Standing at the C-ROSS of China’s Insurance History

– An Outline of China’s Risk Oriented Solvency System (C-ROSS)

BACKGROUND

After enjoying a few decades of rapid growth, China’s insurance industry had accumulated total assets of USD 1.34 trillion at the end of 2013. The annual premium, with an annual growth rate of 18% in the last ten years, reached USD 0.27 trillion in 2013. The market may be booming but the insurance industry is also facing several issues:

- risk management capability is generally weak and not in line with market growth;
- capital efficiency is low due to the volume-based solvency regime;
- long-term investment is not performing well; and
- expenses are high.

As a result, a few cases of ‘not looking after the interest of customers’ were seen in recent years, including misleading sales and difficulties making insurance claims.

The China’s Insurance Regulation Commission (CIRC) conducted an analysis and concluded that the existing simple, but overly strict, regulation environment had contributed significantly to these issues arising.

Currently, the CIRC operates a factor-based solvency system similar to Europe’s Solvency I regime. It is volume driven and focuses on the quantitative assessment with no risk management requirements. Due to the lack of any links between risk management and the regulatory capital requirement, there is no incentive for insurance companies to build comprehensive risk management frameworks. This system worked well in the early stages of market development and served as the first step to the solvency management of insurance companies in China. However, the market’s self-discipline mechanism is weak under this system, and the regulator has had to strictly regulate...
insurers at the front line, i.e. the premium rate, investment channels, product terms and conditions. This approach is not in line with the overall objective of China’s market-oriented reform of the financial industry and the CIRC’s strategic goal to “open up the front, regulate the back”. Recognising these shortcomings, the CIRC decided to launch a project to develop a new regulatory framework to reduce front-line regulation and to strengthen the insurance industry’s market economy. As a result, the C-ROSS project was launched in April 2012.

C-ROSS
To develop the new system, the CIRC conducted a thorough study of regulation and supervision trends across the globe for example:
- Insurance Core Principles from the International Association of Insurance Supervisors;
- Solvency II from Continental Europe;
- Solvency Modernisation Initiative from the National Association of Insurance Commissioners in the US;
- Risk-Based Capital 2 from the Monetary Authority of Singapore; and
- Life and General Insurance Capital from the Australian Prudential Regulation Authority.

A great deal was learnt from these recently developed principles and systems. In the interim we also realised that China has its own characteristics as an emerging market and that no single regulation fits all markets. C-ROSS has been developed to meet local market needs – but it may also be useful to other emerging markets.

SKETCH OF C-ROSS
Similar to the Basel system, C-ROSS adopted a ‘three pillar’ solvency framework. However, by developing China-specific approaches and placing different emphasis in each pillar, China’s ‘three pillar’ framework is intended to fully reflect its own evolution.

The market’s self-discipline mechanism is weak under the current system, and the regulator has had to strictly regulate insurers at the front line.
PILLAR I – QUANTITATIVE ASSESSMENT

There are five key components under Pillar I, including:
1. own fund;
2. minimum capital;
3. solvency ratios;
4. stress testing; and
5. regulatory measures.

Own fund is the difference between admissible assets and admissible liabilities and any such capital is classified into four categories under the technical standards: Tier 1 core, Tier 2 core, Tier 1 ancillary and Tier 2 ancillary. Lower ranked own funds will be admissible with reference to Tier 1 core own fund.

Minimum capital is the total capital requirement, and consists of inherent risk, control risk and system risk. Inherent risk is the risk that objectively exists in the business activities of insurance companies, and includes both quantifiable risk and unquantifiable risk. Quantifiable risk consists of insurance risk, market risk and credit risk, whilst unquantifiable risk consists of operation risk, strategy risk, reputation risk and liquidity risk.

