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**The Management Centre
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THE DEVELOPMENT OF FOREIGN INSURANCE BUSINESS IN CHINA

By

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ABSTRACT

Insurance has an indispensable part to play in China's economic restructuring process. The long-term growth and capital appreciation sought by insurance companies are of critical importance to the term transformation of savings and thus the very success of China's welfare system reform. Insurance encourages the effective growth of domestic capital markets and effectively enhances the fund-raising opportunities for State and corporate bodies. The development of a modern insurance industry in China and the promise of a vast insurance market provide a wealth of opportunities for foreign insurers/insurance intermediaries. Yet the future nature of the restructuring process remains uncertain, and the realisation of the market potential demands a clear understanding of the problems involved in China operation. There has, however, been very little systematic study of the strategic issues involved in the development of foreign insurance business in China. This thesis intends to fill the gap by providing an analysis of provincial life insurance demand, and of such strategic issues as partner selection and location choice criteria.

The thesis first examines the history of the insurance industry in China, and highlights the main features of China's regulatory framework and the implications for foreign insurance participation. The demand for life insurance is then examined by a pooled time-series and cross-sectional analysis of China's twenty-eight provinces (municipalities and autonomous regions) over the period of 1985-1995. The econometric results support the hypotheses that life insurance demand is positively related to income and the economic development level, the degree of insurance consciousness/awareness, the supply of insurance services in the market, and life expectancy; and that demand is negatively related to the anticipated inflation rate. The results suggest that Chinese life insurance purchasing behaviour is more determined by old-age income protection and support than by the concern for dependant income protection against breadwinner's premature death. It is also suggested that life insurance demand in China is constrained by inadequate supply.

For most foreign insurers, the long-term aim is the award of a license to establish a branch, a joint venture or a wholly-owned subsidiary so that they can engage in profit-making activities in the Chinese market. Approval is not automatic, and winning over the Chinese authorities requires more than demonstrable expertise and experience. In compliance with the Chinese authorities' preference and/or requirement, many foreign insurers are seeking joint ventures with Chinese partners despite their corporate preference for the wholly-owned entry mode. The criteria used in the selection of a joint venture partner were examined using a questionnaire survey, and it was found that foreign insurers placed more weight upon compatibility with their prospective partners in terms of objectives than upon complementarity in function. As regards complementarity, the functions of the Chinese partners that most attracted foreign insurers were their contacts with central/local authorities and their market networks. The questionnaire survey was also used to establish the most important criteria in location choice.

Furthermore, the survey evidence was supplemented by an econometric analysis, using a conditional logit model, of the location choice of 138 foreign insurance representative offices in China. Both analyses found that location choice was determined primarily by factors such as accessibility to the Regulatory Authority, local market size and growth potential, the stock of foreign direct investment and the degree of openness and insurance consciousness. Interestingly, offices were not confined to those cities where foreign operations were currently allowed, and that these other variables - in addition to 'openness' - were found to be significant. The survey data were also analysed for differences between the different types of insurance companies, and between companies of different nationalities. Finally, the strategic implications for foreign insurers, as well as the policy implications for the Chinese Government, were discussed.

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LIST OF ACRONYMS

AFIA:	American Foreign Insurance Association
AIG:	American International Group
ATM:	Automatic Teller Machine
EDP:	Electronic Data-Processing
EJV:	Equity Joint Venture
FDI:	Foreign Direct Investment
FMA:	Factory Mutual Association
GATS:	General Agreement on Trade in Services
GATT:	General Agreement on Tariff and Trade
GDP:	Gross Domestic Product
GNP:	Gross National Product
IBNR:	Insured But Not Reported Loss
IJV:	International Joint Venture
IRI:	Industrial Risk Insurers
ITU:	International Telecommunications Union
MFN:	Most Favoured Nation
MNE:	Multinational Enterprise
OECD:	Organisation for Economic Cooperation and Development
PBOC:	People's Bank of China
PICC:	People's Insurance Company of China
PRC:	People's Republic of China
RBU:	Reported But Unpaid Loss
RMB:	Ren Min Bi
SEZ:	Special Economic Zone
SOE:	State-owned Enterprise
TNC:	Transnational Corporation
TSC:	Transnational Service Corporations
UNCTAD:	United Nations Centre on Trade and Development
UNCTC:	United Nations Centre on Transnational Corporations
WFOE:	Wholly Foreign Owned Enterprise
WTO:	World Trade Organisation

PUBLICATIONS AND ARTICLES

The following publications and articles are selected in support of the thesis.

- Wu, X. (1996) 'A Sense of Immaturity', Reactions, September: 48--52.
- Wu, X. (1995) 'On the Road to Regulation', Reactions, October: 57--60.
- Wu, X. (1995) 'Arch of Progress', Reactions, October: 61--63
- Wu, X. (1995) 'Setting Sail', Reactions, October 1995: 65.
- Wu, X. and Strange, R. (1998) 'The Insurance Industry in China: The Experience of European, US and Japanese Firms', in R. Strange, J. Slater and L. Wang, (eds.) Trade and Investment in China: the European Experience, Chapter 12, London: Routledge, in press.
- Wu, X. and Strange, R. (1997) 'FDI Policy and Inward Direct Investment in China', in J. Slater, and R. Strange (eds.) Business Relationships with East Asia: The European Experience, 199--217, London: Routledge.
- Wu, X. and Strange, R. (1998) 'The Location of Foreign Insurance Companies in China', paper submitted for publication to the International Business Review.
- Wu, X. and Dou, W. (1996) 'Regulation vs. Deregulation: A Case of The Chinese Insurance Industry', paper accepted for presentation at American Risk and Insurance Association 1996 Annual meeting, Philadelphia, Pennsylvania.
- Strange, R. and Wu, X. (1995) British Trade and Investment Relations with China, Hong Kong: British Chamber of Commerce in Hong Kong.
- Wu, X. (1993) 'EU's Trade Policy Towards China', unpublished MSc dissertation, London School of Economics.

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CHAPTER 1 INTRODUCTION

“By any standard, the existing insurance industry in China is incompatible with China’s fast social and economic development” (Hadley, 1995: 20). This remark made by Di Weiping, the Deputy Director of the Department for the Supervision and Regulation of Foreign Financial Institutions at the People’s Bank of China (PBOC), in 1995 not only highlights the desperate need for the development and modernisation of the domestic insurance industry in China, but also the important role insurance plays in China’s economic and social development.

Insurance involves the transference of risk from individuals and organisations to specialist insurance companies who can use the laws of probability to spread risks efficiently. The end-products of the industry may be divided into two broad categories: life insurance and non-life insurance. Life insurance involves payment to a beneficiary — usually a family member, business, or institution — in the event of the death of an individual. It is based on the pooling of a large number of independent individual risks, thereby reducing the overall risk. Non-life insurance (also known as property or casualty insurance) provides coverage for the insured against damage or destruction of his/her property, and against damage/destruction of other property and/or bodily harm caused by the negligence of the insured. In addition, reinsurance refers to the diversification of the risks accepted by individual insurers among other insurance companies. The reinsured company (the primary insurer, cedent, or ceding company) reduces its maximum possible loss either on an individual risk (facultative reinsurance) or on a large number of risks (automatic reinsurance) by ceding a portion of its liability to another insurance company (the reinsurer). Reinsurance enables an insurance company to expand its capacity, to stabilise its underwriting results and loss experiences, to finance its expanding volume of business through enhanced large line capacity and surplus relief¹, to secure catastrophe protection against shock losses, and to withdraw from a line of business or geographical area within a relatively short time period².

THE FUNCTIONS OF INSURANCE

The principal functions of insurance are risk-bearing and risk transfer. Insurance is a system under which the payments of participants (individuals, businesses, and

other entities) are made in exchange for the commitment to reimburse for specific types of losses under certain circumstances. Using the law of large numbers and further uncertainty reduction through reinsurance, insurance facilitates the pooling of funds and payments of benefits. Participants in this mechanism benefit through reimbursement of losses that occur, reduction of uncertainty, and additional services provided by the insurer to reduce the possibility of a loss and the resulting consequences.

The risk bearing and transfer function of insurance renders it a critical role in a country's economic and social development. "The existence of a sound insurance market is an essential component of any successful economy" (Chartered Insurance Institute of Bankers, 1996: 27).

- The knowledge that insurance exists to meet the financial consequences of certain risks provides a form of peace of mind. This is important for private individuals when they insure their car, house, possessions and so on, but it is also of vital importance in industry and commerce. Buying insurance encourages the entrepreneurism and the subsequent creation of jobs, goods, and wealth by transferring at least some of the risks of being in business to an insurer. Insurance also acts as a stimulus for the activity of businesses which are already in existence. This is done through the release of funds for investment in the productive side of the business, which would otherwise require to be held in easily accessible reserves to cover any future loss. Because of the effect of common pool, the business is able to purchase insurance at a premium which is less than the fund that the company itself would have to retain, even assuming it could retain anything in the first place.
- The social benefits of the peace of mind or security is that people keep their jobs, their sources of income are maintained and they can continue to contribute to the national economy.
- Insurance also plays a major role in loss prevention and loss control in the national economy, and the reduction of the economic waste which follows from losses. These benefits brought by insurance companies enables business to prevent losses, to minimise losses, and to recover from losses in the most cost-effective way.
- Insurance can generate invisible earnings by insuring overseas risks and contribute to a country's balance of trade. In the case of the UK, invisible earnings from insurance represented £4,623 millions and were the largest single earner of all the

various UK financial institutions in 1993 (Chartered Insurance Institute of Bankers, 1996).

- Owing to the time gap between the receipt of a premium and the payment of a claim, the insurer has a large pool of funds for investment which may provide both government and industry with working capital. The value of life insurance investments exceeds that of non-life insurance investments in that, given the different length of the time gap, life insurance premium can be invested in long-term ventures whilst non-life insurance premium can not be locked away for so long and has to be spread over long-, medium- and short-term investments.

This and other broad economic and societal advantages that can be accrued from having a strong and efficient life insurance market have been highlighted by UNCTAD (1982) and OECD (1987a) studies.

- Life insurance can contribute to social stability and the production of wealth by permitting individuals to minimise financial stress and worry about the financial consequences of loss of life or health and increasing his/her efficiency/productivity. "Without the insurance product, families and businesses would have to live with uncertainty caused by the fact that their financial well-being could be destroyed" (Webb et al, 1992: vii).
- Life insurance can reduce the financial burden on the State of caring for the aged and for those made financially destitute because of the death of a family breadwinner. Apart from hedging against the risk of premature death and loss of health, life insurance is also a means whereby a person can make financial provision for retirement by contributing regularly to a pension funded by a life insurance company. Private pension arrangements such as these therefore tend to supplement or even displace reliance on a State pension scheme, and thus relieve pressure on the social welfare systems in many countries. "To that extent, life insurance is an advantage in the context of public finance, and, as a result, is generally viewed with favour by governments. A number of governments acknowledge this in tangible form by granting tax relief (deduction) to policyholders" (OECD, 1987a: 10).
- Through the accumulation from thousands of policyholders of small amounts of private savings, life insurers can accumulate sums to be invested in the public and private sectors. This can benefit an economy by creating a source of financing for new businesses, and for new homeowners. In developed countries, life insurance companies have grown to be major financial institutions and play a correspondingly important role as institutional investors (Black and Skippers, 1994). Under cash-

value life insurance³ the insurer retains portions of the premiums paid during the early policy years and accumulates them, together with investment earnings on them, toward the payment of benefits in later years. As the rate of return on invested assets increases, life insurance can furnish a safe and profitable investment service.

OVERVIEW OF THE THESIS

Insurance has an indispensable part to play in China's economic restructuring process. It plays an important role in solving China's pension crisis created by the urgent problem of the pension burden of State-Owned enterprises (SOEs) and the long-term problem arising from the rapid ageing of the population. Commercial insurance also provides a necessary way to enhance welfare services in China given the limited State resources, its level of economic development, huge population and vast regional disparities. By developing commercial insurance, the State is able to concentrate its limited resources to keep those in need above the poverty line. By providing a pool of fund for investment, insurance encourages the growth of capital markets in China and effectively enhances the fund-raising opportunities for State and corporate bodies. Life insurance, in particular, provides long-term investment instruments which have been lacking in China and the opportunities for effective term transformation of savings to facilitate the ongoing pension reforms. As a risk transfer mechanism, insurance makes a positive contribution to China which is prone to natural hazard risks and whose risk management record is extremely poor. Moreover, the development of a modern insurance is a requirement of China's opening up process and of China's integration with the international standard.

The essential role of insurance in China's economic reform requires the development of institutional and regulatory capacity for the provision of commercial insurance. It calls for the overhaul of China's insurance industry which has long been monopolised by a State insurer — the People's Insurance Company of China (PICC). Competition mechanisms have started to be introduced to encourage newcomers into the market and to bring the market under a unified regulatory framework which incorporates international standards. Competition stimulates the rapid growth of China's insurance industry which possesses the potential to become one of the world's biggest insurance markets. The fact that the market has started to expand at an exponential speed in the past 16 years or so gives rise to some of the most distinctive features of China's insurance market. There is a severe shortage of insurance professionals in all disciplines. The market is very much underdeveloped with vast

potential promised by steady economic growth, huge population and far-reaching economic/social revolutions.

The vast potential presents an enticing array of lucrative opportunities to international insurance companies blessed with expertise which is not yet possessed by their Chinese counterparts. Many European, US, and Japanese insurers are thus eager to establish operations in China. Foreign participation is welcomed, however, only if it stimulates competition, and increases local market expertise. For China's Supervisory Authority, the establishment and perfection of the regulatory framework, and the healthy development of the domestic insurance industry are the top priorities. Foreign participation is presently encouraged to serve the needs of helping to bring the regulatory framework to the internationally recognised standards and to assist in modernising China's major insurance players, instead of competing with them. The process of opening-up to foreign insurance companies has been slow and partial, and the granting of foreign trading license is totally at the discretion of the Supervisory Authority. The fear of foreign dominance and the need to have know-how transfer without losing market share has prompted the authorities to restrict life insurance licenses to Sino-foreign joint ventures. The trading license is restricted to a specific geographical area [Shanghai or Guangzhou, with the exception of American International Insurance (AIA), an American International Group unit] and a specific type of business (life or non-life insurance, with the exception of AIA). In order to win the license battle, foreign insurers/insurance intermediaries have to demonstrate their long-term commitment to China's insurance industry and to develop strong relationships with the Regulatory Authority.

The restrictive nature of the regulatory framework for foreign participation, together with the discrepancies between the regulatory framework for domestic and foreign participation, are expected to have serious implications for the development of foreign insurance business in China in areas such as license winning strategies, partner-selection criteria, location choice criteria, and the ranking of the favoured locations on the basis of these criteria. The same is true for life insurance demand across China, given the market-seeking motivation of foreign insurers. For foreign insurers, China possesses both vast potential and high risks. Under the rapid growth of the insurance market is the immaturity of the industry in terms of its legal framework, market infrastructure, and market demand and insurance consciousness. The realisation of the market potential, therefore, demands a clear understanding of the problems involved in China operation.

The rapid growth of the Chinese economy over the last decade has generated much interest among scholars, government policy makers, the business community as well as trade officials all over the world. So far, much attention is paid to the Chinese economy as a whole and very few comments have been made about its financial services industry, and in particular its insurance sector. The aim of this research is to fill this gap by looking into this section of the Chinese economy with the first in-depth empirical analysis of the strategic issues involved in the development of foreign insurance business in China, with special reference to the choice of entry mode, partner selection criteria, location choice, and provincial life insurance demand. The discussion of the strategic issues for foreign insurers in China is based on extensive face-to-face and telephone interviews with executives working for both the foreign and Chinese insurance companies, as well as the results from an in-depth questionnaire survey of the representative offices of foreign insurance companies in China. Findings of interviews and questionnaire survey are supplemented by econometric models on the determinants of life insurance demand and location choice of foreign insurance companies in China.

The thesis is divided into eight chapters. After this introduction, chapter 2 examines in detail the role insurance plays in the Chinese economy, and the evolution of the insurance industry in China, followed by a brief account of foreign participation. Chapter 3 highlights the main features of China's regulatory framework and the implications for foreign insurance participation. Theoretical considerations for the choice of entry mode by foreign insurers in the Chinese insurance market are then examined in chapter 4, followed by an examination of provincial life insurance demand in chapter 5 through a pooled time-series and cross-sectional analysis of twenty-eight of China's provinces. For most foreign insurers, the long-term aim is the award of an operating license to establish a branch, a joint venture or a wholly-owned subsidiary so that they can engage in profit-making activities in the Chinese market. The award of an operating license is not automatic, and winning over the Chinese authorities requires more than demonstrable expertise and experience. The criteria used in the selection of joint venture partners and in location choice for foreign insurance representative offices are examined using a questionnaire survey in chapter 6. The choice of location is also examined through a conditional logit analysis of the locations of 138 foreign representative offices in China in chapter 7. Finally, in chapter 8, strategic implications for foreign insurers, as well as the policy implications for the Chinese Government, are discussed.

METHODOLOGY

A questionnaire survey was used to examine the strategic issues in the development of foreign insurance business in China, including location choice criteria, the ranking of cities as locations for business operation, license winning strategies, entry mode selection criteria, as well as the perception of main operation problems in China. The survey method was used in consideration of the following advantages associated with mail questionnaires:

- Questionnaires provide wide access to geographically dispersed samples at low cost;
- Biasing error is reduced because respondents are not influenced by interviewer characteristics or techniques and respondents enjoy a high degree of anonymity.

Questionnaire surveys, however, also have some disadvantages, and thus complementary methods of investigation were also employed.

- Researchers have no opportunity to probe for additional information or to clarify answers;
- Researchers have no control over who fill out the questionnaire;
- Low response rates lead to the problem of how to estimate the effect that non-respondents may have on the findings, and may therefore introduce bias into the study.
- The answers to questionnaire surveys may be subject to personal bias.

In view of these disadvantages of mail questionnaires, interviews with some of the respondents were carried out to clarify answers and to collect additional information. Interviews with other senior insurance practitioners working for both the Chinese and foreign insurance companies were also conducted to further the understanding of the modernisation of China's insurance industry and the strategic management issues regarding foreign participation. The problems of personal bias and the bias introduced by low response rates are alleviated by econometric models. The data used for the econometric analysis of life insurance across China and location choice criteria are compiled from a wide range of sources during the author's fieldwork in China. Although the accuracy of the data itself may be questionable owing to the weakness of China's statistics collection system, the data used in the current study are the best available. It is expected that the virtues of "objective" econometric models and

the “subjective” questionnaire survey will complement each other and give us a firmer understanding of the research topics.

In order to estimate the major determinants of life insurance demand in China's 28 provinces/autonomous regions over the period of 1985-1995, pooled cross-section and time-series estimation was used to provide sufficient degrees of freedom. The basic motivation for pooling time-series and cross-section data was that, if the model is properly specified, pooling provides more efficient estimation, inference, and possibly prediction. The model was estimated by OLS, and the null hypothesis that there was no first-order autocorrelation was tested by Durbin-Watson h statistics.

Based on the assumption that location choice is made to maximise future profit and that the probability of a location being chosen depends on its attributes relative to the other locations in the choice set, a conditional logit model was used to examine the location choice criteria of foreign insurance companies in China. Maximum likelihood estimation was employed to estimate the parameters which make it most likely that the choices in the sample would have occurred.

CHAPTER 2 THE INSURANCE INDUSTRY IN CHINA

INTRODUCTION

Insurance has an indispensable part to play in China's economic restructuring process. The long-term growth and capital appreciation sought by insurance companies are of critical importance to the term transformation of savings and thus the very success of China's welfare system reform. Insurance encourages the effective growth of domestic capital markets and effectively enhances the fund-raising opportunities for State and corporate bodies. In this chapter, we review the insurance industry in China with a detailed account of the indispensable role insurance plays in China's economic reform, the evolution of China's insurance market, and foreign participation in China's insurance industry. We conclude with a brief account of the benefits China can accrue from foreign insurance participation and Chinese authorities' cautious attitude towards opening up the Chinese market for foreign insurers.

INSURANCE AND ECONOMIC REFORM IN CHINA

Insurance is critical for economic reform in China, in terms of social welfare reform, demographic changes, enhanced welfare provision, capital market development, risk transfer, and opening-up to the outside world. The critical importance of insurance in China's economic and social development provide both the urgency and golden opportunities for the development of China's insurance industry and the overhaul of the existing insurance market structure by introducing competition mechanisms and foreign participation.

Social Welfare Reform

The existing social insurance system can no longer cope with China's social and economic reforms. There is a growing consensus in China that the social service provision responsibility of SOEs must be delinked from the economic management functions in order to prepare them for market economic reforms and restructuring. These social functions include provisions of such major services as housing, health benefits, pensions and retention of surplus labour until redeployment. Together they account for nearly two-thirds of the SOEs wage bill (23 percent for pensions, 30 percent for housing, 11 percent for health), in addition to the implicit costs of carrying

surplus labour (World Bank, 1996). The restructuring of the SOEs, either by the form of joint stock/collective share scheme or bankruptcy raises the difficult issue of how the commitment to pensioners will be honoured (along with the other welfare obligations of the enterprises, e.g. life-time employment, free medical care and child care, etc.). When alternative arrangements for pensions and other social services are not available, SOE reform halts in its tracks since liquidation, joint stock ventures, joint ventures, or mergers cannot proceed smoothly until the social obligation of SOEs are assigned elsewhere. What is more, with the SOEs reform on halt, commercialisation of the banking sector can not go head with banks facing an increasing burden of bad debts. The detachment of social welfare obligations from SOEs is therefore urgently needed in China as the restructuring of the SOEs into mixed economy with shareholding or joint-stock systems responsible for their own profit and loss is stressed as the top priority of the country's current economic restructuring by the 15th National Congress of the Chinese Communist Party.

China's social welfare system ever since 1949 when the new China was founded is a largely urban based pay-as-you-go defined benefit system, in which today's contributions are used for today's benefits and there is no saving for the future.

On the one hand, most health, pension, housing, and other social expenditures benefit China's urban workers, especially civil servants and workers in SOEs, and most of these benefits are administrated by enterprises. SOEs run clinics and sometimes hospitals, educate workers' children, run dining and laundry facilities, provide income during retirement and supply lifetime housing. According to statistics, one-third of hospitals and schools in China are run by enterprises⁴. Non-wage labour costs for housing subsidiary, housing (direct), pension, health, and education often running up to 75 percent of the total labour costs of an average sized SOE. The employees receive the "iron rice bowl" containing lifelong employment insurance, and comprehensive housing and medical benefits and allowances. Taking free medical care for instance, State employees only pay a symbolic registration fee while all other charges for treatment and medical care are covered by the State. Statistics show that SOE spending on its own services is about half as large as that of the current government health budget. The importance of enterprise-managed social welfare was revealed by a recent survey where 70 percent of SOE workers felt that social benefits in terms of health, housing and pension were as important as wages (Jiang, 1997). Economic reform, however, has been forcing enterprises to decouple themselves from the provision of welfare benefits. The threats of unemployment and the need to pay for their own medical care are looming large as SOEs have to shed surplus workers and

cut medical spending in order to face the harsh reality of either restructuring or going bankrupt. As such reform measures as mergers, reorganisations and bankruptcies are put into effect, excess employees in enterprises, estimated at 20 percent to 30 percent of total employees, undergo a gradual transition from hidden unemployment to being openly unemployed persons in society. The unemployment level in urban area may be 16 million by the year 2000 (7.4 percent unemployment rate, from 2.9 percent in 1995). The problem is compounded by a projected 300 million surplus labour force in the rural areas by the end of the century. Meanwhile, patients are now required to pay 10 percent to 20 percent of medical care⁵. Also underway is pension system reform which aims at transforming the system from a defined benefit system into a combination of defined benefits and defined contributions (detail of the reform will be discussed later). Reform has, therefore, created the urgency for the development of China's insurance industry to provide support for the establishment of the four main components to China's fledgling social insurance provisions — unemployment insurance, medical insurance, retirement pensions and accident insurance. Reform will also provide a necessary environment for the development of China's insurance industry by giving the Chinese a shock therapy of learning self-responsibility for their own welfare and enhancing the general public's insurance consciousness.

On the other hand, while most urban workers in China have long been covered by social welfare (including pension, housing, medical care, child care, life-long employment, *etc.*) offered by their enterprises, rural workers have little access to formal welfare schemes and have instead relied primarily on the extended families for welfare support. For thousands of years, traditional values in China have placed strong emphasis on the role of the family as a unit of production and consumption, and as a basis for raising the young and supporting the old in particular. Especially in the rural areas, three or four generations live under the same roof to pool resources and share risks. Parents have several children and invested in their future for old-age support. Accumulation of social experience and financial wealth, largely bequest-motivated, by the old through their life-long hard work wins their respect from the family and the society. Strong social norm, plus limited mobility, reinforce reliance on family as an essential social insurance and informal pension system. This traditional natural harmony between generations within the family and among members of a community is now being broken up by "one-child" policy and increased labour mobility brought by economic development. Meanwhile, in an increasingly secular society more activities are valued through market interactions, and there is often more emphasis on self gratification and less on communal responsibilities. This new climate of individualistic endeavour has been diminishing the traditional respect and responsibilities for the

elderly among the younger generations (Jiang, 1997). The sheer size of interregional flow of rural work force is projected to be 40 million by the end of the century (Bo, 1997). The "1-2-4" family system (families of one child, two parents, and four grandparents) and ongoing social/economic changes have, therefore, necessitated people to plan for alternative sources of support, rather than solely relying on their children, in their retirement (Wu, 1995; Jiang, 1997).

The urgency for the modernisation of China's insurance industry is best reflected in pension reform where real progress in social welfare reforms has taken place.

Under the general framework of its social welfare system, China's formal pension system is a largely urban-based, pay-as-you-go defined benefit system that covers mainly the State sector in urban areas. The system is unable to deal with either the short-term/immediate problem of pension crisis in the SOEs or the long-term challenge arising from the rapid ageing of the population (demographic transition) which will be discussed later.

The individual enterprise-based and defined benefit pension fails to delink social welfare obligations from enterprise management and hampers the restructuring of SOEs and overall economic reform in China. This is because the contribution rates⁶, non-compliance rates and exemptions are high, the dynamic non-State sector is not covered, and the pooling is limited. Under China's largely notional account base system, costs for pensioners are met from current contributions from existing employees with notional individual accounts which do not accumulate reserves. Contribution rates are, thus, high in many SOEs. For 13 provinces and 12 municipalities for which data are available, the simple contribution rates in 1984 were 23.5 percent for the provinces and 25.9 percent for municipalities, well above the international norm. Contribution rates are set to increase further in view of the soaring retiree-to-worker ratio in the SOEs with the development of the market economy. The economic reforms have shifted employment growth to the private sector. Employment in the SOE sector is thus static or even declining, while the number of pensioners in relation to employees is rising (if the estimated 15-20 percent internal redundant workers within SOEs were allowed to be shed, the problem would be even more acute) (See Table 2.1). This problem is compounded by the high replacement rate — often as high as 80-90 percent, which is much higher than that 40-50 percent level in most countries⁷. It is predicted that the contribution rate could run up to 34 percent from 2004 to 2031 if the pay-as-you-go system is not reformed. The situation will be even worse for localities with high old-age dependency ratios. The officially projected contribution

rate in the year 2020 is 38 percent for Tianjin and 42 percent for Shenyang. With the transition to market economy, individual enterprises are becoming responsible for their profits and losses. The burden of pension is, therefore, unmanageable for many of SOEs, especially when many of them are in the red. Therefore, as contribution rates rise, compliance rates are declining. Many municipalities have reported a drop in compliance rates from 90 percent for the early 1990s to 80 or 70 percent in 1994 and the first half of 1995. The current system is not sustainable.

Table 2.1 The Pension Crisis in China's State-owned Enterprises

	1990	1991	1992	1993	1994	1995
Workers (millions)	103.5	106.6	108.9	109.2	108.9	109.6
Pensioners (millions)	17.2	18.3	19.7	21.4	22.5	24.0
System dependency ratio (percent)	16.6	17.2	18.1	19.6	20.7	21.9
Wage expenditure (RMB billion)	232.4	251.3	291.5	381.3	517.7	608.0
Pension expenditure (RMB billion)	31.3	37.3	46.6	61.3	86.2	107.4
Pension/wage ratio (percent)	13.5	14.8	16.0	16.1	16.7	17.7

Note: System dependency ratio is pensioners as a percentage of workers.

Source: China Labour Statistics, various issues

Recently, with the introduction of the State Council Circular No.6 on Deepening Reform of Pension Insurance System in March 1995 which put forward two alternative transition models with the target of achieving a unified system by the year 2000, responsibilities for paying pension bills has been shifted from individual enterprises to groups of enterprises at the county, municipality, or prefecture level⁸. Enterprises, however, generally remain responsible for record-keeping and the actual delivery of pension benefits. And in many places, the pooling is only partial: enterprises with larger proportions of retirees in the pooled system have higher contribution rate than those with lower proportions of retirees. Thus the pooling system has made only partial inroads in the individual enterprise-based system. Moreover, by proposing two models and by allowing the localities to choose between them and any combination of the two, the document may only add to the fragmentation of the pension system. Each municipality is attempting to differentiate its scheme from that of others and there are now hundreds of schemes all over the country, with many serious problems. The most challenging task of China's pension system reform is to reform the fragmentation and make the system and its administration more unified.

One way to resolve the pension crisis is to move towards a three-pillar pension system which combines social pooling with funded individual accounts and shares the responsibilities among society, enterprises and individuals. This is the central feature of the "State Council Decision on Establishing Unified Worker Pension System" (the Decision hereafter) introduced in August 1997. The Decision reiterated the goal of the 1995 No.6 Circular to establish a unified pension system by the year 2000⁹. Various types of enterprises and workers now covered under separate plans, or not at all, would be brought into a single system with common standards. Management would be transferred from enterprises to government agencies. Administration and fund management should be separated. There would be multiple channels of funding contributions from workers and employers. The idea of multiple tiers of benefits was reaffirmed, with a substantial part of pension coming from individual accounts (mandatory fully funded accounts and supplementary individual accounts).

The pension system under the Decision combines social pooling with funded individual accounts. It provides for a basic pension component to keep retirees above poverty line (Pillar I — mandatory basic benefits pillar), and for large mandatory individual accounts (Pillar II — mandatory fully funded individual account pillar), supplemented by voluntary accounts (Pillar III — supplementary individual account pillar). The new pension system combines the advantages of defined benefit system with that of the defined contribution system¹⁰. While the defined benefit system providing the basic minimum poverty level income, the defined contribution system is geared towards meeting the extra needs of the elderly dictated by their social and occupational position. Under the unified system, enterprises are to contribute 20 percent of total payroll. After placing a contribution amount to 3 percent of workers' wage into their individual accounts, the contribution by the enterprises is designated as mandatory basic benefit (Pillar I) which is to make up 20 percent of average provincial wage paid to new retirees (*i.e.* a replacement rate of 20 percent for an average earning worker whose payment period is longer than 15 years). The second pillar would consist of mandatory individual accounts that would be fully funded and financed between workers and enterprises. The combined contribution rate would be 11 percent of a worker's individual wages, with workers' share increasing over time to 8 percent. If the real rate of return on pension funds equals the real rate of wage growth, a 11 percent contribution rate would yield a replacement rate of about 40 percent of wage in the final years of retirement. The third pillar would consist of supplementary pensions offered by employers on a voluntary basis, or provided by individual accounts established by informal sector workers (including farmers) in licensed Pension Fund Management Companies, or by life insurance policies purchased from insurance companies. The

amount would vary, depending on enterprise preferences and capacities, and individual's willingness and capability to save for old-age security. Individual accounts (mandatory and supplementary alike) would be fully funded, invested in treasury bonds and deposit in banks (with other investment vehicles forbidden), and portable. To keep the real rate of return on pension funds in line with the real rate of wage growth, mandatory individual accounts are to be indexed to the interest rate of savings deposit of the same period. In addition, while mandatory basic benefits are to be managed by social insurance companies (affiliated to Social Insurance Bureau), mandatory fully funded individual account and supplementary account are to be managed by pension fund management companies (autonomous public companies and private companies) and private/public insurance companies (or employer sponsored pension funds) respectively.

The new pension system will delink social welfare responsibilities from enterprise management by transferring the management of the basic pension benefits from enterprises to government agencies. It should improve the financial viability of the pension system (*i.e.* lowering enterprise contribution rates) by deriving a substantial part of retirement income — about 80 percent of the wages of the final year of retirement for a worker whose payment is longer than 10 years — from fully funded individual accounts, instead of the current contribution from existing employees with notional individual accounts as under the pay-as-you-go pension system. The new pension system keeps the publicly supported benefits low enough to keep some pressure on the elderly to seek extra benefits for themselves. The replacement rate under the mandatory pension (*i.e.* social pension) scheme (Pillar I and Pillar II) is reduced from the current 80-90 percent to 60 percent and thus provides the necessary incentives for the demand of supplementary individual account. The introduction of the fully-funded individual account system and the reduction of replacement rate is, therefore, expected to enhance the insurance conscious among workers who have to look after their own retirement costs rather than depending on contribution from their children (whether in the context of the family, enterprise, or social transfer) and provide a necessary condition for the development of the insurance industry in China.

Demographic Changes

The urgent and immediate task of delinking social welfare responsibility from SOEs is compounded by the challenge created by demographic changes which means an ageing population will have to be supported by the output of the active working population if the present system is not reformed¹¹.

The pay-as-you-go pension system fails to solve the long-term challenge arising from a rapid ageing population and the system's partial coverage which will leave a majority of China's old people without a pension when they retire.

Table 2.2 China's Rapid Ageing Population (Unit for Population: Millions)

	1990	1995	2000	2010	2020	2030	2050
Population 15-64	762.0	808.3	845.8	955.9	988.6	989.4	962.2
Population 65 and above	66.1	75.9	86.6	104.2	153.6	214.9	300.4
Dependency ratio (percent)	8.7	9.4	10.2	10.9	15.5	21.7	31.2

Source: World Bank (1994).

