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The Rise of the Dragon: Opportunities in Insurance Broking Markets in Hong Kong and Mainland China

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Summary

- Large-scale market changes continuously bring challenges for insurance brokers. The global emergence of sophisticated information and communication technology is a potential threat of disintermediation on one hand; on the other, increased insurance liberalisation and deregulation is resulting in greater product differentiation and leading to increased demand for brokerage.
- In Hong Kong, new legislation on semi-portability, effective from autumn 2012, allows employees to choose any scheme in the Mandatory Provident Fund (MPF) market for their own contributions, at least once per calendar year. This will lead to fierce market competition among the service providers and brokers, and will ultimately benefit the consumer.
- Another change in the Hong Kong Stock Exchange listing rules has highlighted the importance of coverage for Directors & Officers, a market which has already grown faster than expected. Competition will become intense in Hong Kong if the clients are able to procure D&O cover from non-admitted insurers through the brokerages.
- Turning to mainland China, heavy losses from catastrophic events across the country have drawn attention to the need for better "Acts of God" cover to protect losses, especially among businesses. More private corporations should be encouraged to take out a catastrophe insurance scheme to protect their investments.
- Meanwhile, China's heavy exposure into Overseas Foreign Direct Investment will carry significant risks that need mitigation. Uncertain growth trajectories and unstable political and financial environments can affect investment opportunities. There is clearly a need for professional insurance brokers to help Chinese companies identify, manage, control and transfer risks through a comprehensive and sophisticated approach.

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CII Introduction: the changing regulatory environment in Hong Kong continues to attract attention from observers, and for good reason given the changes in insurance supervision happening globally. All across China, insurance markets show significant potential for growth covering a diverse array of risks. In this Thinkpiece, released at the critical juncture of a new leadership in Beijing with Xi Jinping taking the helm of the 18th People's Congress of the Chinese Communist Party, Guangzhou-based Solomon Ngan takes stock of the significant insurance broker opportunities in both Hong Kong and mainland China.

Large-scale changes in the market environment continuously bring challenges for brokers in the insurance industry. On the one hand, the global emergence of sophisticated information and communication technology is a potential threat of disintermediation. On the other hand, the liberalisation and deregulation of insurance markets have resulted in greater product differentiation, leading to increased demand for brokerage. The coming years will bring about change, both in legislation and in the regulatory environment. The brokers need to reconsider their future roles and functions, to ensure they provide added value and meet the varying needs of demanding customers.

Progress and evolution of Hong Kong MPF system

Implemented in December 2000, the Hong Kong Mandatory Provident Fund (MPF) system is now in its twelfth year of operation. Administered and managed by the private sector, the schemes are based on a defined contribution basis. Employees and their employers make their own contributions to a scheme, which invests those contributions until the retirement date. The scheme provider could only be chosen by the employer until the recent passage of the Mandatory Provident Fund Schemes (Amendment) No. 2 Bill 2011.[1]

New Employee Choice Arrangement under latest bill passage on MPF

On 1 November 2012, the Employee Choice Arrangement (ECA, also called semi-portability) took effect. The new legislation allows employees to choose any scheme in the MPF market for their own contributions, at least once per calendar year. As at 31 December 2011, the number of members had risen to 2.69 million and assets under management stood at HK$356bn (US$45.9bn),[2] representing an average per scheme member of HK$132,000 (US$17,000).[3] Employees can exercise their rights to choose a new provider. As a result, wider fund choice will lead to greater competition among the service providers. The banks, trust companies and insurance companies have to review their fees for the benefit of the general public.

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Fierce market competition among insurance intermediaries

To encourage a free choice market environment, the brokerages are expected to provide their employees with a full analysis of the scheme provider in terms of investment performance, fees and investment options. The market competition is intense. As at 31 December 2011, there were about 600 authorised insurance brokers and 37,200 insurance agents according to the Office of Commissioner of Insurance Statistics. Every one of these brokers and agents can register as an MPF intermediary. This will undoubtedly create a stiffly competitive market, forcing firms to respond on the capability, experience, expertise, sales or marketing activities of their intermediaries.

