long outstanding receivables and investments may be taken in at full value without any allowance or write down.

- Provision for claims incurred but not reported (IBNR) is limited to an artificial cap at 4 per cent. IBNR is a measure of what claims have been incurred (eg. occurrence of injuries including latent risks such as disease) but not reported to the insurer. These can be significant, particularly in the case of latent risks such as asbestosis. Under international standards IBNR is actuarially determined based on claims history and industry developments, but the cap artificially lowers reserving for this item.

Investment Rules

Critical to effective asset management is the ability to match asset investments to the risk profile of liabilities. Current rules governing investments by insurance companies, which state that capital must be invested in China and then in a limited number of investment classes, significantly limit the ability of insurers to effectively match risk profiles. IAG would seek greater flexibility in investment rules, which would allow for a safer and more efficient insurance sector, as risk weighted capital lowers the amount of capital generally allows a company to carry lower levels of capital.

PART III

COMMENTS ON DEVELOPMENT OF CTP IN CHINA

Summary

As referred to earlier in this submission, the Chinese Government through CIRC, NDRC and the State Council are currently reviewing the third party liability scheme with a view to designing a scheme that meets the goals of consumers, society and the economy overall.

Australia, and IAG in particular, has a very good record of designing and implementing sustainable third party liability schemes, and IAG has provided a submission to the State Council Legislative Affairs Office commenting on proposed regulations and outlining a model scheme – this model scheme is outlined below.

Australian authorities also have a wealth of experience in the pitfalls of a badly designed and implemented scheme. A badly designed scheme can run into billions of dollars worth of debt, and basically bankrupt an entire sector.

Put another way, implementing an unsustainable third party liability scheme in China may be the next banking crisis, requiring just as much financial resources to fix the problem (this is a particular issue when access is limited to a narrow capital base). Australia's experience would also suggest that when a scheme does become unsustainable everyone suffers. Society losses its ability to underwrite risk, which means many events cease.

Further, the genuinely injured also suffer as the scheme becomes one in which people seek monetary awards rather than solutions that help people recover their health.

IAG believes that restricting access to third party liability is not in the long term interests of the scheme, and that the scheme would operate most effectively and sustainably through access to foreign capital and expertise.

Model scheme

A well designed and operated bodily injury scheme has the potential to benefit the broader community through general economic input as well as providing the socially necessary support and treatment of those who have been injured. The scheme should at once protect the injured, provide a stable platform for fostering healthy competition between insurers and promote the development of efficiencies in underwriting and claims handling. Further the scheme should ensure the economic sustainability of the scheme for future generations and its continuing affordability to the motoring public.

The history of statutory compensation schemes, in particular, motor liability indicates the need to constantly reassess the tension between benefit levels and other aspects of scheme design against the affordability of premiums in an effort to maintain scheme stability. The nature of liability insurance is that it is long-tail and therefore predictability of future outcomes is essential to ensuring premiums are set at levels which will avoid boom/bust cycles.

We believe the objectives in designing a model compensation scheme should be:

- Equity – all claimants should be subject to the same processes. Compensation should be fair and just with the majority of compensation going to the seriously injured who need it most.

- Transparency – the scheme processes should be open for all to see and easily seen to be equitable

- Speed – injuries should be dealt with in a speedy manner to ensure the best outcomes

- Sustainability – a scheme must be affordable, stable, and predictable and not produce intergenerational transfers of liabilities.

In order to achieve these objectives, we have had regard to what we believe are the features of a model scheme. Whilst there are inherent conflicts between some of these features, we believe it is possible to develop a viable scheme design model by balancing the weight given to these various components in order to achieve a fair result. From our research (both nationally and internationally) we believe the key features of a model scheme are:

- Fully funded, with stable and predictable performance, which allows the scheme to subsist without legislative change for a substantial period

- Maintenance of premiums which are affordable by all sections of the community

- Provided by private underwriters at a risk based price and operating in a strong prudential framework to generate maximum capital, pricing and operational efficiencies – access to foreign capital and expertise is important to achieve this

- Focus on injury management and optimisation of health outcomes

- Provision of full or close to full indemnity for the economic loss of persons who have suffered serious injury

