JLT Re

# MARKET INSIGHT

JLT RE AUGUST 2017

## REGULATORY CHANGE IN CHINA AND HONG KONG

Hong Kong is currently going through substantial regulatory change by moving towards a Risk Based Capital (RBC) framework. While some details have already emerged, JLT Re believes these are likely to be overshadowed by the bigger issue of achieving regulatory equivalence between Hong Kong and China. Such an outcome would bring about wholesale strategic changes to insurers in both jurisdictions, while also delivering a significant boost to Hong Kong as a domicile of choice for writing cross-border business.

During this interim period, an understanding of China's C-ROSS regulatory system would provide Hong Kong insurers with valuable insight in terms of what the future holds and the challenges that they are likely to encounter. It is also an opportunity to start embedding a culture of risk awareness in preparation for the forthcoming changes in regulations.

At the same time, Hong Kong is looking to develop its regulatory framework in other areas such as captive management, insurance-linked securities and tax incentives. Taken together, these broader changes are aimed at establishing Hong Kong as a hub for insurance and reinsurance in the Greater China region and beyond. Its success is dependent on exploiting growing demand for insurance from economic growth initiatives such as the Belt and Road Initiative and China's commercial expansion into Europe.

### HONG KONG RBC – MOVING INTO THE MODERN WORLD

Although Hong Kong is a relatively sophisticated market it lags behind other global centres in moving towards a risk-based capital framework. The 'one-size-fits-all' formulaic solvency requirement does not distinguish between insurers' different risk exposures, their business compositions or the quality of risk management or risk mitigation.

Compared to other regimes in the region, Hong Kong lacks the qualitative and disclosure components in providing greater transparency to stakeholders.

The RBC regime aims to establish risk-sensitive capital requirements with a consistent valuation standard while also enhancing enterprise risk management (ERM) and periodic public disclosure on capital. RBC further assists insurers in acquiring a deeper understanding of the risks confronting their businesses and the appropriate allocation of capital. Insurers also benefit from having a corporate-wide ERM framework as a means of developing a deeper risk management culture in their organizations over time.

The proposed framework is based on a three-pillar style regulatory system.

Work on the framework initially started back in 2013 and is expected to be completed around 2021-22. Over the course of this process, the regulatory body has been renamed the Insurance Authority (IA), replacing Office of the Commissioner of Insurance (OCI).

## FOUR-PHASE PROCESS TARGETING IMPLEMENTATION IN 2021-22

Hong Kong RBC is being developed under a four-phase process. Phase 1, which began in 2014 and is expected to last until 2017, developed the main framework and approaches. Phase II will run from 2017 to 2020 and JLT Re anticipates further refinements will be made to the rules after industry consultation and the results of Quantitative Impact Studies (QIS) are known. Phase III is likely to last two or three years and will be needed for amendments to the legislation and other preparation work. Implementation will take place in Phase IV and JLT Re expects that this will occur sometime in 2021 or 2022 to allow an adequate run-in period and time for the industry to adapt to the RBC requirements.

Given the recent announcement on mutual recognition, JLT Re further expects that reaching an agreement on this with the China Insurance Regulatory Commission (CIRC) will play a significant role in influencing both the detail and implementation date of Hong Kong RBC.

## SIDEBOX 1: THE THREE PILLAR FRAMEWORK OF HONG KONG RBC

Hong Kong RBC adheres to a similar framework adopted in other countries that have implemented risk-based systems in recent years. As shown in Figure 1, these typically follow a three pillar structure comprising of:

Pillar I (Quantitative Aspects) – Determines the risk-based capital adequacy using a consistent valuation standard for assets and liabilities. Some element of risk diversification will be recognized between insurance and market risks.

Pillar II (Qualitative Aspects) – Additional information to enhance the corporate governance, ERM culture and framework of insurers. Own Risk Solvency Assessment (ORSA) reports will be one of the important components of this pillar.

Pillar III (Disclosure) – Public reporting on capital resources at regular intervals. As things stand today, it is unclear what the detailed requirements will be. While this will enhance the level of transparency, it will also increase insurers' operational burden.