Monitoring of insurance intermediaries

The Mandatory Provident Fund Scheme Authority has a full range of disciplinary powers and authority. The intermediaries should act in the best interest of the client and follow conduct requirements. Any misconduct by the intermediaries will be subject to disciplinary sanctions such as reprimand, fines and revocation or suspension of registration.

More demand for Directors & Officers insurance in Hong Kong

In the latest amendment to Hong Kong Stock Exchange (HKEx) listing rules, the Directors & Officers (D&O) insurance requirements for the issuers have changed from being a "Recommended Best Practice" to being a "Code Provision" (CP). This came into force on 1 April 2012. The issuers will include the companies that are listed already on the Main Board of HKEx and those will apply for an

[1] "MPFA Welcomes Passage of Bill on the Regulation of MPF Intermediaries," MPFA Press Release, 21 June 2012. www.mpfa.org.hk

[2] Exchange rates as of November 2012.

[3] Ernst & Young for the Joint Industry Group, The Evolving MPF System: An Objective Assessment, May 2012.

Initial Public Offering. The implication of the change is to encourage the issuers to maintain the D&O policy. Any issuer not complying with CP is required to give reasons for its deviation. Although this amendment does not have the force of law, most of the Hong Kong issuers tend to purchase the D&O cover in respect of legal actions against their directors.

Significant role of D&O insurance in the corporate world

Over the past three decades, the market for D&O has grown faster than expected, especially since the impact of litigious US practices spread overseas. Hartmut Mai, Global Head of Financial Lines, Allianz Global Corporate & Specialty, estimated that the worldwide premium volume for the D&O market is about US$10bn.[4] The US has probably generated the major share at US$8bn.[5] Europe has seen rapid growth in D&O over the last decade, with a premium of US$1bn. In terms of premiums, Asia is estimated to be US$100m.[6] Hong Kong is one of the regions in Asia promoting the standard of corporate governance and corporate responsibility to stakeholders and shareholders.

The recent regulatory change in Hong Kong raises the awareness of the public company about the importance of protecting directors and officers with D&O provision.

The recent regulatory change in Hong Kong raises public company awareness about the importance of protecting directors and officers with D&O provision. Most insurance brokerages are making use of this opportunity to further develop the Hong Kong D&O sector. Under fierce competition among the insurance intermediaries, the rates for Hong Kong-listed companies without US exposures are continuously declining at renewal. Brokerage ratios are even dropping as brokers try to retain clients with good claims experience and corporate governance. The competition will become more intense in Hong Kong if the clients are able to procure D&O cover from non-admitted insurers through the brokerages.

Is an Independent Insurance Authority needed for the Hong Kong insurance industry?

To provide policyholders with better protection, and facilitate market stability and the competitiveness of the insurance industry, the Hong Kong Government has proposed to set up an Independent Insurance Authority (IIA), separate from both Government and the industry. This would replace the three self-regulatory organisations (SROs) existing in Hong Kong, namely the Insurance Agents Registration Board (IARB) under the Hong Kong Federation of Insurers (HKFI), the Hong Kong Confederation of Insurance Brokers (CIB), and the Professional Insurance Brokers Association (PIBA) regulated by the Insurance Authority under the Insurance Companies Ordinance.

All insurance brokers in Hong Kong are members of either the CIB or PIBA. Those brokers must be fit and proper persons and satisfy the minimum qualifications, experience and minimum capital requirements. Both the CIB and PIBA are responsible for handling all complaints against their members; they are able to carry out investigations and take disciplinary actions on substantiated cases.

While this broker self-regulation has, since its inception in 1995, yielded some flexibility for a dynamic market, a 2007 study by Price Waterhouse-Coopers identified a number of shortcomings:

- A real conflict of interests may arise, as the SROs are trade bodies financed by their members;
- The CIB and PIBA were not consistent in their disciplinary guidelines, procedures and level of sanctions;
- The SROs have limited investigatory and sanctioning powers over their members;
- Hong Kong's self-regulatory regime is not aligned with international insurance practices.

