The Boston Consulting Group

Building Professionalism

THE NEXT STEP FOR LIFE INSURANCE IN CHINA

BCG | A SENIOR MANAGEMENT PERSPECTIVE

PREFACE

With a population of 1.3 billion people and a steadily developing global economy, China has the potential to become the largest life insurance market in the world. This possibility has been clearly recognized both by local players and by powerful international insurers, many of which have set up joint ventures with Chinese insurers or acquired minority equity stakes.

The path to success will not be easy for either domestic or foreign insurers. The Chinese government has strict controls on the participation of foreign players and on the type of investments that any insurer is able to make. Chinese consumers, long subjected to a generally poor level of service from many local insurers, are increasingly wary, demanding and selective. The improvement of the customer experience is shaping up as a key strategic element in the battle for market share.

While government regulations are currently easing, rendering the Chinese market more and more attractive, a far greater degree of liberalization must evolve before China can begin to compare itself to the mature life insurance markets of Western Europe, the United States, and some other parts of the world. Fortunately, the government recognizes the importance of the industry's growth to its overall program of economic development.

This report, the product of an extensive research effort by The Boston Consulting Group involving interviews with myriad local and multinational players, takes an in-depth look at the life insurance industry in China. It focuses on the patterns of its evolution and on the hurdles that both domestic and foreign players currently face. Particular emphasis is placed on the steps that Chinese life insurers must take in order to enhance their overall level of professionalism, and thus, their ability to compete.

We trust the paper will prove engaging and thought provoking in these extremely challenging times for the industry. We welcome your comments and feedback.

SUMMARY OF KEY FINDINGS

Chinese life insurers must take decisive steps to improve the way they run their businesses if they hope to be competitive in their country's rapidly evolving market.

- The overall level of professionalism of many Chinese life insurers is far lower than that of successful international players that operate in mature markets. Improvement will require firm commitment from senior managements and thoughtful utilization of available resources.

- The principal areas in which Chinese life insurers need to sharpen their skills include: strategy and business planning, sales and distribution, products and marketing, financial management, operational processes and infrastructure, and human resources and organization.

- Multinational insurers also face significant hurdles in building professional sales forces in China, but are advantaged by skills and systems already developed in other markets.

Competition from global insurers is gaining momentum in China, and will continue to do so as authorities ease regulations on foreign participation.

- Although foreign insurers are generally limited to participating in joint ventures with local players and to direct-investment stakes, they are clearly anticipating and preparing for increased market access.

- Regulatory authorities have already ruled that the group life market, which has enormous growth potential over the next five to ten years, will be opened to foreign insurers at the end of 2004. Many new cities opened to foreign players at the end of 2003.

The life insurance industry is vital to China's overall economic development.

- Unlike in most countries, the role of life insurance in China primarily involves savings and investment. The government needs the industry to expand in order to help it meet the retirement needs of its aging population, reorganize state-owned enterprises, and further develop capital markets and the asset management industry.

- Most Chinese have no official provision for retirement. The pension system must thus confront the task of providing social security to a nation of 1.3 billion people. Wu Dingfu, Chairman of the China Insurance Regulatory Commission, has publicly confirmed the importance of the life insurance industry to meeting this challenge.

Powerful growth in the Chinese life insurance industry is expected to continue. China may well evolve into the world's largest life insurance market.

- Since 1996, premium income growth in China has averaged 40% per year. It is expected to continue at between 15% and 25% per year over the next five years.

- The drivers of growth include: continuing rapid economic development in China; gradually declining reliance on the public sector for retirement and social security, as the economy becomes more private; social reform; increasing awareness of personal-risk management; greater participation by foreign insurers; ongoing market liberalization; channel proliferation and increased emphasis on marketing; and the perception of life insurance as a relatively safe investment.

Both local and foreign players face many common challenges in their quests for success in China.

- There are different and distinct markets for each of the three primary product groups: individual life, group life, and bancassurance. All players must try to innovate because simple undifferentiated products face considerable substitution risk.

- Chinese consumers, having long endured substandard service and even deceptive behavior regarding products and policies, are extremely wary of basic information and promises they receive from agents. The group life industry has been involved in widespread bad practices such as inducement-based selling. All industry players must work hard to restore a higher degree of credibility to the industry. The government can help by pushing reforms such as agent certification programs.