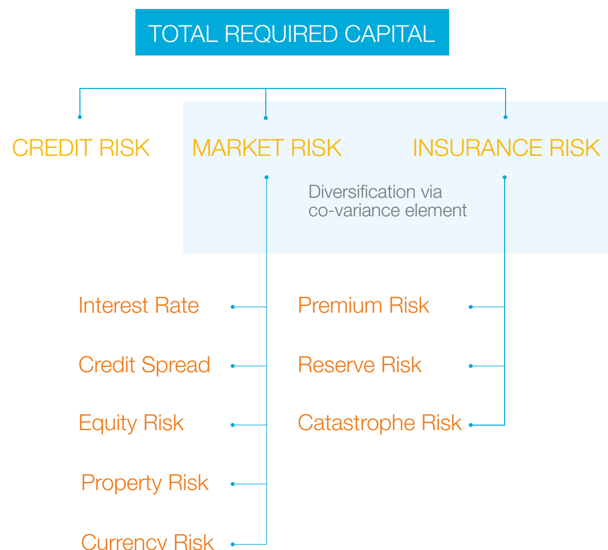
Following the recent QIS 1, the total required capital consists of three components under Pillar I: Insurance Risk, Market Risk and Credit Risk (as shown in Figure 2).

JLT Re expects that the Catastrophe Risk sub-component which was not tested in this QIS is likely to play a key part in influencing the Total Required Capital. In a similar vein to C-ROSS, the treatment of risks that are harder to quantify such as operational or liquidity risks are addressed qualitatively by risk control processes under Pillar II rather than under Pillar I.

JLT Re has successfully assisted a number of clients manage regulatory change risk in various areas and notes that the implementation of Guidance Notes GN10, 13 and 17 ahead of RBC is consistent with expectations and that compliance with certain Pillar II requirements will take precedence over those under Pillar I.

Figure 1: Three-pillar structure used in many risk-based regulatory regimes.

Figure 2: Proposed components of the Total Required Capital under Hong Kong RBC.



## SIDEBOX 2: CAPITAL ADEQUACY UNDER HONG KONG RBC

Consistent with ICP 17 Capital Adequacy, Hong Kong RBC will include two solvency control levels which are intended as intervention thresholds for the IA. This is similar to many other regulatory regimes in the world.

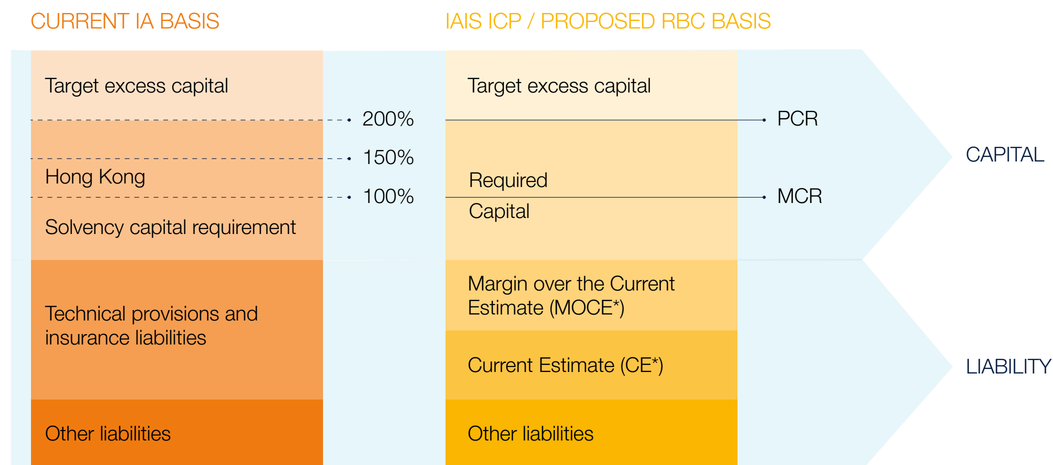
The Prescribed Capital Requirement (PCR), which is calibrated to a 200-year tolerance level over one-year, is the higher level requirement. Insurers are expected to hold capital no lower than the PCR.

