RESEARCH

China's Reinsurance Market Review

Promising Growth, But Limited Returns

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Highlights:

- The China Risk Oriented Solvency System (C-ROSS) is reshaping the reinsurance market. The new regulation, in particular the change of the regulatory solvency ratio calculation, is driving the primary market to seek for more sophisticated reinsurance protection and is changing reinsurance purchasing patterns. In our view, the impact on reinsurers are mostly seen in two areas. First, a shift in the mix of reinsurance business portfolio, with lower proportion for motor insurance (historically the largest line), increased proportion of other lines like property, engineering, marine etc., and more non-proportional reinsurance. Second, increased attractiveness of onshore reinsurers for cedents, due to lower capital charges, compared with offshore reinsurers.
- High market growth continues. The premiums ceded surged to EUR 23.8Bn (RMB165.9Bn) in 2015 from EUR 3.4Bn (RMB 33.9Bn) in 2006 with CAGR of 19.3% (Growth in RMB) following the expansion and development of the country's primary insurance market. We expect the growth of premiums ceded to reduce to around 5-10% in 2016, largely due to reduction in motor business and return to growth of about 10-15% in 2017-18.
- Profitability is satisfactory, but facing strong headwinds. Overall, China's reinsurance industry profitability is satisfactory with the average return on equity (RoE) of 7.7% in 2016. It is mainly driven by investment income. We expect already low profitability to be challenged further in the next few years by increasing competition from new entrants. However, we saw, some positive signals in the Non-life pricing in the renewals of January and July 2017. It is yet to be seen whether it can be sustained.
- Strong capitalisation. The solvency ratios of all the main players were above 200% and the average solvency ratio was at 259% as of YE16. In addition, most of the capital base came from shareholders' equity, indicating high quality of the capital.
- More active role in risk management for society and economic development. Encouraged by government and motivated by potential business opportunities, reinsurers with expertise in Natural Catastrophe (NatCat), liability, high-tech insurance areas can leverage on it and gain more significant role in China's society risk management system and benefit from new business opportunities via developing new products, improving risk management at communities and entities level and aiding economic development of the country.
- The Belt and Road (B&R) initiative may present new business opportunities. According to the Belt and Road Forum for International Cooperation in May 2017, China expected to spend more than USD 135Bn to support various projects under the B&R initiative. Large part of it is related to an infrastructure development and will require insurance and reinsurance protection, especially in engineering and construction, marine, property and liability areas.

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1. REINSURANCE MARKET STRUCTURE

In the challenging and low growth global environment for reinsurers, China is emerging as one of the most important reinsurance markets, mainly due to its high growth potential and its size. The market is developing rapidly driven by a rather short history and fast expansion of the primary insurance industry. In 2015, China's premiums ceded from primary insurers reached EUR 23.8Bn (RMB 165.9Bn) and accounted for about 2% of the global reinsurance market[1].

China's reinsurance market can be divided into onshore and offshore sectors. The reinsurers with mainland-based operations, are considered onshore and usually write business through treaties on a proportional and non-proportional basis. The foreign-based reinsurers are considered offshore, they usually write a higher proportion of facultative business, and must comply with higher regulatory requirements. We estimate the onshore and offshore sectors to account for about 70% and 30% of the overall market share respectively.

In 2017 the market consisted of ten onshore players, six of which are foreign reinsurers[2] based in mainland (Swiss Re, Munich Re, Hannover Re, SCOR, Gen Re, RGA) and four are Chinese domestic reinsurers (China Re with two major reinsurance subsidiaries, Taiping Re/ Taiping Re China, PICC Re, Qianhai Re). PICC Re and Qianhai Re were approved by CIRC in the end of 2016. China Re dominates the market with approximately one-third of the overall market share. However, its dominance has been gradually reducing due to the opening up of the market to foreign players. The total market share of the six foreign reinsurers based in mainland and more than 200 offshore reinsurers has reached around 60% in 2016.

The reinsurance industry in China is highly regulated and protected, although less so than the primary insurance and other financial industries. Reinsurance underwriting capacity in the country is high and growing further due to the new domestic players entering the market and increasing commitment from foreign players. Competition is increasing as most of reinsurance products are perceived and trade as a commodity.