- Ensuring that scarce community resources are husbanded by:
    - Limiting the damages for less serious injuries, and
    - Ensuring that the benefits delivered are preserved for and applied to the purpose for which they are awarded

- Provide a high element of individual assessment within an objective framework resulting in minimal need for the external intervention in the settlement process by courts or tribunals

- Optimise the return of scheme funds to claimants, minimise the drain on funds to meet the financial imperatives of other stakeholders

- Provision of a framework where the veracity of claimants can be properly tested and which ensures that only those who are properly entitled receive benefits

We have concluded that the model we prefer is a combination of no fault and common law with non-economic loss excluded. Whilst there is no model scheme, in its entirety, operating in the world, significant components are operating in a variety of places and we have looked to those schemes in developing our views of the model design. Specifically, we have incorporated components of the New South Wales CTP scheme and the Victorian TAC scheme from Australia and look to the scheme in Ontario, Canada as containing significant components of a model scheme.

The model is closer to the no fault model as we believe there are too many disadvantages to the common law and at fault models as a whole. However, we have sought to combine aspects of both models to design a model that provides:

- encouragement and adoption of risk management and injury prevention principles
- objective assessment of injury
- appropriate treatment to maximise health outcomes
- immediate periodic payments for a limited time - i.e. “basic benefits” available to all who qualify for access to the scheme
- longer term benefits available only to those who are seriously injured
- statutorily defined benefit levels for basic benefits
- higher benefit levels for the seriously injured consisting of ongoing medical/care costs to be met by a pooled fund and payments for loss of earning capacity by way of lump sum
- an administrative structure and administrative review processes with limited access to court.

The major feature of this model is the separation of basic benefits from long term benefits but with the criterion for long term benefits determined according to the seriousness of the injury rather than according to fault. The method of delivering benefits consists of a mixture of periodic payments, reimbursement of ongoing expenses and lump sums.

PART IV

AUSTRALIAN REGULATORY AND ACCOUNTING REGIMES FOR GENERAL INSURANCE BUSINESS IN A GLOBAL CONTEXT

Background

The financial measure of the contribution of the general insurance sector to national income provides little indication of the real value to the economy of general insurance activity. Instances of weakness in the general insurance industry are important not only for their implications for employment, net assets and profits in the insurance sector. The true significance of the insurance industry lies in the fact that it enables a large proportion of the rest of the economy to operate effectively. Without a reliable mechanism for pooling and transferring risk, much economic activity simply would not take place, and neither would social activity such as fairs and play grounds.

Another way of saying this is that when the insurance industry is in difficulty so too, unavoidably, is much of the rest of the economy. It is not overstatement to say that society is weakened. A safe, stable insurance industry is vital for underwriting stability and confidence in economic and social interaction – in underwriting the economy and society.

The prudential regulation of general insurance aims to provide policyholders with a degree of confidence those insurers will be in a position to honour their financial commitments.

All financial products involve exposure to risk. An efficient financial market will manage, allocate and price this risk, rewarding those willing to bear it. Government regulation of financial markets does not aim to remove this risk. It does not aim to prevent an insurer from going out of business.

The prudential framework seeks to balance the objectives of maintaining efficient, dynamic and competitive financial markets, and ensuring the continuing stability and integrity of the financial system. This balancing act requires, on the one hand, that the government does not guarantee the future of any particular player in the financial system; and, on the other, that the failure of one player does not threaten systemic stability.

While systemic risk usually concentrates on the payments system and banks, it also applies as much to the management of risk and general insurance. Therefore, systemic stability is a critical element of any market economy, which makes getting prudential regulation right critical.

Prudential policy frameworks are based on the premise that ultimate responsibility for the prudent operation of general insurers rests with the management and board of each institution. Hence, if a general insurer fails the presumption has to be that the management and board of the institution have failed.

While the design of the prudential framework seeks to reduce the likelihood of failure, there should be no pretence that it can prevent all such instances. Similarly, there must be no pretence that the authority charged with administering the prudential framework can prevent all instances of failure.

The role of the regulator is to prevent a system wide failure, usually described as systemic risk. Australia's prudential regulator does, through a number of mechanisms, try to lower the level of systemic risk. APRA typically does this by ensuring quality assurance of control systems and risk management practices more generally.