Figure 3: Hong Kong RBC Capital Adequacy chart – note that this is solely for representational purposes and is not to scale.

The Minimum Capital Requirement (MCR) is a lower level requirement. Breaching this will result in the IA taking drastic regulatory action which may include the loss of an insurer's license and placing the existing business into run-off. The criteria for the MCR are expected to be set after the QIS.

This two-tier capital requirement under RBC replaces the single solvency capital requirement under the current regime.

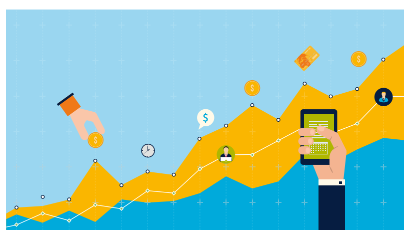
Measurement of the liabilities is split into a central estimate plus a risk margin presently calibrated to a 75% confidence interval which is similar to the level used in the RBC regimes of Australia, Singapore and Malaysia.




## RECOGNIZING THE INTERNATIONAL NATURE OF INSURANCE RISKS

RBC also introduces group-wide supervision to Hong Kong for the first time to account for the international nature of insurance and its dependence on the movement of capital across the global economy. The IA has adopted a three-tier approach for group wide supervision in an attempt to avoid 'doubling up' of regulations for international insurance groups.

- Tier 1 insurers will be subjected to PCR, ORSA and intra-group reporting at group level. JLT Re expects this will mostly affect Hong Kong-domiciled insurance groups such as China Taiping and AIA. Carriers such as these will face the heaviest group requirements under RBC. Only a handful of insurance groups will fall into this category and be subjected to PCR at the group level.
- Tier 2 insurers will be subjected only to ORSA and intra-group reporting at the group level. This will apply to most foreign-domiciled insurers whose parent is subject to regulation in their home country. JLT Re expects that the majority of Hong Kong's larger insurers such as China Ping An, PICC (Hong Kong), Prudential, AXA, Generali etc. will fall into this category. These insurers will be replicating group ORSA for both the IA and their home regulators, and may wish to consider streamlining those processes to improve reporting efficiency.
- Tier 3 insurers will only be subjected to intra-group reporting. Insurers falling into this category will be mostly bank-owned, where the group parent is domiciled in Hong Kong and subjected to Basle-3 requirements. Examples include Dah Sing, ABCI, China BOCOM and BOCGI. JLT Re expects insurers in this group to be least affected by group requirements under RBC.



## SIZE MATTERS: LARGER INSURERS BENEFIT FROM DIVERSIFICATION AND STABILITY UNDER C-ROSS

China's recent experience in moving from a basic Solvency I regulatory system to C-ROSS on 1 January 2016 may provide some useful insights for Hong Kong's RBC regime.

The Chinese insurance industry benefitted from significant capital injection in preparation for C-ROSS implementation. Between 2014 and 2016, the total paid up capital of existing Chinese insurers increased by 28% from CNY 194 bn to CNY 250 bn, while the average capital per insurer increased from CNY 3.4bn to CNY 4.3bn. By applying the valuation basis prescribed under C-ROSS, capital admissible for solvency purposes grew by a significantly greater rate of 98% over the same period, from CNY 4.7bn to CNY 9.3bn per insurer.

However, the capital injection was not evenly spread across the industry, with different outcomes depending on company size. Although solvency ratios were largely unaffected on average, smaller companies – whilst still posting healthy solvency ratios – appear to have been disadvantaged by the rules on asset admissibility and liability valuation.

Conversely, the three largest insurers – PICC, Ping An and CPIC – benefited from size and risk diversification under C-ROSS and saw both their admissible capital and solvency ratios increase. These insurers had no need for additional solvency capital and indeed had not injected any.