On the one hand, the scope and speed of population ageing in China makes the present pension system financially unsustainable even though the Gross Domestic Product (GDP) is assumed to grow steadily over a long period (McCarthy and Zheng, 1996; Friedman et al, 1996). The one-child policy and the increasing life expectancy in China means that the population will be ageing rapidly. According to international standards, population is ageing when people aged 60 and above constitute 10 percent of the population, or when people aged 65 and above account for 7 percent of the population (Ma, 1997). Thus, China will start to have an ageing population in 2000 when the elderly (aged 60 and above) is 10.7 percent of the population. By 2020, the elderly (aged 60 and above) will make up some 16 percent of the population, close to the 18 percent share in OECD countries in 1990. While it took most OECD countries 80 to 100 years to double the proportion of the old people to 18 percent, China will do that in just 34 years. By 2020, this ratio will be much higher in China than in its neighbours in Asia: India (10.3), Indonesia (10.9), Pakistan (6.3), Bangladesh (7.6), Viet Nam (9.0) and Thailand (12.8). The crisis is dramatised by the "1-2-4" phenomena: when the people who are currently entering the workforce retire (the four grandparents), they will have to be supported by one couple (the two parents). By 2030 the absolute size of the labour force in China will begin to decline, and by 2050 the dependency ratio (population 65 and above as a percentage of population 15-64) is projected to rise to 31 percent from 9.4 percent in 1995 (Table 2.2). Precisely at the time that China's old-age burden increases, its GDP growth rates may be slowing down due to declining opportunities for technological catch-up, and GDP per capita in China is projected to be about one-fifth that of industrial countries today. In other words, China will have a high income country's old-age crisis with a middle income country's resources for tackling them (McCarthy and Zheng, 1996).

The notional individual accounts under the pay-as-you-go pension system simply can not cope with the rising pension demand as the population ages rapidly. The notional individual accounts set up under the pay-as-you-go system contain few if any assets because almost all incoming revenues are being used to pay current obligations to pensioners. The interest rates that are paid on the balance are also notional. Total pension reserves are now estimated at less than 1 percent of GDP, and they are not increasing in many localities. Such notional accounts fail to meet the pre-funding or capital accumulation objectives of pension funds. When workers retire and start drawing annuities based on their individual accounts, the annuities will have to be financed out of contemporaneous contributions, which will have to rise dramatically to meet pension obligations. The simulation results by McCarthy and Zheng (1996) showed that the defined benefit pension system under pay-as-you-go scheme would not be financial sustainable (Table 2.3). The first sign of insolvency of the system will appear in 2025 when the current balance of the fund becomes negative. By 2050, the negative effect will make up of 2 percent of GDP. The negative accumulative balance of the fund will accumulate up to 41 percent of GDP in 2075, if the pay-as-you-go pension system is not reformed.

Table 2.3 China's Pension Fund Account under Pay-As-You-Go Scheme (Unit: RMB Billion)

	1995	1996	1997	1998	1999	2000	2010	2025	2050	2075
Revenue collection	221.4	290.4	373.1	472.6	592.2	736.2	2,904.6	14,345.2	85,098.9	421,487.9
Pension payments	128.7	151.4	179.8	214.3	257.1	309.5	1,464.7	14,005.7	139,879.8	793,718.1
Administrative cost	5.3	6.6	8.3	10.3	12.7	15.7	65.5	425.3	3,374.7	18,228.1
Current balance	88	132	185	248	322	411	1,374	(86)	(58,156)	(390,458)
As percent of GDP	1.6	2.0	2.3	2.5	2.7	2.9	2.9	0.0	(2.0)	(1.7)
Investment returns		12	29	55	91	141	895	5,355	(20,208)	(465,750)
Accumulative balance	100	244	459	762	1,176	1,728	15,059	81,763	(445,787)	(9,324,392)
As percent of GDP	1.8	3.7	5.7	7.8	10.0	12.1	31.4	27.8	(15.6)	(40.9)

Source: McCarthy and Zheng (1996)

On the other hand, the partial coverage can not meet the new demand generated by the breaking down of the traditional values and family-based old age welfare system. The non-State sector, which now accounts for more than half the employment in many localities, has only partial coverage, ranging from 20 to 90

percent. Though localities are trying to bring the non-State sector under the formal pension system, most non-State firms are resisting because current contribution rates are so high and the benefit system so uncertain.

The demographic transition necessitates pension reform, whereby "the resources we create today must be used to contribute to tomorrow's needs if we are to avoid placing an undue financial burden on our children and grandchildren" (Sedgwick Noble Lowndes, 1995: 7).

Enhanced Welfare Provision

China's developing country status, its huge population and its vast regional disparities mean that social insurance will only be able to provide the basic benefits to keep people above the poverty line. The higher expectations of welfare can only be met through supplementary private insurance. The experience of the social welfare reforms in both OECD countries and developing countries like Chile suggests that the transformation from a defined benefit system to a combination of defined benefits and defined contributions will pre-empt any future build-up in State social welfare commitments. The development of private (commercial) insurance will not only help to transfer the financial pressure from the government but also help to solve the pension crisis through market mechanisms (Ma, 1997).

On the one hand, the experience of OECD countries shows that high expectations of the capacity of the governments to support social welfare are unattainable. Most OECD countries opted for a defined benefit public pension system after the Second World War. Supporting their retired population through the provision of State pension schemes has become a fiscal and social time bomb under the pressure of demographic transition, unemployment, excessive expectations, inflation and the new world economy (Sedgwick Noble Lowndes, 1995). In the 1990s, many countries have been forced to re-evaluate their social welfare programmes by encouraging greater private provisions. Employees are encouraged to seek greater private pension provisions for retirement to transfer pressure from government.

On the other hand, Chile's experience has been regarded as an international successful example of restructuring social welfare system during the fundamental restructuring of its economy. The original pay-as-you-go system was in deep financial trouble with deficits amounted to 5 percent of the GDP in the early 1980s. Starting in May 1981, Chile conducted a revolutionary reform of its bankrupt public social security

system and replaced it with a private, decentralised and full-funded pension system. The reformed pension system is based on individual capitalisation accounts that are government mandated and regulated but privately managed by specialised companies known as Administrators de Fondos de Pensioners (AFPs) (Sedgwick Noble Lowndes, 1995; Shilling and Wang, 1995).

In the case of China, it is advisable to combine the advantages of the defined benefit and defined contribution systems by encouraging private sector provision of retirement pensions for those who can afford to make proper provision for their own needs. In doing so, the State is free and better equipped to target its limited resources to those who are in most need of help, and to act as guarantor for the minimum pension guarantee or the basic minimum poverty level of income under which the State does not want any individuals to fall².

Capital Market Development

The introduction of fully-funded individual accounts will create a large pool of savings which will not only meet future social support needs but also have the added advantage of providing funds to be invested in renewed economic activity (Sedgwick Noble Lowndes, 1995). By establishing a pool of money for investment, insurance encourages the growth of domestic capital markets and effectively enhances the fund-raising opportunities for State and corporate bodies. Unlike some of the new generation of emerging market investors, the liability and solvency parameters of insurance companies require them to be long-term investors looking not for quick profits but for long-term growth and appreciation. As long-term institutional investors, insurance companies have shown their ability to mobilise and aggregate small savings which are then invested in the local economy (Russell, 1995). Funded pension funds can create an enormous pool of resources (4 to 6 percent of GDP) for long-term investments in domestic infrastructure investment and other investments with a high rate of return for future pensioners.

Chile's success in pension reform demonstrates the benefits of restructuring a competitive and efficient insurance industry for aggregating small private savings, supporting the development of a domestic capital market, building the productive capacity of the economy, and raising aggregate savings. In Chile, the pension fund system ever since the reform in 1981 has grown steadily and played important roles in capital market development. It has become a major source of private savings, accounting for 18.8 percent of national savings in 1990, and 35 percent in 1994.

Pension funds play an important part in the financial market. At the end of 1994, the system held 55 percent of the State securities (Treasury and central bank bonds), 59 percent of corporate bonds, 62 percent of mortgage bonds, and 11 percent of corporate equities. Since 1990, pension funds have been allowed to own foreign assets and have begun to diversify actively into international capital markets. In industrialised countries, the accumulating assets of insurance companies through collecting premiums from policyholders provide the economies with an important source of investment capital. In the US, for instance, insurance companies were ranked third among institutional source of funds, supplying 15 percent of the total funds flowing into the financial markets. Net investment by insurance companies in US capital markets totalled \$146 billion in 1996 (ACLI, 1997).

Table 2.4 Premium Income as A Percentage of Savings, 1988-1995 (unit: RMB 10m)

	1988	1989	1990	1991	1992	1993	1994	1995
Savings	382220	519640	711980	924160	1175940	1520350	2151880	2966230
Premium	10060	9780	13510	17812	22850	30860	48850	61940
Percentage	2.63	1.88	1.9	1.93	1.94	2.03	2.27	2.09

Source: Almanac of China's Finance and Banking, various issues.

Because of the absence of long-term investment instruments, most household savings in China are in short- and medium-term deposits in banks and other deposit-taking financial institutions, which do not provide a solid basis for long-term lending. Premium income as a percentage of savings has been hovering around a mere 2 percent since the late 1980s (Table 2.4). Because of the liability profiles of savings institutions, this huge volume of savings has not necessarily been re-invested in the most productive way. This absence of reliable long-term financial instruments, combined with the system of unfunded notional accounts, is missing the opportunities for term transformation of savings for the country's enormous demand for infrastructure and other long-term investments. Demand for infrastructure investment alone is projected to be as high as \$744 billion for 1995-2004 or 7.4 percent of GDP (World Bank, 1995). However, because long-term instruments are unavailable, foreign financial resources are often mobilised for infrastructure investments (often at high guaranteed rate of return) while domestic deposits are left under-utilised (World Bank, 1996)¹³. The absence of long-term investment vehicles, therefore, hampers the development of broader and more liquid bond and equity markets, restricts the access of companies and State to potentially large sources of finance, and hinders China's economic restructuring and development.

Missing the opportunities for term transformation of savings may also jeopardise the very success of pension reform. Funded individual accounts will yield acceptable wage replacement rate for pensioners only if the long-term rate of return on pension funds is at least equal to the growth rate of wages. Considering China's high wage growth in the recent years (5.4 percent during 1980-93), pension funds face a challenging task in obtaining real rates of return that match or exceed wage growth (World Bank, 1996). Pension reform will fail if pension reform does not go hand in hand with financial sector reform and capital market development. Though in the short run most pension funds would be invested in public securities due to the absence of well functioning capital markets, the volatility of prices and the lack of experience of fund managers (World, Bank, 1996), over the longer term the restrictions over investment vehicles should be relaxed in line with the growing size and maturity of capital markets to allow pension funds to diversify across sectors (public and private), financial instruments (equities, bonds and mortgages), and geographic regions. The Government may gradually allow pension funds to invest in corporate equity and bonds in the medium term. This is because decentralisation and diversification are important for risk diversification, value appreciation, and the allocation of capital to the highest productive uses. Life reserves are long-term funds and need to be invested in long-term instruments and real assets that can produce fixed income and capital gains¹⁴. Given the high productivity of capital in infrastructure and other long-term investments in China, and the high expected returns already paid to foreign investors, it should be possible to devise a scheme that allows pension funds to earn substantially higher yields (World Bank, 1996).

International experience demonstrates that investment rules may be adjusted in a flexible and timely manner in line with the growing size and maturity of capital markets to ensure the success of pension reform. In Chile, for instance, measures have been taken to adjust investment rules in accordance with the maturity of the financial market and pension system. Initially, pension investments were limited to public sector bonds (treasury and central bank bonds), bank deposits, mortgage and corporate bonds, and quotas of other pension funds. The initial upper limits were 100 percent for State bonds, 80 percent for mortgage bonds, 70 percent for bank deposits, 60 percent for corporate bonds, and 20 percent for quotas of other pension funds. No lower limit was imposed. In 1982, the limit on bank deposit was reduced to 40 percent. In 1985, the ban on equity investments in privatised enterprises was lifted, and the initial 30 percent upper limit was raised to the current 37 percent of the total value of the fund. In the same year, the limit on State bonds was lowered to 50 percent and that

of corporate bonds to 40 percent. In 1986, the authorisation to invest in equities was extended to corporations set up as joint stock companies. In 1989, investment in real estate companies was authorised subject to an aggregate limit of 10 percent of the fund and an individual limit of 7 percent of the fund or 20 percent of the capital of the company. In 1990, pension funds were authorised to invest in commercial paper, in shares of investment funds, and in foreign securities, with discrete upper limits (Vittas and Iglesias, 1992). In industrial countries, pension fund portfolios are well diversified in a large variety of instruments — short-term and long-term, equity and debt, public and private, domestic and international, and financial or real estate (Table 2.5). In the US, for example, life insurance companies are important investors in the corporate bond market and have been the largest institutional holder of corporate bonds issued in the US markets since the 1930s. As Figure 2.1 shows, corporate bond issues represented the largest component (41 percent) of life insurance company assets in 1996. Among the \$952 billion issued in 1996, 35 percent (\$330 billion) was long-term corporate bonds. The share of life insurers' share of assets in stocks has also been increasing, from 9.7 percent in 1986 to 20.6 percent in 1996. Historically, stocks have been a small percentage of total assets, due to the contractual guarantees for specified dollar amounts in life insurance policies and the restrictions of the laws regulating life insurance. The situation has been altered with legal changes and the introduction of variable life insurance. State laws now generally permit certain assets of variable life insurance policies to be maintained in an account separate from a company's other assets.

The importance of pension funds for economic restructuring, for capital market development and for the viability of pension reform seems to have been recognised by the Chinese Government through the recent approval by the State Council of regulations for establishing mutual investment funds. The approval signalled the birth of a fund management industry in China to foster institutional investors helping to increase the liquidity and stabilise the speculative and volatile capital markets. The introduction of mutual funds and the boosting of institutional investors is the inevitable complement to China's pledge to use the capital markets to finance SOE reforms. It is believed that the introduction of mutual funds and the imminent permission of Sino-foreign joint venture funds will provide a basis for what could be a large pension fund industry and provide an impetus for the development of China's fledgling stock and financial services industry¹⁵.

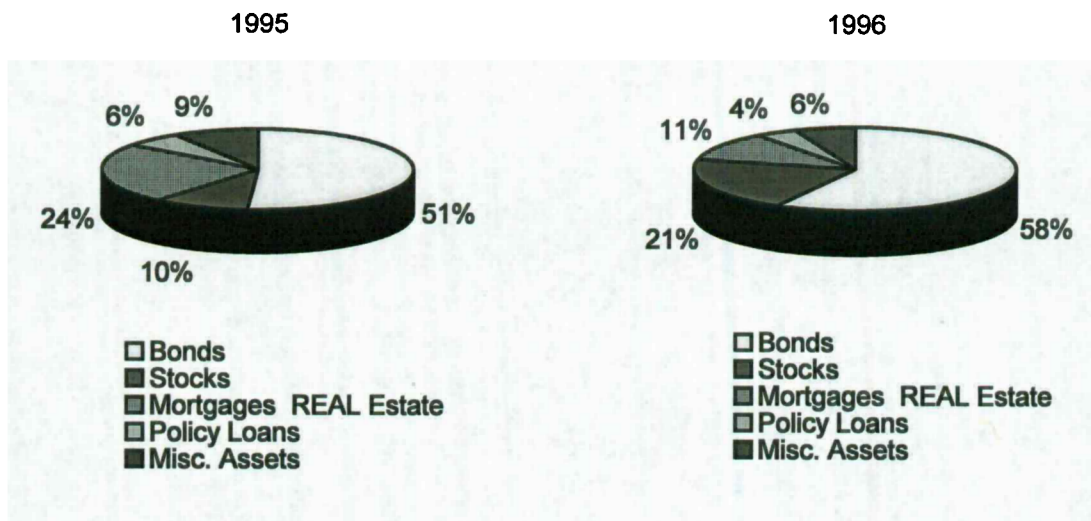
Table 2.5 Asset Allocation of Pension Funds in Industrialised Countries, 1990
(percent of assets)

Instruments or Assets	UK	US	Germany	Japan	Canada	Switzerland
Short-term assets	7	9	2	3	11	12
Market papers	1	3	-	-	10	10
Deposits	6	6	2	-	1	1
Bonds	14	36	25	47	47	29
Government bonds	11	20	17	5	39	-
Private bonds	3	16	8	-	8	-
Equities	63	46	18	27	29	16
Mortgages	-	2	9	1	4	8
Loans	0	0	36	13	0	14
Property	9	-	6	2	3	17
Foreign assets	18	4	1	7	6	5
Other assets	6	2	1	-	2	1
Total	117	99	98	100	102	102

Note: There are some overlapping categories (equity and foreign equity) in some countries, so they do not add up to unity.

Source: Davis (1995)

Figure 2.1 Asset Distribution of US Life Insurance Companies: 1986 Vs 1996



Source: American Council of Life Insurance (1997)

Risk Transfer

The risk profile of China provides the insurance industry with an important role in maintaining the country's social/economic stability and smoothing the reproduction process (Ma, 1997). Chinese firms which are only now assuming the responsibility for the successful operation of their companies are realising that insurance can prove to be expensive, but that the result can be devastating if insurance is not bought (Williams, 1995). China faces unprecedented challenges of massive exposures and liabilities related to construction, engineering and production in its economic modernisation process; China has considerable natural hazard risks, ranging from earthquakes to the constant threat of floods and windstorms. Typhoons are a seasonal risk to much of China's south and eastern coasts, causing massive losses of life and property damage. China's industrial modernisation processes is plagued by an increasing number of industrial accidents, resulting in a succession of fatal fires, high construction site death rates and heavy loss of life, which are in violation of the labour safety and employee benefits the employers are obliged to provide under China's Labour Law. Risk management records in China are extremely poor. It is common in Chinese cities that the older industries are located directly adjacent to schools, hospitals or residential areas. This clearly poses major third party exposure. Third party liabilities are also prominent in the case of new joint ventures which are setting up in newly cleared areas, but which have adjacent buildings and factories where dangerous processes are being carried out.

Moreover, by providing the protection that consumers and businesses can afford, the development of a more competitive insurance sector will assist directly in the wealth creation process. Businesses will be more likely to invest for the future if they can do so in the knowledge that their assets will be protected in the event of disaster or loss. And individuals will invest more willingly if they can pass on accumulated wealth when they die or fall seriously ill. Without effective protection against physical and financial risk, both businessmen and investors will be less willing to plan for the longer term.

Opening to the Outside World

The development of insurance is also required by China's opening up process. International trade and international economic/technological co-operation demand corresponding insurance services which meets international standards. For instance, where foreign commercial banks or international policy banks (such as the World Bank

or Asian Development Bank) are concerned, the insurance requirements may be a condition of the finance (Williams, 1995). Meanwhile, the standard of insurance services is an inherent part of China's investment environment for foreign investors. The foreign company often requires a local insurance arrangement to be placed on the basis of its global insurance arrangements, or a policy similar in form to the global form to be negotiated. Without integrating itself with international standard, the local insurance industry may be failing the need of foreign investors, because it can not provide the classes of insurance and liability coverage required (Williams, 1995).

THE EVOLUTION OF CHINA'S INSURANCE MARKET

On the basis of the urgent requirement to develop modern insurance for economic reform, a brief account of the evolution and the distinguishing features of China's insurance industry is given below to put foreign insurance participation in China into perspective.

Insurance in China has had a volatile history, mirroring the dramatic changes in Chinese society itself. Insurance was introduced into China by Western countries in the late Qing dynasty. Early in the 19th century, various banking branches in China owned by insurers from the UK, US and Germany began functioning as underwriting agencies. The Yihe Insurance Company, the first Chinese-owned insurer was set up in Shanghai in 1865. The Chinese-owned insurance industry developed rapidly and by 1910 there were a total of 34 insurance companies, mainly located in Shanghai, Harbin, Yinkou, Guangzhou and Tianjin. By 1945, the industry had grown ever further. There were 58 insurance companies: 8 were government operated, 7 were run by local governments and 43 were privately operated. And Shanghai was China's insurance centre.

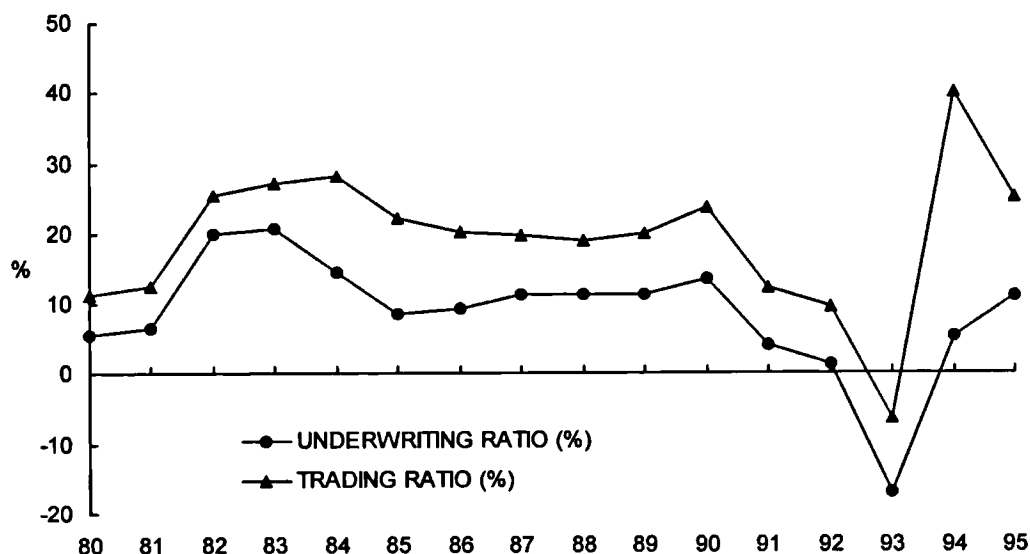
PICC was established in 1949, after the foundation of the People's Republic of China (PRC). Subsequently all other insurance companies in the PRC ceased to operate and, by 1956, PICC had a monopoly position. However, political upheaval and State planning both hindered the development of the domestic industry during the ensuing two decades: domestic insurance was suspended and business was limited to international cargo and aviation insurance (Shao, 1995).

The advance of economic reform in 1979 resuscitated the insurance industry in China. Domestic insurance was resumed in April 1979. As the sole insurance carrier in the whole of China, PICC enjoyed the strong and increasing demand for insurance

services and showed great profitability through the 1980s. Figure 2.2 traces the underwriting and trading ratios¹⁶ of PICC between 1980 and 1995, and Figure 2.3 compares PICC's ratios with those for the non-life industries in the United States, Japan, and the United Kingdom. An additional factor contributing to PICC's impressive results was the annual capital injection by the Chinese Government into PICC's reserve fund, which enabled greater investment than would otherwise have been the case and hence improved underwriting and trading performance.

PICC's monopoly was, however, brought to an end by the transition to a competitive market in response of the surging demand of economic restructuring in China in the mid 1980s. The following sections outlines the distinctive features of China's insurance industry in transition.

Figure 2.2 Underwriting and Trading Ratios of PICC (1980-1995)



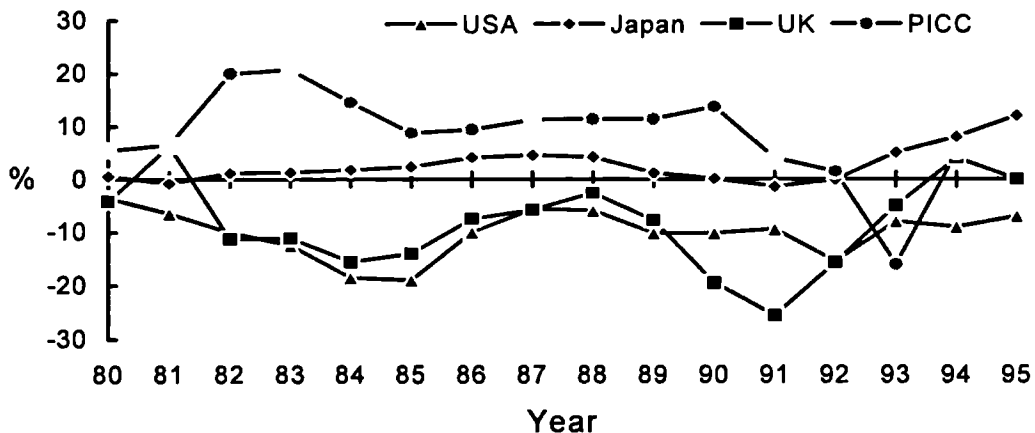
Source: Adapted from PICC Annual Report, various issues; Almanac of China's Finance and Banking, 1996

Transition to A Competitive Market

PICC's long-term monopoly was broken by the establishment of the Xinjiang Agricultural Insurance Company in 1987, followed by the Ping An Insurance Company in 1988, and the China Pacific Insurance Company in 1991. Two regional insurers, Tian An and Da Zhong, were established in Shanghai in 1995, and the People's Bank of China (PBOC) awarded licenses to a further two regional and three national insurance companies in early 1996. The two regional companies (Hua An based in

Shenzhen, and Yong An based in Xian) both specialise in non-life insurance, as does one of the national companies (Hua Tai, based in Beijing). The other two national companies (Tai Kang and Xin Hua) both specialise in life insurance, and are both based in Beijing. PICC was transformed into the China Insurance Group in 1996, and three separate subsidiaries were established: PICC (Property); PICC(Life); and PICC(Reinsurance). There are currently 36 insurance companies operating in China — see Table 2.6 — the 14 companies noted above, 17 regional companies (all joint ventures between PICC and local investors), and 5 companies involving foreign insurers (AIA twice, Tokio Marine and Fire, Manulife, Winterthur).

Figure 2.3 Underwriting Ratio of PICC in Comparison with that of USA, Japan and UK Markets (Non-life), 1980-1995



Source: Sigma, 1995; Sedgwick, 1996; The Marine and Fire Insurance Association of Japan, Inc., 1996; Association of British Insurers, 1996; PICC Annual Report, various years.

In addition to the development of institutional capacity, regulatory capacity was also enhanced by the introduction of the Insurance Law in October 1995 and the implementing regulations, such as the Interim Administrative Provisions for Insurance Agents (Interim Provisions) promulgated by the PBOC and effective on 1 May 1996. A detail discussion of the regulatory framework will be given in chapter 3. The Insurance Law and its implementing regulations are expected to have a significant impact on the development of China's insurance industry. "Whereas before few business practices were expressly forbidden, now each aspect of the industry is covered by prescriptive legislation" (Sedgwick, 1997: 6)

Table 2.6 The Major Companies in China's Insurance Market

Company Name	Year Estb.	Nationality	Insurance Type	Operational Area	Corporate Structure
China Insurance Group, including	1996	Chinese		National	State-owned holding
People's Ins. (Property) Co. of China Ltd.	1996	Chinese	Property	National	Subsidiary
The People's Ins. (Life) Co. of China Ltd.	1996	Chinese	Life	National	Subsidiary
The People's Ins. (Reinsurance) Co. of China Ltd.	1996	Chinese	Reinsurance	National	Subsidiary
China Pacific Insurance Co.	1991	Chinese	Composite	National	Joint Stock
Ping An Insurance Co. of China	1988	Chinese	Composite	National	Joint Stock
Tai Kang Life Insurance Co. Ltd.	1996	Chinese	Life	National	Joint Stock
Xin Hua	1996	Chinese	Life	National	Joint Stock
Hua Tai	1996	Chinese	Property	National	Joint Stock
Yong An Property Insurance Co. Ltd.	1996	Chinese	Property	Regional (Shaanxi)	Joint Stock
Xinjiang Agricultural Insurance Co. ^a	1986	Chinese	Agriculture	Regional (Xinjiang)	State-owned
Tian An	1994	Chinese	Property	Regional (Yangtze River Delta ^b)	Joint Stock
Da Zhong	1995	Chinese	Property	Regional (Yangtze River Delta ^b)	Joint Stock
Hua An Insurance Co. Ltd.	1996	Chinese	Property	Regional (Guangdong)	Joint Stock
17 Regional Insurers, including	1986 (the earliest)	Chinese	Life	Regional (various)	JV between PICC and Local Companies
Sichun Life Insurance Co. Ltd.				Sichun	
Changsha Life Insurance Co. Ltd.				Changsha	
Dalian Life Insurance Co. Ltd.				Dalian	
Shenyang Life Insurance Co. Ltd.				Shenyang	
Xiamen Life Insurance Co. Ltd.				Xiamen	
Zhuhai Life Insurance Co. Ltd.				Zhuhai	
Xiantan Life Insurance Co. Ltd.				Xiantan	
Benxi Life Insurance Co. Ltd.				Benxi	
Dandong Life Insurance Co. Ltd.				Dandong	
Tianjin Life Insurance Co. Ltd.				Tianjin	
Harbin Life Insurance Co. Ltd.				Harbin	
Taiyuan Life Insurance Co. Ltd.				Taiyuan	
Fuzhou Life Insurance Co. Ltd.				Fuzhou	
Guangzhou Life Insurance Co. Ltd.				Guangzhou	
Nanjing Life Insurance Co. Ltd.				Nanjing	
Anshan Life Insurance Co. Ltd.				Anshan	
Kunming Life Insurance Co. Ltd.				Kunming	
American International Group (China) Ltd.	1992	American	Composite	Regional (Shanghai)	Foreign Branch Office
American International Group (China) Ltd.	1995	American	Composite	Regional (Guangzhou)	Foreign Branch Office
Tokio Fire & Marine (China) Ltd.	1994	Japanese	Property	Regional (Shanghai)	Foreign Branch Office
Zhong Hong Life Insurance Co. ^c	1996	Sino-Canadian	Life	Regional (Shanghai)	JV with Sinochem ^d
Winterthur Swiss Insurance (China) Ltd.	1997	Swiss	Property	Regional (Shanghai)	Foreign Branch Office

Source: EIU (1996); Jiang (1997); Insurance in China (monthly faxed newsletter), London: Reactions Publishing Group Ltd., various issues.

Note: ^a Xinjiang Agricultural Insurance Co. is the only insurance company specialised in agricultural insurance in China, and its major client is the paramilitary frontier development unit — Xinjiang Production and Construction Corp; ^b Yangtze River delta include mainly Shanghai, Zhejiang province and Jiangsu province; ^c The Canadian partner is Manufacturer Life (Manulife) Insurance Company which has a controlling interest of 51 percent of the China joint venture; ^d Sinochem stands for China National Chemical Import & Export Corporation.

The China Insurance Group (the PICC Holding Company) was still the dominant insurer with 70 percent of the market, despite the introduction of institutional

and regulatory competition mechanisms, according to the statistics by the end of July 1997¹⁷. Earlier statistics showed the distribution of market shares among the major players in China in 1995 (Table 2.7). Since then, the China Insurance Group has further lost market share. Ping An has moved up to the second place (14 percent of national market share in 1996). Tian An and Da Zhong have overtaken Xinjiang Agricultural insurance company, and the newcomers — Xin Hua, Tian Kang on the life insurance side and Hua Tai on the non-life insurance side — are experiencing rapid growth¹⁸.

Table 2.7 Premium Income and Market Share of Major Insurance Companies in 1995

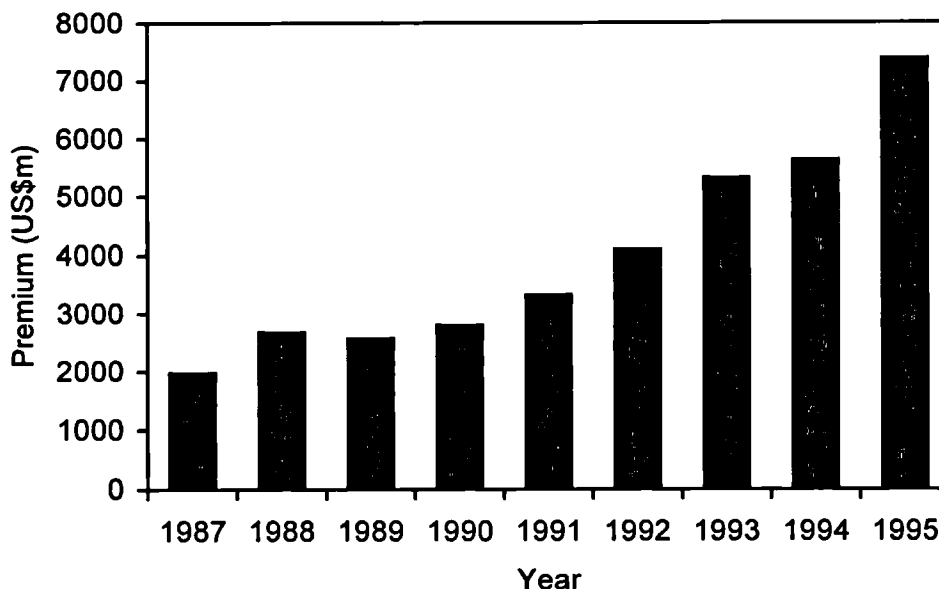
Company	Premium (RMB million)	Market Share (percent)
PICC	47623	79.12
China Pacific	6634	11.02
Ping An	5000	8.31
AIA	415	0.69
Xinjiang Agricultural	194	0.32
Da Zhong	153	0.25
Tian An	143	0.24
Tokio Marine & Fire	27.9	0.05
Country Total	60189.9	100

Source: Chinese Insurance Association

Market Growth and Potential

China's insurance industry has enjoyed substantial growth ever since its re-birth in 1979, and the annual insurance premium exceeded US\$7bn in 1995. From 1979 to 1995, annual insurance premium income has increased 200-fold, at an average rate of over 40 percent (see Figure 2.4). The growth in premium income has been most dramatic for the two new national insurers, China Pacific and Ping An, which recorded growth rates of 120 percent and 270 percent respectively over the period 1991-95. It is estimated that the market might well grow to RMB200bn (US\$24.1bn) by the year 2000, with projected annual increases in the region of 20-30 percent and possibly more for life insurance.

Figure 2.4 Insurance Premium In China (1987-1995)



Source: Sigma, various issues

Table 2.8 Insurance Density (US\$) of China in Comparison with Selected Developed Countries (1987-1995), with World Rankings in Brackets

Country	1987	1988	1989	1990	1991	1992	1993	1994	1995
USA	1668.2 (3)	1751.3 (3)	1817.1 (3)	1928.7 (3)	1927.1 (4)	2067.6 (3)	2191.5 (3)	2279.7 (3)	2372.2 (3)
UK	1121.8 (6)	1208.4 (5)	1335.7 (6)	1775.1 (5)	1998.9 (3)	1769.4 (5)	1913.5 (4)	2002.2 (4)	1694.2 (10)
France	898.8 (12)	933.5 (13)	1126.7 (11)	1316.7 (9)	1412.2 (9)	1469.5 (7)	1646.9 (6)	1908.2 (6)	2268.4 (5)
Germany*	1329.9 (4)	1296.1 (4)	1241.7 (8)	1462.8 (7)	1299.9 (11)	1329.2 (8)	1429.7 (8)	1577.9 (8)	1899.2 (6)
Switzerland	2447.2 (1)	2323.5 (1)	2375.6 (1)	2926.6 (1)	3001.7 (1)	2923.1 (1)	3096.5 (2)	3586.6 (2)	4507.2 (2)
Japan	1974.5 (2)	2320.9 (2)	2149.9 (2)	2252.5 (2)	2484.0 (2)	2576.2 (2)	4395.1 (1)	4849.7 (1)	5088.3 (1)
China	1.9 (63)	2.5 (63)	2.4 (62)	2.5 (63)	2.9 (58)	3.5 (63)	4.5 (75)	4.1 (68)	6.1 (76)

Note: Insurance density is insurance premium per capita.