A new independent regulator for Hong Kong brokers

In addition to replacing the self-regulatory framework for brokers, the new IIA will take over the regulatory role of the Office of the Commissioner of Insurance (OCI). This will result in the following remit:

- Monitoring and regulating the conduct of insurance intermediaries;
- Researching insurance industry trends and issues;
- Promoting public education;
- Assisting the Government in taking necessary measures related to the insurance industry to ensure the financial stability of Hong Kong.

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[4] *Introduction to D & O Insurance*, Allianz Global Corporate & Specialty 2010.

[5] "Directors' & Officers' Insurance in Hong Kong: Challenge and Prospects," by Janet Lau, *Lens Newsletter*, March 2006.

[6] *Ibid.*

The new IIA would perform a direct role in initiating investigations, searching and seizing materials, handling complaints and imposing disciplinary sanctions. In view of the ever-changing market environment and evolving international regulatory standards, the new IIA will not only facilitate compliance and promote market development, but also enhance the competitiveness of Hong Kong as a financial centre. However, the regulator must bear in mind that heavy regulatory enforcement could risk impairing the market both in terms of flexibility, and response to changing conditions.

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Whereas Hong Kong's special administrative region has long been an insurance hub in Asia, both before and after 1997, insurance in the People's Republic still remains a largely untapped market. Hong Kong insurance markets have always attracted a special attention in the global media, elevated in the last year by speculation that major corporations were considering a move to the jurisdiction from western countries such as the UK. However, less has been said about the market potential across mainland China. Despite significant growth in other markets, the opportunities arising from investment within China - and especially about the burgeoning of Chinese investment abroad - deserve more attention.

China's long history of catastrophe losses

One example of such a growth market is catastrophe risk. In August 1931, a devastating and powerful tropical cyclone struck Hangzhou Bay. In the widespread flooding that ensued, casualty estimates ranged between 145,000 and 4 million. This event was one of the single deadliest natural disasters ever recorded.

The 1976 Tangshan earthquake destroyed over 85% of the buildings in the area, caused economic losses of over CN¥10bn (US$1.6bn), and cost 655,000 lives (now thought to be the deadliest quake in the twentieth century). Tangshan is indicative of the scale of natural catastrophe losses in mainland China, and even a cursory look at major natural disasters in 2012 alone gives some insight into the need for insurance in that country.

Major Natural Disasters: China, since April 2012

Month	Cause	Location	Notes
April	Wildfire	Qipan Mountains	700+ people involved in firefighting
	Flooding	Shanxi	10 miners killed in coal mine flood
	Sandstorm	Gansu	Biggest to hit this province
May	Rainstorm	Guangxi	Railway traffic disruption
	Landslide	Shennongjia Hubei	300 tourists evacuated
June	Torrential Rainfall	Eastern & Southern China	Causing floods/landslides
	Sinkhole	Guangxi	800+ villagers evacuated
July	Flooding	Beijing	Heaviest rainfall in the city in 61 years
August	Typhoon	Guangdong	18,000+ evacuated
September	Quake	Yunnan	Hundreds died
	Mine flood	Guizhou	8 workers missing
	Mine flood	Heilongjiang	6 miners trapped
October	Landslide	Yunnan	19 killed incl 18 children
	Landslide	Hunan	Construction site in Sheoyang city, 2 killed
November	Snowstorms	Huailai	3 tourists killed

Source:www.disaster-report.com/2012/03/recent-natural-disasters-in-china.html (accessed Nov 2012)

"Around 30% of the losses from catastrophes in developed countries are covered by insurers, while the percentage is lower than 5% in China," said Wei Yingning, vice-chairman of the China Insurance Regulatory Commission in 2011. "China should establish catastrophe insurance as soon as possible," he added. There is a plenty of room for the insurance brokerages to explore business opportunities from the untapped market potential in developing countries like China.

Recent natural disasters have forced people and corporations to choose "Acts of God" cover (AOG) to protect their losses. More and more people have become aware of the importance of AOG cover to the survival of corporations.

However, the demand for catastrophe insurance scheme remains in the preparatory stage on the mainland. Recent natural disasters have forced people and corporations to choose "Acts of God" cover (AOG) to protect their losses. More and more people have become aware of the importance of AOG cover to the survival of corporations. According to an insurance professor, Central University of Finance and Economics, the state-owned enterprises should set a good example by maintaining an AOG scheme to protect their assets and people. Given that the Central Government is able to provide adequate subsidies and preferential taxation policies, more private corporations should be encouraged to take out a catastrophe insurance scheme to protect their investments.