**AVERAGE PAID-UP CAPITAL**

| CNY BILLION | 2014 | 2015 | 2016 | % CHANGE 2014-16 |
|---|---|---|---|---|
| Overall | 3.4 | 3.9 | 4.3 | 28% |
| Top 3 | 18.4 | 18.4 | 18.4 | 0% |
| Large | 5.9 | 6.4 | 7.5 | 27% |
| Medium | 2.2 | 3.0 | 3.3 | 51% |
| Small | 1.0 | 1.1 | 1.4 | 39% |

**AVERAGE ADMISSIBLE CAPITAL**

| CNY BILLION | 2014 | 2015 | 2016 | % CHANGE 2014-16 |
|---|---|---|---|---|
| Overall | 4.7 | 6.0 | 9.3 | 98% |
| Top 3 | 43.7 | 50.3 | 83.6 | 91% |
| Large | 5.2 | 6.7 | 12.9 | 147% |
| Medium | 2.6 | 3.8 | 4.7 | 82% |
| Small | 0.8 | 1.0 | 1.3 | 76% |

**AVERAGE SOLVENCY RATIOS**

| | 2014 | 2015 | 2016 | # OF INSURERS |
|---|---|---|---|---|
| Overall | 274% | 296% | 280% | 58 |
| Top 3 | 193% | 206% | 283% | 3 |
| Large | 223% | 222% | 262% | 10 |
| Medium | 572% | 850% | 340% | 30 |
| Small | 2507% | 911% | 480% | 15 |

Average paid up capital, average admissible capital and average solvency ratios by insurer grouping in China, 2014-2016. Solvency ratios are calculated the ratio of admissible capital to minimum required capital (under C-ROSS basis in 2016) on an unweighted basis. Source: China Insurance Statistics

Top 3: PICC, PingAn, CPIC; Large: GWP greater than CNY 8bn; Medium: GWP between CNY 1bn and 8bn; Small: GWP between CNY 400m and 1bn. Insurers with GWP under CNY 400m and new insurers after 2015 excluded from the above figures.

## HEAVY REINSURER COUNTERPARTY CHARGES LARGELY IGNORED BY INSURERS – FOR NOW

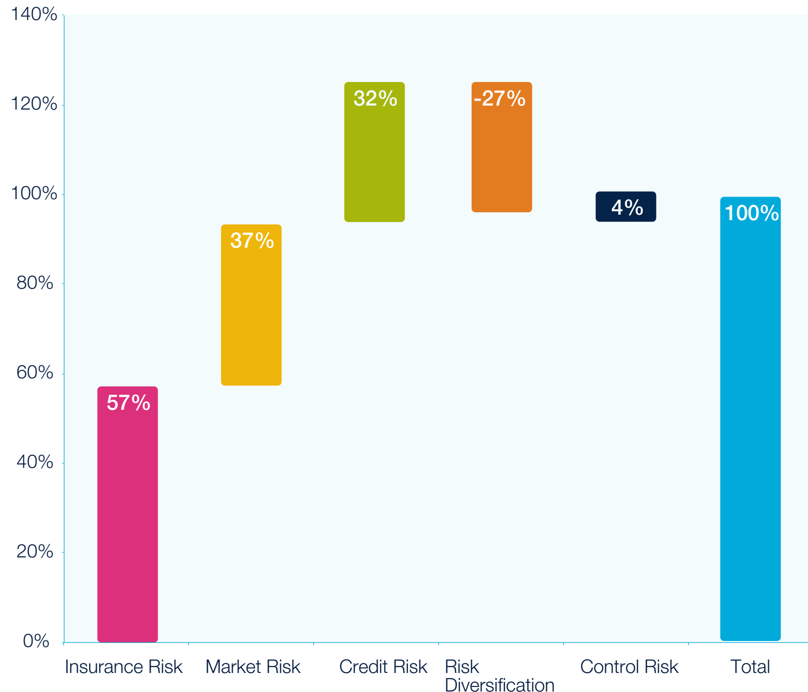
JLT Re's analysis of the minimum capital requirement under Pillar 1 found that insurance risk accounts for the majority of risk capital (see Figure 5). Whilst market risk for foreign insurers accounts for only 6% of the minimum required capital, it rises to 37% for domestic insurers. This reflects a higher proportion of cash and short-term deposits held by foreign insurers who may be unable or unwilling to hold Chinese-domiciled assets.