Historically the majority of reinsurance business is written in the form of treaties and come mainly from Non-life, in particular motor. However, the new regulations and changes in calculation of solvency ratio are changing the way reinsurance is purchased, with reducing share of motor and increasing in other lines, in particular property, agriculture, engineering, marine, and cargo. The industry is relatively young and underdeveloped. Nevertheless, its sophistication level is improving, as illustrated by China Re issuing China's first catastrophe bond to provide coverage on an indemnified basis for earthquakes in China and also supported by positive regulatory changes.

2. OPERATING ENVIRONMENT

China's reinsurance sector enjoys a favourable operating environment with strong macroeconomic and primary insurance growth, and advancing regulatory regime.

In the last decades, China has been the engine of the world economic growth, driven by expanding exports, booming manufacturing, huge investment in infrastructure, roaring real estate market and growing domestic consumption. The growth of wealth and improved risk awareness boost the demand for insurances products from both commercial and private sectors. It is well illustrated by the primary insurance premium growth rates significantly exceeding those of the GDP, except in 2011 (where Life insurance premiums contracted because of regulatory rules change related to the bancassurance). The primary insurance premiums CAGR stood at 18.6% for the period of 2006-2016. Consistently and rapidly expanding primary insurance market favorably affects operational environment for reinsurance.

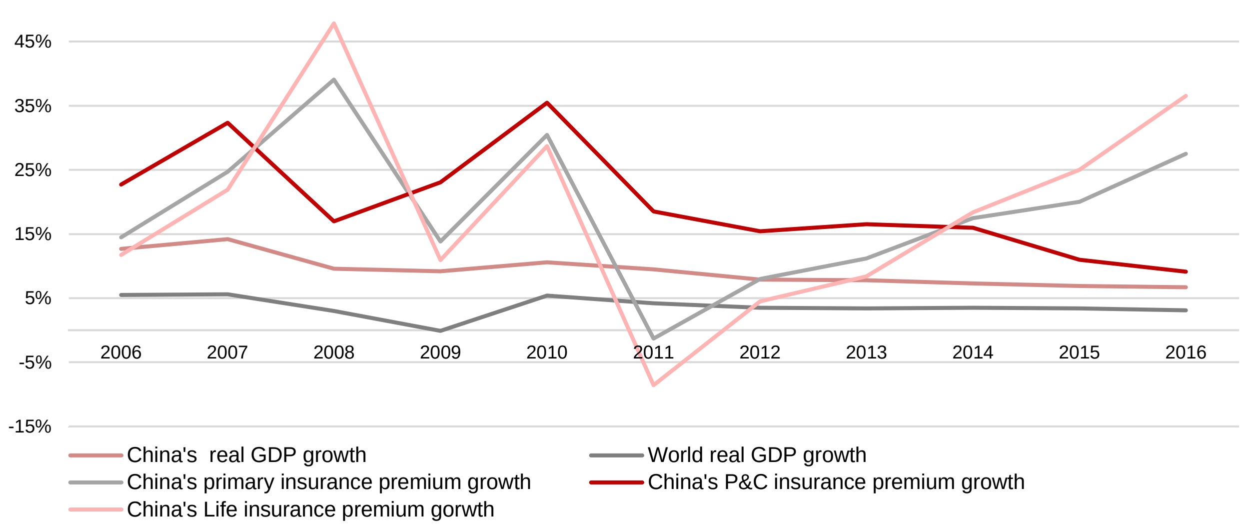
The new regulatory regime C-ROSS, which took effect from 1st of Jan 2016, has been a positive change in regulation. It has similar structure with three pillars (Quantitative Capital Requirement, Qualitative Supervisory Requirement and Market Discipline Mechanism) as the leading international insurance regulatory regimes. It is risk based and is expected to enhance the corporate governance practices, risk management, capital management, reporting, enhance resilience of the industry and aid in crisis prevention.