The Australian prudential regime

The Australian prudential regime is a sophisticated regulatory environment with a focus on self-regulation by insurers with sophisticated actuarial and accounting capabilities. Relative to its international peers, the Australian prudential regime:

- Is a leading international model for sustainable industry development, with aspects being adopted by IASB and other regulators including the UK FSA

- Targets achieving a very high level of certainty in international terms in meeting liabilities and interests of policyholders, and providing more sustainable returns to investors

- Has a focus on quality of capital and reflects mix of business and diversification

- Has learnt from its mistakes, including HIH – with inadequate reserving due in part to formula based approach still employed in other markets including China

As the leading general insurer in Australia, IAG and its representatives have been closely involved with development of regulatory standards in both domestic and international forums.

Global solvency models

There are a number of methods used globally for determining capital requirements, increasing in sophistication based on statutory requirements and the level of information available to the company.

- **Simple fixed minimum capital requirements**, e.g., an insurer must maintain a flat US$50m of capital to support future liabilities – Fixed minimum capital requirements are increasingly viewed as inadequate in analysing the appropriate level of capital for insurers to maintain and have generally been superseded in most jurisdictions

- **“Crude” solvency ratios** are among the simplest capital adequacy models and typically based on a measure of an insurer’s capital base as a proportion of premiums earned in a particular period net of reinsurance expense.

  - This is where China is today - the CIRC requirement is based on the higher of (a) a percentage of net retained premiums (after deduction of business tax and surcharges), or (b) a percentage of claims for the last 3 years.

  - Importantly, not all assets constituting an insurer’s capital base are of the same quality, hence insurers (and regulators) operating with more sophisticated solvency models focus on the structure and mix of capital as well as the quantum. The quality of capital does not tend to be reflected in the CIRC “crude” solvency requirements (eg non-performing debts are able to be counted as capital).

- **Risk-Based Capital (RBC)** modelling involves measuring the minimum amount of capital a general insurer requires to support its obligations based on the size, nature and degree of risks written. Broadly, there are four categories of risk that are measured in the calculation of RBC:

- Asset risk – the measure of an assets' potential default or fluctuation in market value given changes in the market.
- Credit risk – the measure of the default risk on amounts due from creditors, policyholders or reinsurers.
- Insurance risk – the measure of risk arising from either underestimating liabilities from business already written or under-pricing current or future business.
- Off Balance-sheet risk – a measure of risk due to contingent liabilities or other items not reflected on the insurer's balance sheet.

Compared to a crude solvency ratio, this methodology differentiates between different portfolios based on individual business mixes and is viewed as a much more sophisticated and precise capital adequacy methodology

RBC is where CIRC has indicated that it intends to move over the next 3-5 years, and reflects current APRA requirements – outlined further below.

- **Dynamic Financial Analysis (DFA)** modelling involves projecting forward the current financial position of an insurer under different stochastic scenarios to ascertain the impact of key risks upon capital adequacy
  - Key external variables include inflation levels, interest rates, equity and fixed interest returns and pricing levels in direct insurance and reinsurance markets.
  - DFA is increasingly utilised by more sophisticated non-life insurers in order to demonstrate the strength of their capital positions in discussions with regulators
  - DFA can also be used as a strategic business tool by insurers to analyse a range of alternatives including M&A and divestitures, reinsurance strategies, taxation, hedging and investment decisions.

  DFA is where IAG is today. IAG is operating at a level of reserving and solvency analysis ahead of APRA requirements, and is leading edge expertise available to deploy to its interests in China.

The global spectrum of capital models is outlined in tabular form in Appendix 2.

The Australian Experience

Over recent years in particular, Australia has gained a reputation around the world for its movement towards a realistic valuation approach to general insurance business ("fair value") in terms of both regulatory and accounting measurement.

Fair value is a complex accounting concept, but essentially it can be defined as enabling reasonable comparison of balance sheet values in figures that make sense to the reader in a business context. Such a context implies a “market valuation”, incorporating allowance for the uncertainties inherent in the values.

From a regulatory perspective this approach is embodied in an increasing focus on risk-based measures for defining solvency, and a series of principles that target the key causes of fluctuation in the economic value of the insurance business.