* West Germany prior to 1990

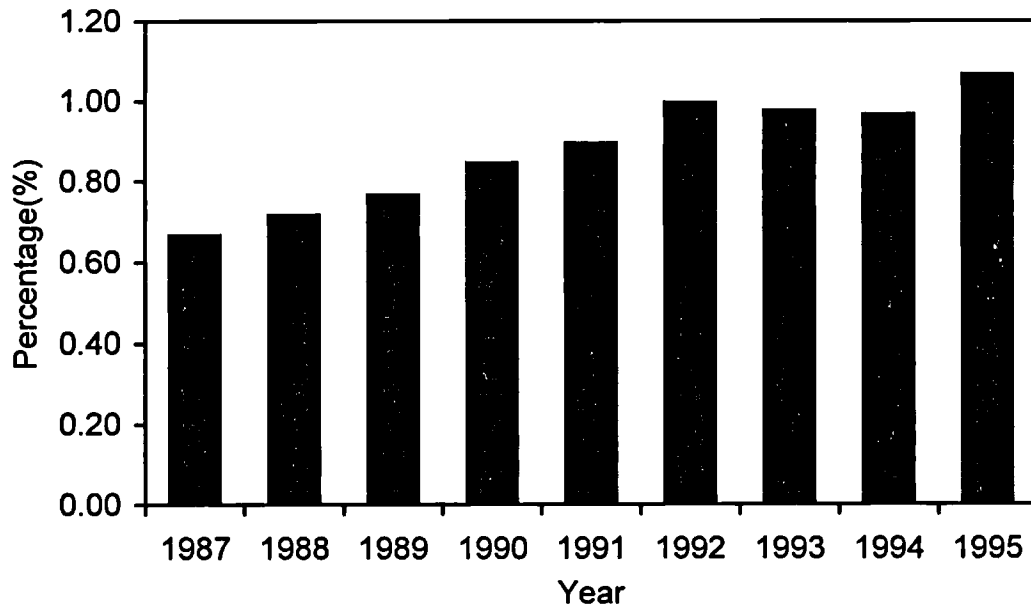
Source: compiled from Sigma, various issues

The dramatic growth, however, is a new phenomena. One consequence is that the level of insurance knowledge of both the provider and consumer is low, with widespread under-insurance and lack of awareness of the benefits of risk management (Taylor, 1996). There is a general shortage of insurance professionals in all disciplines — actuarial, marketing, underwriting, claims handling and accounting. There is no

recognised insurance qualification and up to the first half of 1996, out of about 150,000 insurance personnel, only around 20 in the whole sector held the ACII qualification (Taylor, 1996)¹⁹.

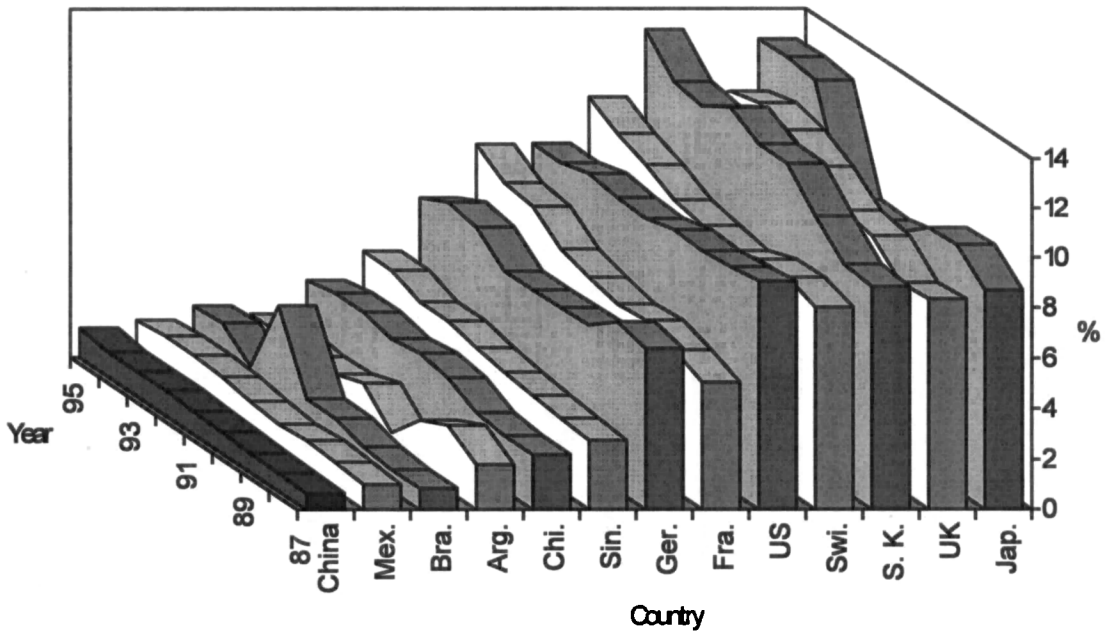
In addition, the dramatic projections of future growth are based upon the fact that China's insurance penetration is far lower than most other countries, even many developing countries. Insurance penetration in China was just 1.17 percent of GDP in 1995, compared to 8-15 percent in developed countries; insurance density was merely US\$6.1 in 1995, compared to US\$12,00-US\$5000 in developed countries — see Figure 2.5, Figure 2.6, Figure 2.7, and Table 2.8. Taking insurance density for instance, China's per capita insurance premium is low in comparison with many developing economies (Figure 2.8). It is lagging far behind the level achieved by the newly industrialised countries/regions (Figure 2.9). Against the US\$6.1 in China in 1995, the figures were \$39.1 for Mexico, \$90.1 for Brazil, \$146.5 for Chile, and \$141.5 for Argentina. In Taiwan, South Korea and Japan, the comparable figures were \$678.5, \$137.6, and \$5088.3 respectively.

Figure 2.5 Insurance Penetration in China (1987-1995)



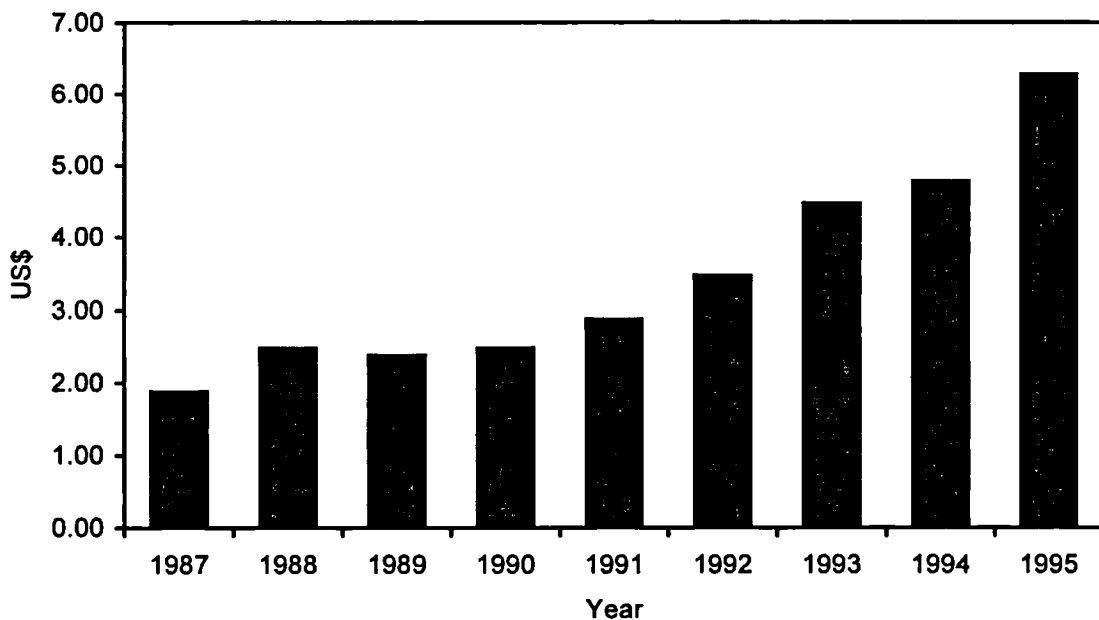
Source: Sigma, various issues

Figure 2.6 Insurance Penetration of Selected Developed, Newly Industrialised and Developing Countries/Regions (1987-1995)



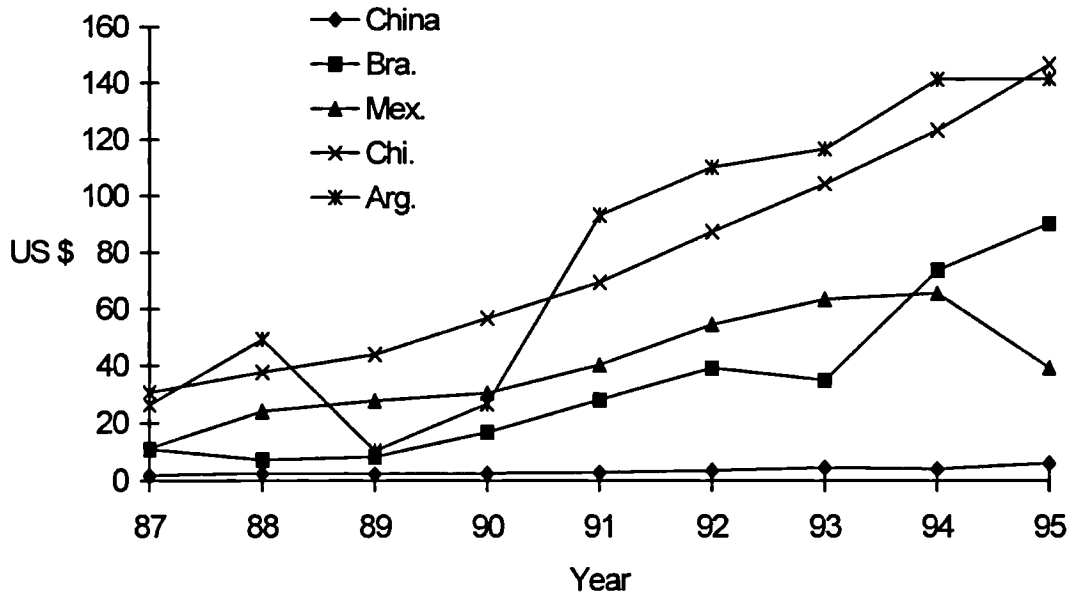
Note: Insurance Penetration is insurance premium as a percentage of GDP. Mex.: Mexico; Bra.: Brazil; Arg.: Argentina; Chi.: Chile; Sin.: Singapore; Ger.: Germany; Fra.: France; Swi.: Switzerland; S. K.: South Korea; Jap.: Japan.
Source: Sigma, various issues.

Figure 2.7 Insurance Density in China (1987-1995)



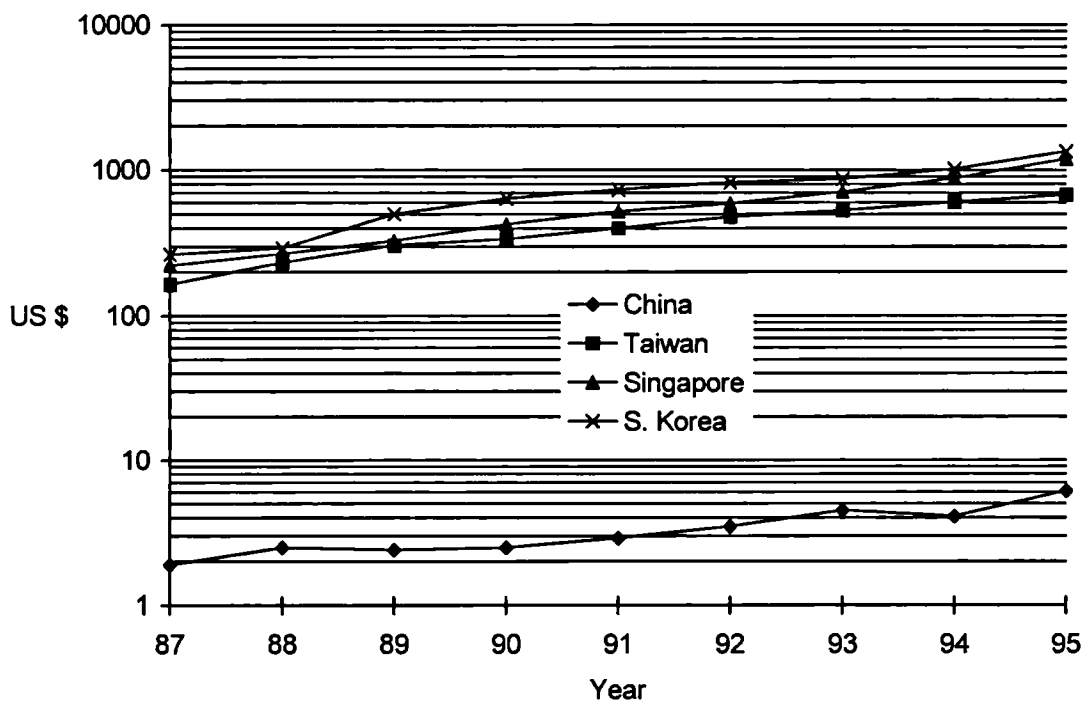
Note: Insurance density is insurance premium per capita
Source: Sigma, various issues.

Figure 2.8 Insurance Density of China in Comparison with Selected Developing Countries (1987-1995)



Source: Sigma, various issues

Figure 2.9 Insurance Density of China in Comparison with Selected Newly Industrialised Countries/Regions (1987-1995)

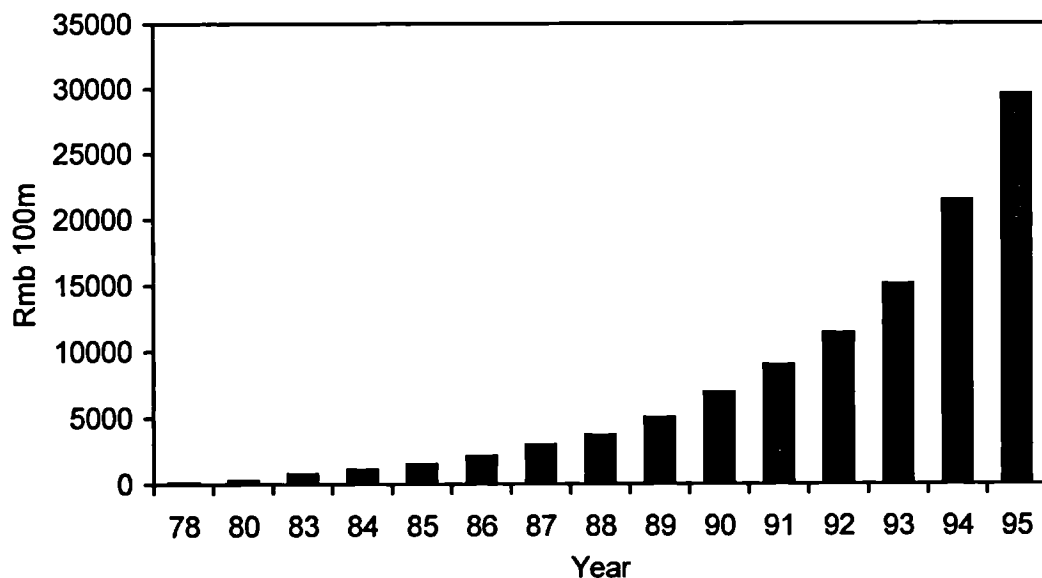


Source: Sigma, various issues

Untapped demand, particularly for life insurance, is enormous. About half of China's urban residents (150m people) have bought some life insurance, but most of the rural residents — who account for 75 percent of the population — remain unaware of its availability. However, this situation will gradually change as a result of increasing affluence, education, birth control, and other social changes:

- Traditional superstitious fears of insuring against death are diminishing.
- The breakdown of extended families, and the increase of nuclear families, have necessitated people to plan for alternative sources of support, rather than solely relying on their children, in their retirement (Wu, 1995).
- The reform of the social security system has accelerated the expansion of private long-term assurance services as SOEs are delinking themselves from the responsibilities of the provision of extensive social welfare. Life insurance will have a wider and better development scope because China has decided to give full play to commercial insurance while developing social security (EIU, 1996).
- With a high savings ratio (Figure 2.10), increasing disposable incomes, and the boosting of institutional investors by China's newly introduced regulations for establishing mutual investment funds, insurance stands to be an attractive vehicle for long-term security and protection against a limited choice of personal investment instruments in China.

Figure 2.10 Savings Deposit Balance in China (1978-1995)

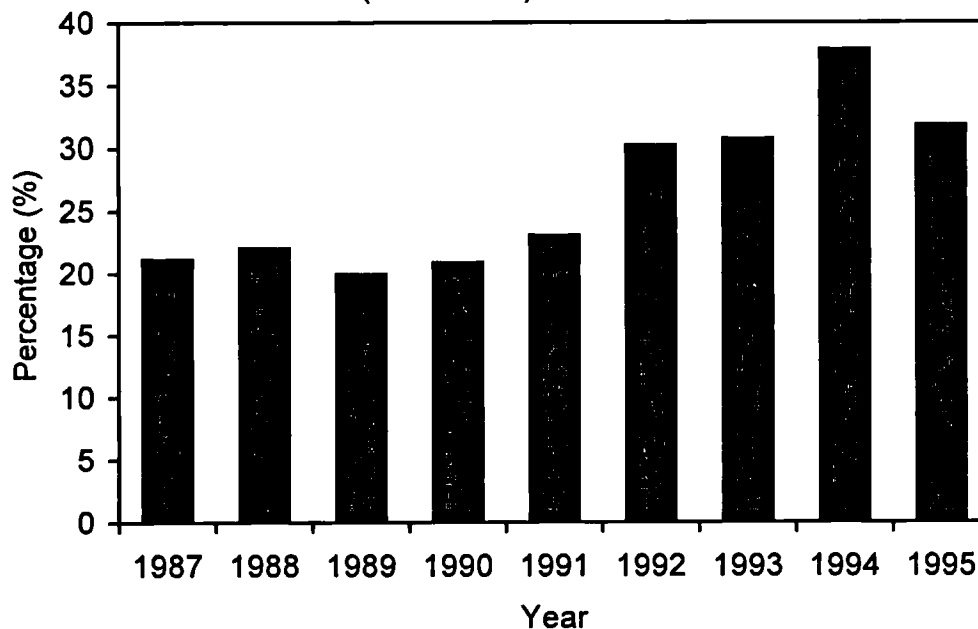


Source: Almanac of China's Finance and Banking, various issues.

The increasing market demand has also brought about a general upward trend of the share of life insurance premium in total business in China (Figure 2.11). By the year 2000, life insurance is expected to amount to approximately 55 percent of the total insurance premium, exceeding the percentage accounted for by non-life business.

China's burgeoning life insurance market is in tandem with the growth prospect of its non-life insurance. The tremendous expansion of the Chinese economy has contributed to the phenomenal demand for insurance protection in the country whose GDP has registered about 10 percent annual growth rate for the last 16 years with not a single year of decline in output. Infrastructure, construction and vehicle insurance, for instance, are projecting a healthy upward trend as a consequence of the rapid upgrading of China's infrastructure and transportation systems, and also because of the State's legal requirement. Household insurance is also expected to take off as the Government intends to turn the country into a nation of private homeowners by abolishing State-subsidised housing²⁰. SOEs, which are increasingly responsible for their own profit and loss, have neither the means nor the inclination to keep on paying for the accommodation of 370m city dwellers²¹.

Figure 2.11 The Share of Life Insurance in Total Insurance Business In China (1987-1995)



Source: Sigma, various issues.

FOREIGN PARTICIPATION IN CHINA'S INSURANCE INDUSTRY

The potential of China's insurance industry, coupled with the relative lack of local expertise, have led to the world's leading insurance companies queuing up to start operations in China. Compared with Chinese domestic insurers, foreign insurers enjoy salient advantages in being able to provide a higher quality and more extensive range of insurance policies at more competitive prices.

- The immaturity of the life insurance market, as evidenced by the low insurance density and penetration rates, reflect the facts that Chinese firms lack experience in selling life policies and in choosing suitable vehicles for long-term investments. Given the lack of local expertise in the provision of private insurance, foreign insurers/reinsurers are well-placed to tap the lucrative market.
- Foreign insurers/reinsurers are much better equipped to analyse and rate all sorts of exposures/liabilities related to construction, engineering and production associated with China's industrial expansion plans (Wu,1996). The Chinese companies have been finding that their knowledge and expertise have been stretched by the number and complexity of these risks. Thus, although Chinese non-life business volume increased by 65 percent between 1992 and 1994, the profits of the Chinese insurance companies decreased by 18 percent.
- Marketing skills are of particular importance for a country like China where the whole concept of insurance is new, and where policies are optional for much of the population. Given their long experience, foreign insurers have a clear advantage over their domestic competitors in pushing the concept of insurance and in developing the market.
- Foreign insurers also have a clear advantage with respect to risk management and loss prevention. Risk management is a relatively new practice in China. Most data available on natural hazards are related to the coastal areas, and there is very little information on seismic and climatic conditions in the inland provinces where many new factories and plants are now being established.
- The myriad new risks produced by China's economic development have challenged the capacity and expertise of China's domestic insurers. The insurance expertise and high capitalisation of foreign reinsurers are essential for the provision of sufficiently professional cover for rapid economic expansion.

The ban on cross-border trade, together with the technical features of the insurance business, has made some form of local presence within the market

necessary. According to the latest statistics compiled from various sources, about 82 foreign insurers have opened about 178 representative offices in China. The most favoured locations were Beijing (70 offices), Shanghai (51 offices), Guangzhou (19 offices), Shenzhen (18 offices), Tianjin (8 offices), Dalian (6 offices), 2 Chengdu, 1 Nanjing, 1 Wuhan, and 1 Xiamen. Among them, 51 are from the US, 40 from Japan, 54 from Europe (29 UK, 4 France, 5 Germany, 2 Italy, 6 Netherlands, and 8 Switzerland), and 33 from other countries (including 10 Australian, 8 Canadian, 5 Hong Kong, 7 South Korean, and 2 Singaporean). These representative offices/branches were set up by 82 foreign insurers, including: 22 American, 14 Japanese, 27 European (14 British and 13 other European countries, including 4 France, 1 Netherlands, 3 Germany, 2 Italy, and 3 Switzerland), and 19 other countries (including 4 Australian, 3 Canadian, 3 Hong Kong, 3 Singaporean, 5 South Korean, and 1 Thailand). The majority of these representative offices were established after 1992. Representative offices of foreign insurers before 1992 are very limited due to the closure of the insurance market to foreign participation .

AIA was the first foreign insurer to be granted an operating license to open a branch office in China. The office was opened in Shanghai in 1992, and was licensed to underwrite both life and non-life insurance. In September 1994, the Japanese company, Tokio Marine and Fire, was also authorised to establish a branch office to underwrite non-life insurance in Shanghai. AIA opened a second branch office in Guangzhou in October 1995 to underwrite both life and non-life insurance. The first joint venture was established in May 1996 when approval was granted to Manufacturers Life and Insurance Co. (Manulife) of Canada to set up a venture with Sinochem. The venture started operation in Shanghai in late 1996. Following Manulife's example, the Swiss company Winterthur became the first European insurer licensed to operate in the Chinese market. Their Shanghai branch started to issue non-life insurance policies in January 1997. The latest developments are: the approval by the PBOC of the joint venture life insurance company in Shanghai between Allianz Holding of German and Da Zhong Insurance of China (April 1997); the approval of the joint venture life insurance company in Shanghai between Aetna of the US and China Pacific Insurance Co. of China (November 1997); And the granting of trading license in Shanghai to AXA of France, subject to finding a Chinese partner (April 1997). With respect to insurance intermediaries, Sedgwick Insurance and Risk Management Consultants (China) Ltd became the first and the only foreign insurance broker licensed in China (1993). (see Table 2.9).

Table 2.9 Licensed Foreign Insurance Companies in China

Venture Name	Foreign Partner	Chinese Partner	Country of Foreign Company	Business Type	Venture Type	Year Est.	Location
American International Group China Ltd.*	American International Group	N/A	USA	Life and Non-life	Branch	1992	Shanghai
American International Group	American International Group	N/A	USA	Life and Non-life	Branch	1995	Guangzhou
Tokio Fire & Marine China Ltd.	Tokio Marine & Fire	N/A	Japan	Non-life	Branch	1994	Shanghai
Zhong Hong Life Insurance Co.***	Manulife (51 percent)	Sinochem	Canada	Life	Joint Venture	1996	Shanghai
Winterthur China Ltd.**	Winterthur Swiss Insurance Co.	N/A	Switzerland	Non-life	Branch	1997	Shanghai (Pudong)
	Allianz Holding	Da Zhong	German	Non-life	Joint Venture		Shanghai
	AXA-UAP	Pending	France	Life	Joint Venture		Shanghai
	Aetna International	China Pacific	USA	Life	Joint Venture		Shanghai

Note: * The first foreign insurer licensed to operate in China since 1949.

**The first European insurer licensed to operate in China since 1949.

*** The first Sino-foreign insurance joint venture since 1949.

Sources: Insurance in China (monthly faxed newsletter), London: Reactions Publishing Group Ltd., various issues.

CONCLUDING REMARKS

Insurance has an indispensable part to play in China's economic restructuring process. It is important for solving China's pension crisis created by the urgent problem of the pension burden of SOEs and the long-term problem arising from the rapid ageing of the population. It is also important for providing enhanced welfare services in China, given the limited State resources, China's level of economic development, its huge population and vast regional disparities. It enables the State to concentrate its limited resources to keep those in need above the poverty line, while permitting those with resources to take out private insurance to suit their own needs. As institutional investors, insurance companies may make significant contributions to the development of capital markets in China, especially at a time when the restructuring of SOEs into stock-holding companies requires more liquid, more stable and more transparent capital markets, when China has enormous needs for infrastructure and other long-term investments, when international capital markets are still not easily accessible to many of Chinese institutions, and when adequate returns are required for the very viability of fully-funded individual accounts. As a risk transfer mechanism, insurance makes a positive contribution to China which is prone to natural hazard risks and whose risk management record is extremely poor. Moreover, the development of

modern insurance is a requirement of China's opening up process and China's integration with the international standards.

Despite the important role that insurance might play in China's economic reform, the insurance industry in China is still very much underdeveloped in terms of both demand and supply. Present pension reform and the recent introduction of mutual fund regulations have created the necessary impetus for the commercial life insurance industry to grow in China by alleviating the two major impediments that have slowed the development of private/supplementary pension providers in the country: the high replacement rate in the pay-as-you-go system that reduced the incentives for supplementary (private) insurance provisions on the demand side and the absence of a legal framework for pension funds that has prevented the providers of supplementary pensions on the supply side. To provide further opportunities for the insurance sector to develop, competition which aims at ending the monopoly of PICC and at encouraging new insurers into the market has been introduced into the market. Foreign insurance participation in the Chinese market is also welcomed, provided that it stimulates competition, brings in know-how and upgrades the Chinese technicalities up to the international standard. Just as foreign banks have been hailed as an indispensable part of China's booming financial industry, the entrance of foreign insurance companies is expected to make similar positive effects on the development of China's insurance industry by helping to lead China into market-oriented and standardised management concepts and operational systems and means²². In fact, the arrival of foreign insurance companies has motivated local insurance companies to accelerate their restructuring pace.

Yet enthusiasm by the Chinese authorities for what the foreign insurers have to offer is tempered with caution. As remarked by Di Weiping, "Foreign insurers' skill and capacity will be necessary. But without an orderly point of entry, the impact on China's social and economic development could be disastrous" (Hadley, 1995: 21). What concerns China's Supervisory Authority most is how to create the necessary conditions for the Chinese domestic insurers to compete with foreign insurers on an equal footing. The establishment and perfection of the regulatory framework, and the healthy development of the domestic insurance industry are, thus, the top priorities. The process of opening-up to foreign insurance companies has been slow and partial, with stringent requirements for foreign entry and operations in China.

CHAPTER 3 THE REGULATORY FRAMEWORK

INTRODUCTION

China's insurance industry has been growing rapidly ever since its renaissance in 1979. The healthy development of the market warrants the control and regulation of this sector as the top priority of the Chinese fledgling insurance operations. The first and the long-awaited Insurance Law was introduced in October 1995 aiming to provide a sound legal as well as regulatory framework for fair competition and set the industrial standard for China's fledgling insurance industry. And as China has adopted a cautious approach in opening up its insurance sector to foreign participation, attention is therefore firmly drawn to the impact and possible implications of the Insurance Law on foreign insurance businesses in China.

In this chapter, the implications of the Insurance Law for foreign participation will be examined under the context of the features and inadequacy of the Insurance Law, as well as the discrepancies between the regulatory framework for the insurance industry and that for foreign participation. The impact of the regulatory framework on the entry mode of foreign insurance participation will also be examined, followed by an assessment of both the opportunities and challenges facing the foreign insurance companies under the regulatory framework. Finally, we speculate on the likely development of the regulatory framework for foreign insurance participation, drawing upon the identified parallels with the development of the manufacturing sector.

THE HISTORY OF REGULATION OF THE INSURANCE INDUSTRY

Before the Insurance Law, insurance in China was loosely governed by various laws and regulations.

- The Economic Contract Law (1981), which set forth the basic requirements of a contract, governs, amongst other industries, insurance companies' contracts — both between Chinese parties, and between Chinese and foreign parties.
- The Articles of Association for the People's Insurance Company of China (1982) established PICC's monopoly position to have the authority to transact all kinds of insurance and reinsurance — China and abroad — in response to business demand.

- The Regulations of the PRC on Contracts of Property Insurance (1983), which established not only the liabilities of both the insurer and the insured, but also the governance of economic contract law over the formation of insurance contracts.
- Interim Regulations Governing the Administration of Insurance Enterprises (1985), which authorised the PBOC as the State insurance regulatory authority²³, and granted to PICC the exclusive right to underwrite compulsory insurance, foreign currency insurance, foreign enterprises and joint venture insurance, and international reinsurance²⁴. The Regulations further provided that all insurance coverage needs, including those of foreign invested enterprises, should be furnished by insurance companies registered and authorised to operate in China. The Regulations prohibited foreign insurers from doing any business in China.
- Marine Commercial Law, 1985: the practices of maritime insurance.
- China Maritime Law, 1992: the practices of maritime insurance.
- Provisional Measures to Administer Foreign Insurance Enterprises in Shanghai (Shanghai Measures), 1992: the main provisions of the Shanghai Measures will be examined later under the regulatory framework for foreign participation in China's insurance industry.

These fragmentary laws and regulations could not lend the predictability and stability required by China's burgeoning economy and foreign trade/investment. Economic development required the enactment of a unified Insurance Law which incorporated internationally recognised practices, *e.g.* clear definitions of key insurance concepts, a codification of good faith and fair dealing, and essential details clarifying the grounds for compensation/claims should a risk occur. The unique characteristic of the Chinese court system where judgement is made on the grounds of "Heqing, Heli and Hefa" (*i.e.* according to feelings, reason and the law, and in this order) might act to the insurer's advantage in defence or prosecution of a claim (Chaput, 1995). A survey conducted by AIG in the mid-eighties found that many foreign investors were buying insurance outside China on a non-admitted basis²⁵ because the unsophisticated legal system, together with political risk, discouraged potential foreign customers from using the services provided by Chinese insurers. As the traditional intimacy of business relationships based on personal trust decreases, insurance contract has been finding an increasingly important role in business dealings. The vague contract laws, however, are ill-equipped for these changes.

In addition to the problem caused by the Chinese approach to law, a unified insurance law was required to put the insurance market under control. On the one hand, the existing market was strained to its limit by rapid economic development,

economic reforms and increasing personal wealth. On the other hand, without proper control and supervision, illegal, incompetent insurers/intermediaries and fierce price war could well have produced a nation of disillusioned policyholders, and the impact on China's social and economic development could have been disastrous (Hadley, 1995). Ushered in by the American insurer, AIA, in 1992, the individual insurance agent system, whereby individuals rather than part-time agents sell insurance policies for insurance companies, has been spreading from Shanghai to Beijing and some other big cities²⁶, which has pushed proper regulation and supervision up to the top agenda. Many so-called insurance agents without proper qualification and experience of the market have been endangering the tentative steps of China's populace into the world of insurance cover. Fraud in the individual agent system is made worse by the poor standard of services provided by specialised and part-time insurance agents, who often use their administrative power and convenience of office to create a monopoly and impose insurance policies upon customers. Matters have certainly not been helped by the cut throat rates and premium rebates offered by rival insurance companies competing for market shares, and malpractice in claim settlement. Premium rebates and commission fees have been pushed up to an exceptionally high level by insurance companies competing for market shares. Taking malpractice in claim settlement for instance, insurance companies often "negotiate" claims by taking time with settlement and only speed it up if a discount is agreed (Lancaster, 1997a, 1997c). As a result, a nation of discontented policyholders and financially unsound insurers could well endanger the healthy development of the newly revitalised insurance industry in China (Hadley, 1995; Wu, 1996). It is clear that China desperately needs to introduce standards for the conduct of insurance companies/insurance intermediaries, and to promote fair competition (Wu, 1996).

Moreover, commercialisation of China's insurance industry requires the separation of life and non-life insurance business, the separation of compulsory reinsurance business from PICC, and the separation of specialist non-commercial insurance (policy-related insurance) from commercial insurance.

- The Separation of Life and Non-life Insurance Business

Composite insurance is detrimental to the modernisation of China's fledging insurance industry. Before the introduction of the Insurance Law, the insurance companies in China, though limited in number, were all composite insurers. An insurer operating both lines of insurance businesses had thrown the use of funds and management into confusion and chaos because of different policy periods, and had led to the allocation of savings of life policyholders to make up the losses incurred on other classes of insurance (Di, 1995). Commercialisation of the insurance industry requires

the separation of life and non-life insurance which entails the basic principle of companies (subsidiaries) specialising in different sectors of the market being accountable for their own losses and profits. As indicated by Di Weiping, the separation of life and non-life insurance business will eradicate the long-standing malpractice in China's insurance industry, and clarify the boundary between life and non-life insurance businesses (Di, 1995).