We see that this regulatory change has affected the reinsurance market mainly in two areas. First is the change in insurers' regulatory solvency capital requirements and calculation. The primary insurers are required to use different, risk related capital charges for different business lines when calculating regulatory solvency ratios (e.g., lower for lower risk lines like motor insurance and higher for lines associated with higher underwriting risk such as property, marine insurance etc.). We expect this to change the mix and volumes of reinsurance business portfolio, the proportion for motor insurance to reduce and proportion of other products like property, engineering, marine etc. to increase. We also expect that the non-proportional reinsurance will be more attractive for primary insurers. Secondly, in the same solvency ratio calculation,

[1] China Insurance Regulatory Commission (CIRC)
[2] Considering that Lloyds' China registered as primary insurer other than a reinsurer in China, we exclude it from our statistics.

cedents[3] are charged for reinsurance credit risk based on the reinsurer's origin of registration. For placement with offshore reinsurers credit risk factors range from 8.7% to 86.7%, while for placement with onshore reinsurers it ranges from 0.5% to 4.7%, if their solvency ratio exceeds 100%. Therefore, we expect this will result in a reduction of offshore reinsurers premiums and an increase in onshore reinsurers premiums.

Ex.1 The Growth Rate of China's Economy and Primary Insurance Premiums



Source: IMF, CIRC

In addition, CIRC introduced registration system for reinsurance market. Any reinsurance institution, that deals with ceding companies in mainland China, is required to register with the system. In February 2017, CIRC published requirements for collateral in cross-border reinsurance transactions. Although the collateral is not mandatory, non-collateralized treaties are subject to a punitive capital charge under C-ROSS. Due to these rules, we expect to see an increased number of foreign reinsurers registering their operations in mainland China.

The Equivalence Assessment Framework Agreement on Solvency Regulatory Regime, signed between CIRC and the Office of the Commissioner of Insurance of Hong Kong in May 2017, will also impact China's reinsurance market. The two parties aim to complete equivalence agreement within four years. Under the current C-ROSS, Hong Kong based reinsurers are considered as offshore players with higher credit risk capital charges compared with the onshore reinsurers. The mutual recognition of regulatory equivalence should provide the Hong Kong based reinsurers with easier access to China's reinsurance market as they will be treated as onshore reinsurers. This which is likely to lead to a wider choice of reinsurance counterparties for primary insurers and new business opportunities for the Hong Kong based reinsurers.

The C-ROSS also requires performing a Solvency Aligned Risk Management Requirements and Assessment (SARMRA), which is a unique characteristic of C-ROSS compared with other solvency regimes. It assesses insurer's or reinsurer's risk management capabilities, risk environment, objectives and tools and seven sections of risk management including insurance risk, market risk, credit risk, operational risk, strategic risk, reputational risk and liquidity risk. SARMRA on-site inspection teams from CIRC review the completeness and effectiveness of risk management annually, which results in a specific SARMRA score, which is directly connected to a capital requirement for controlling risk. We expect this will encourage market participants to enhance their risk management capabilities.

3. PERFORMANCE REVIEW

Sourcing publicly available, accurate and consistent data for the China's reinsurance market is challenging. Our analysis is based on information provided by CIRC, Insurance Association of China, companies' financial statements and solvency report abstracts (From January 2016, C-ROSS requires all insurers and reinsurers to publish quarterly disclosure of solvency report abstract, however the disclosed information is very limited).

Growth

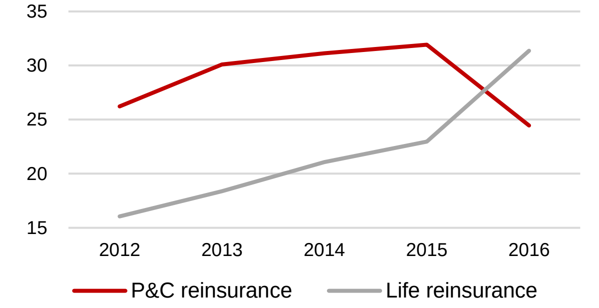
Over the last 10 years, Chinese reinsurance and insurance market has expanded significantly and benefited from fast economic growth and increasing risk-awareness. Premiums ceded surged to EUR 23.8Bn (RMB 165.9Bn[4]) in 2015 from