In accounting terms, liabilities are recognised as a series of cash flows, with appropriate allowance for the uncertainty of the cash flow outcomes, and valued using a (risk-free) rate of interest to discount the cash flows back to a present value) that enables comparison with the market value of the insurer’s assets.

These are being tangibly recognised by a number of important bodies on the world stage including the International Association of Insurance Supervisors (IAIS) and the International Accounting Standards Board (IASB). This recognition is made evident by the strong influence of the Australian approach on international standards and policy.

Development of Australian Regulatory Standards

Until 2002, supervision of the general insurance industry was heavily subjective, with reliance on a capital standard based heavily on business volume (a formula based approach) and regular visits to individual insurers by the regulator.

However, in July 2002 a new regime was introduced that enabled a risk-based “Minimum Capital Requirement” (MCR) to be calculated for each insurer, and offered the opportunity for insurers to calculate minimum capital needs using their own internal models.

Additionally, APRA introduced a standard requirement for insurers’ directors to obtain annual reports on outstanding claim liabilities from an “Approved Actuary”.

- This enabled both APRA, and company management to obtain a more accurate view of the liability estimates and more consistent opinions on quantification of risk margins to be included in the valuations. These margins (based on a “75% Probability of Sufficiency” requirement) as well as quantifying the risk helped demonstrate the different levels of uncertainty across the classes of business.

- Approved Actuaries also opine on the diversification effects across “APRA classes” of business, hence enabling focus on product and business mix . These initiatives have already had a clear impact on improving the accuracy of measurement for insurance liabilities and have hence increased policyholders’ confidence that such liabilities can be met.

Other regulatory standards introduced in 2002 included focus on broader risk management issues through the need for a Risk Management Strategy document, incorporating aspects of governance and capital management. Additionally, admissible assets (for capital measurement purpose) were clearly defined and documentation of the reinsurance management process was required.

The fallout from the demise of HIH (Australia’s second largest general insurer) in early 2002, whilst not driving the reform process, has helped to reinforce the need for transparency and realistic reporting of results inherent in the new regime through an, as yet draft, “Stage 2” of the process. This ability to learn from past “mistakes” has bolstered the regulatory control process in the areas of risk and financial management.

The IAIS has embraced the new Australian regulatory regime as part of its drive for a globally consistent approach to solvency assessment for insurance business. The Australian system has been particularly influential with the Technical Committee of the IAIS. Also aspects of the system have been adopted by individual regulators in other countries around the world, including the UK FSA.

Accounting Standards

Generally accepted accounting practice, and supporting standards, for general insurance in Australia incorporate market valuation of assets and “best estimates” of liabilities.

Implementation of Phase I of the International Financial Reporting Standards (IFRS) in respect of financial years commencing on 1 January 2005 and later will result in convergence between the current standards and the regulatory reporting requirements in a number of respects. In particular, formal recognition of risk margins and the principle of transparent recognition of liability adequacy has been added to the existing market valuation of assets.

Investor confidence continues to grow with an increased understanding of the sources of insurance profit, and hence the sustainability of returns, as identified by these accounting standards. Further, this confidence extends to stronger support for industry development

In moving towards Phase II of the IFRS process, the IASB has indicated that the Australian approach to valuation of insurance liabilities will form the core of the Fair Value definition in respect of insurance liabilities.

Appendix 1: Limitations on acquiring greater than 25% for foreign insurers

Investment cap of 25% for foreign insurers

The Administrative Provisions on Insurance Companies (15 June 2004) issued by CIRC set out the criteria for foreign insurers seeking to operate in China, and empower CIRC to supervise, administer and grant licences for insurance companies.

The regulations provide that where a foreign insurer acquires 25% or more of the equity in an unlisted Chinese insurer, that Chinese insurer is converted into a "foreign insurance institution".

The relevant articles of the Administrative Provisions are extracted below.