Credit risk accounts for a hefty 32% and 54% for domestic and foreign insurers, respectively. JLT Re estimates that about four-fifths of the credit risk component is for reinsurer counterparty charges as a result of exposure to offshore reinsurers. The higher charge for foreign insurers also points to a greater dependence on offshore reinsurance. While this charge is substantially higher compared to other territories, the abundance of capital in the Chinese insurance industry means it has not surfaced as an issue of concern to date. The highly competitive reinsurance market in China also means that purchasing decisions are often dictated more by price than capital costs.

Achieving regulatory equivalence between China and Hong Kong – even if this is limited to the area of reinsurance recognition – will reduce the credit risk component significantly and result in higher solvency ratios for insurers. This potentially could bring significant value to insurers in the future, when reinsurance capital may not be so readily available, or when asset values come under pressure from rising interest rates or depressed market conditions.

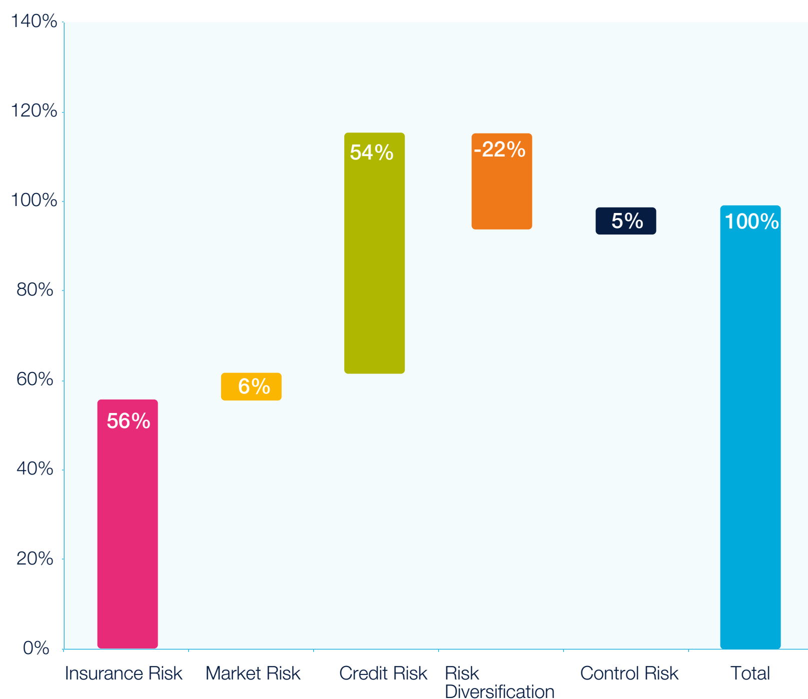
### 2016 Breakdown of Minimum Capital Required: Domestic Insurers

Figure 4: Estimated breakdown of non-life insurer's minimum capital by component.
Source: China Insurance Statistics




### 2016 Breakdown of Minimum Capital Required: Foreign Insurers

Figure 5: Estimated breakdown of non-life insurer's minimum capital by component.
Source: China Insurance Statistics



## CHINESE INSURERS FACE OTHER CHALLENGES DESPITE HEALTHY SOLVENCY RATIOS

While industry solvency ratios have generally been unaffected, the challenges faced by insurers are largely related to the qualitative requirements under Pillar 2. As expected, these challenges were more pronounced for small to medium-sized insurers that lack the resources and expertise to fulfil these requirements.

Common problems reported by the CIRC include a lack of understanding around regulations and weak institutional implementation of ERM, which has reduced the effectiveness of its regulations. In particular, issues identified under its Own Risk and Solvency Assessment (also known as SARMRA) were focused in areas of management controls and governance, difficulty in integrating risk control functions, translating risk appetite statements into business objectives and influencing the decision making process. It also found that many insurers lacked sophisticated tools to monitor and measure risks adequately.