[3] Cedent is the insurer who cedes premium to reinsurer and obtains protection from reinsurer.
[4] CIRC

EUR 3.4Bn (RMB 33.9Bn[5]) in 2006, with CAGR of 19.3% (Growth in RMB), which is a little bit higher than that of the primary market of 17.6% in the same period. We estimate that the growth in premiums ceded in 2016 was around 5-10%. However, the growth rate has been volatile. Reinsurance utilisation differs significantly among companies and changes year on year. The average ceded premiums in Non-life were about 11% and in Life about 4% of gross premium written (GPW) in 2015. Under C-ROSS we expect reinsurance utilisation in the Non-life to reduce.

The implementation of C-ROSS in 2016 is reshaping the reinsurance market landscape. The new solvency regime encourages insurers across the country to reexamine their reinsurance arrangements and optimize capital allocation. The impact of the C-ROSS on the reinsurance premiums is mixed. One of the most impacted business lines is motor insurance, which accounted for about 73.8% of the total Non-life gross premiums written in 2016. The capital requirement for motor insurance decreased to 8%-10% of net premium retained under C-ROSS from previously 15-17%. This led to a significant reduction of related reinsurance premiums. As example, China Re's reinsurance premiums related to domestic motor market dropped by 48.1% to EUR 1.4Bn (RMB 9.4Bn) in 2016.

Ex.2 China Re Reinsurance Premiums (RMB, Bn)



Source: SNL

Although China Re's P&C reinsurance premiums shrunk by 23.4%, the Life reinsurance premiums increased by 36.5% in 2016. The company developed a new business model for financial reinsurance business[6], which amounted to RMB 17.3Bn, representing a y-o-y increase of 16.5%. China Re also accomplished notable growth in protection-type business of 43.8% and savings business of 467.0% (although from low levels). In total, China Re reinsurance premium in 2016 increased by 1.7% to EUR 8Bn (RMB 55.8Bn).

Six foreign reinsurers registered in mainland China also play very important roles. They wrote about EUR 5.5Bn (RMB 40.7Bn) of premiums in 2016. It accounted for about a third of the total market and was a little bit lower than China Re Group. Taiping Re China has registered as a domestic reinsurer in the beginning of 2016 and wrote premium of EUR 353Mn (RMB 2.6Bn) in 2016.

In the beginning of 2017, four of the six foreign reinsurers revealed that they had partially pulled back from underwriting in China due to increasing competition and less attractive terms and pricing. This was illustrated by six foreign reinsurers combined decrease in GPW of 26.1% in 1H17. However, the withdrawals provided more growth opportunities for other participants. The two new entrants, PICC Re and Qianhai Re, wrote premiums of EUR 172Mn (RMB 1.3Bn) and EUR 338Mn (RMB 2.5Bn) respectively in 1H17.

We expect reinsurance premiums to grow on average at 10-15% in 2017-18, driven by rapidly growing primary-market and increasing risk-awareness.

Ex.3 Reinsurance Premiums of the Six Foreign Reinsurers (EUR,

	2016
Swiss Re	2.2
Munich Re	1.7
Hannover Re	0.8
SCOR	0.6
Gen Re	0.2
RGA	0.02
Total	5.5

Source: Insurance Association of China

Profitability

In our view, the overall profitability of the reinsurance industry is satisfactory and largely driven by the investment income. So far, high domestic interest rates, compared with developed markets, supports the industry and drive its profitability. Underwriting profitability is low and volatile, affected by the highly competitive environment. The aggregated earnings of reinsurers in China (three Chinese reinsurers and six foreign reinsurers) stood at EUR 455Mn (RMB 3.3Bn), with an average RoE of 7.7% in 2016.

We estimate that in 2016 the Non-life reinsurers' combined ratios were on average around 100%, indicating low underwriting profitability and high reliance on investment income. Due to the fierce competition in China's Non-life primary insurance market, the industry's average combined ratio was at 99.5% in 2016. The weak technical performance of the primary market also has negative impact on the reinsurers profitability. We consider the performance of China Re as a good benchmark for the industry's overall performance. The combined ratios of China Re P&C were in the range of 98.0%-99.2% in the last five years. According to our analysis, the most profitable reinsurance business is from the foreign-owned primary insurers and marine business is one of the most profitable reinsurance lines among the Non-life lines.