Outward foreign direct investment in Chinese companies

Chinese overseas investment has become a landmark of early twenty-first century globalisation, and this spells opportunities for insurance. Based on the statistical data of China's Ministry of Commerce in 2010, China's outward foreign direct investment (OFDI) reached US$68.8bn; a growth of 21% when compared with 2009. As at the end of 2010, more than 13,000 Chinese entities had established over 16,000 overseas enterprises spreading across 178 countries globally. The value of contracts completed abroad in 2011 was US$103bn, an increase of 12%. OFDI covers a wide range of industries including energy, mining, technology, real estate, infrastructure, agriculture, telecommunication and property. China is ranked fifth among all economies in terms of OFDI, according to the World Investment Report 2011.

Benefits and risks

China's OFDI benefits from diversifying its investments and spreading over multiple economies, instead of putting all of its money into one single market. In addition, the return on this type of investment in the emerging countries tends to be higher than what could be expected elsewhere. However, OFDI will carry significant risks, especially if the economic and political development trajectory is uncertain. The unstable political and financial environment of the developing countries can have a negative impact on the overall investment opportunity.

Role of the broker, Chinese companies and government

What is clearly needed is a professional insurance broker helping the Chinese companies to identify, manage, control and transfer risks through a comprehensive and sophisticated approach.

Chinese companies going overseas may encounter a series of risk exposures, leading to financial consequences that are severely underestimated. What is clearly needed is a professional insurance broker helping the Chinese companies to identify, manage, control and transfer risks through a comprehensive and sophisticated approach.

Chinese companies face personnel risks in overseas ventures. The Chinese government should assist in this regard, especially in mobilising resources and capability to evacuate its nationals from host countries suffering threatening or deteriorating political conditions. However, in situations short of this extreme of total host country political meltdown, news of Chinese workers in Africa and the Middle East being kidnapped for ransom are not uncommon. Therefore, staff protection from all risks is one of the important duties for firms involved in any overseas work.

Currently, firms operating abroad are familiar with the traditional types of insurance cover like property, public or product liability, contractors all risks, personal accident, and travel. In the face of increased uncertainty and risk in the political environment of emerging countries, the insurance broker needs to offer an additional range of products:

- Kidnap and Ransom
- Environmental Impairment Liability
- Medical and Emergency Evacuation
- Trade Credit and Political Risks
- Warranties and Indemnities
- D&O Liability

Driven by China's "go abroad" strategy that is supported by Central Government, insurance brokerages are trying to capture a slice of the pie. In fact, Chinese overseas ventures have paved the way for potential growth in insurance for insurers and brokers in the next ten years.

Many Chinese companies continue to expand overseas, through merger and acquisitions over the past few years. We have seen the China Investment Corporation purchase a share in Blackstone, Geely Auto took over Volvo and the China Development Bank acquired a stake in Barclays. However, not all of these overseas investments can be as successful as some might expect. Strict regulatory requirements and frequent changes in the political landscape overseas compel Chinese companies to control and manage the risks cautiously and prudently when investing overseas. Driven by China's "go abroad" strategy that is supported by Central Government, insurance brokerages are trying to capture a slice of the pie. In fact, Chinese overseas ventures have paved the way for potential growth in insurance for insurers and brokers in the next ten years.

Conclusion

The deregulation and liberalisation of insurance markets, the emergence of natural catastrophes, aggressive foreign investments, and frequent lawsuits in the market environment have all increased the importance and complexity of risk management for companies. As a result, there is a rising demand for brokers to give advice regarding risk exposure in such areas. Customers would appreciate the brokers providing innovative and effective solutions to meet their specific and individual needs.

The global emergence of advanced information and communication technology is a threat to the demand for insurance intermediaries, especially brokers. They must redefine their roles and functions to adapt to the dynamic business environment and changing customer requirements. This will require an in-depth understanding of the client's specific needs and issues. Brokers will need to move away from product-driven and distribution business models toward approaches that emphasise consultation and delivery.[7]

If you have any questions or comments about this Thinkpiece, and/or would like to be added to a mailing list to receive new articles by email, please contact us: thinkpiece@cii.co.uk or by telephone: +44 (0)20 7417 4783.