To a degree, C-ROSS has increased risk management awareness and capability and provided the CIRC with an opportunity to bring about much needed regulatory change in a relatively short time. Nevertheless, it has acknowledged the need to reduce systematic risks further and JLT Re believes that current trends point towards stricter enforcement of regulatory compliance to address these issues.

There are signs things are moving in the right direction. A number of insurers have started adopting the Economic Value Add (EVA) approach to measure profitability on a risk-adjusted basis and assist with capital allocation between lines of business. However, adopting and embracing a whole new risk management culture will inevitably take time. And Chinese insurers will need to overcome the shortage of skilled expertise if they are make meaningful progress in this area.

## IMPLICATIONS OF REGULATORY EQUIVALENCE BETWEEN HONG KONG & CHINA

On 16 May 2017, both China and Hong Kong entered into a framework agreement aimed at mutual recognition of their solvency regimes within four years. While the details of this arrangement are still being worked out, China's C-ROSS system retains a high 'reference value' among other international regulatory environments in influencing how Hong Kong's RBC system develops.

That said, JLT Re also notes that the CIRC has to date been very protective of China's domestic insurance and reinsurance industry and while the initiative of moving towards mutual recognition is a promising step, the benefits to Hong Kong and China will only be clearer when more details emerge.

It is also important to note that equivalence does not convey passporting rights, and the usual licensing requirements would still apply for Hong Kong insurers to sell its products in China (and vice versa). Recent strengthening of regulations and a reduced appetite for non-compliance suggests that barriers to entry will remain high, especially to foreign companies.

Should full equivalence materialize, it would represent a major step forward for the Asia Pacific region and provide a significant boost to cross-border business, particularly for Hong Kong insurers with insurance operations in China. These groups would be classified as on-shore and could be free from being subject to dual group supervision. Chinese insurance groups would receive reciprocal benefits.

International reinsurers will also benefit from having a level playing field for access into China as they would no longer be subject to heavy credit charges currently levied on off-shore insurers. This will provide a significant boost to Hong Kong as a jurisdiction of choice for writing reinsurance business originating from China.

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## WHAT NOW FOR HONG KONG?

The experience of other Asia Pacific countries suggests that Hong Kong is likely to face similar challenges under an RBC regime (see Figure 6). JLT Re expects the RBC rules to be calibrated over multiple consultations and industry dialogue, if only to assist the IA in minimizing any unintended consequences of regulatory change. The extended implementation timeline (compared to Solvency II or C-ROSS) is also a prudent move that will alleviate some of these pressures and prevent unintended loopholes. Nevertheless, a fragmented market also means industry consolidation is inevitable to some degree, particularly among smaller and less diversified insurers.

During this transition period, Hong Kong insurers should have sufficient time to adjust their business strategies and adapt to these changes as they have done in the past. The real challenges will be in embedding a culture of risk awareness, and equipping themselves with the resources and expertise to do so.

At a broader level, the insurance industry in the Asia Pacific region is facing longer-term structural change in terms of scale, magnitude, sophistication and strategic importance, and Hong Kong is no exception. Employing any change management must account for the human element, and executive boards need to prepare now to navigate these future challenges successfully.

Figure 6: Degree of challenges faced by Hong Kong insurers

| Category | Challenge | Degree |
|---|---|---|
| GENERAL | Regulations poorly or mis-understood | Medium |
| | Adapt business strategy | Low / Medium |
| | Identify data gaps & improve data collection | Low / Medium |
| | Unintended consequences of regulations | Medium |
| | Shortage of skilled expertise | Medium |
| QUANTITATIVE | Increased complexity in asset & liability valuation | High |
| | Increased dependence on actuarial & professional judgement in setting assumptions | Medium |
| QUALITATIVE & REPORTING | Embedding holistic risk awareness culture and governance | High |
| | Completing ORSA & additional disclosures | High / Medium |
| | Lack of adequate reporting systems | High / Medium |

Low Medium High

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