[5] CIRC
[6] Financial reinsurance is a type of reinsurance used by Life insurers to keep profits steady from one year to the next.

We noticed some positive signals on the pricing in the Non-life sector during the renewals of January and July 2017. As we mentioned before, the foreign reinsurers are focusing more on profitable underwriting, and some even making significant cuts to the unprofitable business and therefore significantly reducing their market shares. Overall, the market is not as soft as last year and the price of some property contracts even increased depending on a loss history of cedents in mid-2017 renewal. Placement in general was more difficult than previous renewals. However, more time is needed to observe and confirm if this can become a positive shift in the pricing trends.

At this stage, we expect reinsurers' profitability to be challenging in the next few years by increasing competition due to new entrants, while underwriting profitability is already low. We also expect investment income to reduce due to the expected decrease in domestic interest rates and increased volatility in equity markets.

Ex.4 Profitability 2016

	Net Income (RMB, Mn)	RoE
China Re P&C	1,186.2	6.7%
China Re Life	1,374.0	10.7%
Swiss Re	359.7	8.3%
Munich Re	14.0	0.4%
Hannover Re	176.0	11.3%
SCOR	74.9	5.9%
Gen Re	65.7	13.0%
RGA	-25.0	-9.8%
Taiping Re China	116.5	8.8%

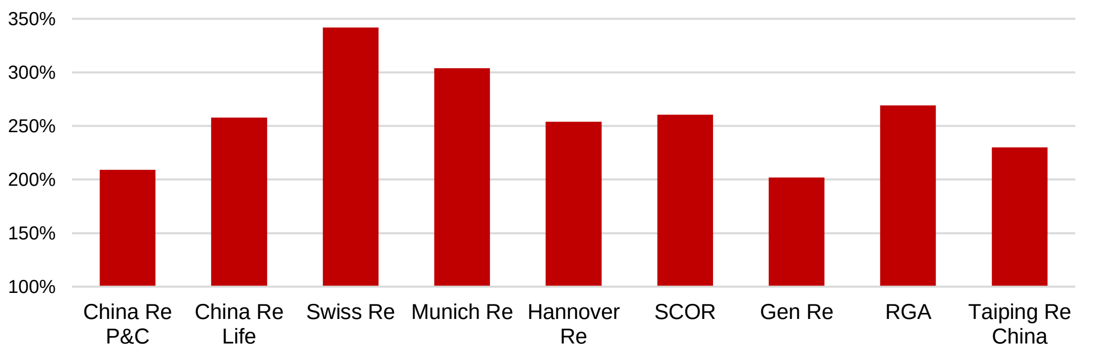
Source: Insurance Association of China, Dagong Europe calculation.

Capital

We see the industry's capitalisation as very strong and sufficient to finance the business growth and absorb potential large-scale losses. The solvency ratios of all the major players in 2016 were above 200%. The average[7] solvency ratio stood at 259%, which is well above the regulatory requirement. In addition, most of the capital base comes from shareholders' equity, indicating high capital quality.

In March and June 2017, China Re issued totally USD 1.5Bn subordinated bonds, with a purpose of supporting reinsurance operations and overseas investment. There are also some new entrants with high capital base still in the process of being approved, e.g. Asia Pacific Reinsurers assumed to have the capital of EUR 1.4Bn (RMB 10Bn). We consider those as signs of strengthening in industry's capital and financial flexibility.

Ex.5 Solvency Ratios 2016



Source: Insurance Association of China

However, we anticipate that reinsurers' capitalisation could be challenged if profitability deteriorates due to the high competition, sustained erosion of underwriting margins, prolonged low interest-rate environment, and sharp decline in the equity market, or abnormal catastrophe events, while at the same time rapidly expanding exposure.