- The Separation of compulsory reinsurance business from PICC

The introduction of competition mechanism urges the removal of compulsory reinsurance from PICC to an independent national reinsurance company, and the development of reinsurance market in China. Before the Insurance Law was enacted, PICC enjoyed a compulsory cession of 30 percent of all non-life insurance business written by insurance companies in China. This had given rise to a conflict of interest between PICC and its competitors in terms of underwriting rate and information. It had also hindered the development of reinsurance capacity in China (Hadley, 1995).

- The Separation of specialist non-commercial insurance (policy-related insurance) from commercial insurance

Fair competition and commercialisation also necessitate the separation of specialist non-commercial (policy-related insurance, such as agriculture and export credit) from existing companies such as PICC (Di, 1995).

THE 1995 INSURANCE LAW

The Insurance Law came into effect on 1st October 1995. It was China's first ever unified Insurance Law, and 'a codification of internationally recognised insurance principles and the first attempt to create a comprehensive regulatory structure for China's burgeoning insurance industry' (Clifford Chance, 1995). The law is all-encompassing, containing 152 articles in 8 chapters covering all aspects of insurance industry²⁷. The Insurance Law

- Created a national regulatory framework
- Required insurance companies to sustain a high level of liquidity
- Clarified the legal liabilities of companies
- Separated life and non-life insurance, commercial business and specialist non-commercial covers
- Contained clear definitions of core insurance concepts, and the rights and liabilities of insurers and policyholders.
- Defined the concept and code of conduct of insurance agents and insurance brokers

- Provided fair competition

National Regulatory Framework

The Insurance Law provided that all insurance activities carried out within the territory of the PRC shall be subject to the application of this law (Article 3). Legal persons and other organisations in the territory of the PRC shall insure with the insurance companies within the territory of PRC if they need to arrange insurance. Only insurance companies established in accordance with the Insurance Law were allowed to underwrite commercial business (Article 5 and 6). The Law designated the Department for the Supervision and Regulation of Finance under the State Council as the Supervisory Authority responsible for the supervision and regulation of the insurance industry (Article 8). It was vested with a wide range of regulatory and supervisory powers, such as

- The power to draft and determine the basic terms of insurance policies and rates of premiums of main classes of commercial insurance (Article 106).
- The power to inspect the business affairs, financial position and utilisation of insurance funds of an insurance company (Article 107); The power to carry out rectification (Article 109-112); The power to assume management (Article 113-115); And the power to apply to the people's court for the liquidation of an insurance company (Article 116).

High Level of Liquidity

Insurance companies were obliged to maintain no less than four types of reserve funds and a number of protection funds, to reinsure 20 percent of all risks (life insurance only), and to adopt a conservative investment approach.

- Stipulation on various reserve funds, guarantees, and insurance protection fund

The Insurance Law required that insurance companies allocate certain amounts of reserve fund, including contingent liability reserve fund and outstanding claim reserve fund, in accordance with its retained premium, no matter what type of business the insurance company is engaged in. Insurance companies were also required to set aside such sums as required by the Supervisory Authority to the insurance protection funds, which shall be centrally administered and used in a unified way (Article 96).

- Stipulations on minimum margins of solvency

Article 97 of the Insurance Law stipulated that the excess in the value of an insurance company's assets over the amount of its liabilities may not be lower than the

levels prescribed by the Supervisory Authority. In the event an insurance company fails to meet its minimum solvency margin, it will have to inject capital to make good the shortfall. By virtue of Article 98, retained premiums in the current financial year of insurance companies engaging in property insurance must not exceed four times the total amount of its actual assets and accumulation funds.

- **Stipulations on reinsurance**

The Insurance Law required the insurance company to arrange reinsurance if a risk unit exceeds 10 percent of its actual capital assets and social reserve funds. By Article 99, a risk unit is the maximum risk which can possibly be caused by the occurrence of an insured event. Furthermore, insurance companies, except for those engaged in life insurance business, shall procure reinsurance for 20 per cent of the risks they undertake in each policy in accordance with the regulations of the State (Article 101). The Insurance Law further provided that, where an insurance company needs to procure reinsurance covers for the risks it has undertaken, insurance companies within the territory of the PRC shall be given the priority to underwrite such reinsurance business (Article 102). The priority was defended by Article 103 which empowers the supervisory Authority to restrict or prohibit insurance companies from placing reinsurance business with insurance companies outside China, or to underwrite reinsurance business from the overseas market.

- **Stipulations on the permitted investment activities of insurance companies**

In light of China's weak stock market and its stringent monetary policy, the Insurance Law prohibited insurance companies from engaging in securities trading or investing in enterprises. It restricted investment by insurance companies to low risk and relatively stable activities (Article 104) — fixed deposit with the banks, the purchase of government or financial bonds, and other forms of investment as prescribed by the State Council.

Legal liabilities of Insurance Companies

In the event an insurance company fails to meet the required liquidity, the Insurance Law authorises the Supervisory Authority to take a range of actions, depending on the nature and seriousness of the breach. These actions include orders to rectify the violation, restriction of business scope, suspension of undertaking a new business, termination of the license, confiscation of unlawful proceeds, levying fines, and criminal prosecution if the violation constitutes a criminal offence.

Separation of Life Insurance and Non-life Insurance, Commercial Business and Non-commercial Business

By virtue of Article 91, a newly set-up company can write life or non-life insurance, but not both, and insurance companies established before the law comes into effect shall separate their business scope according to the implementing measures made by the State Council. Furthermore, insurance regulated by the Insurance Law is commercial insurance, whilst specialist non-commercial insurance, such as agricultural insurance and other insurance institutions other than the insurance companies provided in this law, shall be regulated by laws and regulations to be adopted (Article 2, 5, 149 and 150).

Codification of Rights and Liabilities

The Insurance Law provided important definitions to core concepts, such as insurance contract, policyholders, insurer, insured, insurable interest, subject matter insured, beneficiary, indemnity (insurance proceeds), subrogation, reinsurance, property insurance and life insurance, and so on. A significant part of the Insurance Law was devoted to the codification of the rights and liabilities of policyholder and insurer, e.g. the principle of utmost good faith, such as honest disclosure; the principles of fairness and mutual benefit, mutual consent through consultation and freedom of contract; subrogation; average; double insurance benefits; the killer beneficiary.

Code of Conduct for Insurance Agents and Insurance Brokers

The Insurance Law defined the role of insurance agents (Article 122) and insurance broker (Article 123), and held the insurance company responsible for what the insurance agent has done in arranging insurance business on its behalf (Article 124)²⁸. It subjected agents and brokers to broadly similar regulation of the Supervisory Authority in terms of being properly licensed (Article 127), establishing account for inspection (Article 128, Article 107 and Article 117). The Law prohibited insurance agents and insurance brokers from using administrative power, power of office, professional privilege and convenience or other improper means to force or induce the policyholder to conclude an insurance contract, or restrict the policyholder in its arrangement of insurance (Article 126). It also prohibited insurance agents and insurance brokers from deceiving the policyholder, insured or the beneficiary, from concealing important issues in respect of the insurance contract from the policyholder, from obstructing the policyholder from performing its obligation to make honest disclosure as provided in the Insurance Law, or inducing or misleading the policyholder

not to perform such obligation (Article 105). Where an insurance agent or broker deceives the policyholder, insured or beneficiaries, they were subject to fine, revoking of the Permit for Conducting Insurance Agency Business or Brokerage Business, and even criminal liabilities if the violation constitutes a criminal offence (Article 133).

Promotion of Fair Competition

The Insurance Law provided that insurance companies shall observe the principle of fair competition (Article 7). It prohibited insurance companies and insurance intermediaries from engaging in improper competition by promising to pay the policyholders, insured and beneficiaries premium rebates and other benefits in addition to those provided in the insurance contract (Article 105).

THE 1996 INTERIM PROVISIONS

Pursuant to the Insurance Law, Interim Provisions were promulgated by the PBOC and were effective on 1st May 1996. The Interim Provisions reiterated the ethical requirements of the insurance agents. It also set down implementing provisions regarding the qualification and licensing, as well as penalty provision for those who violate the regulations. Moreover, provisions were made to safeguard the independence of the agency companies and alleviate administrative interference which is prevalent in China's agency system (Article 22 and Article 37).

THE REGULATORY FRAMEWORK FOR FOREIGN PARTICIPATION

Although the Insurance Law was the first unified legal framework for China's insurance industry, it did not provide a clear regulatory framework for foreign participation.

Legislation regarding representative offices — the most common mode of entry for foreign insurers using the establishment as a initial presence in the Chinese market — dates back to the Interim Regulations for Control of Resident Representative Offices of Foreign Enterprises in China (1980 Interim Regulations), which became effective on 30th October 1980. The regulations introduced a basic system for the approval and registration of representative offices which have, over time, been supplemented by many more detailed national and local regulations on matters such as employment of staff, taxation of the office and its staff, foreign exchange control, continuing reporting requirements, use of company names, and visas²⁹.

The 1980 Interim Regulations and the subsequent legislation have restricted the activities of representative offices, both in function and in location. The representative office was limited to liaison-type activities of a non-profit making nature. Technically representative offices should not negotiate or sign contracts, engage in trading activities, or be directly involved in financing transactions³⁰. Article 8 of the 1991 PBOC Procedures for the Administration of the Establishment of Resident Representative Offices in China by Financial Institutions with Foreign Investment (The 1991 Procedures) stipulated that the work of resident representative offices of foreign financial (including insurance) institutions should be limited to non-profit activities such as consultation, liaison and market investigation. The representative office is not allowed to engage in business operations on behalf of its parent company's Head Office agencies, including those in China. Although a certain level of trading or business activities in some industries has been tolerated by the Chinese authorities owing to the practical difficulties in delineating pure liaison-type activities and profit-making activities, such tolerance has certainly not been the case for the representative offices of foreign insurance companies and other financial institutions³¹. These foreign financial institutions have been subject to special rules and extra restrictive controls, and their business development in China has been severely circumscribed.

Special rules apply also to the location of representative offices of foreign financial institutions. The 1991 Procedures restrict their location to 14 open cities³². Moreover, the restrictive regulation regarding the operation of foreign financial institutions was also evident in the extra documents required for registration. In accordance with Article 4 of the 1986 Provisional Regulations of Shanghai Municipality concerning the Control of Representative Offices of Foreign Enterprises, a banking, insurance, or stock exchange institution which desired to establish a resident representative office should, apart from submitting the documents and reference materials specified for other foreign institutions, submit at the same time an annual report on the accounts, liabilities, profits, and losses of the head offices of the enterprise, its contribution, and the composition of its Board of Directors.

Foreign equity participation in the Chinese insurance industry was totally banned under the 1985 Provisional Regulations Governing the Administration of Insurance Enterprises. In 1992, however, Shanghai was selected by the Chinese Government as an experimental zone to test the impact of foreign participation, and AIA became the first foreign insurer to be granted a license to underwrite both life and non-life insurance. The so-called Shanghai Measures were introduced to provide a

legal framework for the supervision of foreign insurance companies, and these imposed strict entry requirements:

- three years' experience through a representative office in China;
- thirty consecutive years of experience in the insurance industry;
- total assets in excess of £5bn (US\$7.94bn);
- corporate structure in the form of a joint venture or a branch office, but wholly-owned subsidiaries were not permitted.

The major intention of admitting foreign entrants on this strictly controlled basis, with a particular emphasis on quality and financial strength, was to ensure that foreign participation would help to bring in know-how, to stimulate healthy competition, and to protect potential policyholders.

THE DISCREPANCIES BETWEEN THE INSURANCE LAW AND SHANGHAI MEASURES

The 1995 Insurance Law was designed to control China's insurance industry, rather than encouraging the openness of the industry (Lewis, 1995; Clifford Chance, 1995). Foreign participation was only mentioned in the Supplementary Provisions of the Insurance Law. Article 148 provided for the Law to apply to the establishment of an insurance company with an investment of foreign capital, and to the establishment within the PRC of branch offices of foreign insurance companies. Where other laws and regulations provide otherwise, such laws and regulations shall apply. The Shanghai Measures were, therefore, acknowledged as the principal legal framework for the supervision and regulation of foreign insurance companies. There are, however, many discrepancies between the stipulations of the Insurance Law and those of the Shanghai Measures. And various amendments to the Shanghai Measures are being introduced in accordance with the basic principles of the Insurance Law. These have given rise to considerable confusion and uncertainty, and may well have been detrimental to the growth of foreign insurance business, as well as being incompatible with the major principles of the General Agreement on Trade and Services (GATS) (Wu and Strange, 1998).

The minimum registered capital requirements for insurance companies under the Insurance Law are much higher than previously required by the Shanghai Measures. The Law provided for a minimum registered capital of RMB200 million (approximately US\$25 million) which must be fully paid up. In contrast, the Shanghai

Measures permitted foreign insurance companies a lower minimum registered capital of US\$20 million of which only 50 percent needs to be fully paid up.

In spite of the same provision for non-life insurance companies, the Insurance Law and Shanghai Measures were different in their requirements of minimum margin of solvency for life assurance. Under the Insurance Law, the minimum levels of the balance between the asset values of insurance companies and the amount of their liabilities would be set out by the Supervisory Authority. The Shanghai Measures, in contrast, provided a concrete margin, by which long-term life assurance reserves should not be less than total insurance liabilities. An additional provision of a minimum margin of solvency in the Insurance Law was the provision on the upper limit of the retained premium in the current financial year. There was no such stipulation in the Shanghai Measures.

Moreover, under the Insurance Law, the terms and rates of main classes of commercial insurance are determined by the Supervisory Authority. In contrast, the Shanghai Measures entitled foreign insurance companies to formulate their own insurance premium rates, other business charges, and various contractual terms and conditions, in accordance with the applicable rules of the PBOC.

In addition, the 1995 Insurance Law confined investment vehicles employed by insurance companies to specific low risk and long-term investment activities. The ratio of the total amount of funds of an insurance company used in investment to its total assets, and the ratio of the funds used in a specific kind of investment to the total assets of the company should also be prescribed by the Supervisory Authority. In contrast, the Shanghai Measures not only allowed foreign insurance companies to invest in those relatively stable areas stipulated in the Insurance Law, but also permitted them to engage in more volatile and short-term investment activities of securities trading and enterprise investment — corporate bonds (a maximum of 10 percent of their total investment fund), loans (to a maximum of 30 percent of their total investment fund), and stocks and shares (to a maximum 15 percent of their total investment fund).

Marked differences were also exhibited on the stipulations on various reserve funds, guarantees, and insurance protection fund³³; stipulations on reinsurance³⁴; insurance business³⁵; corporate form³⁶, and the power of Supervisory Authority³⁷.

It is not yet clear how, and indeed whether, these discrepancies will be removed. The main features of the current regulatory framework for foreign participation may be summarised as follows:

- stringent preconditions³⁸: two years' experience through a representative office in China (as compared to the three years required under the Shanghai Measures);

demonstrated financial prudence and a long history of conservative operation. It has been reported that specific regulations will be enacted regarding the establishment of foreign insurance companies in China (Clifford Chance, 1996a) .

- a ban on wholly-owned subsidiaries in order to protect China from undercapitalised foreign insurers.
- a requirement of Sino-foreign joint venture for life insurance.
- a limited number of possible locations: formerly only Shanghai, but extended to Guangzhou and the surrounding areas.
- the paramount importance of the goodwill of the Chinese authorities: applicants who satisfy the preconditions are not necessarily granted operating licenses (Clifford Chance, 1996a).

The rules for foreign entry were thus loosened somewhat. By the year 2000, according to PICC, China will open all of its main coastal cities for foreign insurers (World Insurance Report, 1995).

THE DISCREPANCIES BETWEEN THE REGULATORY FRAMEWORK AND GATS PRINCIPLES

The Insurance Law and the associated modernisation of China's insurance industry can be viewed as a part of China's long-time campaign to resume contracting party status of GATT and to join the WTO³⁹. China has been campaigning for its GATT/WTO membership for 12 years without success, even though most of the WTO members are pressing for China to be upgraded from its current observer status to full founder membership. One of the major obstacles is the discrepancies between the regulatory framework of the Chinese insurance industry and GATS.

GATS is a multilateral treaty based on the following trading principles derived from GATT negotiations (Kakabadse, 1992).

- Non-discrimination among members [most-favoured nation (MFN) treatment], whereby all signatories to the agreement must be given the most favourable trading terms available to other trading countries. That means concessions granted to one nation will be automatically granted to others. This is the fundamental principle of multilateral trading system.
- National treatment, which entails equal treatment of foreign and domestic services companies.
- Transparency and predictability of rules and regulations affecting trade in services.

- Progressive lowering of trade barriers (full market access), which contains both obligation and flexibility for former centrally planned economies to prepare their domestic insurance industries for foreign competition. Where a member undertaking a specific commitment to maintain or adopt market access measures as part of its domestic regulation, these commitments should be listed in its National Schedule as limitations on market access which should, over time, be negotiated away. Market access measures which must be scheduled include the limitations on the number of service suppliers, the size of domestic market available for foreign suppliers, cross-border transactions, as well as the restrictions on the types of legal entity through which a service supplier may provide a service.

The major principles of GATS were reinforced by the multilateral deal which was completed on the 27th July 1995 in Geneva in order to liberalize financial services. The EU-inspired Geneva Interim Accord guaranteed a measure of foreign access, for the first time, on a non-discriminatory MFN basis to banking, securities and insurance markets in more than 90 countries which accounted for over 90 percent of the world's financial business⁴⁰, even though the scope of multilateral market access was restricted by limited US participation on its bilateral reciprocity footing⁴¹.

The US has adopted an "all-or-nothing" approach to China's campaign⁴². Apart from insisting on China being treated as a developed country, the US has laid out a "road map" identifying six key areas where substantial disagreements remain between China's regulatory framework and GATS⁴³. In particular, China was pressed to make more adventurous commitments towards opening its services sector, including the participation of foreign banks, insurance companies and other service-oriented businesses. This area is regarded as a key test of China's commitment to market liberalisation, as well as "the biggest hurdle" for China's accession to the organisation (EIU, 1996).

As pointed out by the US, there are, indeed, considerable discrepancies between the regulatory framework of China's financial industry and GATS principles. In the case of insurance services, these inconsistencies exist in the following areas:

First, a big gap remains in the areas of national treatment and transparencies of trading rules.

- There are numerous disagreements between the stipulations of the Insurance Law which regulates China's domestic insurance companies and those of the Shanghai Measures which control foreign insurance companies operating in China.
- Additionally, it is still unclear what amendments to the Shanghai Measures have been/will be made by the Supervisory Authority in accordance with the Insurance Law, even though Article 148 of the Insurance Law States that the Shanghai

Measures will apply where these disagreements occur. Unless this conflict is resolved, foreign insurance companies will be left with a maze of regulations to puzzle about.

- Moreover, a long-lasting monopoly on reinsurance would be protected in China's insurance industry by PBOC through its authorisation of 20 percent compulsory reinsurance cession to the reinsurance company currently under the control of China Insurance Group and to a new national reinsurance company when it is established in the future. Monopoly in reinsurance, together with the national preference stipulation, is claimed to be contrary to both the principles of GATS and the best interests of the market. It is argued that concern over the competitiveness of the national industry and the domination of foreign insurers/reinsurers should not prevent China from getting the experience and expertise which are needed by China's direct insurers to provide adequate and professional cover for the increasingly complicated insurance demands in China (Reactions, 1996a).

Second, according to the US WTO negotiator, China's insurance market is opening up at the slowest possible pace both in terms of the removal of barriers to the establishment of foreign or foreign-owned insurance companies, and restrictions or other measures detrimental to the placing of insurance or reinsurance with insurers established abroad:

- Market access to China's insurance market is carefully restricted to a handful of foreign insurers and confined to two cities throughout the country. In addition, limitations are imposed on cross-border transactions that 20 percent compulsory reinsurance must be placed with the State reinsurer, with the rest reinsured with companies inside China on a priority basis.
- The Insurance Law confined the insurance arrangement of legal persons and other organisations in the territory of the PRC to the insurance companies operating within the territory of PRC. The legal entity of foreign insurers operating in China is constrained to branch offices or joint ventures, with foreign subsidiaries banned.

THE IMPLICATIONS OF THE INSURANCE LAW FOR FOREIGN PARTICIPATION

The regulatory framework established by the Insurance Law and its implementing regulations, the carefully-controlled and slow opening-up process of the insurance industry, as well as the substantial discrepancies between the regulatory framework of China's regulatory framework for foreign insurance companies and the

principles of GATS, have serious implications for foreign participation in China's insurance industry.

A local presence is required by the regulatory framework, as it outlaws non-admitted insurance and restricts overseas reinsurance. By the Interim Provisions, insurance agents may only act for the insurance services of the insurance companies established with the approval of the PBOC (Article 47). And insurance agents may only handle insurance services for registered insurance companies within their administrative jurisdiction (Article 49). If an insurance agency acts as an agent for an insurance company which has not been approved by the PBOC, it can be ordered to rectify the situation by the PBOC and its illegal income can be confiscated. A fine of RMB 5,000-10,000 yuan for an individual, or a fine of RMB 10,000-50,000 yuan for the unit, may be imposed. In serious cases, the agency may be ordered to close down or its "Qualification Certificate for Insurance Agents" and "License for Conducting the Insurance Agency Business" may be revoked (Article 1).

In addition, the entry mode of foreign insurers is further circumscribed to joint ventures or branch offices for foreign non-life insurers and joint ventures for foreign life insurers. Whilst in the past, the PBOC had favoured branches of foreign insurance companies, the need to put foreign insurers under firm control and the need to promote the transfer of know-how without losing market share has prompted the Supervisory Authority to restrict the availability of licenses as a whole, and to grant licenses to Sino-foreign joint ventures, especially in the case of life insurance. The overwhelming dominance of AIA in Shanghai life insurance market could only have exacerbated the Chinese fear over foreign dominance (Wu, 1996). The reasons are twofold. Wholly-owned foreign branches are not legal entities under Chinese law, and their business in China cannot easily be controlled and managed by the Supervisory Authority. Furthermore, joint ventures are preferred by the Chinese authorities, because this mode enables domestic companies to increase their industry knowledge without substantial start-up investment or a prolonged learning curve. It can bring the timely provisions of insurance cover in China, providing security to individuals who are moving away from the Government provided safety net (Wu, 1996). At the moment, the joint venture partners on the Chinese side are restricted to insurance companies and financial institutions in China. Likewise, Chinese life insurers are encouraged to forge joint ventures with foreign insurers in order to get a license.

The regulatory framework, nevertheless, has created promising opportunities for foreign participation in China's insurance market. Although the Insurance Law was primarily designed to control the development of China's domestic insurance industry,

rather than to encourage the openness of the industry, it creates a more certain environment embracing international practice and thus prepares the conditions necessary for foreign participation.

By enhancing the Chinese awareness of the benefits of risk management, as well as the qualification and professionalism of insurance companies/insurance intermediaries, the Insurance Law and the implementing regulations will facilitate the healthy development of China's fledgling insurance industry, and in turn provide foreign insurers with a better environment in which to operate. Lack of awareness of the benefits of risk management has been revealed as one of the main problems for foreign insurers to overcome in their China operations (Taylor, 1996). Article 35 of the Insurance Law imposed an obligation on the insured to observe all regulations on fire prevention, safety, production, operations and labour protection. An insurer can make recommendations and if these are not followed then the premium can be increased or the policy terminated. This provision will create a need for loss control and/or risk management skills within China. This, together with provisions on qualification/professionalism of insurance companies/insurance intermediaries, and provisions on the promotion of fair competition, will certainly be beneficial for foreign insurance operation.

The Insurance Law and the implementing regulations have also created challenges for foreign participants to overcome in their China operations. The legal requirements will affect capital injection, innovation, trading results, and the speed of business development.

- Large injections of capital are required to meet not only the high minimum registered capital levels, but also the high levels of liquidity. "The solvency margin requirement will act as a brake on development as this will require \$1 of capital for every \$3 of premium. To write £300 million of premium this will be backed by \$100 million of capital. Whilst some of this will be achieved from retained profits, a competitive environment, cost of set up taxes, *etc.* will require continuing allocation of capital from the parent" (Lancaster, 1997a: 42). In addition to the minimum fully paid up registered capital of RMB200 million (approximately US\$25 million), insurance companies are required to maintain no less than four types of reserves [unearned premium reserve, 50 percent for non-life insurance, and an amount equivalent to the total net value of the life insurance policies for life insurance; loss and loss adjustment reserve, including IBNR (Incurred But Not Reported Loss) and RBU (Reported But Unpaid Loss); and Accumulated Reserve], a number of protection funds, minimum margin of solvency, retained premium (net premium) (not exceed

four times the total amount of paid up capital and accumulated reserve), net retained risk (not exceed 10 percent of paid up capital and accumulated reserve), and 20 percent reinsurance for non-life insurance companies.

- The standardised tariff rate might affect foreign insurers' innovative approach. Whilst a standardised tariff system is necessary for protecting domestic insurers and ensuring the market order, it also inhibits innovation and protects the least efficient.
- The conservative approach to investment might affect the trading result (operating profit/loss) of foreign insurance companies. Insurance operations generate large amounts of funds for investment, primarily loss reserve, loss adjustment reserves, and unearned premium reserve. The long delay inherent in life insurance between the cash disbursement and cash receipt, as well as the long delay inherent in the liability loss adjustment process, generate very large loss reserves⁴⁴. This large sum of loss reserve can be used to generate investment income which consists of interest, dividends, and rents derived from bonds, stocks, real estates, and other assets held for investment purposes. The insurer realises capital gain from its investment asset by selling it for more than its cost. In view of the limited investment mechanisms available for foreign insurance companies, opportunities for creative or innovative investment strategies would be limited. Investment income will therefore be limited, and foreign insurers would have to rely more on underwriting profit.
- The success of an insurance company, to a considerable degree, depends on the performance of its agents (Huggins and Land, 1992). The agents are the intermediaries through which insurance products are delivered to the ultimate consumer. The daunting task of training, managing and auditing agents means a slow and costly process of building a distribution network for foreign insurance companies. Both the Insurance Law (Article 124) and the Interim Provisions (Article 2) hold the insurer responsible for the conduct of the insurance agents who act on behalf of, and under the authorisation of the insurer in providing insurance services. In reality, there is a general deficiency in insurance professionalism in China, manifested by rampant misrepresentation, and illegal rebating (Wu, 1996; Lancaster, 1997a, 1997c). This, together with the underdeveloped nature of the insurance intermediary system in China, results in an expensive and time-consuming process to develop and manage the distribution network for foreign insurance companies.
- The slow licensing process and the restrictive geographic confinement means the expansion of foreign operations has to be slow and patient, innovation will be geographically limited in line with the regulatory framework. Access to the whole China market is sought by most foreign insurers. However, the restricted current

regulatory framework and the precedent established with the entry of foreign banks in China make this unlikely. According to Article 79 of the Insurance Law, an insurance company requires the approval of the Supervisory Authority before establishing any branch offices within or outside the territory of the PRC and shall obtain insurance licenses for these branch offices.

CONCLUDING REMARKS

Though the Insurance Law is aimed at the regulation of China's insurance industry, instead of the operation of foreign insurance companies, it has serious implications for foreign participation in China's insurance industry. By bringing China's insurance industry under a more uniform and stricter regulation which embraces international practice, the Insurance Law creates a more stable, more certain operating environment for foreign insurers. The ban on non-admitted insurance and restrictions on overseas reinsurance make FDI the only effective mode to tap the huge potential of the Chinese market. The realisation of the potential, however, requires a long-term commitment with substantial capital injection, tremendous patience and hard groundbreaking work. The ongoing capital to meet the high liquidity requirement, the limited investment income, the pains taking process of developing and managing a distribution network, and the severely restricted operation scope may well be hard to reconcile with the other objectives of foreign insurers. Foreign insurers would have to balance the long-term approach to China with their shareholders' demand for quick and improving returns. They would also have to ration scarce capital with the competing opportunities in other markets such as India, Indonesia, Eastern Europe, and Latin America. The rationing is especially difficult to make when insurers' global profitability has been hit by prolonged unprofitable results, and by exposure to major global catastrophes, and when there is limited amounts of reinsurance cover to insulate global insurers against such catastrophic losses (Lancaster, 1997a, 1997b).

By drawing attention to the discrepancies between the stipulations of the Insurance Law and those of the Shanghai Measures, it has been shown that there is presently no unified and clear provision on foreign insurance participation. The considerable confusion and uncertainty may well have been detrimental to the growth of foreign insurance business in China, as well as being incompatible with the major principles of GATS. Moreover, in many ways, the Insurance Law is only the skeleton or framework. The full extent or direction the regulators will take, will not be defined in detail until the Regulations are announced (Lancaster, 1997c). Much has been left to be dealt with according to administrative rules and regulations. And further

implementing regulations are needed for the implementation of the principles laid down by the Insurance Law. Examples are:

- agricultural insurance (Article 49);
- specialist non-commercial insurance (Article 150);
- insurance brokerage regulations;
- the ratio of the total amount of funds of an insurance company used in investment to its total assets, and the ratio of funds used in a specific kind of investment to the total assets of the company;
- the sums of insurance protection funds, social reserve funds, and minimum margin of solvency for life and non-life insurance companies of different operation scales;
- basic terms of policies and rates of premiums for the main types of commercial insurance;
- the exact meaning of “priority” basis upon which insurance companies requiring outward reinsurance are required to deal with insurance companies within the PRC.

It is, however, important to recognise that the development of the insurance industry in China and in particular the perfection of its legal framework is a lengthy process. The reasons are threefold. First, it takes time to establish an effective supervisory mechanism. “A lack of suitably trained personnel and administrative capacity often makes it difficult for developing countries to adopt finely-tuned policies towards the development of the services sector. As a result, economic regulations of service industries in many developing countries tend to be of a broader nature” (UNCTC, 1989: 132). Second, it takes time and supervisory technicalities to implement the existing provisions, and to develop the new implementing regulations to alleviate the inadequacy of the existing regulatory framework. Considerable supervisory work, for instance, has yet to be done to stop the malpractice of insurers violating the liquidity provisions in a desperate attempt to grab market shares, and to formulate implementing procedures for combating unfair competition and misconduct in claim settlement, premium rebate and false documentation etc⁴⁵. Third, the modernisation of China’s insurance industry is an integral part of China’s economic reform. Where economic development and reform provide great momentum and potential for the development of China’s insurance industry, they also dictate the pace of liberalisation of this industry. It will be a steady process to build up the competitiveness of China’s domestic insurers.

Among the developed economies, the UK insurance sector is regarded as one of the least regulated markets where self-regulation is the key to the supervision of insurance operations (Finsinger and Pauly, 1986). The principle of self-regulation, achieved through self-regulatory organisations formed by trade associations and

companies, is generally recognised as preferable to government regulatory/intervention mechanisms, as it helps to promote fair competition, maximise market efficiency and most importantly, provide consumers with a wide choice of quality service (Tapp, 1986). At the same time, it has been argued that, only when a marketplace reaches this level of maturity, will it be able to materialise and safeguard the guiding principles promoted by GATT/WTO. However, it must be emphasised that this form of regulation should be, and can only be, achieved in the right market environment where there is a well developed mature industry in addition to a sophisticated legal framework (Wu and Dou, 1996).

In this regard, the evolution of China's insurance industry and the major features of the Insurance Law illustrate that the establishment and perfection of the regulatory framework should be a top priority of China's insurance industry. Foreign participation is presently encouraged to serve the needs of helping to bring the regulatory framework to the internationally recognised standard and to assist in modernising major Chinese players in the insurance sector, instead of competing with them. It is only when a properly regulated market has been established, and the competitiveness of domestic companies has been enhanced can the deregulation of foreign participation in China's domestic market be expected. The discrepancies between China's insurance regulatory framework and GATS can only be phased out at a cautiously controlled pace compatible with the maturing of China's domestic insurance market (Wu and Dou, 1996). The Chinese authorities have stated that the insurance market will open up fully to competition, but only when the domestic insurers can compete on an equal footing with the foreign insurers (Wu, 1996). And this is the fundamental principle of China's WTO campaign.

Given that the introduction of "national treatment" to foreign insurers and the opening-up of the insurance sector may hit hard the fledgling indigenous insurance industry, the Chinese Government has thus been adopting a carefully controlled steps towards foreign insurance participation. The pattern of liberalisation, however, appears set to follow the gradualist approach witnessed in manufacturing: from special economic zones (SEZs) and open cities to an all-round opening of the whole country; from joint ventures to a more liberal approach permitting wholly foreign-owned ventures; from centralised control of the allocation of operating licenses to decentralised local autonomy; from strategically less important sectors to strategically important sectors. The opening of Shanghai and Guangzhou as experimental zones for foreign insurance participation bears resemblance to the establishment of SEZs to test the effect of China's first opening up to the outside world. The Chinese Government's pledge to open the other coastal cities to foreign insurance operation at the end of the century reminds us of the second step towards further opening up of the country when

the SEZ confined experiments prove successful. To provide another example, there is a clear parallel between the requirement for foreign insurers to prove themselves worthy of an operating license through two years' operation of a representative office, and the requirement that foreign car manufacturers demonstrate their worthiness to be a partner in a joint venture through the prior establishment of parts, *etc.* production (Wu and Strange, 1998).

CHAPTER 4 INTERNATIONAL TRANSACTIONS IN INSURANCE: THEORETICAL CONSIDERATIONS

INTRODUCTION

International transactions in insurance can be achieved by direct insurance and reinsurance through arms-length frontier trade⁴⁶, through non-equity agreements (e.g. franchise or management contracts) where the insurer/reinsurer appoint agents in foreign countries with binding powers to underwrite business on its behalf, or through foreign direct investment (FDI) when the insurer/reinsurer establishes its own branch office or subsidiary in the foreign country. The academic literature regarding international insurance has, to date, been founded largely on the development of risk theory with universal application and on governmental barriers to trade in insurance (Carter and Dickson, 1977, 1992; Bar-Niv and Blackelhaupt, 1981; Skipper, 1987). Those scholars who have discussed FDI theory have done so with a broad brush. That is, they have examined the dichotomy of services as opposed to manufacturing industry. Little has been done on the FDI theory of a specific service industry such as insurance. This chapter intends to fill this gap by developing a theory of FDI in the insurance industry based on Dunning's eclectic paradigm.

We begin with a review of the eclectic theory of FDI in services which identifies the distinctive features of services and examines the tradeability of services across national borders. A theory of FDI in the insurance industry is then developed with a discussion of the special features of the insurance industry that set it apart from other services, and of the differences between different types of insurance. Special attention will be given to the impact of the special features of the insurance industry and political/legal restrictions on international trade and FDI in insurance.