The quantifiable risk is calibrated and assessed by a VaR approach under Pillar I. The unquantifiable risk is qualitatively assessed under Pillar II. Control risk is the risk that the internal management and governance of the insurance company is ineffective or invalid, and as a result, the inherent risk is not identified and controlled in time. The control risk capital is calculated by a scoring system under Pillar II. System risk is the risk caused by the external environment and macro-economy and is a global risk in the insurance system. It is normally un-hedgeable. There are four types of system risk capital, i.e. the risk capital to adjust counter-cyclical effect, capital requirement on Domestic Systemically Important Insurers (D-SII), capital requirement on Global Systemically Important Insurers (G-SII) and other capital adjustment to defend the system risk.

Stress testing is another important quantitative measure of solvency. If the solvency ratio is an indicator of a company’s current solvency, stress testing reveals the sustainability of a company’s solvency. We include mandatory, voluntary and reverse scenarios in stress testing.

Regulatory measures are instruments to enforce Pillar I regulation. Two solvency ratios are monitored: the core solvency ratio (Tier 1 core capital / minimum capital requirement) and the aggregated solvency ratio (own fund / minimum capital requirement). A company with an aggregated solvency ratio below 100% will have different regulatory measures applied to rectify the problem according to its specific risk exposure. Whilst a company with a core solvency ratio below 50% for a number of consecutive periods will have more serious measures applied, like suspension of new business, takeover and restructure by the regulator or moving to bankruptcy / liquidation.

PILLAR II – QUALITATIVE SUPERVISOR REQUIREMENTS

Under Pillar II, CIRC focuses on four risks, which are important but difficult to quantify currently given companies’ technical capabilities and data availability. These four risks are operational risk, strategy risk, reputation risk and liquidity risk. As well as the regular supervision measures like analysis and examination, the CIRC intends to apply the following two supervisory assessments under this pillar:
1. Integrated risk rating (IRR): CIRC comprehensively evaluates an insurer’s overall risk rating based on both quantitative results under Pillar I and qualitative risk assessments under Pillar II, which will classify a company into four levels of risk, with different regulatory measures applied according to the risk level.
2. Solvency Aligned Risk Management Requirements and Assessment (SARMRA): The companies’ own solvency
management (COSM) plays an important role in the C-ROSS regime. CIRC will set up minimum standards of risk management for insurers and periodically evaluate their implementation. These standards will include governance structure, internal controls, management structure, processes, and assess insurance companies’ risk management capability and risk profile.

One key feature of Pillar II is to motivate companies to establish a comprehensive enterprise-wide risk management framework. This is achieved by introducing control risk capital, which is determined by the result from SARMRA assessment under Pillar II and serves as an adjustment to the minimum capital under Pillar I. The control risk capital is a reduction to minimum capital for companies with a well-implemented risk management framework and an increase for companies with poor risk management.

PILLAR III – MARKET SELF-DISCIPLINE MECHANISM

Pillar III incorporates three aspects: the insurance company’s public information disclosure; the regulator’s public information disclosure; and the insurance company’s credit rating. All these will require a more transparent disclosure and enforced supervision on insurance companies from media, investors, rating agencies, financial analysts and the general public, thereby maximising the market self-discipline mechanism. Self-regulation complements the C-ROSS system, and overcomes any limitations in supervisory resources.

BEYOND C-ROSS IMPLEMENTATION

We are standing at a major crossroad in China’s insurance history, heading towards an era of a much more open and competitive market. The regulatory environment will be risk-oriented with scientific quantitative assessment and comprehensive qualitative assessment. The market self-discipline mechanism will play an important role.

The industry will see strengthened market reform, particularly through market entry and exit, investment channels and premium rates. Companies with superior risk and capital management strategies will enjoy improved capital efficiency, higher returns on capital and more competitive advantages. Last but not least, customers and investors will be better protected by increased disclosure and transparency.

We are confident that C-ROSS will drive the market reform of China’s insurance industry, enhance capital efficiency, inject vitality, exploit the market potential and strengthen risk management awareness and techniques. Ultimately we envisage a more mature insurance industry with increased business development opportunities within China for international insurers.

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