4. OPPORTUNITIES AND CHALLENGES

There are four significant factors we believe that going forward will drive development of China's reinsurance market: a) high market growth, b) opening up and more market oriented regulatory regime, c) more active role in risk management for society and economic development, and d) the Belt and Road initiative. However, these factors are a double-edged sword as they present both significant opportunities and challenges.

a. High market growth: Both primary insurance and reinsurance premiums have shown impressive historic growth. With its large economy, population and geographic spread, China still presents very attractive growth opportunities. In the last ten years, China has been the main growth engine of the world insurance market. In 2016, the total

[7] We used arithmetic average calculation

premiums of the China's insurance market accounted for 9.9%[8] of the global share, expanding from 1.9%[9] ten years ago. If measured by the contribution to the growth, it is even more impressive, where China's insurance market in 2016 accounted for 59.2% of the total increase in the global premiums.

Despite concerns about China's slowing down economic growth prospects, we believe that the industry will not be significantly affected because of favourable industry's fundamentals and high support from the policy makers. Several structural factors such as rapid urbanization, growing middle class, aging population and increasing risk awareness will also fuel sustained demand for insurance and reinsurance.

However, the entry barriers to the reinsurance market are high with fierce competition, and dominated by China Re, with long and well-established ties to the major players in the primary market. In addition, we observe that operating and distribution costs are also high and the country lacks a pool of highly skilled technical and sales personnel due to the industry young history.

Despite these challenges, the industry remains attractive for new entrants. In 2016, two new domestic players entered the market: Qianhai Reinsurance Company with registered capital of EUR 410Mn (RMB 3Bn) and PICC Re with registered capital of EUR 137Mn (RMB 1Bn). Asia Pacific Reinsurance with registered capital of EUR 1.4Bn (RMB 10Bn) is in the process of being approved. Going forward, we expect to see more domestic entrants and onshore foreign reinsurers, which also means more fierce competition.

b. **Opening up and more market oriented regulatory regime:** The Chinese insurance regulator has been opening up the domestic insurance and reinsurance markets in the last decade, which also meant more competition. Going back to 2002, China Re was the only player in the market. Until 2006, there was mandatory cession for China Re according to the regulatory rules. Starting from 2006 Chinese reinsurance market opened up for foreign reinsurers as required by WTO concession. Now reinsurance became the most international industry among all the financial sectors in China. China's State Council published the Notice on Several Measures on Increasing of Openness to Foreign Investment and Active Use of Foreign Investment in January 2017. One of the clause requires to further lift the foreign investment restrictions in the key service industries like insurance and reinsurance.

We consider the implementation of C-ROSS in 2016, as one of the most important regulatory changes. It has an increasingly sophisticated and market oriented regulatory framework and is a significant improvement compared with previous regime. On the other hand, the C-ROSS do have some negative impact on the offshore reinsurers due to higher credit risk capital charges than for onshore reinsurers. In August 2017, CIRC decided to update the C-ROSS in the next three years. One of the main 25 tasks is to upgrade regulatory solvency rules for reinsurance sector. The impact to the industry is more difficult to assess at this stage, but we believe that clearer, more transparent and market oriented regulatory rules will improve risk management practices and foster healthy development of the industry.

The establishment of Shanghai as a regional reinsurance centre also brings potential opportunities for foreign reinsurers. Shanghai is aimed to be an international financial centre by 2020, to achieve this goal a regional reinsurance centre position will be crucial. In June 2016 Shanghai Insurance Exchange, with an initial registered capital of EUR 304Mn (RMB 2.24Bn) launched and will act as the trading platform of insurance products and insurance derivatives, including international reinsurance, marine and mega insurance deal bidding. Similarly to Shanghai Pilot Free Trade Zone and other free trade zones, we expected the government will publish more innovative measures to boost the reinsurance market, including lowering entry barriers for foreign reinsurers, loosening foreign exchange controls, offering more favourable tax conditions for offshore reinsurance business and encouraging new product development.

c. **More active role in risk management for society and economic development:** Several Opinions of the State Council on Accelerating the Development of the Modern Insurance Service Industry, released by China's State Council in 2014, stated that insurance should be considered in the grand plan of economic and social policy management to modernize the social governance system and meet the public's increasing need for diversified insurance services. Since then we can see insurers and reinsurers taking more active roles in developing new products and services to assist society in better risk management, including agricultural insurance, catastrophe and liability insurance among others. One latest example is a proposed guideline on environmental pollution liability insurance published by regulators, which requires eight categories of companies (including those engaged in the extraction of petroleum and natural gas; gathering, storage, utilization and disposal of hazardous wastes; and a production of active pharmaceutical ingredients) to purchase mandatory environmental pollution liability insurance. Insurers and reinsurers can benefit from such regulations.