THE ECLECTIC THEORY OF FDI IN SERVICE INDUSTRIES

International involvement in services usually takes one of three forms: (a) the export of final service; (b) intermediate services sold to independent buyers, which include the services of technology, marketing, management skills, etc., transacted through non-equity licensing or other contractual agreements; or (c) FDI which embraces the sales of services produced by foreign affiliates of MNEs.

Current explanations of FDI in service industries are based on Dunning's eclectic theory, which is derived from the existing theories on FDI in manufacturing (Hymer, 1960; Vernon, 1966; Kindleberger, 1969; Johnson, 1970; Dunning, 1977, 1979; Hakansson, 1979; Ozawa, 1979; Giddy and Young, 1982; Robock and Simmons, 1983; Kolde, 1985; Casson, 1990). Dunning's eclectic theory of service FDI is based on the famous OLI paradigm (Ownership, Location and Internalisation) (Dunning, 1977, 1979, 1989; Dunning and McQueen, 1981; Dunning and Norman, 1987). The OLI paradigm suggests that the proprietary ownership-specific advantages of MNEs offset the extra costs, *vis-à-vis* indigenous firms, of operating in a foreign country.

Given the limited tradeability of many services, the foreign country often has obvious location advantages. And, as there are imperfect markets for many intermediary products, MNEs will often choose to transfer intangible knowledge assets within their organisational structures in order to protect their ownership advantages and avoid transactions costs. This necessity to internalise the transfer of intangible assets is particularly acute for service MNEs due to the distinctive characteristics of service activities, and the vital need for quality control and customisation.

It is the interaction between the ownership advantages of MNEs, the location advantages of potential host countries, and economies of common governance of cross-border activities that accounts for the extent, pattern and growth of international involvement of service firms.

Ownership Advantages

The ownership advantages of service MNEs can be ascribed to their strength in number of areas.

Economies of scale bestow service MNEs with the advantages of risk spreading and economies of common governance. Economies of common governance lead to the efficient integration of economic resources and a concomitant reduction in transaction costs. It enables firms to provide a wide range of services at lower marginal cost, to move people, money and information between different parts of the same organisation, and to take advantage of differential factor costs and environmental flexibility (Dunning, 1989, Enderwick, 1989).

Scale economies are particularly valuable in those sectors characterised by relatively high fixed-cost and comparatively low operation costs. It is argued that ownership advantages in essence are monopolistic advantages which are typically

based on proprietary product or process technology emanating from R&D (Casson, 1990). These monopolistic advantages by nature involve high fixed costs and comparatively low marginal cost of use (Pearce, 1991). Classical examples are proprietary R&D intensity, managerial competence and advertising intensity, which are very expensive to create, but relatively cheap to use at home or transfer to overseas markets (Casson, 1990).

Size and scope not only erect monopolistic barriers for market entry, but also make service MNEs more able to enter new markets. In parallel with research findings in the manufacturing industries which suggest a stronger FDI propensity for large firms (Horst, 1972; Bergsten, et al 1978; Grubaugh, 1987; Culem, 1988), researchers have identified firm size as an important variable in the international behaviour of several service industries such as banking and advertising (Ball and Tschoegl, 1982; Terpstra and Yu, 1988).

Thanks to their economic scale and scope, MNEs are typically capable of acquiring, assembling, storing, monitoring, interpreting and analysing information, which is essential for such information-intensive service sectors as banking and insurance. Such capability lends itself not only to specialisation and economies of integration in the different stages of production, but also to favoured input access, which provides multinationals with not only competitive edges over indigenous firms, but also with first-mover advantages over rival multinationals (Dunning, 1989, Enderwick, 1989). Favoured access to inputs provides MNEs with capabilities to minimise their clients' transaction costs in search negotiating and monitoring (UNCTC, 1989). It helps to create international brokerage or arbitrage-linked service firms whose main purpose is to act on behalf of buyers and/or sellers to find an appropriate seller or buyer for their products and services.

In addition, as a result of their scale and scope, their capability to acquire, monitor, and analyse information, service MNEs are typically capable of developing differentiated products. This ability enables service MNEs to supply a wide range of products and provide speedy and reliable services to customers, which provides them with a major source of competitive advantage over indigenous firms (Dunning, 1989).

Furthermore, thanks to their expertise in product development, marketing, management, financial, and accounting, service MNEs are typically capable of providing high and consistent quality services (Rugman, 1987; Dunning, 1989; UNCTC, 1989). In comparison with manufacturing industries, greater human element is embodied in the provision of services and each service is an "one-off" operation whose performance can only be assessed after consumption. The quality of services is likely

to vary with different providers. The experience-intensive characteristic of many services, thus, decides that the ability to ensure a high and consistent quality of service is particularly important for services. Quality services also provide service MNEs with goodwill and corporate identity advantage (Caves, 1982; Dunning, 1989; Enderwick, 1989). This advantage is further encouraged by the product specialisation characteristic of many service firms and the diffusion of corporate identity which are particularly valuable in such service industries featured by supplier-client confidentiality as banking and insurance.

Likewise, goodwill and corporate identity also provides service MNEs with favoured market access to multinational clients (Weinstein, 1977; Khoury, 1979; UNCTC, 1979; Goldberg and Saunders, 1980; Ball and Tschoegl, 1982; Nigh et al, 1986; Terpstra and Yu, 1988; Dunning, 1989; Enderwick, 1989; Casson, 1990). The early venturing abroad of multinational insurance, banking, advertising, accounting and executive search companies were primarily to supply migrating individuals and affiliates of MNEs with services they had previously supplied to their parent companies. These pre-established relationships gave service MNEs an advantage over indigenous firms in serving the affiliates of MNEs. This advantage is the goodwill derived from the special knowledge of the customer's requirements and it is a monopolistic advantage which is unpatentable and which can be transferred abroad (Casson, 1990).

Location Advantages

In principle, firms possessing any of the ownership advantages identified above typically have a choice of where and how to engage in their value-added activities. They have a choice between serving the overseas market from the home or having a local presence in the country they intend to serve. Given the intangibility, non-transportability, and non-storability of many services, FDI is the most convenient (and in many instances the predominant) form of delivering services to foreign markets in many service industries (UNCTC, 1989). Recent developments in information technology, however, have considerably enhanced the tradeability of many services, resulting in the separation of delivery of services in time and place from production.

Rugman (1987) defined a service as an intangible economic good, distinct from physical commodities. The primary value received by the purchaser of a service is not a physical object, but consists of the function performed by the seller. Thus defined, most services are intangible, and hence non-storable. They can not be transported and hence are difficult to trade across borders. They have to be produced when and where they are consumed. In other words, most services can only be delivered to a foreign

market by establishing a presence therein (Enderwick 1989; UNCTC, 1993; United Nations, 1993; UNCTAD, 1994; Bagchi-Sen, 1995). The lack of an alternative to exporting is mainly responsible for the dynamic increase of FDI in services in the past two decades (Enderwick, 1989; United Nations, 1993; UNCTAD, 1994). And by demonstrating how non-transportability has made inward FDI or non-equity arrangements with indigenous firms the only viable way to provide many services to local customers, previous studies have examined the close link between the unique features of services and the stronger predisposition towards overseas production for many services in comparison with manufacturing industries (Boddewyn, et al 1986; Enderwick, 1989; Bagchi-Sen, 1995).

Services are, nevertheless, difficult to define unambiguously. It is possible to find services that are intangible but transportable (principally, information services, such as data processing and software services). Here, face-to-face contact between producers and consumers is not necessary, resulting in the separation of delivery of services in time and place from production. We, however, have to recognise that information services are new services brought with the development of computer and telecommunication technologies, which has resulted in the considerable improvement in the tradeability of traditionally non-transportable services over the past decade (Sauvant, 1986a, 1986b, 1990; Dunning, 1989; UNCTAD, 1994).

International tradeability, in its strictest definition, refers to the ability to undertake cross-border transactions involving the exchange of the value-added generated by the factors of production resident in one nation for the value-added product generated by factors of production resident in another nation (UNCTC, 1993). Thus defined, tradeability of services is a possibility for the cross-border delivery of final services or individual components (intermediate products) in the services-production chain without the movement of the provider or the customer (UNCTAD, 1994). FDI in services is thus excluded from the category of trade in services because its transactions do involve the movement of factors of production across national borders.

Technically, tradeability refers to the divisibility of production processes and the purely transportability of final or intermediate or final products in services. Recent developments of computerised information processing systems have greatly enhanced the technical tradeability of many services. The introduction of electronic data-processing (EDP) has increased the possibilities of dividing the production process into different components. This divisibility of service products affects the actual division of labour by increasing the possibilities for transporting services or parts of services. By splitting up the production process into different components with varying degrees of

transportability, the production of the least transportable components can take place at the location of the customer, while the remaining parts can be produced elsewhere. Moreover, the diffusion of digital network technologies in public telecommunications networks increasingly facilitates network based delivery of information. In combination, these technical innovations permit instantaneous, interactive, long-distance processing of transactions. Distance and national borders become much less important factors in access to information and the processing of large quantities of data. This has increased the possibilities of transporting the final products of services and/or the components of services (UNCTAD, 1994).

In banking, for example, which has been positioned in the forefront with regard to the application of information technology and telecommunications, automatic teller machine (ATM) enables the instantaneous cross-border delivery of banking products, whereby customers abroad use debit or credit cards to draw local currency from their home country account. And given a growing rate of diffusion of electronics payment cards and terminal equipment related to electronic funds transfer (the so-called EFTPoS terminals) and the expansion of telecommunication links, banks will be increasingly able to offer retail services in markets that extend across national borders (UNCTAD, 1994). Another example concerns back-office processes, whereby the data-processing of banking transactions in developed countries increasingly take place at computing centres locating far away from the data-entry point (which would typically be at the centre of a branch office). The enhanced tradeability has resulted in the reduction of FDI in the local affiliates of banks operating internationally. There are signs of relocating data processing to home countries of transnational banks. US banks that established foreign affiliates in small European countries, for instance, are now in a process of concentrating their activities in major regional centres from where they serve primarily corporate customers. Meanwhile, data-processing involved in modern services such as banking has been increasingly sub-contracted out by out-sourcing agreements (*e.g.* facilities management in developed countries).

The application of information/telecommunication technologies in facilitating the international trade of services is, however, not without serious limitations. Firstly, both technical tradeability and current trade of service products depend, to a large degree, on the nature of the production process and the final product (UNCTAD, 1994). The unbundling of functional tasks has so far been restricted to labour-intensive back-office processing rather than the provision of services which require managerial and specialised expertise (*e.g.* risk assessment in relation to credit intermediation). And it is unlikely that core bank processing will be subcontracted to independent firms. There is

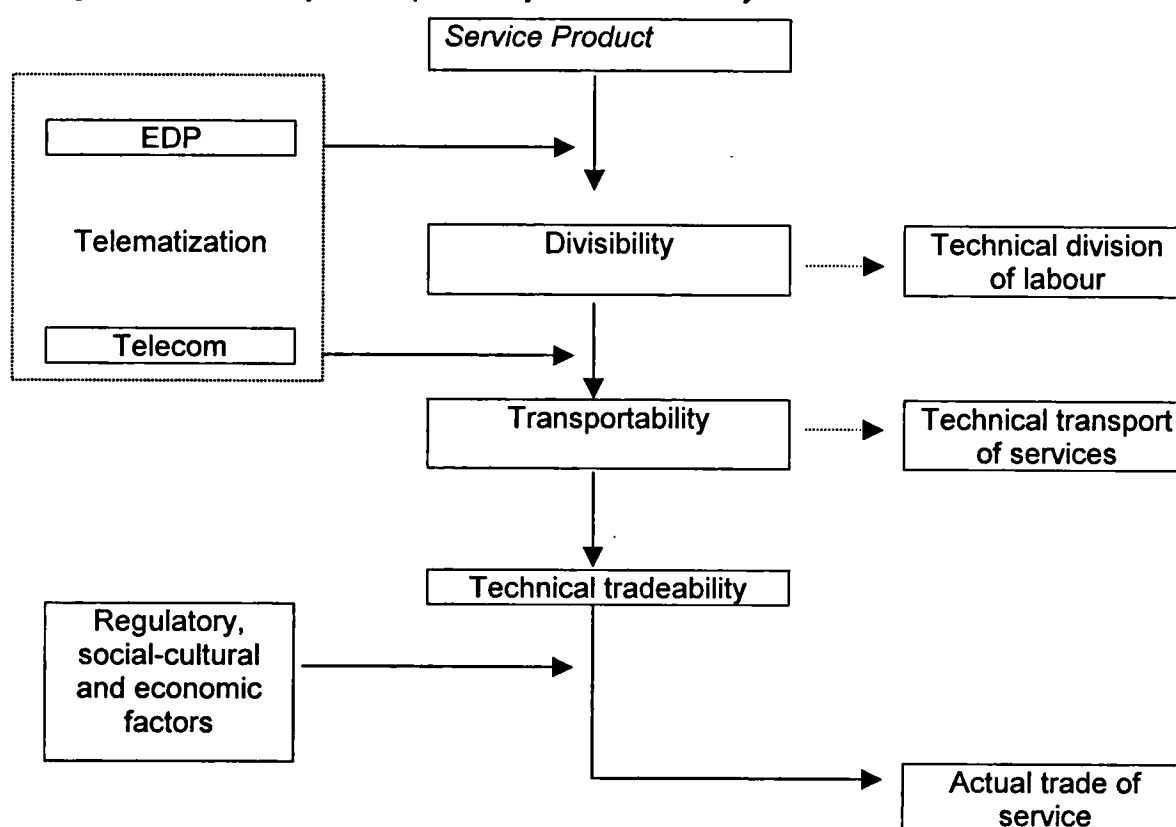
a belief in the banking sector that it is dangerous to lay too much emphasis on the straight machine-processing element, because banks get competitive edge not from systems but from management and marketing (Laurie, 1991). Secondly, cultural factors such as language, cultural background and trust have also reduced the actual amount of trade taking place (UNCTAD, 1994). Services supplied by transnational service corporations (TSCs) to local customers may need to be adapted to a greater extent than manufacturing products, particularly in developing countries (UNCTC, 1993). The level of confidence or trust that customers associate with their service transactions influences the extent to which services will actually be traded. Local residents' trust in locally-established companies is especially apparent in financial services (UNCTAD, 1994). The fact that cross-border electronic money transfer has not taken place on a major scale suggests that the importance of trust between banks and their customers remains highly significant as determinants of actual market potential (UNCTAD, 1994). Thirdly, tradeability across national borders is difficult to achieve when there is a lack of reliable and advanced information and telecommunication technology infrastructure and/or suitable sub-contractors capable of offering services at competitive prices in the country where the services are to be consumed, and when there is a lack of qualified labour force to maintain the necessary infrastructure at high levels of reliability and security⁴⁷. Thus, service firms typically choose to engage in FDI in the host country rather than exporting their services from the home country or transacting their services through non-equity arrangements when it is necessary to be near to customers, when it is necessary to adapt the service to the needs of their local customers, and/or when the international transaction costs (either to the buyer or seller, or to both) are in practice too high to allow much trade (Dunning, 1989).

The realisation of the technical tradeability of services is further discouraged by the considerably more pervasive government regulations/policies which restrict the delivery of service products/components overseas in comparison to goods (Buckley and Casson, 1976; Boddewyn et al. 1986; Feketekuty, 1988; Enderwick, 1989; UNCTC, 1989; Dunning, 1989; UNCTC, 1993). Figure 4.1 outlines schematically the impact of information/telecommunication technologies on the technical tradeability of service products, coupled with the impact of regulatory barriers, cultural and economic factors on the actual tradeability of service products.

Though there has been a strong movement towards deregulation and liberalisation of some services (e.g. telecommunications, finance and insurance) in recent years, many others remain strongly under government control or surveillance (UNCTC, 1989). Additionally, foreign multinational enterprises (MNEs) may be subject

to a range of non-tariff barriers and less favourable treatments than indigenous companies. This is particularly true for those services that are considered politically or culturally sensitive, such as banking, transportation and telecommunications, owing to their critical importance for economic development (UNCTC, 1989). The basic concerns of national governments include: consumer protection and prudent supervision; national security; the protection of indigenous industries (*i.e.* infant industry argument); and balance-of-payments considerations.

Figure 4.1 Divisibility, Transportability and Tradeability



Source: UNCTAD (1994: 3)

Regulations are required to ensure service quality, provided that the quality of services can only be determined at the time of consumption. The performance of services is a source of structural adjustment and has a marked social-cultural impact (UNCTC, 1989). In this respect, prudent supervision is particularly important for banking and other financial services, given that the social and economic costs entailed by a corporate bankruptcy are not confined to the corporation that has failed.

In the interest of national security, there is a strong desire for national governments to put services under domestic control. For this reason, (public or public-

endorsed private) national monopolies in telecommunications, air and maritime transport and utilities, financial services, *etc.* are favoured by many countries. The threat of dependence upon foreign supplies of essential services is particularly felt by small countries. In addition, in the area of data services (data processing, databases, software, telecommunications service), dependence on computers and databases located abroad is sometimes considered a risk to national security. National security considerations are sometimes compounded by cultural identity concerns developed in favour of limiting foreign participation in areas such as educational services and the media, particularly in broadcasting, advertising, television and films.

The need to protect national interests is also met by protecting indigenous industries. Many countries encourage and protect the growth of domestic companies which provide services considered as particularly important for their economies. Countries which have an export potential in some services naturally wish to develop it, especially when these services are an important source of structural adjustment. Regulations have been put into place to restrict, at least temporarily, the participation of foreign service companies. In order to combat serious balance-of-payment difficulties, developing countries often impose restrictions to curb the imports of intermediate services, and to limit profit remittance and capital repatriation by foreign service MNEs.

Political and legal restrictions motivated by the above-considerations are normally put in place to restrict the cross-border movement of people, capital, goods or information. In doing so, they restrict the supply of services across national borders (UNCTC, 1989). The restrictions of the international movement of persons may take the form of tariffs, quotas or non-recognition of qualifications. Tariffs may take the form of visa fees and/or entry or exit taxes, or discriminatory airline landing fees and port taxes. In most countries where such tariffs are low, quotas and immigration policies constitute the primary means of restricting market access of persons. Such restrictions are compounded by non-recognition of imported services or services procured abroad (*e.g.* diplomas obtained in foreign education or training programs) as well as nonrecognition of the certifications or professional qualifications of foreign services providers. Alternatively, there may be discriminatory standards imposed upon foreign services providers that are more stringent or more costly to meet than those affecting domestic providers of similar services (UNCTC, 1989; Hoekman, 1997). In addition, international trade in services is often subject to local substitution policies, local content policies, or government procurement and sourcing policies in favour of domestic service providers (Sauvant, 1986a, 1986b; UNCTC, 1989; Hoekman, 1997). In fact, many countries require that activities such as legal, insurance, education, surveying or

investment advisory services be provided by residents or citizens of the country concerned (Hoekman, 1997). International trade in services is further impeded by restrictions and/or price distortions of international telecommunications and information services which impair the modes for international trade delivery and bolster the producer surplus of monopolistic carriers (UNCTC, 1989; Hoekman, 1997).

Internalisation Advantages

Why should firms located in one country wish to exploit their competitive advantages in a foreign country by engaging in vertical or horizontal integration, rather than lease the rights to those advantages to indigenous firms in the foreign country? Transaction cost theory suggested market imperfection as the main reason (Williamson, 1975).

As a result of the existence of market imperfections, the transaction costs associated with the transfer of intermediate products via arm's length contracts are much bigger than via the hierarchy of the MNEs. Four major transaction costs were identified: costs in concluding and implementing the licensing agreement, ranging from searching (for the right buyer or seller), negotiation, to exhaustive licensing terms and conditions⁴⁸; surveillance costs (enforcement costs) in preventing/limiting opportunism and future threat; costs in the contract terms and conditions being broken; and litigation costs in contract breaching (Williamson, 1975; Rugman, 1981; 1987; Dunning, 1989; Casson, 1990).

The need to avoid transaction costs is motivated by buyer uncertainty and seller uncertainty associated with the open-market transfer of proprietary (intangible) assets. It is postulated that if the licensor specifies the knowledge he is selling in order to give the potential licensee quality assurance, he faces the danger of devaluing his knowledge and putting himself in a disadvantageous position (Casson, 1990). In fact, the intangible knowledge, often generated by R&D or marketing skills, can not be contracted out without a risk of dissipating the firm-specific advantage of the MNE (Rugman, 1987). There is also a seller uncertainty over the future threat to his proprietary ownership advantage by the licensee who develops new technology based on the knowledge obtained from the licensor. Such uncertainty is not preventable by the all-encompassing licensing agreement and "know but not use" mechanism built into the licensing agreement. For many services, the risk of abuse or dissipation of the knowledge related to service activities is high, because such knowledge may not be expensive to replicate. Internalisation also gives MNEs considerable opportunities for price discrimination through hierarchies by taking advantage of the highly segmented

nature of many services. Moreover, quality control and customisation can be best achieved by control over subsidiary activities, given the experience- and skill-intensive nature of many services (Rugman, 1987; Dunning, 1988; UNCTC, 1989). Compared to manufacturing, services are subject to more idiosyncratic customer tailoring and quality variation, given the greater human element involved. For some services, the major proportion of information provided and the certain knowledge and experience connected with interpreting and evaluating the information is tacit and non-codifiable (UNCTC, 1989).

The Choice of Entry Mode

If the necessity to internalise the transfer of intangible assets gives rise to the preference for FDI, a further choice for service multinationals to make is between the equity joint venture and the wholly-owned venture modes. The preference for the wholly-owned venture mode is increased where enforcement costs are high for protecting proprietary ownership advantages, where the firm wishes to have a high degree of control over product or service quality, and where price discrimination is not practised (Dunning, 1989). In contrast, the joint venture mode will be preferred if partner's complementary skills or resources are required for the competitive success of the venture. Examples include patent or technical know-how, financial resources, experienced managerial personnel, access to marketing and distribution systems, and political clout (de Houghton 1966; Tomlinson 1970; Franko 1971; Gullander 1976; Berg and Friedman 1982; Killing, 1983; Harrigan 1985; Dymsha 1988; Geringer 1988, 1991).

The choice of the joint venture entry mode entails the choice of the JV partner. The limited empirical research on partner selection criteria in services highlights not only the above-mentioned complementary in function, but also compatibility in objectives, corporate philosophy, and mutual trust, as the main bases for partner selection (Awadzi, 1987; Geringer, 1988, 1991).

Both the choice of entry mode and the choice of partner in services are subject to the restrictions of government policy and regulatory framework (OECD, 1987b; United States 1986a, 1986b; UNCTC, 1989). FDI is either excluded or limited to minority holding in a variety of service sectors, including broadcasting, other media services, air transport, international maritime transport, telecommunication services, and banking and other non-bank financial services (UNCTC, 1989). Foreign acquisition of domestic financial institutions is subject to severe restrictions. Even in some developed countries which have adopted rather liberalised approach towards FDI, lead management of bond issues by foreign-controlled institutions is either restricted or

admitted only on a reciprocal basis. Limitations on foreign membership in stock exchanges or professional associations also apply in certain countries. Moreover, in many cases, the regulatory regimes governing foreign branches are generally more stringent than that governing foreign-controlled subsidiaries. Branches are either forbidden, admitted on a reciprocal basis, or subject to prior authorisation or special conditions concerning their operations (UNCTC, 1989). This is because, as a legal part of the parent company incorporated overseas, branches are more difficult to supervise by local Regulatory Authority than separately incorporated subsidiaries.

POSSIBLE ENTRY MODES FOR FOREIGN INSURANCE COMPANIES

As a synthesis of prior research, Blackelhaupt and Bar-Niv (1983) documented up to nine possible methods through which an insurance company can enter a foreign market.

1. Formation of a branch office or use of an authorised representative.
2. Establishment of a new subsidiary or an affiliated insurer.
3. Acquisition of an existing foreign insurer as subsidiary, or purchasing majority or minority interest in existing foreign insurers.
4. A joint venture between a foreign insurer and a domestic insurer, or between a foreign insurer and a domestic corporation not principally engaged in insurance. Where it is an insurer, the domestic company may serve as a fronting company or the combination may be a control group. The insurance is written by a domestic insurer, but immediately reinsured by a non-admitted foreign insurer.
5. Non-admitted insurer for a foreign insurer. However, only about 20 countries, including the US, recognise non-admitted carriers. The primary advantage enjoyed by non-admitted insurers is the freedom from substantial regulation by State insurance departments.
6. Establishment of a reinsurance company. An insurer from one country may act as an approved reinsurer in another country, recognised by the government in that country, or in some cases the insurer may operate there as a reinsurer without approval.
7. A co-operative agreement for licensing agents between insurers from different countries. This may often be done between a domestic insurer and an insurer from another country. However, sometimes such an agreement is between two or more insurers from different countries for operations in a third country.
8. Arrangement between a foreign insurer and a local broker. The broker places the insurance but the foreign insurer remains non-admitted. This practice exists in the

excess and surplus-line markets, which involves types or amounts of insurance that are difficult for admitted insurers to write.

9. Provision of services, consulting and expertise, especially in risk control and other risk management areas.

All these techniques have been used by the US insurers in their international operations. As Table 4.1 shows, the primary methods that life and health insurers have used to operate internationally are the establishment of branch offices or subsidiaries, joint ventures, and acquisition of foreign companies. These three entry modes are claimed to be the most practical in the current market place (Huggins and Land, 1992). It is noted that there are some differences between the expansion modes used by US/Canadian member companies and those by the international member companies of other countries. The branch office is the single most popular mode for US/Canadian companies; the wholly-owned subsidiary, acquisition and joint venture modes are of similar popularity among international companies from the other countries.

Table 4.1 Structure Used in Most Recent Foreign Expansion by International Life and Health Insurance Companies

	Expansion by international member companies	Expansion by US/Canadian member companies
Subsidiary	30%	13%
Acquisition	25 %	16%
Joint venture		
with an insurance company	10%	3%
with a noninsurance financial service co.	10%	6%
with a nonfinancial service co.	5%	6%
Branch office	15%	36%
Other *	15%	20%
	**	100%

* For international companies, "other" structures include an affiliate brokerage service, a managing general agency, and an agency agreement with an insurance company of the country being entered; For US/Canadian companies, "other" structures include use of an existing property/casualty sales force, a general agency operation, and using two or more types of structures. ** One company used several structures.

Source: LIMRA (1990)

According to the transactions cost approach, insurance activities can be contracted out to external agents/brokers (low resource-commitment and risk, and low-control mode) or they could be internalised and performed by the international insurance company's own employee (high resource-commitment and risk, and high integration/control mode). The selection of a particular entry mode is the trade-off between the benefits and costs of internalisation (Erramilli and Rao, 1993; Buckley and Casson, 1996). The pros and cons (*i.e.* benefits and costs) of the major international entry modes in the insurance industry are illustrated by Table 4.2.

Table 4.2 International Entry Modes in The Insurance Industry

Major entry modes	Degree of control and integration	Degree of resource commitment/risk	Designation
Representative office	Full	Little	Full-control mode
Agent/broker	None/Little	None/Little	Shared-control Mode
Joint venture	Some	Some	Shared-control Mode
Branch/wholly-owned subsidiary	Full	Full	Full-control Mode

Source: Table 12.1, chapter 12 (Wu and Strange, 1998)

We examine below in detail the pros and cons of the major entry modes in order of increasing within-firm governance. Although the representative office is not a common entry mode in international expansion by multinational insurers, we include it here in view of its current predominant role in foreign insurance participation in China's insurance market.

- **Representative Offices**

The representative office stands apart from the other major entry modes in that it is a combination of full-management control/integration and none/little resource commitment/risk. It is one of the most common ways for international insurance companies to establish an initial presence in a foreign market, given that it is the most flexible and inexpensive way to make an entry. In some countries, this mode may be the only permissible means to directly enter that market. The main function of such an office is to collect information and to forward it to the head office or insurance branches. However, a representative office generally can not conduct

major insurance activities, and is usually given limited decision-making authority by the parent. It usually lacks economies of scale in its operations. And the normal range of insurance activities at the office is generally restricted by the host country government regulations. In some countries, such as China, representative offices are restricted to liaison-type activities of non-profit making functions.

- **Managing General Agencies/Brokerage**

Managing general agencies may provide a speedy entry into the foreign market and may be a useful training ground for less experienced companies. Agent/broker system also enables insurance companies to operate with low overheads, whereby the insurance company could more easily withstand a fall in premium income than a company with a large branch organisation geared towards obtaining its business directly from the public. Research has shown that, other things being equal, the higher the proportion of fixed costs to total costs the nearer a firm must operate to its planned capacity in order to cover total costs (Carter, 1979).

A number of differences exist between agency and brokerage. Firstly, while an agent is the agent of the insurer, a broker is the agent of the insured who employs him to effect insurance. However, both are remunerated by the insurer by payment of commission on premiums handled, and moreover, a broker may perform certain duties as agent of the insurer, e.g. issuing cover-notes and collecting premiums. Secondly, unlike an agent, a broker holds himself out to the public as possessing an expert knowledge of insurance business and the insurance market, and ought to have access to a representative range of insurers (Carter, 1979).

Despite providing entry and operation flexibility, agency/brokerage has serious drawbacks. It gives the international insurance company very limited control and profit. Besides, the transactions costs involved in monitoring the performance of the general agencies could prove high, especially when the "small-numbers bargaining" problem is presented. In countries where insurance markets are underdeveloped, the range of agents/brokers available to the international insurance company is restricted and, the agents/brokers generally become non-replaceable. Their tendency to behave opportunistically is reduced only through stringent negotiation and supervision of contractual relationships, and thereby greatly increases the transactions costs associated with this low-control mode. Agency/brokerage, therefore, may not be a viable choice in countries where there are underdeveloped insurance entities. Under such circumstances, an international insurance company can significantly reduce its transaction costs by replacing

external agents/brokers with its own employees, whose behaviour it can monitor and control more effectively (Dwyer and Oh, 1988; Hennart, 1989).

Agency/brokerage mode is thus only a transitory entry mode for less experienced insurance companies. Research has found that companies with greater experience in entering foreign markets are less likely to use this entry mode (Schroath, 1988; LIMRA, 1990; Gora, 1991; Huggins and Land, 1992).

- **Joint Ventures:**

A joint venture is a partnership agreement in which two or more firms undertake a business project together, usually for a specific length of time. Benefits that can result from joint ventures include possible economies of scale through savings in overhead expenses when companies combine their operations. They can also help to achieve the reduction of total costs and enhance product differentiation, as well as bring brand names with local value and distribution systems (Meldrum, 1996). Also, in a joint venture, the two parties share risk involved in the alliance. In addition, a foreign insurer may face less stringent regulations upon entering the new market when it is paired with a company that is already doing business in that market. Moreover, the complementary functions of the local joint venture partner help the multinational insurer to have a clear understanding of the local social, cultural, economic and political factors and adapt policies, coverage and terminology to local needs. The domestic companies bring a knowledge of local customer and market place, including the skills needed to navigate through the regulatory process (Meldrum, 1996).

A joint venture, however, is not risk-free. The use of the international joint venture (IJV) form of organisation results in additional costs attributable to shared decision-making and co-ordination of partners, the lack of compatibility, as well as partner searching (Killing, 1983; Harrigan, 1985; Huggins and Land, 1992). The companies may not be compatible in their objectives, corporate philosophies and cultural outlook, and they may lack mutual commitment. Carter (1979) argued that firms may differ in their management objectives: some seek to maximise long-term profit maximisation, others may only seek short-term profit maximisation; and some management may seek to maximise other objectives than profit. For example they may seek to maximise either sales, or the firms' market share, or perhaps to maximise the rate of growth of some other aspect of the firms such as their assets. Also, companies may find out later that they are partners in one arena and competitors elsewhere. In addition, a multinational insurance company operating in

a joint venture may be frustrated that it is not in complete control of its own business. Moreover, it is a consensus among company executives that finding the right partner is a costly and time-consuming business (Schroath, 1988). The costs of organising a joint venture can thus run high.

An international insurance company has to weigh the potential benefits against the potential drawbacks before entering into a joint venture. From the transactions costs viewpoint, a firm typically attempts to form an IJV *only if* perceived additional benefits outweigh expected additional costs of utilising the IJV option (Beamish and Bank, 1987). An international insurance company, for instance, will abandon the joint venture mode of entry if the potential partner is complementary in functions but incompatible in objectives. For a joint venture to be viable, each party must have a strategic interest in the enterprise with the long-term perspective. A joint venture should not be undertaken just for a short term gain. To succeed, a joint venture needs compatible corporate philosophies and cultural outlook and a mutual commitment (Reactions, 1996b).

- **Branch offices or subsidiaries:**

Amongst the various methods of entering a foreign market, the establishment of a branch office or subsidiary gives the home office the greatest control over its company's international activities. As a legal and functional extension of the head office, branches have their policy and product decisions made and implemented primarily by home office personnel. Centralisation helps control common goals (Blackelhaupt and Bar-Niv, 1983). The parent company typically provides direct oversight of subsidiary's activities. The control facilitates global integration and co-ordination of strategies in multinational corporations, and overcomes the disadvantages inherent in shared-control venture, *e.g.* conflicts with partners, partners becoming competitors (Kobrin, 1987; Contractor and Lorange, 1987; Hill et al. 1990).

The main difference between branches and subsidiaries is whether they are legal extensions of the head office. For international insurance companies wishing to have full control and more substantial presence than a representative office, the selection between the branch and subsidiary modes depends on whether the international insurer wishes to establish a separate overseas enterprise. A subsidiary, whether wholly-owned or a joint venture, is a local institution incorporated under host-country law, and with a separate legal entity from its parent company. The parent company is thus not liable for its debt in the host country. In

contrast, as a legal and functional extension of the head office, a branch office is not a separate legal entity, and the parent company is liable for its debt. This legal difference has pros and cons attached. On the one hand, supported by the entire capital of the international insurance company, branches are usually exempt from capital requirements by the host country. Conversely, establishing a subsidiary usually requires a higher capitalisation than a branch of the same size of operation. On the other hand, in some jurisdictions branching may throw the entire insurance company under the legal suit under local law for any act committed by a branch and its offices. In contrast, insurance companies can isolate their offices from host country laws by setting up subsidiaries.

Notwithstanding considerable management control, branch offices and subsidiaries, are not without drawbacks. One of the major disadvantages is the high initial capital and lower flexibility (*i.e.* high switching costs). Another major disadvantage is that they can be risky if the home office or parent company is unfamiliar with ways of doing business in the host country (Erramilli and Rao, 1993; Waheed and Mathur, 1995). Knowing how to adapt to the needs of the host country is the key to successful global operations, especially for life insurance companies which depend on the demand of the local market rather than that of the MNEs. Such high resource commitment and high risks have motivated some international insurers to trade-off the single management control for shared-control joint venture entry mode with companies already operating in the foreign market.