- Profit pressures are intense. The market is characterized by high customer-acquisition costs, generous agent commissions, a low-growth investment climate, and limited options due to government regulations on the types of investments that life insurers can make.

To begin the process of improvement, Chinese life insurers need to manage their businesses better and build and strengthen professional capabilities throughout their entire organizations.

- They must coordinate their corporate centers and business units, carefully assess growth opportunities, and focus on developing human capital. They must also identify key customer segments, tailor their marketing approaches, and formulate better risk-management processes. IT must be managed for business value.

- Improving the customer experience must be made a top priority. Managers need to set clear goals for customer satisfaction and deploy specific tools to track it on a constant basis. These tools can include customer surveys, metrics to monitor customer-service related processing, and strict oversight of service levels in all channels.

Opportunities in China are vast and the profit potential is enormous. Domestic players can learn much from established international players, but foreign entrants can also benefit from local, homegrown knowledge and relationships.

- In the long run, the winners – both domestic and foreign – will be those players that best manage increasing customer demands, the evolving regulatory environment, and their own internal capabilities and resources. The ability to offer superior, trustworthy, and reliable service to consumers – and to cultivate the most profitable customers – will be critical to success.

THE IMPORTANCE OF LIFE INSURANCE IN CHINA

While life insurance in most countries primarily serves as protection against possible events, its principal role in China concerns savings and investment. The government needs growth and development in the sector in order to achieve three critical aims: to provide for the retirement needs of its aging population so that the state is not solely responsible; to enable the continued restructuring of state-owned enterprises (SOEs); and to stimulate the development of capital markets and the asset management industry.

Currently, SOEs and large companies in urban centers are responsible for providing health care and pensions to workers and their families. These programs operate on an employer-liability, "pay-as-you-go" basis, with today's workers funding the benefits and pensions of yesterday's employees. The system has a serious flaw, however: many SOEs have long operated at a loss and have diverted assets away from their pension schemes. These funds now run significant deficits.

Furthermore, most Chinese fall outside the pension system and have no official provision for retirement whatsoever. According to some reports, fully three-fourths of the population falls into this category. The pension system thus faces the huge demographic effect of an aging population, the one-child policy introduced by the government during the late 1970s, and the cost of providing social security to a country of 1.3 billion people. According to a World Bank estimate, roughly 300 million Chinese will reach the pension age of 65 by 2050, making contributions from three workers necessary to support each retiree at current benefit levels.

The government, therefore, in order to continue its economic restructuring program, dismantle the SOEs, and avoid creating economic distress for workers, needs to transfer its pension obligations to the private sector. It has already begun encouraging citizens to take greater responsibility for their own financial welfare and retirement.

Life insurance can play a major role in developing the corporate pension sector, in addition to its role as a long-term savings vehicle. According to Wu Dingfu, Chairman of the China Insurance Regulatory Commission (CIRC):

> "Chinese insurers can assist with the development of corporate pension funds with pension-plan designs, pension-fund investment, and account management. They can also help

improve pension-fund investment returns, cut operating costs, and increase overall competitiveness."

In short, developing the life insurance and pension industries is crucial for the Chinese government if it hopes to deliver economic growth and provide long-term social stability for its citizens. These initiatives will also help the restructuring process of SOEs and serve as a catalyst for the smooth functioning of capital markets.

