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Regulatory Foundations for Bancassurance in China

2003 is likely to be a decisive year in the development of bancassurance in China. Some of the world's largest financial institutions with both banking and insurance operations have recently taken a foothold in China: HSBC purchased a 10% equity interest in Ping An Insurance Company Limited by Shares ("Ping An"), and Citibank bought a 5% equity interest in Shanghai Pudong Development Bank. Other leading international insurers are obtaining licenses in the wake of China's accession to the World Trade Organization ("WTO").

As global and domestic competitors respond to these moves, many will look to bancassurance as one of the most promising distribution strategies. A recent Swiss Re report[1] estimates that bancassurance could capture 13% of life insurance premiums and 6% of non-life premiums in Asia by 2006 and reap substantial cost savings thanks to the lower cost of bank distribution versus agents. According to the China Insurance Regulatory Commission ("CIRC"), in China bank distribution already accounted for 17.1% of life premiums in 2002.

Worldwide, banks and insurance companies have made a compelling case for operating in a more integrated manner than had historically been the case. Bancassurance has been an extremely successful business model in Europe, and banks and insurers are eager to repeat this success story in Asia.

In China, some regulatory obstacles to bancassurance have recently been removed: under the amended Insurance Law (effective January 1, 2003), corporate agents are no longer prohibited from selling life policies for more than one insurer. For distribution of non-life policies, there was no such restriction even before 2003. The People's Bank of China ("PBOC")[2] also has created a clear framework for banks' intermediary (including insurance agency) businesses through regulations promulgated in July 2001. However, other practical and regulatory difficulties remain.

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1 Sigma no. 7/2002, "Bancassurance developments in Asia - shifting into a higher gear".

2 In March 2003, the National People's Congress approved the transfer of the PBOC's supervisory function to a newly created China Banking Regulatory Commission ("CBRC"). PBOC will remain China's central bank.

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The scope of bancassurance ranges from the simple distribution of insurance products in bank branches to joint ventures between banks and insurance companies and universal provision of integrated financial services. This article looks at the opportunities for transplanting these business arrangements to China and its challenges in light of the current Chinese regulatory environment.

Distribution and Alliance Arrangements

Distribution agreements between banks and insurers are frequent in China, but they have not yet led to the kind of close cooperation and synergies that have underpinned the success of bancassurance as a business model. Existing arrangements have usually been short-term, ad hoc and non-exclusive.

A major, China-specific difficulty in fostering distribution alliances is the high degree of autonomy enjoyed by bank branches. Prior to the enactment of the Commercial Bank Law in 1995, regional and local branches of China's main State-owned commercial banks (Bank of China, Industrial and Commercial Bank of China, China Construction Bank and Agricultural Bank of China) determined lending principles and limits themselves. As a result, they were largely independent from their head office, and loans were granted on the basis of the interests of local governments. Since 1997, the PBOC has required that unified management structures and lending principles be installed in these State-owned commercial banks. However, the centralization of bank management does not yet extend to all areas. Local governments retain a measure of influence on the appointment of branch executives. Also, branch managers have a vested interest in maximising the profits of the branch rather than those of the bank as a whole.

A typical bancassurance arrangement in China involves a master agreement between the insurer and the bank at the national level. This agreement remains relatively vague and envisages cooperation in various areas (distribution, investment, credit-card insurance, collection and payment services, etc.) without stipulating binding commitments. Specific agency agreements are then negotiated piecemeal at the branch level. The head office is not necessarily in a position to compel the branches to sign such agency agreements.

This practice is likely to change as Chinese insurers wake up to the benefits of deeper, better executed distribution alliances and foreign investors attempt to transfer their relevant experience to China. To build successful long-term relationships with Chinese banks, insurers will have to create incentives for both the bank's head office and its branches. This may require creativity in defining the areas of cooperation. Agency commissions can be used to incentivize the distribution partner only to a certain extent, since these commissions are deductible from taxable income only up to 8% of premium paid.