- **Acquisition**

Some insurers choose to purchase companies already based in the host country to make an entry. Foreign ownership of local companies has a number of benefits and drawbacks. Among the benefits of acquiring an existing firm is that the insurer establishes an immediate presence in the foreign market with a ready-made market network offered by the acquired company. It can be used as a rapid response to the threat caused by the initial investment of a competitor (Durbin, 1975). Although costs of acquisition exist, the risk of losing this investment may not be as great as setting up a branch office, because the insurer is typically buying a company with established operations. Acquisition, however, is not feasible in countries which prohibit foreign ownership of insurance companies, and targets for acquisition may not be available in countries where the insurance market is not yet well developed.

INTERNATIONAL INSURANCE TRANSACTIONS IN THE OLI FRAMEWORK

The observed international transactions suggest that FDI is by far the most important mode of international transaction of insurance services, as opposed to cross-frontier trade (United Nations, 1993). Moreover, in comparison with life and non-life insurance, reinsurance accounts for the largest volume of cross-border trade in insurance. The reasons for the prominence of FDI, the choice of appropriate entry mode, and the differences among various lines of insurance may be examined in the light of the OLI framework.

Ownership Advantages

International insurance companies are typically capable of providing a better quality and a more extensive range of insurance policies at more competitive prices than local national insurers. These ownership advantages arise from a variety of factors:

- *Economies of scale* : Economies of scale provide MNEs absolute cost advantage over indigenous firms. The economies of scale of international insurance companies are reinforced by the market organisation through which they operate. Many international insurance companies operate internationally through pools, group or associations [e.g. the American Foreign Insurance Association (AFIA)]. An insurance pool writes business on behalf of its separate member-insurers, each of which shares a proportion of the insurance written by the pool. Another method of operation is through companies of a common insurance group of subsidiary companies. In fact, most of the major insurance companies have developed into composite groups transacting all classes of insurance business, so possessing the advantage of being able to offer the public a comprehensive insurance service. One example is the American International Group (AIG), which has over 200 subsidiaries in more than 130 countries. A third method of operation is an association, in which separate companies (rather than a pool or group) write insurance directly, but all share in losses and expenses. Examples are Industrial Risk Insurers (IRI) and the Factory Mutual Association (FMA)⁴⁹. Furthermore, as Fu (1996) has pointed out, size and scope not only reduce costs but are positively correlated with the propensity of firms to enter foreign markets. On the one hand, large insurance companies with diversified assets are more able to absorb risks. On

the other hand, the stringent asset and/or capital requirements imposed by many national governments mean that only large companies are eligible for entry.

- *Financial and Marketing Expertise*: Although insurance is not a high-technology industry, it nevertheless demands a substantial degree of financial and marketing expertise. This expertise is more important in the provision of non-life insurance and reinsurance than in life insurance, and local companies may well not have the necessary skilled labour and technology.
- *World-wide Reinsurance Agreements*: Just as individuals and businesses buy insurance to protect themselves against loss by various perils, insurance companies transfer insurance to reinsurers. Insurers have always sought to achieve the widest possible dispersions of risks. Because of their world-wide reinsurance agreements, international insurance companies are able to spread further the risk of loss, to improve the stability of their underwriting results, and to achieve greater flexibility in the type and size of risks they are able to accept. In contrast, just like the barriers potential new entrants may face when entering a well established insurance market, indigenous firms in under-developed insurance markets are disadvantaged in that they may not be able to obtain precisely the type of insurance cover they would like. For example, a new motor insurer may not be able to obtain quota share reinsurance, so restricting their rate of expansion, and on excess loss cover it may be necessary for a company to carry higher retention limits than desired (Carter, 1979). In addition, an indigenous firm may have to pay a larger proportion of its gross premium income for reinsurance than a large established international insurance company.
- *Cost Differentiation*: This advantage may be identified two headings: (1) *Wide Range of Services and Products*. As a result of economies of scale, international insurance companies are typically able to offer a wider range of services and products at more flexible terms, prices and conditions. This will include not only the devising of new forms of insurance to cater for new risks and the adapting of existing products to meet changing consumer requirements, but also the packaging of existing products in new ways to provide contracts which give wider cover at lower costs. (2) *Capability to Underwrite Big Specific Risks*. Because of their size, their easier access to international capital markets, their membership of pools, group and association, as well as their world-wide reinsurance agreements, international insurance companies typically have larger underwriting capability for high risks which arise from natural hazards or from new, large-scale, technologically-advanced industrial processes. Furthermore, from underwriting similar risks elsewhere in the

world, they have built up the technical competence to estimate possible loss frequencies and severity. This capabilities and competencies put them in a better position (relative to local insurers) to provide services for large MNEs investing in the local economy.

- *Reputation and Corporate Image*: The fact that they operate internationally helps to create a prestigious corporate reputation for foreign insurers, and enables them to reap economic rents. Such reputation advantage over indigenous firms are conducive to business development in that insurance buyers have accumulated preference for established insurers based on their reputation for financial strength, quality of service provided, etc. (Carter, 1979).
- *Quality of Service*: Even if international companies are no more efficient than their domestic competitors, they are often able to provide wider cover and/or additional ancillary services such as loss prevention and risk management. Furthermore, international insurance brokers may be able to provide competitive brokerage services by taking advantage of their privileged access to the international insurance/reinsurance network.
- *Greater Security*: International insurance companies with world-wide operation are able to offer a higher degree of security to policyholders due to their size, their larger capital bases, their ability to spread risks internationally, their easier access to international capital and reinsurance markets.
- *International Experience*: Such experience bestows international insurance companies with greater knowledge of foreign markets, and reduces the risks and uncertainty of their investment environment.

Location Advantages

Proximity between insurers and the markets in which they operate is needed for the protection of the integrity of the insurers' underwriting and the quality of their services. Speedy and efficient transfer of information between insurers and prospective clients is needed for risk assessment, tailoring insurance policies to the specific needs of the clients, claims investigation, negotiation and settlement. This need for proximity, and for often instantaneous interaction between the insurer and the insured, has traditionally obliged insurers to have a physical presence in every country in which they wished to conduct business.

On the one hand, insurance service is idiosyncratic with a good deal of customer tailoring. It is skill-labour intensive with a significant human input, and to a

great extent, tacit and non-codifiable. Unlike many service sectors (e.g. hotels, restaurants, fast-food outlets and car-rental companies) where the performance requirements of the contractors can often be satisfactorily codified in a management contract or franchising agreement and hence more easily transferred and controlled through non-equity agreements, the external quality control through non-equity agreement in the insurance industry is both difficult and more expensive (UNCTC, 1989).

On the other hand, the considerable requirements for on-the-spot pre-sales risk assessment, after-sales claim settlement, risk prevention services and initiative marketing make it difficult, if not impossible, to provide cost-effective insurance services by arms-length trade. Local presence is very importance for an insurer to get a precise knowledge of the local economic, technological, social and legal conditions required by an underwriter to assess accurately the risks it is offered and the claims it is asked to settle. First-hand knowledge is also needed for the insurance company to supply loss prevention and risk management services for its customers. In some cases, these matters can be resolved by specialist intermediaries, such as claims adjusters, but this cannot always be done. In countries where there are inadequate reliable brokers, including possibly local offices of international brokers, or independent loss adjusters to handle marketing, surveying and claim-servicing arrangements on its behalf, a foreign insurer is often compelled to establish itself on the ground.

Information technology may open up the prospects for an international division of labour in the production of insurance services by facilitating network-based intra-firm and inter-firm trade in insurance services. It may enable insurance affiliates to fulfil specialised tasks and trade the results of their labour through transnational computer-communication networks. It may also enable information-intensive final services (bill payments, insurance policies, software and so on) to be delivered abroad via electronic mail systems. In the extreme case, some foreign affiliates may be reduced to "terminal" affiliates that merely enter data, while most of the value (for example, risk calculation) is added elsewhere⁵⁰.

Thus, through the use of computer-communications systems, these developments permit instantaneous, interactive, long-distance transactions and facilitate certain modes of international involvement. Three examples illustrate such facilitation. First, a locally-owned agency staffed by local nationals may be able to process information and transact business on the basis of guidelines provided by a foreign insurer. The agency may even retain control over operations to the extent that it has the option of placing business with the foreign insurer of its choice. Second, a

locally-owned insurance company, which lacks the expertise and managerial skills to assess risks, might take advantage of the enhanced tradeability of insurance products and license the required know-how from foreign companies (United Nations 1993). Third, locally-owned agencies or companies may place reinsurance directly with foreign insurers in return for the payment of a share of the premium income and a fee for the managerial services. Hitherto, the bulk of reinsurance business (especially in developing countries) has been transacted through large international brokers and specialist companies established in the local market.

However, the potentialities of information technology have not yet been substantially realised in the insurance industry. Instead of exploiting the potential of information technology for international trade in insurance, insurance companies have concentrated on the more traditional concerns for local presence⁵¹. There appears to be a general belief shared by insurance companies that a local presence remains essential for the effective development of business. Indeed, it "seems that, in the immediate future, FDI and TNC activities, will continue to be the most important form of delivering insurance services to foreign markets. In fact, their importance is likely to grow, precisely as a result of the use of information technology because this technology considerably facilitates the success of these new and extended FDI-based groupings" (United Nations, 1993: 40). The unbundling of functional tasks and their geographical dispersion has so far been very much confined to labour-intensive back office operations, such as data processing and claim processing, rather than the provision of insurance, which requires the expertise and managerial skills to assess risks. Moreover, the intra-company and inter-company networks which permit economies of common governance among geographically-dispersed activities within a firm have been operated primarily to link insurers to tied agents/brokers or to link head office to branch offices, and this network-based linkage has been largely restricted to national markets with only a few companies using it internationally. And, even in these few cases, the application of the information technology has been used primarily to improve the efficiency of the existing business structure (normally incorporating extensive local presence) rather than to replace it with an alternative structure.

The insurance industry has thus lagged behind other service sectors in the widespread use of information technology (United Nations, 1993; Newman, 1997). As United Nations (1993) noted, the choice between FDI and pure trade/licensing is largely governed by the nature of the transaction which is determined by the inherent characteristics and technological parameters of the service concerned. Generally speaking, the idiosyncratic nature of the insurance business requires close personal

contact between transacting parties for the purpose of underwriting or marketing, which limits the impact of telecommunications and information technology on the tradeability of insurance business in the immediate future (United Nations, 1993). The need for proximity to customers also differs among different insurance products.

In the case of life insurance and some forms of health and personal accident cover, however, a local presence is demanded as close contact and trust between the insurers and the policyholders is of paramount importance. Because of the long-term-savings nature of life insurance, which is largely purchased by individuals with limited knowledge of the insurance markets, there has been a far stronger tendency for life insurance buyers to prefer insurers with local offices capable of providing the kinds of services they require and with assets maintained locally to guarantee the payment of claims. Thus, the need to cater for individual's preferences to and trust in locally-incorporated insurance companies makes local establishment imperative for foreign insurers underwriting life insurance, even though these "personal lines" can be generally accepted and underwritten in reasonably standardised form by network-based trading and licensing agreements with local agents because the liability on any one risk is small and the number of homogeneous risks is sufficiently large to ensure the application of probability. Likewise, in contrast to large corporations which normally possess detailed knowledge of insurance markets and practice and often need overseas servicing of their insurance needs, small/medium corporate clients are more reluctant to place their insurance with non-established foreign insurers and, indeed, may not prefer to deal with a major international insurer. This is especially so when there is an insufficient local supply of suitable agents and telecommunications facilities/skilled labour offering products at competitive prices.

Moreover, a local presence is often required for efficient transactions in the case of complex insurance products, such as the property or liability risks generated by large institutions. On the one hand, there are difficulties in translating complex information requirements into electronic form, and these difficulties are compounded by the technical and legal differences between countries concerning electronic mail systems. Not only are international transactions hampered by the lack of suitable telecommunications infrastructure in many developing countries, but the absence of clear case law contributes to uncertainty concerning the legal position of legal contracts concluded through electronic means. On the other hand, detailed scrutiny and risk assessment is needed to decide the precise structure and terms of cover for complex risks.

In contrast, the need for a local presence will generally be lower when risks are generally accepted and may be underwritten in reasonably standardised form by network-based trading and licensing agreements with local agents. Such risks are typically “personal lines” in relation to property and liability held by private individuals. Here no detailed scrutiny or risk assessment is required because the liability on any one risk is small, and the number of homogeneous risks is sufficiently large to ensure that the application of probability will generate secure underwriting. Likewise, a continuous local presence is not essential for reinsurance, provided that the reinsurer can visit clients and/or avail itself the service of both local or international reinsurance brokers (who themselves have such regular contact with their clients and with the market) and of legal and other experts (Carter and Dickson, 1992).

The idiosyncratic nature of the insurance business thus means that recent developments in telecommunications and information technology may only have a limited impact on the tradeability of insurance products in the immediate future. A further factor favouring local presence is the plethora of government restrictions regarding cross-border trade and FDI in insurance (Carter and Dickinson, 1977; Bar-Niv and Bickelhaupt, 1981; Skipper, 1987; Carter and Dickinson, 1992). Many governments impose tight restrictions on international trade in insurance in order to maintain national control of the industry for a variety of reasons:

- To protect local consumers from loss in the event of insurance companies becoming insolvent or failing to provide an acceptable standard of services at a reasonable price. Government legislation for the protection of policyholders from incompetent and unscrupulous insurance companies usually include the following stipulations:
 - I. Regulations governing the qualifications and registration of insurance companies for the transaction of insurance business, whereby applicants for licenses usually have to qualify for solvency, competence and financial/business integrity.
 - II. Regulations on the basic terms of insurance policies and rates of premiums of main classes of commercial insurance. By taking such measures, the Supervisory Authority aims to control price competition among insurance companies in their fight for market shares. Such destructive price competition may destabilise the market by forcing insurers into liquidation and driving premiums up sharply where large insured losses occur.
 - III. Regulations on the inspection of business affairs, financial position and utilisation of insurance funds, and regular statistics reports or accounting reports of an insurance company by the Supervisory Authority;

- IV. Regulations on the level of liquidity of insurance companies, including stipulations on various reserve funds, protection funds and guarantees, the minimum margin of solvency, as well as reinsurance arrangements;
- V. Regulations governing the investment activities of insurance companies, including stipulations on the eligible types of investment/assets, portfolio composition and deposit of securities;
- VI. Regulations governing the rectification and liquidation of insurance companies which fail to meet prescribed standard of solvency/liquidity;
- VII. Regulations regarding the qualification, supervision rules and punitive penalties of insurance intermediaries, *i.e.* insurance agents and brokers. Such regulations subject insurance intermediaries to similar inspection of their business affairs, financial position and utilisation of insurance funds by the Supervisory Authority as insurance companies. Insurance intermediaries are required to obtain licenses, and deposit guarantee funds or arrange liability insurance for professional negligence.
- VIII. Regulations which constrain or prevent residents from placing their insurance with non-admitted (non-established) foreign insurers on the ground that the Supervisory Authority can exercise no control over the behaviour or solvency of companies not established in the country.
- IX. Regulations of or preference for branch or joint venture with local participation. If the legal liability of the parent company for the debts of its branch explains the requirement/preference for branch, precaution against the insolvency and wrong-doings of foreign insurance companies, together with know-how transfer, explain the requirement/preference for joint venture mode with local participation.
- To foster a national insurance industry by protecting domestic insurers from foreign competition. The protection measures may explicitly exclude or actively discriminate against foreign insurers. Such measures are justified by the infant-industry theory which argues that unrestricted foreign competition will destroy the national insurance industry in its infancy.
 - To ease the strain on the national balance-of-payments by avoiding the net long-term loss of foreign exchange arising from the purchase of insurance/reinsurance overseas and/or the remittance of funds abroad by foreign insurance companies.
 - To retain funds generated by insurance operations for investment through the local capital markets. If insurance is placed abroad with foreign insurers without any

restrictions on the remittance of premiums, the accumulated funds will be lost to the local capital markets. The need for fund retention is especially strong when a country's economic development is hampered by a scarcity of capital.

- To reduce, in the interest of national security, dependence on foreign insurance and/or reinsurance. Because of its strong links with other sectors of the economy, insurance industry is regarded as one of the cornerstones of an economy, and national control of its activities is regarded as essential to promote national development objectives. National autonomy and self-reliance is, therefore, stressed for the sake of national security, even though the costs may exceed the economic benefits.

Cross-border trade in direct insurance has come under increasingly strict control by many governments which prohibit their residents from placing insurance with non-admitted (non-established) foreign insurers, and the movement of premiums and claims payments have been increasingly circumvented by exchange-control restrictions. In contrast, reinsurance has typically been subject to a much less prohibitive regime for two main reasons (UNCTC, 1980; Carter and Dickson, 1992). On the one hand, reinsurance provides the means by which local insurers can gain access to the expertise and international capacity of the international market without the national government relinquishing control of the local industry. On the other hand, consumer protection is not so vital as most reinsurance takes place between sophisticated and well-informed companies. Thus, while many developing countries have increased their restrictions on trade/investment in direct insurance, there has been a growing demand for reinsurance so that indigenous insurers might compensate for their insufficient underwriting capacities. The combined effect of a lesser need for proximity and more relaxed government regulations is that there is much less incentive for reinsurance companies to establish overseas offices/affiliates than direct insurance companies.

Most of the existing literature on FDI location choice is related to the manufacturing sector, and many papers are concerned with the likelihood of locating manufacturing FDI in the US (Boddewyn et al, 1986; Dunning and Norman, 1987; Coffey and Polese, 1987; Coffey and McRae, 1989; Beyers, 1989; Coughlin et al, 1991; Campbell and Zhang, 1992; Friedman et al, 1992; Woodward, 1992; Wheeler and Mody, 1992; Cheng and Zhao, 1995; Head et al, 1995; Bagchi-Sen, 1995; Head and Ries, 1996).). The important factors may be summarised into five categories: (1) market size and growth prospects; (2) agglomeration effect produced by the concentration of producer services and other FDI; (3) government policy orientation and restrictions; (4) infrastructure development, ranging from transportation and

telecommunications to the existence of a pool of specialised labour force; (5) cost structure in terms of labour and land costs

There has been very limited empirical work on producer services so far, and hardly any addressing specifically the insurance industry (Dunning and Norman, 1987; Coffey and Polese, 1987; Beyers, 1989; Goe, 1990; Cuadrado-Roura and Gomez, 1992; Bagchi-Sen, 1995). Market size and growth potential, and the need to follow international clients are borne out by the literature as the most important location determinants (Dunning and Norman, 1987; Goe, 1990; Bagchi-Sen, 1995). In their examination of the factors that influence the location choice of international offices in the UK based on a survey on producer services MNEs, Dunning and Norman (1987) concluded that the primary determinants were market size and the need for personal presence to serve this market⁵². Strong positive relations between the location of service FDI and market size is revealed, for instance, in the internationalisation of multinational banks (Gray and Gray, 1981; Rugman, 1981; *etc.*), international advertising agencies (Terpstra and Yu, 1988), multinational insurance firms (Schroath and Koth, 1989). Client-following was also observed in international banking (Ball and Teschoeg, 1982; Nigh et al, 1986), in the international advertising industry (Weinstein, 1977; UNCTC, 1979; Terpstra and Yu, 1988), and the international insurance industry (Schroath, 1988). With the globalisation of markets, firms in other service industries have found it increasingly necessary to become multinational to win new or retain existing business (Dunning, 1989). As far as the insurance industry is concerned, it must be prepared to handle the expanding international exposure of international business, provided that large and small firms with international exposure are seeking coverage for their entire operation, domestic and international, from a single source whenever possible (Munro, 1995). By following their international clients abroad, foreign insurance companies have competitive edges over indigenous insurers thanks to their pre-established relationships with and better understanding of the needs of their international clients, as well as their ownership advantages in terms of product differentiation, insurance capacity, skilled personnel and organisational skills (Blackelhaupt and Bar-Niv, 1983; Schroath, 1988).

The other factors that are found to be of significant importance are agglomeration in producer services and the "bandwagon effect" (Dunning and Norman, 1987; Coffey and Polese, 1987; Coffey and McRae, 1989; Beyers, 1989; Cuadrado-Roura and Gomez, 1992; Bagchi-Sen, 1995). Dunning and Norman (1987) found clear evidence of the "bandwagon effect", whereby the location choice had been spurred on by the expectation or actuality of a similar decision by their major competitors. There

was a fear that a failure to respond to competitors may result in their position being usurped by their competitors.

The inclination of foreign services investors to locate near domestic agglomerations of producer services is due to the fact that agglomerations provide proximity to competitors, suppliers, clients and a large pool of skilled labour. In his studies of the determinants of the spatial pattern of FDI in finance, insurance and real estate sectors in the United States, Bagchi-Sen (1995) found that the location choice of FDI was positively related to individual State's domestic agglomerations of producer services (measured by the share of employment in the domestic finance, insurance and real estate sector). He found that agglomerations provide both supply- and demand-side incentives. On the one hand, supply-side incentives stem from the localisation economies reducing transaction costs in terms of high-skilled labour and proximity to complementary activities which provides inter-organisational face-to-face contact. On the other hand, demand-side incentives provide a diverse clientele and opportunities to reach clients in other geographic areas and develop exports of service products. These incentives would potentially reduce the search costs of foreign services firms in the United States by facilitating accessibility to suppliers, clients and competitors. Likewise, Dunning and Norman (1987) found that, among a series of factors that were felt to influence the location of an overseas office of a multinational company, proximity to specialist services was rated as important by all firms in the trade and finance sector. Coincident location was thought to give rise to external economies by generating a pool of skilled labour. It was noted that FDI in financial services demonstrates a preference for populous metropolitan centres with established service networks seeking economies of agglomeration despite the high price of commercial and industrial property in these locations. The location choice had been urged by the expectation or actuality of a similar decision by their major competitors (Coffey and Polese, 1987; Coffey and McRae, 1989; Beyers, 1989; Cuadrado-Roura and Gomez, 1992).

Despite marked differences between office type and sector, the quality and availability of resources were generally regarded as more important than direct costs (Dunning and Norman, 1987). Those resources which were found important for location choice were the availability and convenience of travel and telecommunications facilities, and the availability of quality labour and support services.

The distinctive characteristics of services warrant extreme caution when applying manufacturing based FDI theory (Boddewyn et al, 1986; Dunning, 1989). The prior work on the location choice of FDI has some, but limited, relevance to the present

study.

Infrastructure and Cost Structure

Infrastructure encompasses both the “hard” and “soft” dimensions, ranging from such “hard” aspects as transportation facilities, telecommunication facilities, supplies of energy and other utilities, to such “soft” aspects (*i.e.* institutional development) as the availability of business-related (producer) services (*e.g.* accounting, legal services and consultancy services), the availability of both specialised and diversified labour force, accessibility to major financial markets, *etc.* The importance of transportation network for the manufacturing industry, for example, is well documented in terms of the differential costs of reaching overseas or domestic markets, as well as the differential costs of obtaining essential parts, components, sub-assemblies, raw materials, *etc.* Its importance, however, is very much diminished, when it comes to such an information-intensive intangible service industry as insurance. Likewise, the sensitivity of insurance industry to the variation of intra-country general labour costs seems to decrease in the similar account.

In contrast, the quality of “soft” infrastructure seems to be of much greater importance for business profitability of the insurance industry given its information-, skill-, and experience-intensive nature. If the cost structure is considered important for manufacturing industry given the fact that foreign investors generally aim to take advantage of host countries’ cheaper factor inputs, the quality of the labour force may be a much more important consideration than the cost of labour itself for such a skill- and experience-intensive service sector as insurance. This is demonstrated by the emphasis of the agglomeration effect created by the supply of specialised and diversified labour pool on the location choice of FDI in producer services. Likewise, given the concentrated agglomeration feature of financial service FDI noted above, the cost of office space is unlikely to have as strong bearing on the location choice for insurance MNEs as for manufacturing MNEs. Thus, while a city with higher labour costs could be expected to compete less favourably in its efforts to attract FDI in insurance, it is expected that this variable is not likely to yield a strong negative impact on the city’s probability of being chosen. The similar test result is expected of a city’s rental charges of offices in the prime locations and its attractions to foreign insurance companies.

The very nature of the insurance industry also indicates the appropriateness of the quality of telecommunications in terms of the availability of these facilities, any cost

discrimination, and the reliability of their supply. Owing to the unavailability of data on the reliability of telecommunications facilities, the literature typically settles on the availability of supply, which is often measured by the ownership of telephones in the province (city, etc.) concerned. And strong positive relationships between the location probability and the availability of telecommunications facilities have been reported (Dunning and Norman, 1987).

Follow-the-Client Phenomenon

As aforementioned, one of the most important motivations for foreign insurers going abroad is to serve the needs of their international clients which have already engaged or will engage in FDI in the foreign countries (Price Waterhouse, 1991)⁵³.

Government Restrictions and Regulations

The extent and form of foreign involvement in service industries are strictly controlled in many countries, particularly in industries that are considered politically and economically sensitive and important, such as insurance, banking, transportation and telecommunications (UNCTC, 1988; Carter and Dickson, 1992; United Nations, 1993). Changes in national regulatory patterns of controls and impediments to inward FDI by service MNEs have been reported as one of the most important factors affecting the location of service activities by MNEs in recent years (OECD, 1982; 1987b; Walter, 1985; Nigh et al, 1986; UNCTC, 1988). The openness of the host country to new foreign branches, for instance, was found to affect the US international banking involvement in that country (Nigh et al, 1986).

Internalisation Advantages

The largest part of the value-adding activities of the insurance industry consists of the acquisition, interpretation, and dissemination of information. As a service sector, the nature of the technology involved is "soft". Instead of involving primarily processes which can be patented and products which can be submitted to reverse engineering, many technologies typical of service industries are primarily skill- and experience-intensive and require considerable organisation and management capabilities (United Nations 1993). The inability to codify the key competitive advantages of insurance companies in management contract and/or franchising agreements and the high transactions costs of external quality control explain why non-equity modes of market

entry (e.g. intermediary brokers, agents) are typically only entertained as transitory steps to facilitate speedy market entry and the acquisition of local experience.

The transactions costs associated with market-based entry modes may well hinder the international insurance company from securing the full economic rent arising from its ownership advantages, and thus ensures that such companies will typically prefer equity-based modes of market entry. This leads to a choice between a wholly-owned subsidiary and a joint venture with a local partner.

The wholly-owned subsidiary will be favoured if there are high perceived risks of the deterioration of service quality or of the dissipation of proprietary knowledge, or if the costs of writing and enforcing suitable contracts are high, or where global strategic considerations warrant tight co-ordination across business units worldwide. On-the-spot client work necessitates a tight control over the appraisal of individual risk before acceptance, the underwriting policy pursued, and the settlement of any subsequent claims. Different interest and opportunism in a joint venture mode, however, often lead to difficulties in technical management, competitive success and the development of long-term goodwill (Dunning, 1989). A firm also runs a risk of losing its long-term revenue by sharing its knowledge with a partner which decides to operate as a separate entity in the future. The risk is especially high in international transactions where inter-organisational infrastructures are poorly developed, highly changeable, and particularly weak across national boundaries (Van de Ven and Marshall, 1989). Insurance companies have, therefore, preferred complete control and have looked upon looser arrangements only as a way of exploring a new market's potential (UNCTC, 1989).

On the other hand, a joint venture will typically be preferred if there is a need to reduce initial start-up costs, or a need to share the risks of providing insurance services, or a need to customise services to meet the requirements of local customers. By taking over an existing local company, a foreign insurer can reduce the initial start-up costs and offer competitive premium rates. Moreover, in such industries as investment banking and property/casualty insurance, the risks borne in providing particular services are such that they have to be shared by, or syndicated among, a consortia of firms. Sometimes these may involve firms from only one country and, in some cases, from several countries (UNCTC, 1989). In addition, the need to customise service often means that the ownership advantage of TNCs have to be combined with those of firms in the country in which the services are sold, if the economic rent of the former is to be maximised (UNCTC, 1989).

However, the choice of ownership structure may well be circumscribed by government regulations and/or requirements on local equity participation (see above). In particular, as discussed, branches are often preferred to locally incorporated subsidiaries by host country governments because of the difference in legal liability and the implications for policyholder protection⁵⁴. Such requirements often force foreign insurers to adopt a "second-best" entry mode (Carter and Dickinson, 1977; Bar-Niv and Bickelhaupt, 1981; Skipper, 1987; United Nations, 1993).

CONCLUDING REMARKS

Service, including insurance, MNEs often have pronounced ownership advantages over indigenous firms which enable them to overcome the environmental risks and uncertainties involved in operating in a foreign country. In order to exploit their salient ownership advantages most profitably and effectively, insurance companies have to make strategic decisions about the right vehicle for international transactions. They have to choose between equity or non-equity modes of exploitation, *i.e.* whether to internalise their ownership advantages or license the property rights to other firms. The prevalence of the FDI entry mode in the insurance industry is the result of the interaction between the limited impact of information technology on the tradeability of insurance services, government restrictions on international transactions of insurance services, and the high transactions costs associated with non-equity mode of entry.

The impact of information/telecommunication technologies on the tradeability of the insurance industry has been more limited than many other services. The distinctive nature of the insurance industry with respect to the need for proximity, and for often instantaneous interaction between the insurer and the insured, has traditionally obliged insurers to have a physical presence in every country in which they wish to conduct business: proximity between insurers and the markets in which they operate is needed for trust-building and active marketing, for the protection of the integrity of the insurers' underwriting and the quality of their services; speedy and efficient transfer of information between insurers and prospective clients is needed for risk assessment, tailoring insurance policies to the specific needs of clients, claims investigation, negotiation and speedy settlement upon a careful assessment of the local economic and social conditions. The requirement of on-the-spot client work has led to the restriction of the unbundling of functional tasks and their geographical dispersion to labour-intensive back office operation, such as data processing and claim processing, rather than the provision of insurance which requires the expertise and managerial

skills to assess risks. Local presence is further warranted by the need to reap full quasi-rent from their ownership advantages, and to save transactions costs of quality control in such a skill- and information- intensive service industry as insurance. And the on-the-spot requirement may well be turned into a necessity by government regulations which prohibit local residents from placing insurance with foreign insurers not authorised to transact insurance business within the countries concerned. Therefore, in view of the technical, legal/governmental and economic aspects of the tradeability of insurance services, the possibilities of direct transaction of insurance business across national borders without the local presence of foreign affiliates can not be expected to be substantially realised in the immediate future. FDI, rather than export, will continue to be the prime mode of international transaction of insurance business. The relevance and limitation of the existing FDI literature on location choice for foreign insurance companies in China will be examined in chapter 7.

The FDI literature suggests that multinational insurers' preference for wholly-owned entry mode arises from the need to exercise complete control when there is high contractual risks associated with the joint venture entry mode. The contractual risks are the perceived high risks of dissipation of knowledge, risks of deterioration of quality service, and high costs of writing and enforcing contracts. Joint venture mode of entry, on the other hand, is favoured if there is a need to offset risk, to save start-up costs, to customise services, and if partners' complementary skills and resources are required for the competitive success of the venture. Examples include patent or technical know-how, financial resources, experienced managerial personnel, accesses to marketing and distribution systems, and political clout. The choice of equity mode, however, may well be a forced choice for foreign insurers in compliance with national government's requirement or preference for overseas incorporated branch offices and/or joint venture with local equity participation. It is expected that for those foreign insurers forced into joint venture by the predominant government influence, their paramount desire is to ensure foreign management control in order to minimise the transactions costs associated with the joint venture entry mode. These hypotheses will be verified by the findings of the questionnaire survey of the representative office of foreign insurance companies/insurance intermediaries regarding their partner selection criteria in chapter 6.

CHAPTER 5 AN ECONOMETRIC MODEL OF PROVINCIAL LIFE INSURANCE DEMAND

INTRODUCTION

As discussed in the introductory chapter, insurance is a risk transfer mechanism whereby the individual or the business enterprise can shift some of the uncertainty of life on to the shoulders of the others. In return for a known premium, usually a very small amount compared with the potential loss, the costs of that loss can be transferred to an insurer. Without insurance, there would be a great deal of uncertainty experienced by an individual or enterprise, not only as to whether a loss would occur, but also as to what size it would be if it did occur (Dickson and Steele, 1995). The basic demand for insurance, therefore, arises from the satisfaction a consumer gains from the increase in financial security achieved by transferring the risk of loss to an insurer, *i.e.* the financial security derived from substituting the certainty of the amount and timing of a premium for the uncertainty of actual losses. The rational consumer, whether an individual or a firm, would give priority to insuring those risks which he estimates (regardless of how subjective the estimating process may be) as having high expected loss values because either the probability of occurrence is high, or if a loss does occur, it is likely to be of a catastrophic size relative to his financial resources (Carter, 1979).

Basic forms of life insurance, *i.e.* term and whole-life contracts, are purely contracts of insurance undertaking the payment of an agreed sum upon the death of the life insured. Thus they are concerned with meeting a demand for financial security. Today, however, most of the contracts underwritten by life offices incorporate a greater or lesser degree of savings in addition to pure insurance. Endowment policies, premium loading for participation in profits, equity-linked and unit trust schemes are stages in the movement from pure insurance to what have become predominantly savings contracts as individuals seek not merely financial security for dependants but also a return for themselves on their savings. Nowadays, with pure life insurance policies to provide financial security for dependants against the risk of the breadwinner dying young and annuities providing financial security against the risk of living too long

in the two extremes, most life insurance policies are a combination of the protection, saving and other options.

The determinants of life insurance policies are well documented in the insurance studies. Fischer (1973), Campbell (1980), Ferber and Lee (1980), Burnett and Palmer (1984), Lewis (1989), Gandolfi and Miners (1996) reported demographic and economic factors for the demand of life insurance policies for protection and savings alike. Moreover, studies have been attempted on the national level and cross-national level. Cummins (1975), De Pamphlis (1977) and Gandolfi and Miners (1996) studied the US market, while Diacon (1980), and Schwebler (1984) researched the UK, French and West German markets. Meanwhile, Beenstock (et al 1986), Truett and Truett (1990), Browne and Kim (1993), and Outreville (1990, 1996) conducted cross-country studies on this subject. These studies, however, are predominately on the determinants of life insurance premiums in industrialised countries and cross-national studies on a general basis. No attempt has been made to undertake an empirical study of provincial life insurance demand within China.