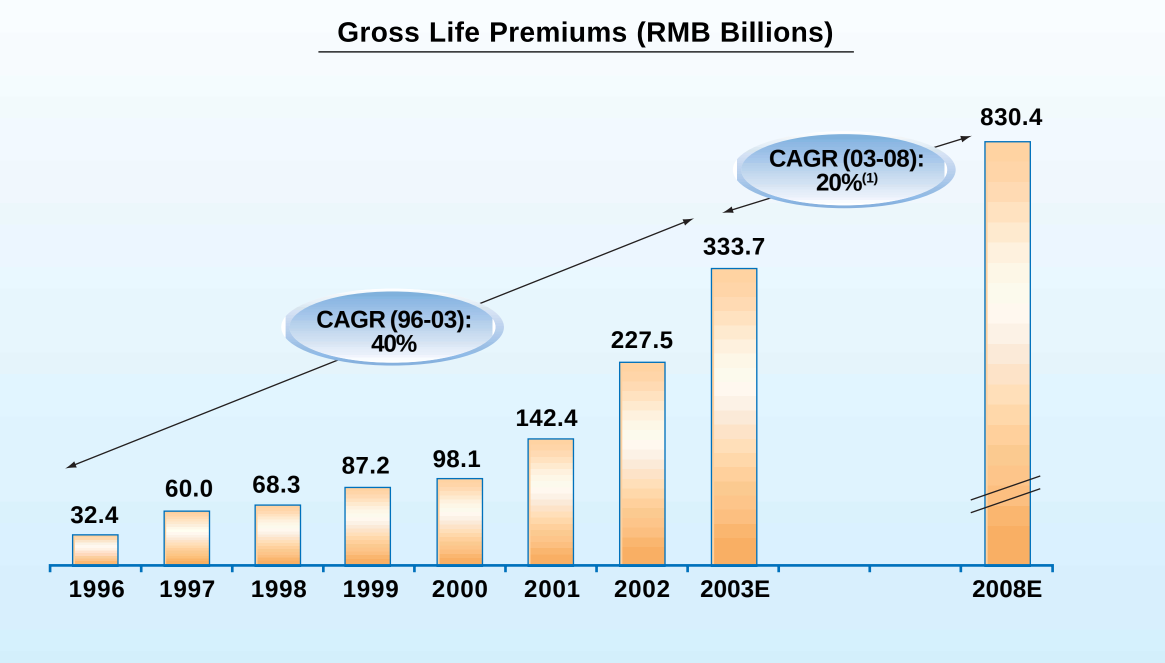
STRONG INDUSTRY GROWTH IS LIKELY TO CONTINUE

The life insurance market in China has expanded substantially in recent years. Since 1996, premium income growth has averaged 40% per annum and is widely expected to continue at between 15% and 25% per year over the next five years. Based on a compound annual growth rate of 20%, the market could reach more than RMB 830 billion by 2008. *(See Exhibit 1).* In 2002, premiums surged by 60% due to new and improved distribution channels (such as bancassurance) and to stronger customer demand. We expect 2003 premiums to have grown strongly as well, based on latest available figures.

Throughout the market's ascension, a contributing factor has been rising levels of financial assets among urban residents, although asset allocation in life insurance remains under 5% for all households. *(See Exhibits 2 and 3).* Today, life insurance penetration in China has reached 2.3% (total premiums as a percentage of GDP), up from 2.0% in 2001. This is substantially higher than in the early 1990s, when the level was less than 0.5%. In a global context, however, penetration in China is still relatively low compared with a world average of around 5%. *(See Exhibit 4).*

Several factors are likely to continue to drive penetration and growth in the sector:

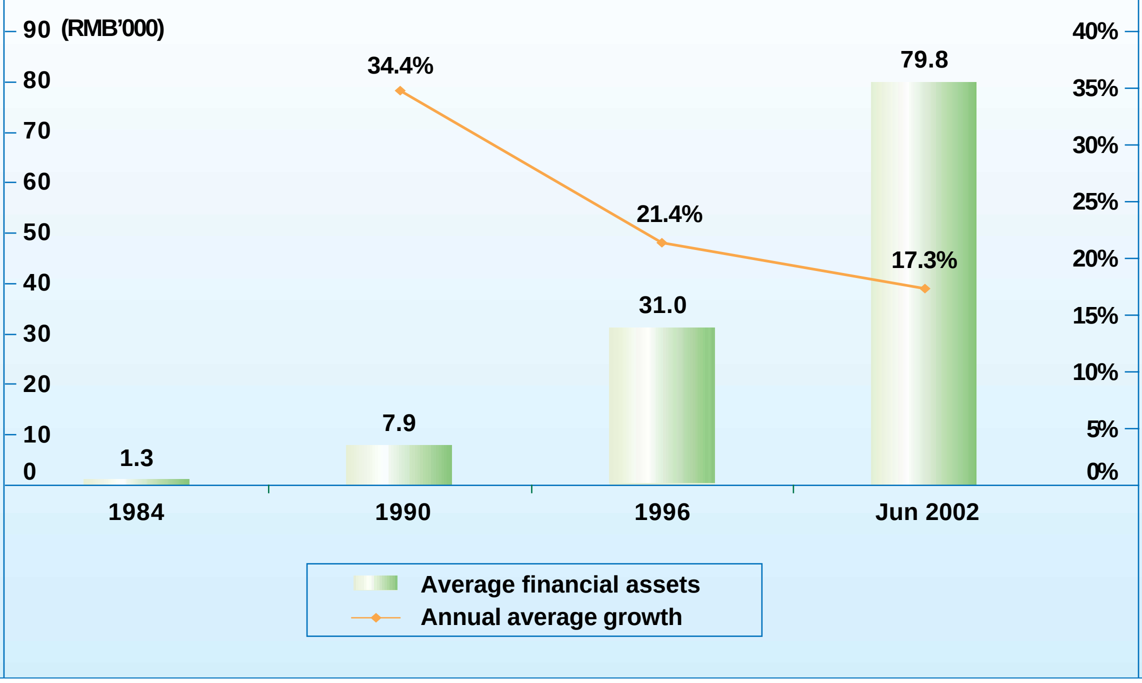
Exhibit 1. China's Life Insurance Industry Is Booming



(1) Growth forecasts based on consensus of analysts, market participants, 1st half 2003 figures and BCG analysis

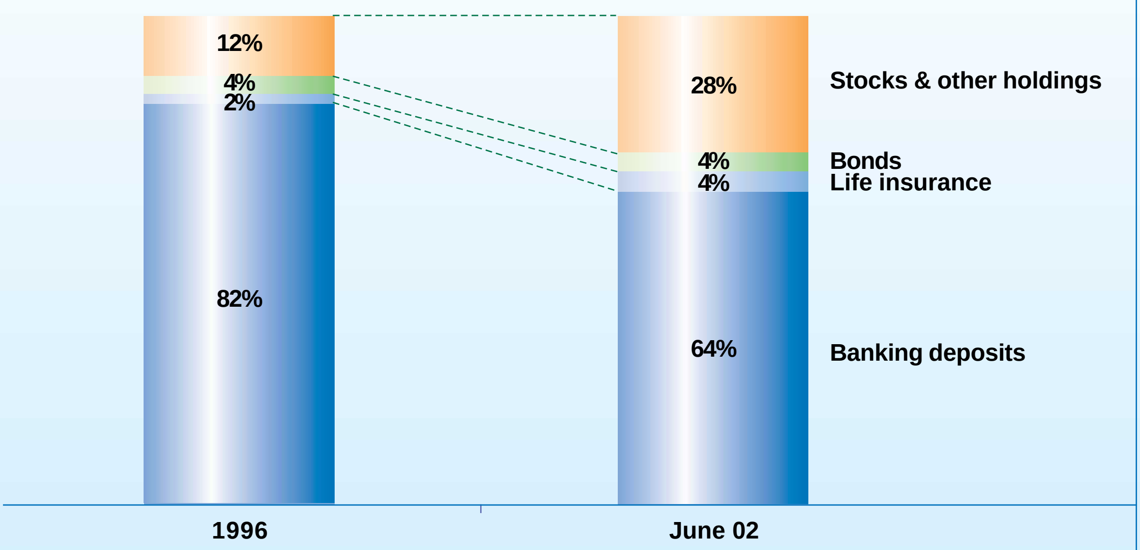
Source: CIRC; China Insurance Yearbook; Press releases; BCG market interviews; BCG analysis

Exhibit 2. The Financial Assets of Urban Residents Are Rising



Source:
CEIC;
Analyst reports;
BCG analysis

Exhibit 3. Life Insurance Is Still A Minor Part of Household Assets



Source:
CEIC;
Analyst reports;
BCG analysis

Continued rapid economic development in China. Growth in GDP per capita should result in deeper penetration of life insurance as individuals gain disposable income, become more risk-averse, and opt for insurance products.