China's insurance and reinsurance markets are young and still immature. The major domestic players have limited expertise in specialist areas, product innovation and risk management. Therefore, we believe that foreign reinsurers

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[8] Swiss Re, Sigma
[9] Swiss Re, Sigma

have bigger roles to play and leverage on their global and regional expertise, experience in product development and risk management. We see the greatest potential for those with specialty product lines, related to natural disasters, aerospace and aviation, petroleum, green energy, advanced manufactories, special liability and agriculture.

One of the good examples of leveraged global expertise and experiences in China is Swiss Re, which launched the first parametric disaster insurance programme for agriculture in China covering participants against the impact of flood, excessive rain, drought and low temperatures in 28 counties across Heilongjiang province. Swiss Re also became the sole reinsurer for a parametric disaster insurance pilot providing protection against tropical cyclone and excess rainfall in the Chinese province of Guangdong in 2016. In July 2017, Swiss Re signed a Memorandum of Understanding (MoU) with the Chinese Dalian city administration to improve its comprehensive insurance programme, including catastrophic insurance solutions to protect against natural and man-made disasters such as fire and explosion.

The knowledge and expertise of alternative capital markets and issuance of natural catastrophe bonds could help to develop a new niche, better manage climate change and impact from natural disasters in China, which has significant exposure to earthquakes, floods and other similar perils. The relevance of this niche is demonstrated by China Re issuing first Chinese catastrophe bond in 2015, raising USD 50Mn. And Shanghai Insurance Exchange was also considering the feasibility of catastrophe bonds and other insurance-linked securities (ILS).

d. **The Belt and Road initiative:** The Belt and Road (B&R) initiative is regarded as one of top priorities for Chinese government. It aims to connect China with 65 countries, representing around a third of global GDP, and encourage policy co-ordination, facilitate connectivity, unimpeded trade, financial integration and people-to-people bonds. According to the Belt and Road Forum for International Cooperation, which took place in May 2017, China will add more than USD 135Bn to support various projects under the B&R initiative, most of which are infrastructure related. Such huge investment will definitely need insurance and reinsurance protection. Swiss Re estimates that various projects outside of China will generate about USD 28Bn of commercial insurance premiums until 2030, most of which are in engineering and construction, marine, property and liability. This presents opportunities for domestic and foreign insurance and reinsurance specialists. China Re is promoting a B&R community for the insurers and reinsurers to better support the insurance and reinsurance need related to B&R projects. In 2016, China Re also established Singapore branch to serve the B&R initiative.

In addition, despite the recent constrain of irrational overseas investment, the Chinese government is still supporting the ‘Going Out’ policy when the investment targets are aligned with core business of the investors and especially when the investments are supportive to B&R initiative. Chinese insurers and reinsurers are looking for partners and opportunities abroad, whether it is premium expansion, risk diversification or cooperation and acquisitions of foreign insurers and reinsurers. For foreign insurers and reinsurers this provides opportunities for business development, strategic partnerships or change of ownership structure. Acquisitions of foreign players could provide an attractive opportunity for domestic players to build a global franchise, diversify, and also acquire technical expertise and specialist knowledge. Below we list some of the major foreign acquisitions and investments of Chinese re/insurers in 2016-17:

- Shenzhen Qianhai Financial Holdings Co. and Shenzhen Investment Holdings Co. acquired Singapore based Asia Capital Reinsurance, the biggest player in Singapore.
- JD Capital acquired Ageas Insurance Company (Asia) Limited.
- Anbang acquired Allianz Life Insurance Korea.

We believe that Chinese companies will continue looking for and acquiring foreign insurers and reinsurers in the next few years at a moderate pace. This is mainly because of the limited number of large domestic players with global ambitions and readily available excess capital.

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