The purpose of this chapter is to fill the gap by developing a dynamic life insurance demand model in China's provinces/autonomous regions/municipalities. As examined in the previous chapters, China has got great potential in insurance demand, and foreign insurers are racing for the promising future the market projects. Economic restructuring and the subsequent overhaul of China's welfare system, the rapidly ageing population and the breaking down of the traditional values and family-based old age welfare system, the diminishing fears of insuring against death, the increasing disposable income, as well as the boosting of institutional investors by the newly introduced regulations for establishing mutual investment funds, have all created the necessary impetus for life insurance demand in China. Rational consumers in China are facing an increasing need to protect themselves and their families from the financial uncertainty arising from these reforms. With the transformation of the pension system from the pay-as-you-go defined benefit system to a combination of defined benefits and defined contributions, the pension reform provides the incentives for supplementary (private) insurance provisions by reducing the high replacement rate under the old system. What is more, China's developing country status, its huge population and vast regional disparities mean that any higher expectations above the basic poverty benefits will have to be met through the provision of supplementary private insurance. The demand is reinforced by the rapid ageing population as a result of the one-child policy and the increasing life expectancy, whereby the ratio of workers to pensioners (population age 65 and above) is subject to steady decline and it is impossible to rely

on the traditional way of family support for the old-age welfare. The increasing insurance demand is also backed by rising income levels enjoyed by the Chinese as a result of the current economic reform.

An empirical study of the main determinants of insurance demand in China is warranted by the fact that market size and growth potential is the prime motivation for foreign insurance FDI in China and one of most important determinants of location choice for foreign insurance representative offices in China, as argued by the previous chapters. Cross-section estimation of the major determinants of life insurance demand in China's 28 provinces/autonomous regions over the period of 1985-1995 has been conducted to study the determinants of life insurance demand and, particularly, the relations between economic development/income level and life insurance demand. The cross-section estimation is based on aggregate life insurance annual premium income of China's 28 provinces and autonomous regions over the period of 1985-1995 published by "China Statistics Yearbook" and "Almanac of China's Finance and Banking"⁵⁵.

This chapter is composed of five sections. After a brief review of the literature, hypotheses of the major determinants of insurance demand are developed. A dynamic model of insurance demand is subsequently specified, followed by a discussion of the test results of the model. Finally, some concluding remarks are made, projecting some suggestions for future research.

THEORETICAL REVIEW

The basic function of insurance maintains that individuals demand insurance protection in life policies because there is a risk of premature death and in such an event the dependants may suffer financial hardship. The demand for insurance on the breadwinner's life is based on a life-cycle model where income is uncertain (Yarri, 1965; Hammond et al, 1967; Ducker, 1969; Fischer, 1973; Cummins, 1975; Campbell, 1980; Burnett and Palmer, 1984; Beenstock et al, 1986; Rejda, 1986; Fitzgerald, 1987; Lewis, 1989; Truett and Truett, 1990; Browne and Kim, 1993; and many more). The household's intensity for bequest and risk aversion (*i.e.* its demand for insurance protection), is found to be positively related with the extent of parental dependency (*i.e.* dependency ratio and the proportion of the population with dependants)⁵⁶ and inversely related with life expectancy (Hammond et al, 1967; Fortune, 1973; Campbell, 1980; Burnett and Palmer, 1984; Rejda, 1986; Beenstock et al, 1986; Lewis, 1989; Truett and Truett, 1990; Browne and Kim, 1993). On the one hand, the demand for life protection is expected to rise with the extent of parental dependency because there will be more

people who need to protect their dependants from the financial hardship upon their premature death. On the other hand, the demand is expected to fall with the age of parents because the chances of surviving until dependants are financially self-sufficient will tend to rise with age (Hammond et al, 1967; Beenstock et al, 1986; Lewis, 1989).

Consumers seek in life insurance policies not merely financial security for dependants, but also retirement income protection and savings, especially at a time when government retirement benefits are reduced or privatised. Whilst the demand for insurance protection is expected to fall with the life expectancy of those people who are likely to have dependants, the demand for retirement savings in the case of pension scheme is expected to rise because the longer people expect to live the greater will be their pension requirements (Cummins, 1975; Beenstock et al, 1986; Poortvliet and Laine, 1994). With an increasing ageing population resulted from increasing life expectancy and declining fertility rates, there is an increasingly perceived inability of the working population to support the retirees at an acceptable level of benefits. Demographic changes, together with economic and social changes, have resulted in a worldwide trend of privatisation of government social security systems and increased reliance on individual savings to secure retirement income. In the case of China, as discussed in chapter 2, the defined benefit system is in process of being transformed into a combination of defined benefits and defined contributions. Meanwhile, the old-aged may not be able to rely on family which has traditionally been one of the major sources of support during retirement. Two generations or so ago in many countries one could expect that the majority of elderly could be supported by children or grandchildren living at home or nearby. But increasingly this is impossible. There are fewer extended families, couples are having fewer children or remaining childless, children or other family members may have moved far away, and divorce and remarriage may have weakens bonds between children and parents (Poortvliet and Laine, 1994). Individuals will thus increasingly need to save for their own retirement. In response to market demand, insurance companies have been developing insurance products with an increasing focus upon asset accumulation rather than protection (Poortvliet and Laine, 1994).

Research has shown that the accumulation of life insurance savings were affected by anticipated inflation, the real price of insurance policy, the competitiveness of the rate of return of life insurance in comparison with other types of long-term savings mechanisms, and ultimately, the level of income (Carter, 1979; Cargill and Troxel, 1979).

Previous empirical studies have produced ambiguous results of the impact of anticipated inflation. On the one hand, Neumann (1972), Modigliani (1972), Cummins (1975) found no significant relationships between inflation and the demand for life insurance, probably due to the offsetting effect produced by inflation on insurance protection and savings. Escalating price levels encourage the purchase of large amounts of life insurance protection but discourage increased savings through fixed dollar cash values. It was assumed that the demand for life protection was positively related with inflationary anticipation, while savings through life insurance was negatively related with inflationary anticipation. On the other hand, Houston (1960), Hammond (et al, 1967), Hofflander and Duvall (1967), Fortune (1972, 1973), Cargill and Troxel (1979), Babbel (1981), Babbel and Staking (1983), and Browne and Kim (1993) found that inflationary anticipation adversely affected the demand for life insurance. It is argued that whether life insurance is perceived as protection, savings, or a combination of both services, benefits afforded by the majority of the contracts' guarantees at some future date are fixed in monetary terms. Any increase in the price level decreases the real value of life insurance. The demand for insurance will thus decrease if the contract is not indexed (Hammond et al, 1967; Machnes, 1982). And even if it is indexed, Babbel (1981) showed with empirical data from Brazil that the demand for life insurance was reduced during an inflationary period. Since the death benefit of an indexed life insurance policy is typically adjusted only at the beginning of each year to recover the value lost due to inflation during the previous year, the real value of life insurance is reduced if an insured dies during a year of high inflation (Browne and Kim, 1993)

The use of realised price changes as a basis for measuring anticipated price changes is employed (Choate and Archer, 1975; Browne and Kim, 1993), given that the use of direct estimates of anticipated inflation suggested by Cargill and Troxel (1979) was not possible. The average inflation rate over the prior eight years in each country was used as a proxy for the expected rate of inflation in the analysis of international insurance demand (Browne and Kim, 1993). The method is based on the delayed information hypothesis that consumer's expectation of inflation rates is established by the inflation rate in prior years (Choate and Archer, 1975). Cargill and Troxel (1979) found that realised price changes have been used as a basis of measuring anticipated price changes.

Research has suggested that, except under extreme risk aversion, the real quantity of insurance in force demanded, whether provided by whole life, term, or some other insurance vehicle, was a decreasing function of its real price (Fortune, 1973;

Carter, 1979; Babbel, 1985). Insurance company's loading charges and expected net cost-benefit ratio have been used to measure the price of life insurance policies (Campbell, 1980; Babbel and Staking, 1983; Babbel, 1985; Lewis, 1989). Constructing rationally perceived cost indices from the consumer's point of view, Babbel and Staking (1983) and Babbel (1985), for instance, denoted the price of life insurance policy as the ratio of the present value of expected premium costs, net of dividends and accumulations of cash values, per present-valued unit of indemnification benefits expected to be received, in excess of the actuarial costs⁵⁷. Moreover, the degree of responsiveness of demand for life insurance policies is often measured by price elasticity, and by far the most important influence on the price elasticity of insurance demand is the availability of substitutes. As a long-term savings mechanism, life insurance policies have to compete with other financial mechanisms in investors' portfolios, such as savings deposits, savings certificates, government bonds, and high-grade corporate bonds. And it is especially the case for new life contracts (Carter, 1979). The comparative returns generated by life insurance policies and other financial assets are examined in three major approaches: a direct comparison of the rates of return generated by life insurance policies and that of other financial assets; tax shield; and the options package approach.

Firstly, savings flows to life insurance companies have been found to respond positively to returns on life insurance savings and negatively to returns on competing financial assets (Headen and Lee, 1974; Cargill and Troxel, 1979). The yields on newly issued AAA utility bonds (Cummins, 1975; Cargill and Troxel, 1979), tax-free municipal bond yields, and corporate bond yields (Babbel and Staking, 1983) have been used as proxies for competing rates of return; The yield on industrial bonds placed privately with a representative group of life insurance companies is used to approximate the return on life insurance savings (Cargill and Troxel, 1979).

An alternative approach was proposed by Beenstock (1983) and Beenstock (et al, 1986). It was argued that savings through life insurance reflects consumers' desires to take advantage of the tax shield generated by life insurance-linked investment modes, where the tax shield is denoted as:

$$T = R_a - R_c, \text{ where}$$

T = implicit tax shield expressed in percent per annum

R_a = return on savings in life insurance policies supplied by life insurance companies

R_c = return on competing financial assets.

Beenstock (1983) and Beenstock (et al, 1986) maintained that comparison of the rates of return is only valid in the light of tax shield generated by life insurance linked investment schemes, such as single premium bonds, capital investment bonds, maximum investment plans, friendly society funds, and pension plans. The Tax shield is directly related with personal tax rates, and inversely related to the real interest rate and the holding period [except for single premium bonds (Beenstock, 1983)].

If the tax shield approach provides a partial explanation for the failure of many policyholders to surrender their contracts in favour of higher yielding investments in comparison with the returns on life insurance cash values, the complete explanation of policy-owners' behaviour is, nevertheless, not accounted for if the option viewpoint is not considered (Smith, 1982; Walden, 1985; Babbel and Ohtsuka, 1989). From the option viewpoint, the unique option package offered by life insurance influences the demand for life insurance. The unique options in a life insurance contract form an important part of the package of benefits provided by the policy in such areas as policy loan option⁵⁸, options involving guaranteed mortality rates⁵⁹, and the surrender option⁶⁰. These options enable life insurance to enjoy a unique position in the field of investments by providing a package of options that is not precisely duplicated by any other combination of commonly available contracts.

Research has also shown that the demand for life insurance has been positively related with income, both for the sake of protection and savings (Hakansson, 1969; Fischer, 1973; Fortune, 1973; Cummins, 1975; Campbell, 1980; Burnett and Palmer, 1984; Babbel, 1985; Beenstock et al, 1986; Lewis, 1989; Truett and Truett, 1990; Browne and Kim, 1993). Income appeared to be the only variable consistently positively linked to life insurance sales, though other variables have shown ambiguous impacts on life insurance sales, depending upon the time period under study and the lag specification of the variables (Babbel, 1985). The measure of income has been typically GDP and Gross National Product (GNP) (e.g. Truett and Truett, 1990). The responsiveness of life insurance demand to a change in income is measured by the income elasticity of demand, and the greater than unitary income elasticity leads to the prediction that demand for insurance will continue to grow at a faster rate than the economy generally (Carter, 1979; Beenstock et al, 1988).

In addition to the above-mentioned economic, social and demographic reasons, the decision whether to buy insurance and how much insurance to buy is also influenced by personal attitudes to risks — the uncertainties of loss, and the degree of risk aversion (Fortune, 1973; Carter, 1979; Campbell, 1980; Lewis, 1989; Dickson and Steele, 1995). People experience risks (the uncertainty of loss) on two accounts: first

they do not know if and when the loss will occur (*i.e.* frequency), and secondly they do not know how severe the loss will be once it has occurred (*i.e.* severity). And one of the most important aspects in the measurement of risk states that different people have different attitude to the same situation, with some individuals placing far greater value on security than others. This psychological aspect of risk measurement was typically studied by examining the relationships between individual's education level and insurance demand (Hammond et al, 1967; Baldwin, 1971; Ferber and Lee, 1980; Burnett and Palmer, 1984; Outreville, 1990; Truett and Truett, 1990; Browne and Kim, 1993; Gandolfi and Miners, 1996). It was found that insurance spending is positively related with education level, because people with higher education are more risk averse, more aware of the purpose and necessity of insurance in general (Hammond et al, 1967; Burnett and Palmer, 1984; Truett and Truett, 1990). What is unique to the Chinese case, however, is that insurance is a new concept to the general public after the long disruption of commercial insurance under the State-planning economy. The development of China's insurance market relates back only as far as 1979 and the introduction of China's open door policy. Insurance education is a new practice introduced in the country's opening-up process. What is more, Western influence and economic development in the opening process have been weakening family bonds and the social responsibility for the old-age. It is, therefore, plausible to suggest that insurance consciousness is positively related with the degree of the openness to the outside world.

Finally, empirical research has also been made to investigate the impact of State monopolistic market structure on insurance demand in developing countries (Outreville, 1990). It was found that monopolistic market structure was negatively related with insurance demand, though the result was not significant (Outreville, 1990).

Based on the above theoretical propositions, hypotheses of the determinants of life insurance demand are proposed as follows:

HYPOTHESES

Determinants of Insurance Protection in Life Insurance and Pension Policies

Demographic Determinants

Life expectancy (LE): Whilst the demand for insurance protection is expected to be *inversely* related with life expectancy, the demand for savings for retirement in pension

schemes is expected to be *positively* related with life expectancy. The net effect of life expectancy on the demand for life insurance is determined by the balance between the decreased demand generated by insurance protection and the increased demand generated by savings for retirement.

Dependency ratio (DR): The demand for life insurance protection is expected to relate *positively* with dependency ratio, which is defined as the ratio of the population in age group 0-14 to the age group 15-64 under the Chinese context⁶¹. It is assumed that people in the age group 15-64 have the greatest need to protect their dependants from declining incomes as a result of their premature death.

The average age of those people who are likely to have dependants (A): Whilst the demand for insurance protection is expected to be *negatively* related with the average age of those people who are likely to have dependants, the demand for savings for retirement in pension schemes is expected to be *positively* related with the average age of those people who are likely to have dependants. The net effect of A is decided by the balance between decreased demand generated by dependent income protection against their premature death and the increased demand generated by savings for their own retirement.

The percentage of the population which is likely to have dependants (P): The demand for life insurance protection and pension policies is expected to be *positively* related with the percentage of the population who is likely to have dependants. P is defined as 15-64 age group as a percentage of the total population.

Determinants of Savings in Life Insurance and Pension Policies

Demographic and Social Determinant

Retirees as a percentage of work forces (RW): demand for savings in life and pension policies is expected to be *positively* related with RW. It is arguably a better measure than support ratio in assessing the impact of ageing population on social security funding mechanism. The ability of the cohorts of working age people to support the cohorts of retirees is often measured by "support ratio", which is the ratio of the number of people above the ages at which retirement benefit eligibility generally begins to the number of people of working age. In the case of China, the working ages are 15 to 64 for the male and 15 to 59 for the female. The official population census, however, only generally defines working ages as 15 to 64. It is asserted that the support ratio overstates the possibility of support because it does not reflect the fact that many

people of working age are not employed, whether because of unemployment, disability, or inactivity, and are thus unable to provide support for those retired (Poortvliet and Laine, 1994). A better measure — RW is thus used to reduce the measurement bias by incorporating the employment rate. RW is obtained by multiplying the support ratio by the employment rate.

Economic Determinant

Anticipated inflation rate (AIR): The period covered by the study is characterised by continuous inflation and therefore inflationary anticipation is expected to have produced some impact on the demand for life insurance. As aforementioned, the relationship between life insurance demand and inflationary anticipation is uncertain given the aggregate premium data employed by the study and the opposite effect produced by inflationary anticipation on insurance protection and savings. Whilst escalating price levels could encourage the purchase of large amounts of life insurance protection, it could discourage increased savings through fixed dollar cash values. The outcome of the statistical test lies in the balance between the negative effect produced by savings, and the positive effect generated by protection. To the extent that consumers' expectations of inflation rates are established by the inflation rate in prior years, the average inflation rate over the previous three years in each province/autonomous region/municipality is used as a proxy for the anticipated inflation rate.

Common Determinants of the Demand for Insurance Protection and Savings

Economic Determinants

Gross Domestic Product per capita (GDP): Deflated GDP per capita is used as a proxy of the level of real income and the level of economic development. The demand of life insurance is expected to be *positively* related with GDP per capita.

Savings deposit per capita (SAVINGS): As an indicator of the level of disposable income, deflated savings deposit per capita is introduced to assess the market potentials. It is expected that life insurance demand is *positively* related with savings deposit per capita.

Demographic and Social Determinants

The percentage of adult population with higher education (EDU): The demand for life insurance policies, for protection and savings alike, is expected to be *positively* related

with the education level of the population. Here, the adult population is the population aged 15 and above.

Export as a percentage of GDP (EX): To examine the impact of insurance consciousness on the demand for life insurance in China, export as a percentage of GDP is introduced. Export as a percentage of GDP is expected to be *positively* related with the demand for life insurance. It is assumed that export as a percentage of GDP is positively related with a province/autonomous region/municipality's openness to the outside world, and that the degree of the openness to the outside world is positively related with people's insurance consciousness.

Monopolistic market structure (EC): The constraint of supply is studied by testing the impact of monopolistic market structure on life insurance demand in China. Here, the market structure of a province/autonomous region/municipality is regarded as monopolistic if the presence of PICC's national competitors, China Pacific and Ping An, are very limited and the monopoly of PICC is virtually unchallenged in the local life insurance market. Given that the branches/representative offices of China Pacific and Ping An are concentrated in the Eastern and Central provinces/autonomous regions/municipalities, a dummy variable is introduced. 1 is assigned to the 20 Eastern and Central provinces/autonomous regions/municipalities and 0 to the 8 Western provinces where there is monopolistic market structure. The demand for life insurance is expected to be *negatively* related with monopolistic market structure.

Real investment return of insurance companies (RIR): The constraint of supply is further examined by gauging the impact of real investment returns of life insurance companies on the demand for life insurance. Given the positive relations between the real investment return of life insurance companies and the real profitability of life insurance companies, it is assumed that the real investment return of insurance companies is positively related with the supply of life insurance in the market. It is expected that the demand for life insurance is *positively* related with the real investment return of insurance companies. By real investment return, we mean the investment return net of inflation rate. Provided that the main investment vehicles available to life insurance companies in China are government bonds and bank deposit, the long-term yield of government bond in the period of 1986-1995 is deployed as the proxy for investment return. Here, the three year yield of government bond is used for the sake of data availability.

Average size of the household (H): In order to test the impact of the one-child policy and the associated decreasing family size on the old-age income protection and savings in China, the average size of household is introduced. It is expected that the

demand for life insurance for old-age income protection and savings is *negatively* related with the average size of household. It is assumed that, as a result of the one-child policy, ageing population, and diminishing traditional social norms, the family is gradually losing its function as the unit for old age income protection and savings. People are, therefore, increasingly forced to seek the other alternative for old age support.

The hypotheses are summarised in Table 5.1.

Table 5.1 Summary of The Hypotheses

Independent Variable	Definition	Expected Impact
GDP	GDP per capita	+
EX	Export as a percentage of GDP	+
EC	Eastern and Central provinces/autonomous regions/municipalities assume the value 1, Western provinces/autonomous regions/municipalities assume 0.	-
RIR	Real investment return for insurance companies	+
AIR	Anticipated inflation rate	?
LE	Life expectancy	?
A	The average age of those people who are likely to have dependants	?
RW	Retirees as a percentage of work force	+
H	Average size of household	-
DR	Dependants as a percentage of working population	+
P	The percentage of population who is likely to have dependants	+
EDU	The percentage of adult population with higher education	+
SAVINGS	Savings deposit per capita	+

THE MODEL

First of all, we assume that it is the desired long-run demand of life insurance in China's regions in which we are interested. For simplicity, we assume that the desired life insurance demand Y^* is a loglinear function of the explanatory variables as follows:

$$\begin{aligned} \ln Y^*_{it} = & \ln \beta_0 + \beta_1 \ln GDP_{it} + \beta_2 \ln EX_{it} + \beta_3 EC_i + \beta_4 RIR_{it} + \beta_5 \ln AIR_{it} + \beta_6 \ln LE_i + \beta_7 \ln RW_{it} + \\ & \beta_8 \ln A_{it} + \beta_9 \ln H_{it} + \beta_{10} \ln DR_{it} + \beta_{11} \ln P_{it} + \beta_{12} \ln EDU_{it} + \varepsilon_{it} \end{aligned} \quad (5.1)$$

Where, Y^*_{it} = the desired life insurance premium income per capita in province/autonomous region/municipality i at year t ;

ε_{it} = the random error term;

$\beta_0 \dots \beta_{12}$ are the regression parameters to be estimated.

Since the desired demand for life insurance is not directly observable, let us assume the stock adjustment hypothesis, namely,

Where

$$\frac{Y_{it}}{Y_{i(t-1)}} = \left(\frac{Y^*_{it}}{Y_{i(t-1)}} \right)^\delta$$

$0 < \delta \leq 1$. (5.2)

Equation (5.2) postulates that the actual change in life insurance demand per capita in province/autonomous region/municipality i in any given time period (year) t is some fraction of the desired change for that period (year). It suggests that a constant percentage of the discrepancy between the actual and the desired demand for life insurance per capita is met within a single period (year). If $\delta = 1$, it means that the actual change of demand for life insurance per capita in province/autonomous region/municipality i is equal to the desired change in any given time period t . On the other hand, if $\delta = 0$, it means that the actual demand in province/autonomous region/municipality i in time t is the same as that which was observed in the previous period.

Typically, δ is expected to lie between the two extremes since adjustment to the desired level of demand for life insurance per capita for province/autonomous

region/municipality i is likely to be incomplete because of rigidity, inertia, contractual obligation, costs of change, etc. In the case of China, demand has been constrained by limited supply in the market. The adjustment of life insurance supply in the market to meet market demand is a gradual process, provided that it takes time for the Government to relax investment rules in accordance with the growing maturity of the capital markets and the insurance industry and for life insurance companies to develop professional competence and skills. The recent Asian financial crisis may prompt the Chinese authorities to take a more cautious approach towards the liberalisation of capital markets⁶². Life insurance business was not resumed in China until 1982, and there has been limited competition in the market place under PICC's monopoly. There were only 8 life insurers in the whole country by the end of 1996, as compared with 1695 in the US (Li, 1997; ACLI, 1997). The insurers typically lack the skills to meet the consumers' demand of flexible, transparent, interest- and/or investment return-sensitive products, such as universal life insurance⁶³, variable life insurance, and variable universal life insurance⁶⁴, to safeguard the real value of life insurance policies against high inflation and to ensure the competitiveness of life insurance policy against other long-term investment vehicles (Li, 1997). The products currently available typically lack flexibility in that they can provide neither the required hedge against inflation nor the competitive return to fight off other long-term investment vehicles. The development of the skills requires further competition and further opening-up of the country to foreign operation. Competition has yet to be upgraded from pure price undercutting to product development and innovation. International life insurance skills and experiences have yet to be introduced to the Chinese market through foreign insurance participation. And insurers' capability to offer such products is yet to be facilitated by relaxed investment rules.

In natural log form, equation (5.2) can be expressed as

$$\ln Y_{it} - \ln Y_{i(t-1)} = \delta [\ln Y_{it}^* - \ln Y_{i(t-1)}] \quad (5.3)$$

Substituting $\ln Y_{it}^*$ of equation (5.1) into equation (5.3) and rearranging, we obtain:

$$\begin{aligned} \ln Y_{it} = & \delta \ln \beta_0 + \beta_1 \delta \ln GDP_{it} + \beta_2 \delta \ln EX_{it} + \beta_3 \delta EC_i + \beta_4 \delta RIR_{it} + \beta_5 \delta \ln AIR_{it} + \beta_6 \delta \ln LE_i + \\ & \beta_7 \delta \ln RW_{it} + \beta_8 \delta \ln A_{it} + \beta_9 \delta \ln H_{it} + \beta_{10} \delta \ln DR_{it} + \beta_{11} \delta \ln P_{it} + \beta_{12} \delta \ln EDU_{it} + (1-\delta) \ln Y_{i(t-1)} + \delta \varepsilon_{it} \end{aligned} \quad (5.4)$$

Since equation (5.1) represents the long-run, or equilibrium, demand for life insurance per capita, equation (5.4) can be called the short-run demand function for life insurance per capita because, as we have demonstrated, in the short-run the existing demand for life insurance demand per capita in province/autonomous region/municipality i may not necessarily equal to its long-run level. By estimating the short-run life insurance demand function (5.4), we can easily derive the long-run (desired or equilibrium) life insurance demand function (5.1) by simply dividing the obtained coefficient estimators $\delta n\beta_0, \delta\beta_1, \delta\beta_2 \dots \delta\beta_{12}$ by δ , the estimate of the coefficient of adjustment.

We can apply OLS estimation directly to the stock adjustment model to obtain the short-run demand at first, and then long-run desired demand function, if we assume that ε_{it} and hence $\delta\varepsilon_{it}$ satisfy the assumptions of the classic linear regression model, *i.e.* $E(\varepsilon_{it}) = 0$, $\text{var}(\varepsilon_{it}) = \sigma^2$ (the assumption of homoscedasticity) and $\text{cov}[\varepsilon_{it}, \varepsilon_{i(t+s)}] = 0$ for all $s \neq 0$ (the assumption of nonautocorrelation).

In equation 5.4, variables with both subscripts vary across provinces/autonomous regions/municipalities and over time. The variable with only i subscript, *i.e.* LE , only varies across provinces/autonomous regions/municipalities subject to data availability. R/R does not take the log form because some of the values are negative. δ is the coefficient of adjustment, indicating the percentage of the discrepancy between the desired and actual life insurance demand eliminated in a year. Moreover, domestic life premium incomes per capita, GDP per capita, and savings deposit per capita (SAV) are used to minimise heteroscedasticity. Since we are concerned with the real size of the life insurance market, domestic life premium per capita, GDP per capita, and SAV are expressed at constant 1985 prices. And the unavailable information on the price of insurance products and tax shield of life insurance linked investment modes will be subsumed in the error terms ε_{it} .

Since both the short-run and long-run life insurance demand equations are expressed in log form, we can readily derive the short-run income elasticity and long-run income elasticity from (5.4) and (5.1) respectively. For example, the short-run income elasticity equals $\beta_1\delta$, whilst the long-run income elasticity equals β_1 .

Readers are referred to Appendices 2 and 3 for the definitions of the various economic, financial and demographic variables employed in the model and data sources from which they are derived.

TEST RESULTS

The test results are reported in Table 5.2, with t-statistics in parentheses.

Except for model 1, the estimated short-run life insurance demand function shows that demand for life insurance relates directly with income (LnGDP), and the income elasticity is positive and significant ($p < 0.01$). In model 1, the inclusion of LnEDU made LnGDP insignificant. The correlation matrix (see Appendix 4) revealed that the correlation between LnEDU and LnGDP is 0.924. Thus, multicollinearity between EDU and GDP made it difficult to isolate the separate influence of the individual variables on the demand for insurance. LnEDU was, therefore, dropped from the estimation of Model 2 and Model 3.

Demand for life insurance is positively related with the degree of openness to the outside world (EX) ($p < 0.02$ for model 3 and $p < 0.05$ for model 2), which suggests that as people are more insurance conscious their demand for life insurance rises. The supply constraint effect is borne out significantly both by the dummy variable EC and by the real investment return (RIR) ($p < 0.2$), suggesting that the liberalisation of the insurance market, and the creation of insurance companies and their supply of financial assets, liabilities and insurance services, are needed to meet life insurance demand. Last but not least, the lagged dependent variable (LnY_{t-1}) is statistically significant, implying that the appropriate model is dynamic and that the long-run demand function differs from its short-run counterpart.

The demand for life insurance is an inverse function of the anticipated inflation rate (AIR) ($p < 0.1$), indicating that concerns over the real costs of life insurance savings more than offset the need for dependant income protection in the face of high inflation. Likewise, increased life expectancy (LE) increases savings and old-age income protection in pension schemes by more than it reduces income protection for the dependants so that the net effect is positive.

The positive signs for DR and P agree with the expectation that the degree of dependency and the percentage of the population with dependants raise the demand for income protection for the dependants against breadwinner's premature death. Both variables are, however, insignificant, implying that the relations between income protection for the dependants and the rise of life insurance demand is a weak one⁶⁵. In comparison, the consistent findings on AIR, LE, RW (retiree-worker ratio), A (average age of those people who are likely to have dependants) and H (average size of household) suggest people are more inclined towards old-age savings and income protection in making their life insurance purchasing decisions. The problems of an

ageing population and the increasing extent of old-age support are further highlighted when the average age of the working population is on the increase. Compounded by the shrinking family size as a direct result of China's one-child policy, people are forced to seek such alternative arrangements as life insurance to the traditional extended family for their old age income support and protection. The need is further strengthened by the heightened individualism and increasing labour mobility in an ever open society, as indicated by the findings on EX.

Table 5.2 Summary of the Dynamic Short-run Life Insurance Demand Model.

Variable	Model 1	Model 2	Model 3
C	1.7014 (0.4574)	1.6509 (0.4459)	2.3814 (0.8731)
LnY _{t-1}	0.6712 (29.9186 ^a)	0.6704 (30.3047 ^a)	0.6706 (31.8986 ^a)
LnGDP	0.1421 (1.2538)	0.1638 (2.9373 ^a)	0.1553 (3.1045 ^a)
LnEX	0.0975 (2.1204 ^c)	0.0956 (2.1421 ^c)	0.095 (2.4079 ^b)
EC	-0.0625 (-1.4274 ^e)	-0.0633 (-1.4545 ^e)	-0.0652 (-1.5967 ^e)
RIR	0.0321 (1.3154 ^e)	0.032 (1.3122 ^e)	0.0316 (1.3099 ^e)
LnAIR	-0.9645 (-1.7584)	-0.928 (-1.8195 ^d)	-0.9298 (-1.8544 ^d)
LnLE	0.6212 (1.2815 ^e)	0.6029 (1.2735)	0.5931 (1.2696)
LnRW	0.0982 (1.1024)	0.0908 (1.1005)	0.1057 (1.2546)
LnA	0.0214 (0.5836)	0.0282 (0.6093)	
LnH	-0.2268 (-0.5204)	-0.2257 (-0.5027)	
LnDR	0.1689 (0.7258)	0.1623 (0.7111)	
LnP	0.2107 (0.4175)	0.2026 (0.4027)	
LnEDU	0.1368 (0.5696)		

Note: ^a denotes significance at the 1% level; ^b denotes significance at the 2% level; ^c denotes significance at the 5% level; ^d denotes significance at the 10% level. ^e denotes significance at the 20% level; R² is 0.91. t-statistics are in brackets. Sample size is 280.

All in all, the findings suggest that Chinese life insurance purchasing behaviour is more determined by old-age income support and protection than by the concern for dependant income protection against breadwinner's premature death. And their

insurance buying behaviour is heavily influenced by the availability of insurance provision and services in the market place.

On the other hand, the insignificance of A, H, DR, and P (t-statistics all less than 1) could well be because the use of aggregate data made it impossible to test the separate effects of pure insurance protection, savings and various options on the demand for life insurance in China. A constrained life insurance model (Model 3) is thus presented, which excludes A, H, DR, and P.

In model 3, the coefficient of adjustment is $\delta = 1 - 0.6706 = 0.3294$, implying that only about 33% of the discrepancy between the desired and actual life insurance demand is met in one year. The low adjustment speed suggests that life insurance demand in China is constrained by supply in the market place. It takes time for the supply in the market place to meet the demand for flexible, transparent, interest-sensitive and/or investment return-linked savings-oriented life insurance products. New product development not only requires the right capacity, techniques and experience which have been lacking for Chinese domestic insurers, but also the relaxation of investment mechanisms for life insurance companies by the Chinese Government. The development of skills and experience requires further liberalisation of China's insurance industry for competition and for foreign insurance participation. It also requires the Government to adjust investment rules in line with the growing maturity of the capital markets and the insurance industry. These requirements, however, can only be met in a gradual manner, especially in the wake of the Asian financial crisis.

The long-run life insurance demand function can be obtained by dividing the short-run life insurance demand function by δ and dropping the $\ln Y_{t-1}$ term. The results are as follows:

$$\ln Y^*_{it} = 7.2295 + 0.4715 \ln GDP_{it} + 0.2884 \ln EX_{it} - 0.1979 EC_i + 0.0959 RIR_{it} - 2.8227 \ln AIR_{it} + 1.8006 \ln LE_i + 0.3209 \ln RW_{it} + \varepsilon_{it} \quad (5.5)$$

As we can see from equation 5.5, the long-run income elasticity of demand for life insurance is about 0.47, which is greater than the corresponding short-run elasticity of about 0.16. Nevertheless, both the short-run and long-run income elasticity of demand for life insurance are smaller than unity, which could be explained by the lack of insurance supply in the market place, the high perceived opportunity cost of life insurance as a result of the high anticipated inflation rate, as well as the lack of long-term investment vehicles to ensure the term transformation of savings through life insurance in China. The Chinese strong propensity to purchase life insurance for old-age income support and their strong concern over the real cost of savings through life

insurance is further revealed by the size of the elasticities associated with AIR and LE respectively. As shown by equation 5.5, the AIR elasticity and LE elasticity for life insurance demand are both more than unity: about 2.8% for AIR and 1.8% for LE. Given the lack of long-term investment vehicles for insurance companies and underdeveloped capital markets, the Chinese are, therefore, more inclined to deposit their savings in the bank, rather than buying insurance, when they have more income. Finally, Durbin-Watson h statistics was calculated to test the null hypothesis that there was no first-order (positive or negative) autocorrelation in the dynamic short-run life insurance models.

For Model 3, Durbin-Watson $d = 1.803$, thus

$$h = \left[1 - \frac{1.803}{2}\right] \sqrt{\frac{280}{1 - 280 \times 0.00044}} = 0.0985 \times 17.87 = 1.760$$

Since the computed h value lies between ± 1.96 , we do not reject the hypothesis, at 5 percent level, that there is no first order autocorrelation

The alternative specification of the model incorporates savings per capita (SAVINGS) instead of GDP per capita (GDP). As Table 5.3 shows, the savings elasticity of demand for life insurance is a mere 0.11% in the short-run. In the long-run, its corresponding value only increases to 0.33%. The low savings elasticity of demand for life insurance implies that life insurance is still, and will remain, low in the Chinese savings structure, unless insurance consciousness is promoted and long-term investment vehicles for life insurance are further liberalised.