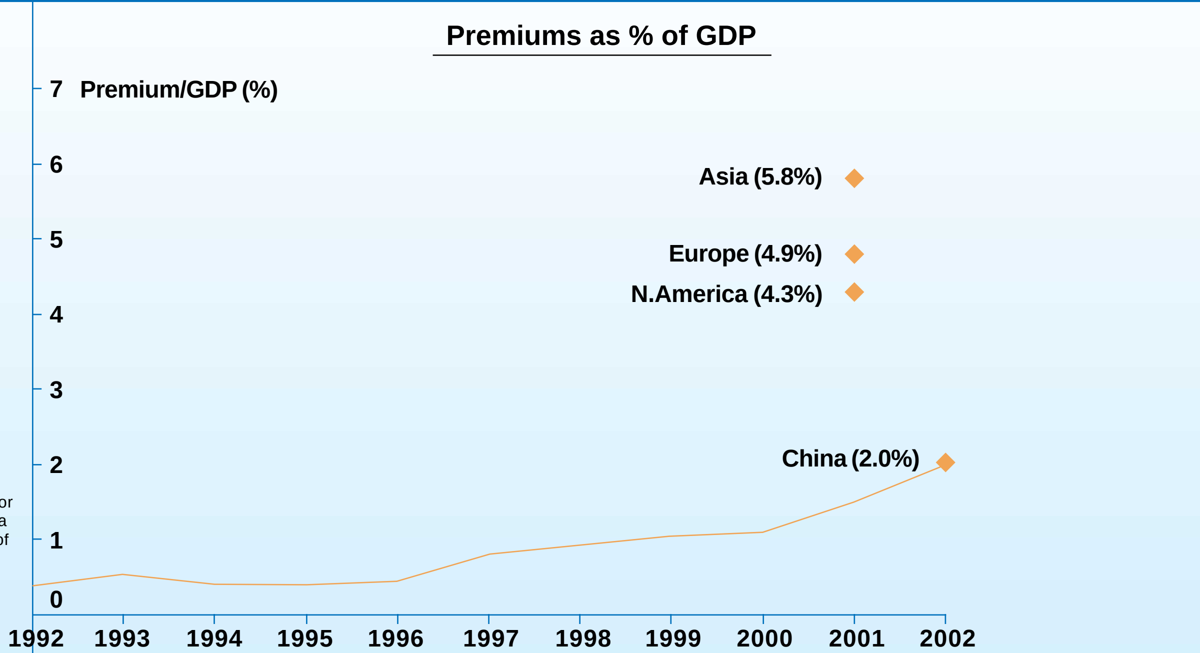
Reduced public-sector social obligations as the economy shifts from public to private. The elimination of the "iron rice bowl" social-security net, as well as the shift toward a more private economy, should lead people to seek security in pension funds and protection products.

Increased awareness of risk management and risk pricing. The Chinese are generally becoming more aware of income and disability risk. Although protection premiums are currently among the highest in the world, uptake should increase as we see more consumer-friendly pricing.

Greater participation of foreign players. Since China is likely to evolve into one of the largest global insurance markets over the next two decades, increasing numbers of foreign insurers are becoming influential on two fronts: first, they are bringing much-needed expertise and higher standards into the market; and second, they are helping educate consumers and drive demand.

Improved regulation and liberalization of the market. Although regulation in China is still restrictive compared with mature, global markets, it is easing somewhat. In January 2003, liberalizing amendments were made to the existing Insurance Law, and in June 2003 there was a relaxation of regulations governing insurers' investment allocations. Changes such as these – especially if they continue – should gradually improve consumer confidence and lift sector performance.

Exhibit 4. Life Insurance Penetration Is Growing



Note:
Penetration levels for Asia, North America and Europe are as of 2001

Source:
CIRC; SwissRe

The view of life insurance as a "conservative" investment. Equities are often regarded as unsafe holdings, particularly in light of the struggling stock markets we have witnessed over the past few years. A significant proportion (64%) of Chinese household assets continue to be held in cash. Continued expansion in household savings (which grew by 18% in 2002) should result in increased numbers of life policies, which are perceived as safer investments.

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