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CPD Reflective Questions

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Reading this Thinkpiece with respect to the learning outcomes below can count towards *Structured CPD* under the CII CPD Scheme. The questions are designed to help you reflect on the issues raised in the article. Please note that the answers to the questions are not meant for CPD records purposes.

Learning Outcomes

- To understand the various opportunities and challenges affecting the insurance intermediation market in Hong Kong and Mainland China.
- To be able to summarise the background behind behind the formation of the new Independent Insurance Authority in Hong Kong and describe some its key implications for the market.
- To identify some issues in the insurance market in mainland China, particularly some of the risks that need to be covered both in China and overseas.

Reflective Questions

1. The formation of the new Independent Insurance Authority will represent some major changes to insurance regulation in Hong Kong. What are the key changes from the existing regime? How will this affect the supervision of firms including both providers and intermediaries?
2. The author describes the scope to widen the catastrophe losses market in mainland China, given the risk characteristics of natural disasters. How does this compare with other markets in the region? You might want to consider Dr Padmavathi's Thinkpiece no.88 about the non-life market in India.
3. Given the increased prevalence of China's overseas foreign direct investment market, do you agree with the author's view that this could spell opportunities for insurers and brokers? How would this compare to other aspects of doing business in China?

[7] Peter Maas,"How Insurance Brokers Create Value", *Working Papers on Risk Management and Insurance*, no. 27, September 2006.

The CII Thinkpiece Series

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There are a number of centralised services which the large integrated oil companies retain and manage internally. Insurance is one of these. The author describes this unique arrangement and explains why insurance market players should recognise the increasing role of captives and design new tailor-made specialist services that could work within this business niche.

No.89: **Ties that Bind: The Importance of Science and Technology to the Insurance Profession**, by Rt. Hon. David Willets MP (5 Oct).

Describes the many links between insurance and information technology in the UK. In his view, the UK's comparative advantage is intrinsically linked to industries like financial services building increasingly strong ties with research and development centres and universities which are at the frontiers of developing new technology.

No.88: **Non-Life Insurance in India: Managing Disaster Risk Exposures – An Opportunity for Better Risk Management and Growth**, by Vankayalapati Padmavathi (14 Sep).

Dr Padmavathi of the Institute of Insurance & Risk Management in Hyderabad, India focuses on issues affecting its growth. In the process, she examines how the insurance industry could play a greater role in creating a sustainable and balanced approach to disaster risk management which, as her research shows, is one of the greatest issues facing the Indian economy going forward.

No.86: **The Power of Networking in the New Economy**, by Sue Carette (10 August).

Getting a march on the competition is difficult during the best of times, let alone when conditions are as testing as they are now. Access to the right network of support and contacts can be the difference between success and failure. The author examines how networking is changing with the advent of new technologies and how it can be of value to you professionally and personally.

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Traditional approaches explaining human choices in financial services have done little other than reveal our limited understanding of this subject. More recently, researchers have come to realise that emotions have a more powerful part to play in the decisions of casual consumers and professional investors alike. This article explore some of these new theories and their implications to understanding financial markets.

No.76: **Is the Renminbi the New Dollar? Chinese Monetary Policy and the Global Reserve Currency System**, by Andrew Leung (14 May).

The author focuses on monetary policy in China and its potential implications, arguing that any drastic appreciation of the Renminbi (RMB) is likely to cause catastrophic job losses and social instability in the country. As a consequence, Leung argues that China must retain an independent RMB exchange rate, allowing for only gradual and measured appreciation.

No. 71: **The Challenge of Age: Global Longevity Trends and Economic and Social Implications**, by George Magnus (23 March).

George Magnus ("the man who predicted the financial crisis") argues that the current economic turmoil is colluding with rising longevity to severely depress returns for the elderly. Governments, societies and industries must take robust action now in order to ensure that rising longevity is celebrated rather than feared over the decades to come.

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