Foreign-invested insurance companies face an additional problem in developing an exclusive distribution relationship. Under China's commitments to other members of the WTO, foreign-invested insurers and branches of foreign insurance companies will be allowed to operate in only five cities until December 11, 2003 and fifteen cities until December 11, 2004, when all of China will be opened. In addition, existing companies that want to create additional branches in the permitted cities face formal and informal obstacles to their expansion: for each additional branch, the insurance company's registered capital must be increased by 50 million RMB (up to maximum of 1.5 billion RMB for holders of national licenses or 500 million RMB for holders of regional licenses). In practice, foreign-invested insurance companies have been very slow in obtaining approval for, and actually establishing, additional branches.

Foreign-invested banks and branches of foreign banks are subject to similar restrictions when considering a marketing alliance with a Chinese insurance company: until geographical restrictions on Renminbi business are phased out by December 11, 2006, foreign banks' expansion will be slowed with respect to bancassurance as well as other products.

Cross-ownership

In developed insurance markets, cross-ownership arrangements between banks and insurance companies strengthen the bancassurance relationship between the two institutions and expand its scope beyond mere distribution.

PRC law, however, categorically prohibits such cross-ownership arrangements. Under the Insurance Law, insurance companies are not allowed to hold equity interests in any company other than an insurance company. Likewise, the Commercial Bank Law prohibits commercial banks from investing in entities other than financial institutions. (Insurance companies are not deemed to be financial institutions for such purpose.)[3]

However, two types of institutions may invest in both banks and insurance companies: foreign entities and PRC financial holding companies.

Cross-border investments

Because they are not governed by the PRC Insurance Law and Commercial Bank Law, foreign banks are allowed to invest in Chinese insurance companies, and foreign banks are allowed to invest in PRC insurance companies. The non-PRC affiliates of Chinese banks and insurers, such as the Hong Kong-listed BOC Hong Kong (Holdings) Limited, The Industrial and Commercial Bank of China (Asia) Limited, and China Insurance International Holdings Limited ("CIIH"), enjoy the same freedom. They are not deemed to be domestic entities subject to those limitations. Thus, a bank or insurance company incorporated or operating in China could invite one of these "red chips" (i.e., foreign incorporated entities controlled by PRC parents) to invest in them to create or reinforce a bancassurance relationship with the Chinese parent of the "red chip".

In addition, several large banks and insurance companies are preparing overseas initial public offerings ("IPOs") for the next few years. Through the IPOs, foreign banks could acquire shares in these Chinese insurers and foreign insurers could acquire shares in Chinese banks. On the other hand, it is not clear whether the newly listed companies themselves will be allowed to invest in PRC banks. This will depend on the structure of the IPO; if the issuers are PRC-incorporated banks or insurance companies, they could be subject to the cross-ownership prohibitions under the Commercial Bank Law or the Insurance Law. If, however, the listed companies were "red chips", the

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3 One historical exception is Bank of Communications' shareholding in China Pacific Insurance. China Pacific Insurance was originally a division of Bank of Communications and was spun off in 1991, before the Commercial Bank Law was adopted. Also, Ping An acquired a trust and investment company before the Insurance Law became effective and was allowed to retain ownership during Ping An's restructuring in 2002.

restrictions would not apply. Even in the case of PRC issuers with the endorsement of the State Council, CBRC, CIRC and the China Securities Regulatory Commission ("CSRC", the regulator in charge of listing of domestic issuers), might grant exemptions from such cross-ownership restrictions.

Foreign investments of this type raise several issues, which must be addressed when contemplating such a transaction:

- Impact of foreign ownership restrictions. Foreign equity interests in life insurance companies, commercial banks and other financial institutions in China are limited to a certain percentage of registered capital. This limitation is subject to China's commitments upon its WTO accession. An equity investment by a "red chip" company in a foreign investment enterprise ("FIE") might be considered "foreign" for the purpose of calculating the foreign ownership ratio and thus reduce the maximum percentage ownership available to "real" foreign investors. However, there are no written rules as to whether "red chips" are considered foreign shareholders, and in practice the regulatory authorities (PBOC and CIRC) have shown some flexibility. For example, CIRC allowed CIIH to hold a majority interest in Tai Ping Life, without treating CIICH's investment as foreign investment. The impact of the foreign ownership limitation must be assessed case by case.