> **Article 42**
>
> A legal enterprise that invests in a PRC domestic insurance company must:
>
> (1) be in conformity with the provisions of the laws and administrative regulations;
> (2) ensure that the source of investment funds is legitimate, and its operating status is good; and
> (3) Meet other conditions as provided for by the CIRC on the basis of the principle of prudent supervision.
>
> **Article 45**
>
> Upon approval of CIRC, a foreign financial institution meeting the conditions specified in Article 42 may invest in a PRC domestic insurance company. The shares held by all foreign shareholders shall be less than 25 % of the total shares of the PRC domestic insurance company. The relevant administrative provisions on foreign-funded insurance companies shall be applicable to an insurance company in which the shares held by all foreign shareholders are 25% or more of its total shares. Where foreign shareholders make investments into a listed insurance company, it is not subject to the limits prescribed in the preceding paragraph.

Limitations imposed on foreign insurance institutions

The WTO Protocol on the Accession of the People's Republic of China provides specifically at Annex 9 - Schedule of Specific Commitments on Services - List of Article II MFN Exemptions that foreign insurance institutions shall not engage in statutory insurance business.

The Circular of CIRC on Distributing the Contents Related to Insurance Industry in the Legal Documents of China's Accession to WTO (12 March 2002) elaborates upon the WTO commitments made by the PRC government and sets out the permitted scope of activity for foreign insurance institutions. Among the provisions, paragraphs 1(3)(a) and 2(3) of the WTO Circular, provides that a foreign insurance institution is not permitted to engage in statutory insurance business, including automobile third party liability insurance and liability insurance for drivers and operators of buses and other commercial vehicles.

The relevant provisions of the WTO Circular are extracted below.

Paragraph 1(3)(a)

Foreign-funded insurance companies are not allowed to undertake statutory insurance business.

Paragraph 2(3)

Statutory insurance

The statutory insurance mentioned in the schedule of specific commitments and concessions of China shall be limited to the following specific types, and will not be expanded to any other industry or product: automobile third party liability insurance, liability insurance for the drivers and operators of buses and other commercial vehicles.

25% limit does not apply to listed Chinese insurers

Article 45 of the Administrative Provisions provides that the 25% investment limit does not apply in respect of investments made into listed Chinese insurers.

By way of background, prior to the promulgation of the Administrative Provisions, investment by foreign insurers in listed Chinese insurers was permitted as an exception to the 25% investment cap pursuant to the Interim Provisions on Investment into Insurance Companies promulgated by CIRC (effective 1 April 2000) (Interim Provisions). As such, the acquisition of 25% or more of the equity in a listed Chinese insurer would not convert the listed PRC insurer into a foreign insurance institution.

The relevant regulations of the Interim Provisions are extracted below:

Article 4

An insurance company with more than 25% of its total shares held by offshore enterprises and onshore wholly foreign-owned enterprises shall be administered according to the relevant provisions governing foreign-funded insurance companies and these provisions do not apply.

Article 15

Insurance companies limited by shares that meet conditions for listing may, with the approval of CBRC and CSRC, make public offers for shares; these provisions do not apply to public offers.

Two Chinese insurers, PICC and Ping An listed on the Hong Kong stock exchange in 2003 and June 2004 respectively. At the time those companies listed, the Interim Provisions were effective and, accordingly, no special exemption or waiver from CIRC was required to circumvent their categorisation as foreign insurance institutions or to facilitate their ongoing capacity to write statutory insurance business.

Appendix 2: The Spectrum of Capital Models

Fixed Minimum Capital Requirement	Crude Solvency	Modified Solvency	Risk-Based Capital	Rating Agency	Simple Scenario Models	Sophisticated Internal Models (e.g. DFA)
External Perspective (no access to internal information)			**Regulator/Rating Agency Perspective** (partial access to internal information)			**Internal Perspective** (full access to internal information)
■ Fixed amount (e.g. $50m) ■ May be scalable based on GWP	■ Capital divided by NEP ■ For growing companies NWP can be a better measure	■ Modified capital divided by NEP ■ Modified Capital defined as Admitted Assets minus Admitted Liabilities	■ Specific risks measured — Insurance risk — Asset risk — Credit risk — Other risks ■ Risk amount is then measured against defined capital ■ Usually includes Hybrid Capital	■ Similar to Risk-Based Capital method ■ Other qualitative and quantitative testing	■ Deterministic scenario analysis e.g. isolating the impact of specific external shocks ■ Lacks sophistication / multiple variable analysis	■ Internal statistical and actuarial analysis ■ Complex scenario testing ■ Company specific ■ Usually tests “risk of ruin”