- Ceiling on foreign minority investments. PBOC and CIRC allow foreign investors to hold equity interests of less than 25% in domestic banks and insurance companies, respectively, without subjecting them to the geographical and business scope restrictions that apply to FIEs operating in these two industries.[4] However, as a minority shareholder, the foreign investor will have to negotiate satisfactory minority protection rights. Also, a bank or an insurance company will be impacted in its overseas listing plans if existing foreign minority investments, together with shares issued to the public, raise aggregate foreign ownership above 25% of share capital. Ping An may have to obtain an exemption from the restrictions governing FIEs to solve this problem in its contemplated Hong Kong IPO.

- Group structure of Chinese banks and insurance companies. In case of a cross-ownership arrangement involving an overseas affiliate of a PRC bank or insurer, the affiliate's position within the group structure must be considered. "Red chips" are typically subsidiaries of a state-owned holding company in the PRC. Critical decisions (including an exclusive bancassurance relationship) are made at the parent company level, and not by the affiliate in which the foreign investor holds shares and may have a board seat. Also, the "red chip" possibly does not own all the operational entities (branches or subsidiaries) in the PRC.

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4 A company with 25% (or more) foreign ownership must be organised as an FIE and is subject to restrictions on foreign-invested service providers. PBOC allows foreign investment of up to 15% in a bank (but CBRC may increase this limit); CIRC allows a single foreign investor to own up to 10% of an insurance company (but cases of higher foreign equity interests exist), subject to an aggregate limit of 24.9%.

Investments in financial holding companies

A company that is neither a bank nor an insurance company is not subject to the investment restrictions in the Commercial Bank Law and the Insurance Law. There is no rule prohibiting such a company from holding equity interests in both insurance companies and banks. There are several examples of such investments, including China International Trust and Investment Corporation ("CITIC"), which holds interests in CITIC Industrial Bank, and CITIC Prudential Life Insurance Company Ltd.. Also, certain shareholders of Minsheng Bank, China's first privately-owned bank, have been approved in principle to establish a life insurance joint venture with a foreign partner who remains to be identified.

There are no specific regulations governing financial holding companies, and none of the current PRC regulatory authorities in the financial services industries seems to have jurisdiction over them. However, certain restrictions do apply. The PRC Company Law prohibits equity investments exceeding 50% in the aggregate of the investing company's net assets. Also, the approval requirement for substantial shareholdings in financial institutions and insurance companies allow regulators to block investments they consider undesirable.

Some of the existing conglomerates are interested in attracting foreign investment in their respective bank and insurance subsidiaries. So far, however, there is no precedent for the same foreign and domestic investors holding equity interests in both a bank and an insurance company.

Towards Integrated Financial Services?

The logical conclusion of the convergence between banking and insurance services would be the formation of integrated financial services groups. Internationally, major corporations like CitiGroup and Allianz have embraced this strategy.

In China, many of the factors that favor the integration of banking, insurance and securities services in other markets are not yet at work. Bank and insurance products are seen as distinct, so that banks and insurers do not directly compete for the management of retail customers' assets. Insurance companies are only beginning to replace an agency-based push strategy with more sophisticated financial planning services.

The regulatory situation also hinders further convergence. CBRC, CIRC and CSRC supervise discreet industries and institutions, with little coordination. There is acute need for more flexible supervision and greater regulatory coordination with respect to the development of new business products and other matters.

Regulatory restrictions are not likely to change in the short term. In the meantime, foreign investors can explore cross-ownership opportunities that arise through overseas IPOs of Chinese companies and the evolving role of domestic financial holding companies. Such potential investments have issues for the foreign minority shareholder, who will at best have negative control. A corporate governance structure acceptable to all shareholders also has to be negotiated and implemented. In addition, and equally importantly, the economic interests of the shareholders need to be aligned in the long term. This is best achieved if, in addition to equity investments, all shareholders may derive benefits from the jointly provided consumer services (such as distribution of insurance products, credit card services, etc.).

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