For this model, Durbin-Watson $d = 1.792$, thus

$$h = \left[1 - \frac{1.792}{2}\right] \sqrt{\frac{280}{1 - 280 \times 0.000558}} = 0.104 \times 18.217 = 1.895$$

Once again, we do not reject the null hypothesis, at the 5 percent level, that there is no first-order autocorrelation.

Table 5.3 Summary of the Dynamic Short-run Life Insurance Demand Model, Replacing GDP Per Capita with Savings Per Capita As One of The Explanatory Variables.

Variable	Estimated Coefficient	t-statistic
C	0.1334 (2.6326)	-0.0507
LnY _{t-1}	0.6517 (0.02363)	27.5821 ^a
LnSAV	0.11 (0.3862)	2.8491 ^a
LnEX	0.0995 (0.04)	2.491 ^b
EC	-0.0476 (0.0411)	-1.1573
LnRIR	0.027 (0.023)	1.174
LnAIR	-0.7608 (0.4563)	-1.6671 ^d
LnLE	0.8842 (0.4691)	1.8849 ^d
LnRW	0.1198 (0.0844)	1.4192 ^e

Note: ^a denotes significance at the 1% level; ^b denotes significance at the 2% level; ^c denotes significance at the 5% level; ^d denotes significance at the 10% level; ^e denotes significance at the 20% level; R² is 0.91. Standard errors are in parentheses. Sample size is 280.

CONCLUSION AND DISCUSSION

This study represents the first attempt to identify the major determinants of life insurance demand across China by pooling cross-section and time-series data for China's 28 provinces/autonomous regions/municipalities over the period of 1985-1995.

The following conclusions can be drawn from the test:

- I. The income elasticity of demand for life insurance is significant and positive, but less than unity. The low income elasticity may be ascribed to the combined effect of the lack of long-term investment instruments for life insurance and the lack of insurance supply. The combined effect means that most household

savings in China are in short- and medium-term deposits in banks and other deposit-taking financial institutions, which do not provide a solid basis for long-term lending. Missing the term transformation of savings undermines insurance companies' role as institutional investors, their ability to meet public demand for flexible and interest-/investment return-sensitive products, and may well jeopardise the very success of pension reform which is badly needed for China's economic restructuring programme. The realisation of China's vast potential of life insurance demand, therefore, requires the efficient term transformation of savings and the development of life insurance skills and competence. The term transformation of savings into long-term investment in the most productive way demands the liberalisation of investment vehicles for insurance companies and the development of China's under-developed capital markets. The recent approval of regulations for establishing mutual investment funds by the State Council marked the birth of a fund management industry in China to foster institutional investors and help to increase the liquidity and stability of the speculative and volatile capital markets.

- II. The demand for life insurance is a direct function of the provision of life insurance in the market place. Demand for life insurance increases in the Eastern and Central Provinces as the market structures there are less monopolistic than those in the Western provinces. Likewise, life insurance demand is on the rise when there are more insurance suppliers/services in the market place motivated by the decent investment returns from their products.
- III. Life insurance demand in China is more geared towards the need for old-age income support and protection than towards dependant income support. The old-age insurance protection and pension scheme is positively related with insurance consciousness of the general public, increasing life expectancy, and the rising old-age support ratio. It is adversely related with the anticipated inflation rate and the average size of the household. Here, the need for old-age income protection and support is particularly underpinned by the breaking down of the traditional extended family both in its form and in its value by the one-child family plan policy, increasing individualistic assertiveness, and the increasing labour mobility.
- IV. The test results indicate the importance of distinguishing between the pure insurance protection and savings components in the life insurance demand model. We, however, are prevented from making such distinctions by the lack of disaggregated data.

Further insight into the major determinants of life insurance demand in China could be gained from future research. First, given that life insurance policies sold by insurance companies consist of components of pure insurance, savings and various options (Smiths, 1982), further research is needed to test the separate effects of the components on the demand of life insurance in China; Second, also required are careful examinations of price elasticity, life insurance demand motivated by the tax shield effect, and the competitiveness of the rate of return of life insurance products against that of the other long-term savings mechanisms. Third, a further study into the income elasticity of consumers of different income groups and income distribution will shed some light on the different insurance demand potentials of consumers across income sub-groups, and the impact of income distribution on the demand of life insurance.

These further studies, however, have the following requirements: (I) disaggregation of life insurance premium income into conventional life insurance business and insured pension plans; (II) disaggregation, albeit approximate, of the insurance protection element in life and pension business from the pure savings element; (III) data on policy terms, *e.g.* cash surrender value, death benefit, dividend (if any), and policy loans (if any), survival rates and discount rates; (IV) provincial data on income distribution. The lack of disaggregated data on provincial life insurance premium and the lack of provincial data on income distribution, however, have made these estimations impossible for the current study.

Despite the inadequate disaggregation of data, the current study is important for the understanding of China's life insurance market and its potential by identifying the major determinants of provincial life insurance demand. The research furthers our understanding of the linkage between economic development and life insurance demand, and suggests the ways for promoting life insurance demand in China.

CHAPTER 6 RESULTS OF THE QUESTIONNAIRE SURVEY

INTRODUCTION

As discussed above, the potential of China's insurance market, coupled with the relative lack of local expertise, have led to the world's leading insurance companies queuing up to start operations in China. The ban on cross-border trade, together with the technical features of the insurance business, have determined some form of local presence within the market. Licenses to operate through branches or joint ventures are coveted by the foreign insurers, but approval by the Chinese authorities is far from automatic and must be earned. Given the high contractual risks involved in China operation, one would expect foreign firms to have a strong preference for wholly-owned subsidiaries as a mode of entry. Yet fear of foreign domination has led the authorities to thwart such desires, and foreign life insurers are required to adopt the joint venture mode of entry. These considerations raise a range of strategic questions for foreign insurers, to which answers have been sought using a questionnaire survey:

- What strategies have foreign insurers adopted in pursuit of the elusive operating licenses?
- What criteria have been used in the selection of Chinese partners in joint ventures?
- What have been the criteria determining the choice of location within China? And which cities have been the favoured locations on the basis of these criteria?

Also sought in the questionnaire survey have been responses regarding foreign insurers' perception of the main operating problems in China, given the high risks involved in China insurance business in terms of the deficient legal framework, underdeveloped market infrastructures, widespread under-insurance and lack of insurance awareness.

The survey was undertaken in July 1996. Questionnaires were distributed to 95 representative offices of foreign insurance companies/insurance intermediaries in China, and 41 valid responses were received (44% response rate). These responses came from offices whose parent companies were European (18)⁶⁶, American (10), Japanese (12), Australian (1), and Canadian (1). 11 of the valid responses were from specialist life insurance companies; 14 from specialist non-life insurance companies;

10 from composite (*i.e.* life and non-life) insurers; 6 from insurance intermediaries; and 1 from a reinsurer. 18 of the offices were located in Beijing; 14 in Shanghai; 3 each in Guangzhou, Dalian and Shenzhen; and 1 in Tianjin.

The questionnaire involved two types of questions. The first type — used for eliciting views on location and selection criteria, as well as the perception of the main operating problems in China — required each respondent to score the importance of specific factors on a 5-point Likert-type scale. A score of 5 on this scale indicated that the factor was considered to be 'very important'; a score of 4 'quite important'; a score of 3 'important'; a score of 2 'of little importance'; and a score of 1 indicated 'of no importance'. The second type of question addressed the popularity of 10 cities as locations for representative offices within China. Respondents were asked to score each city on each of the location factors using a 10-point scale. The distribution of data was found not to be normally distributed, so an appropriate non-parametric procedure was used for all statistical tests (*i.e.* the Kruskal-Wallis test as three populations were being compared).

STRATEGIES TO OBTAIN OPERATING LICENSES

For foreign insurers/insurance intermediaries, the approval of an operating licence is not automatic and "winning over" the Chinese authorities requires rather more than demonstrable expertise and experience. As Roger Taylor, the Executive Deputy Chairman of Royal Sun Alliance, has put it: "It's politics — first, second, and third."⁶⁷

Our questionnaire survey thus sought views about the relative importance of a number of factors which might have a positive influence upon the authorities. These factors may be grouped as follows:

- Corporate strategies which aid the development of the domestic insurance industry;
- The expertise and experience of the foreign insurer;
- "Political" strategies which foster good relations.

It has been noted in the previous chapter that the objective of the 1995 Insurance Law was to control the development of China's domestic insurance industry, rather than to encourage greater openness and/or competition. Furthermore, the reforms of the social security system, with the associated emancipation of the SOEs from their social welfare responsibilities in the economic restructuring process, have led to particular demand for private life assurance services. It would thus seem wise for

foreign insurers, in their pursuit of the coveted operating licenses, to emphasise their potential contributions to the development of the domestic industry. This might be achieved through a clearly stated long-term commitment to the Chinese market or, more concretely, through investment in an insurance training and education programme. Or the foreign insurer might incorporate an explicit proposal to provide life insurance, given the importance attached to this by the authorities. The authorities also have a clear preference for the joint venture mode of entry. Hence an explicit strategy of forging a joint venture with a Chinese partner, notwithstanding any corporate preference for a wholly-owned branch or subsidiary, might also be a successful strategy.

The expertise and experience of the foreign insurer may be captured under three headings. First, the length of time the foreign insurer has had links with China clearly testifies not only to experience and expertise, but also to commitment. Second, corporate expertise in life insurance may be particularly important given the requirements of the Chinese authorities. Third, the authorities' clear preference for foreign insurers of size and stature should be reflected in the weight accorded to financial prudence and corporate reputation.

The political dimension may be important at both the corporate and the governmental level. At the corporate level, *guanxi* has long been recognised as the lifeblood of the Chinese business community (Roehrig,1994;Davies,1995; Bjorkman,1996). Without *guanxi*, one simply can not get anything done. On the other hand, with *guanxi*, many things are possible (Davies,1995). Companies possessing good *guanxi* with the right people are seen to enjoy an advantage over their rivals (Bjorkman,1996). Thus the chances of being granted an operating license might well depend upon maintaining good relations with the PBOC. At the governmental level, it is expected that good relations between the foreign insurer's national government and the Chinese Government will also be important. It is widely believed (by the China executives of foreign insurers) that the Canadian insurer Manulife had, to a great extent, benefited from the fact that the Chinese authorities were reluctant to grant a license to the German firm Allianz, following friction with the German Parliament over the issue of human rights. A co-ordinated approach involving active promotion by the foreign insurer's national government might also prove valuable, particularly in enabling potential entrants to leapfrog their competitors. Finally, given the politicisation of China's campaign for WTO admission, support for China's WTO membership campaign might also prove to be a fruitful strategy in the search for an operating license.

Tables 6.1 and 6.3 provide a summary of the respondents' views on the relative importance of these eleven factors by nationality and by business category respectively. The results confirm the expected importance of political considerations, with the promotion of good relations with PBOC and between the respective governments seen as crucial. At the other end of the scale come the factors related to the provision of life insurance. This probably reflects the fact that the development of all forms of insurance are required in China, even if life insurance is the type where the requirement is most urgent. The most surprising result is perhaps the low importance accorded to forging joint ventures with Chinese partners. Maybe, as Vanhonacker (1997: 136-137) noted, "more important than what the rule books say are the principles that underlie the rules. China wants and needs its foreign investors to bring something of value to the table. My experience has shown time and time again that if they do the form of investment is largely negotiable. That is why WFOEs are just as feasible as a way to enter the market of the Middle Kingdom as EJV's."

Table 6.1 Strategies to Obtain Operating Licenses, Analysed by Nationality of The Respondents

Strategy Sample Size	Mean 40	European 18	US 10	Japan 12	Sig.
Good relations with the PBOC	6.325	6.111	6.8	6.25	
Good relations between the foreign Insurer's national government and the Chinese Government	6.175	6.111	6.5	4	
Clearly-stated long-term commitment to Chinese market	4.025	6.167	6.1	3.75	
Financial prudence and corporate reputation	3.95	4	3.9	3.917	
Promotion by the foreign insurer's national government	3.95	3.833	6.1	4	
Length of time foreign insurer has had links with China	3.625	3.778	3.3	3.667	
Investment in an Insurance training and education programme	3.6	3.5	3.7	3.667	
Forging joint venture with Chinese partner	3.45	3.667	3.9	2.75	*
Support for China's WTO membership campaign	3.1	3	3.5	2.917	
Corporate expertise in life insurance	2.9	3.056	3.3	2.333	
Explicit proposal to provide life insurance	2.6	2.722	2.9	2.167	

Note: * denotes $p < 0.1$

Furthermore, Kruskal-Wallis tests were undertaken to see if there were any significant differences in the importance attached to the factors by the European, the US and the Japanese respondents in the sample. No such differences were found, except with regard to the importance of forging joint ventures with Chinese partners. Here the Japanese respondents gave significantly lower scores than their European and US counterparts, and this contributed to the low overall importance accorded to this strategy. This finding is consistent with the survey finding that Japanese insurers were the least interested in establishing joint ventures with Chinese partners (Table

6.2). Japanese lack of interest in joint venture entry mode will be discussed further in the next section.

Table 6.2 Preference for a Sino-foreign Joint Venture Entry Mode, Analysed by Nationality of The Respondents

Nationality	Yes (%)	No (%)
European	72.22 (13)	27.78 (5)
US	70 (7)	30 (3)
Japan	25 (3)	75 (9)

Note: Sample size in brackets.

Table 6.3 Strategies to Obtain Operating Licenses, Analysed by Business Category of The Respondents

Strategy Sample Size	Mean 41	Life 11	General 14	Composite 10	Intermediary 6	Sig.
Good relations with the PBOC	6.336	6.455	6.357	6.7	3.833	
Good relations between the foreign insurer's national government and the Chinese Government	6.122	6.272	6.214	6.5	3.5	
Clearly-stated long-term commitment to Chinese Market	4.035	4.091	3.714	6.5	3.833	*
Financial prudence and corporate reputation	3.972	3.727	3.929	3.9	6.333	
Promotion by the foreign insurer's national government	3.885	3.727	6.214	6.1	3.5	
Investment in an insurance training and education programme	3.644	3.727	3.714	3.8	3.333	
Length of time foreign insurer has Had links with China	3.602	3.091	3.786	3.7	3.833	
Forging joint venture with Chinese partner	3.54	6.273	2.786	3.6	3.5	***
Support for China's WTO membership campaign	3.114	2.727	2.929	3.8	3	*
Corporate expertise in life insurance	2.892	4.091	2.143	3	2.333	***
Explicit proposal to provide life insurance	2.624	3.455	2.143	2.9	2	**

Note: * denotes $p < 0.1$; ** denotes $p < 0.05$; *** denotes $p < 0.01$

Kruskal-Wallis tests were also taken to test the differences among the respondents of different business categories. As Table 6.3 shows, significant differences were found in "clearly-stated long-term commitment to Chinese market", "forging joint venture with Chinese partner", "support for China's WTO membership campaign", "corporate expertise in life insurance", and "explicit proposal to provide life insurance". Although "clearly stated long-term commitment to Chinese market" is endorsed as one of the most important strategies in foreign insurers/insurance intermediaries license pursuit, it seems that greater importance is pinned on this factor by life insurers and composite insurers than general insurers and insurance intermediaries. And composite insurers put higher premium on "support for China's

WTO membership campaign” than (life and general) insurers and insurance intermediaries. Unsurprisingly, significantly higher scores are given to “corporate expertise in life insurance” and “explicit proposal to provide life insurance” by life insurers. And the same pattern for “forging joint venture with Chinese partner”. Here, highest scores are from life insurance respondents and the lowest scores are from general insurers. Life insurer’s highest/general insurers’ lowest endorsement of forging Sino-foreign joint venture is consistent with the findings on respondent’s interest in establishing a joint venture with a Chinese partner. As table 6.4 shows, all of the life insurance respondents are interested in joint venture, in contrast to a mere 16.29% in the case of general insurance respondents. As revealed by the results of the main reasons for not choosing a joint venture entry mode, the need to exercise complete management control in the running of the venture is the single most important factor that decides general insurer’s predominant endorsement of wholly-owned venture entry mode (Table 6.5).

Table 6.4 Interest in Joint Venture Entry Mode, Analysed by Business Category of The Respondents

Business Categories	Yes (%)	No (%)
Life insurance	100 (11)	0 (0)
General insurance	16.29 (2)	85.71 (12)
Composite insurance	80 (8)	20(2)
Insurance intermediaries	66.67 (4)	33.33 (2)

Note: Sample size in brackets.

Table 6.5 Factors for Endorsing Wholly-owned Venture Mode

Factor	Mean	Ranking
To exercise complete management control of financial matters	6.375	1
To exercise complete management control of product development	4.083	2
To exercise complete management control of marketing	3.958	3
To increase total profit	3.333	4
Unable to find a suitable joint venture partner	3.167	5
Insufficient financial incentives	2.708	6

Note: Included in the sample are 14 general insurance respondents and 5 composite insurance respondents. The other respondents are interested in the joint venture mode, and hence skipped this question. Due to the insufficient sample size for composite insurers, mean differences between general insurers and composite insurers can not be compared using Mann-Whitney-Wilcoxon test. It is, nevertheless, sufficient to detect the marked difference between general insurers and life insurers concerning the choice of joint venture entry mode. While all life insurers are interested in joint venture entry mode, general insurers are predominantly interested in joint venture entry mode. Further, the endorsement of wholly-owned venture mode by composite insurers very much reflected their general insurance business concerns.

THE SELECTION OF A CHINESE PARTNER FOR A JOINT VENTURE

The FDI literature highlights complementarity in function and compatibility in objectives as the main bases for partner selection. In the same vein, Geringer (1988, 1991) differentiated various criteria as being either task-related (complementary) or partner-related (compatible). Examples of task-related (complementary) criteria include patents or technical know-how, financial resources, experienced managerial personnel, and access to marketing and distribution systems. And partner-related (compatible) criteria include the partners' national or corporate culture, the degree of favourable past association between the partners, compatibility of and trust between partners' top management teams, and partners' organisational size or structure. In addition, given that perceptions of environmental and internal characteristics (rather than the "objective" characteristics of the environment) are the important factors to consider in the strategy formulation process (Anderson and Paine, 1975), firms of different national origin (and different types of business) are expected to put different weights upon the same partner selection criteria. Moreover, given the paternalistic attitude of Chinese Government towards Sino-foreign insurance joint ventures, government restrictions and guidance are also expected to have great impact on the partner selection.

Thus the questionnaire survey listed eleven criteria, grouped as below, as possible determinants of the selection of a Chinese partner:

- partner-related (compatible) criteria.
- task-related (complementary) criteria.
- direction from the Chinese authorities.

As regards partner-related criteria, Schroath (1988) found that the biggest concern among international insurance companies about joint ventures was management control. The nature of the product and the desire to maintain acceptable levels of quality mean that foreign insurers are attracted by the willingness of the partner to accept foreign management control of the venture. Furthermore, given that trust between the two management teams has been identified as an important determinant of the success of joint ventures (Buckley and Casson, 1987), a favourable past relationship would appear to be a sensible *a priori* criterion for partner selection.

A number of complementary criteria may be identified. The importance of the local knowledge and political clout of joint venture partners in the insurance industry has been highlighted by various authors (Schroath, 1988; LIMRA, 1990; Gora, 1991; Huggins and Land, 1992). Thus convenient access to partner's market network is likely

to be an important complementary asset to fulfil the foreign firm's need to acquire country-specific knowledge of the customs of the Chinese insurance-buying public. In view of their different client bases, it is expected that life insurance and non-life insurance companies might have different perceptions of the importance of this criterion. It is expected that life insurance companies will attach more importance to this criterion, given that their primary clients are local Chinese residents, rather than multinational companies as is the case of the non-life insurance companies. In a similar vein, other criteria which might be suggested are the Chinese partner's facilities and resources, the partner's ability to offset risk, the partner's access to local financial markets, the partner's satisfactory location, and the partner's technological capacity and management resources. All such assets may be valued by the foreign insurer but, given the ownership advantages which foreign insurers are likely to enjoy relative to Chinese firms, it seems unlikely that such criteria will be of major importance. As regards political clout, the partner's contacts with central/local authorities are also expected to be an important criterion, given the need of political backing (see the section above) in such a heavily regulated and sensitive industry as the insurance industry in China.

Last but not least, the effects of government restrictions and guidance on the partner selection process must also be taken into account. A certain amount of "interference" from the Chinese Government is to be expected in joint venture negotiations with local Chinese partners⁶⁸. Zheng (1993) found that the selection process in China is sometimes circumscribed by the intervention of the central authorities in terms of the selection choice, partner availability and selection channels. Central government institutions tended to recommend enterprises under their own jurisdiction to foreign firms. Thus the final two criteria are the restrictions of PBOC or the Chinese Government and the guidance/persuasion of PBOC or the Chinese Government.

Table 6.6 and Table 6.7 provide a summary of the respondents' views on the relative importance of these eleven criteria by nationality and by business category respectively. Four criteria have average scores in excess of four. Two of these relate directly to the direction of the Chinese authorities, and suggest that the choice of a Chinese partner is, in many instances, not really a choice but a requirement. This conclusion reinforces the impression that good relations with the authorities are paramount in the pursuit of operating licenses. And the willingness of the partner to accept foreign management control of the venture was also of major importance, and it was particularly valued by the Japanese respondents. Some Chinese insurance

company executives have little experience of the insurance industry in a capitalist sense, and may find it difficult to function in concert with the foreign partner's Westernised management and insurance principles⁶⁹. Moreover, the local partner may also veto major decisions, such as amending the Articles of incorporation and increasing capital, which require unanimous approval. The finding echoed the results of major deciding factors for wholly-owned venture mode. The other partner-related criterion, a favourable past relationship, also scored well.

Table 6.6 Selection Criteria for Joint Venture Partner, Analysed by Nationality of The Respondents

Criterion Sample Size	Mean 32	European 16	US 8	Japan 8	Sig.
The restriction of PBOC or the Chinese Government	6.442	6.25	6.375	6.25	
Willingness of the partner to accept foreign management control of the venture	6.442	6.186	6.125	6.375	
Partner's contacts with the central/local authorities	6.353	6.5	6.125	3.625	**
The guidance/persuasion of PBOC or Chinese Government	6.235	3.75	6.375	6.375	
Convenient access to partner's market network	3.588	3.875	3.75	2.75	*
Favourable past relationship	3.5	3.688	3	3.375	
Partner's facilities and resources (including labour and financial assets)	3.441	3.313	3.5	3.375	
Partner's ability to offset risk	3.412	3.188	2.75	3.625	
Partner's access to local financial markets	3.412	3.375	3.375	3.25	
Partner's satisfactory location	3	2.75	3.375	2.875	
Partner's technological capacity or management resource	2.941	2.813	2.75	3.125	

Notes: * denotes $p < 0.01$

**denotes $p < 0.05$

As regards the task-related criteria, the Chinese partner's contacts with the central/local authorities and the convenient access to partner's market network were both deemed important, particularly by the European respondents. Indeed the European and US respondents accorded significantly greater importance to these complementary assets than did the Japanese insurers. The reasons are perhaps twofold. First, the Japanese firms are probably more acquainted with the Chinese economy and culture than their Western counterparts, and thus have less need of local partners to build relationships with the authorities. Second, the Japanese insurers have, to a large extent, geared their operations to serving their existing client base of Japanese MNEs operating in China. Thus they have less use of local partner's market

networks than do the European and US insurance companies. Such an explanation would be consistent with the low weight attached by Japanese insurers to forging joint ventures as a strategy for obtaining operating licenses.

Table 6.7 Selection Criteria for Joint Venture Partner, Analysed by Business Category of The Respondents

Criterion Sample Size	Mean 34	Life 11	General 10	Composite 8	Intermediar y 5	Sig.
Willingness of the partner to accept foreign management control of the venture	6.303	6.364	6.4	6.286	4	
The restriction of PBOC or the Chinese Government	6.286	6.182	6.3	6.714	3.8	
Partner's contracts with central/local authorities	6.268	6.273	4	6.571	6.4	
The guidance/persuasion of PBOC or Chinese Government	4.063	4.091	6.4	6.143	3.2	
Convenient access to partner's market network	3.768	6.143	3.3	3.818	3.8	**
Favourable past relationship	3.483	3.546	3.5	3.429	3.4	
Partner's facilities and resources (including labour and financial assets)	3.399	3.364	3.4	3.571	3.2	
Partner's access to local financial markets	3.366	3.455	3.3	3.429	3.2	
Partner's ability to offset risk	3.286	3.182	3.3	3.714	2.8	
Partner's satisfactory location	2.983	2.909	3	3.429	2.4	
Partner's technological capacity or management resources	2.975	2.818	2.9	3.143	3.2	

Note: ** denotes $p < 0.05$

Political contacts and quick market access are capabilities which are difficult, if not impossible, for foreign insurers to obtain if they operate alone. In contrast, foreign insurers do not look to their Chinese partners to provide technological, managerial, and financial capabilities, hence the lower importance attached to these selection criteria. These findings are consistent with those of earlier studies on joint ventures in China, albeit for different industries (Shan, 1991; Glaister and Wang, 1993; Dong et al, 1997).

Kruskal-Wallis tests were also executed to detect any significant differences in the importance accorded to the joint venture partner selection criteria by respondents of different business categories. No such differences were reported, except for the importance of "convenient access to partner's market network". As expected, life insurance respondents deem partner's market access significantly more important than general insurance respondents (Table 6.7).

THE CHOICE OF LOCATION

The OLI paradigm postulates that the location choice of FDI within a host country is chosen to maximise the benefits of combining ownership-specific advantages with the local immobile factor endowments to undertake value-added activities (Dunning, 1988). The determinants of service FDI can be classified into six categories:

- Market demand;
- Follow-the-client;
- Competition;
- The availability of suitable inputs;
- Operating costs; and
- Government influence.

Analogous to its positive impact upon the inflow of manufacturing FDI (Scaperlanda and Mauer, 1969; Dunning, 1973; Hood and Young, 1979; Agarwal, 1980; Davidson, 1980; Lunn, 1980; Caves, 1982; Culem, 1988; Pearce, 1992), the size and potential of host-country market has demonstrated its importance in the transnationalisation of transnational banks (Gray and Gray, 1981; Rugman, 1981), international advertising agencies (Weinstein, 1977; UNCTC, 1979; Terpstra and Yu, 1988; UNCTC, 1993), transnational insurance firms (UNCTC, 1980; Schroath and Koth, 1989; United Nations, 1993) and in the location choice of offices of international companies (Dunning and Norman, 1987). FDI seems to be positively related to the level of market size and its long-term growth prospect, rather than the short-term market fluctuation (Pearce, 1992). As shown by chapter 5, provincial life insurance demand in China is positively and significantly related with the real size of the life insurance market measured by GDP per capita and savings per capita at constant prices.

A follow-the-client motive has also been reported by empirical studies of the international banking and advertising industries (Weinstein, 1977; Khoury, 1979; UNCTC, 1979; Goldberg and Sanders, 1980; Ball and Tschoegl, 1982; Nigh et al, 1986; Terpstra and Yu, 1988; UNCTC, 1993). As observed by Knickerbocker (1973), the growth of trade, industrial FDI, transfer of technology and travel has been accompanied by increased demand for services facilitating and supporting this growth.

In this process, TNCs serving their clients in their home countries are pulled along to establish themselves abroad.

In addition, the impact of the behaviour or anticipated behaviour of competitors on location decisions has been confirmed by empirical research of FDI in services (*e.g.* advertising, accounting, trading, retailing, insurance/reinsurance, securities) (Terpstra and Yu, 1988; Dunning, 1989; United Nations, 1993).

Also maintained is the positive relation between the location choice of service FDI and the supply of suitable inputs [*e.g.* communication/travel facilities, trained labour and the existence of agglomeration economies which are the result of the frequent joint demand of intermediate services by customers (*e.g.* tourist related services, banking, insurance and financial services, and trade-related services)], as well as the negative relation between the location choice of service FDI and operating costs (*e.g.* the costs of labour and premises) (Dunning and Morgan, 1971; Dunning, 1989).

Last but not least, the prominent role of government in influencing the location of service activities is emphasised by the FDI literature. As documented in chapter 4, notwithstanding the movements towards deregulation and the liberalisation of FDI in some service industries in recent years, service FDI is under much tighter control by the host country government than manufacturing FDI, ranging from entry to every aspect of operation (UNCTC, 1989). Regulatory controls have been reported as one of the important factors affecting the location of service FDI in recent years (OECD, 1982; Walter, 1985; UNCTC, 1989; UNCTC, 1993). Positive relations have been found between service FDI and the openness of the host-country to the establishment of new foreign service affiliate (Nigh et al, 1986; UNCTC, 1993).

In a country as vast as China and with such substantial regional variations in per capita income and even awareness of insurance, the state of the immediate local market takes on particular significance. We might therefore expect the locational decision to be affected by the current level of local market demand, by local market growth potential, by consumer risk awareness and the demand for insurance products, and by proximity to major clients. As regards this latter factor, it is important to note that several studies (Blackelhaupt and Bar-Niv 1983; Schroath 1988) have shown that insurance companies often feel compelled to follow their international clients in order to both win and retain business. Failure to do so may even result in domestic business being lost to competitors who are willing and able to provide the requisite services to the foreign subsidiaries. And since this client-following phenomena is most applicable to international general insurance companies, we would expect more importance to "proximity to major clients" by general insurance respondents in their location choice.

We might also expect the state of competition in the local market to be important, with relevant factors thus including proximity to major competitors supplying similar services, and the limited local provision of insurance services. Here, higher scores are expected of general insurance respondents with regard to “proximity to major competitors supplying similar services”, given their prime concern is to retain or win business for their international clients. In the same vein, less importance is expected to be attached to “local market growth potential” by general insurers than their life insurance counterparts, given that foreign insurers’ prime attention is the prospective location’s attraction to their clients, rather than the growth potential of the local insurance demand itself. The assumption is reinforced by a recent survey finding of Gallup in association with CIGNA. It was found that the awareness of insurance in nine major Chinese cities is concentrated in foreign-invested or export-oriented companies, and that the purpose and mechanics of insurance are still a mystery to most Chinese companies (O’Connor, 1997).

As regards the availability of suitable inputs, five factors may be identified: the availability and convenience of telecommunications facilities, the availability and convenience of travel facilities, the availability of specialised labour and financial service personnel, proximity to advisory services, and accessibility to the major financial markets of China. Operating costs are largely confined to manpower costs and office rental charges. And last, but certainly not least, government influence is likely to play a substantial role. Good relations with the PBOC might be ensured by locating the office near PBOC headquarters in Beijing or, alternatively, near one of the PBOC branches. And the Government may also exert its influence rather more directly through guidance/persuasion or restrictions, through financial incentives, or through requirements to establish joint ventures. In the latter case, the location of the representation office might well be determined by the location of a suitable (future) joint venture partner. Since a Sino-foreign joint venture is a prerequisite for the license approval of foreign life insurers, higher scores are expected of foreign life insurance respondents in this respect. In addition, given their lack of interest in joint venture entry mode, foreign general insurance respondents are expected to attach the least importance to this factor compared with their life, composite and intermediary counterparts.

Nineteen factors which might have an impact upon the locational decisions of foreign insurers regarding their representative offices were thus identified. The survey results regarding the relative importance of these factors by nationality and by business category of the respondents are shown in Table 6.8 and 6.9 respectively. The three

most important factors were judged to be proximity to PBOC headquarters, local market growth potential, and proximity to major clients: all achieved mean scores markedly higher than the other factors. In general, the factors related to market demand and government influence scored well and appeared in the top half of the table, those related to the availability of inputs appeared in the middle of the table (but with mean scores less than three), whilst those related to competition and operating costs were judged to be of least importance. Manpower costs and office rental charges came bottom of the list of nineteen factors.

Table 6.8 The Determinants of Location Choice, Analysed by Nationality of The Respondents

Factor	Mean	Europe 18	US 10	Japan 12	Sig.
Sample size					
Proximity to PBOC headquarters	4	6.222	3.9	3.75	
Local market growth potential	3.825	6.167	3.9	3.25	*
Proximity to major clients	3.625	3.722	3.2	3.833	**
Government restriction	3.35	3.444	3.3	3.25	
Current local market demand	3.325	3.389	3.3	3.25	
Government guidance/persuasion	3.25	3.333	3.2	3.167	
Consumer risk awareness and demand for insurance products	3.25	3.278	3.4	3.083	
The availability and convenience of telecommunication facilities	3.175	3.056	3.6	3	
Accessibility to major financial markets in China	3.175	3.222	3.7	2.667	*
Proximity to PBOC branch	3.15	2.944	3.3	3.333	
The availability and convenience of travel facilities	2.975	2.944	3.2	2.833	
The availability of specialised labour and financial service	2.85	2.778	2.9	2.917	
Financial incentive	2.7	2.389	3.2	2.75	
Proximity to advisory services	2.65	2.444	2.2	3.333	*
Proximity to major competitors supplying similar services	2.625	2.333	2.2	3.4167	*
Location of a suitable joint venture partner	2.575	2.611	3.3	1.917	**
Limited local provision of insurance products	2.55	2.611	2.6	2.4167	
Manpower costs	2.275	2.278	2.3	2.25	
Office rental charges	2.2	2.222	2.1	2.25	

Note: * denotes $p < 0.1$

** denotes $p < 0.05$

Comparisons of the mean scores returned by the 18 European (including the 12 UK) respondents with those of the 10 US and 12 Japanese respondents reveal significant differences for six of the factors (see Table 6.8). The Europeans and US respondents accorded significantly greater weight than the Japanese to "local market

growth potential", "location of a suitable joint venture partner", and "accessibility to the major financial markets in China". The Japanese respondents, on the other hand, attached significantly more importance than their European and US counterparts to "proximity to major clients", "proximity to major competitors supplying similar services", and "proximity to advisory services". Both the Japanese and the European respondents attached great weight to "proximity to major clients". Indeed, these three variables are all rated amongst the top four determinants of location choice by the Japanese respondents (together with "proximity to PBOC headquarters").

Table 6.9 The Determinants of Location Choice, Analysed by Business Category of The Respondents.

Factor	Sample size	Mean	Life 11	General 14	Composite 10	Intermediary 6	Sig.
Proximity to PBOC headquarters		3.951	4.091	3.714	6.2	3.833	
Local market growth potential		3.878	4	3.427	6.4	3.667	*
Proximity to major clients		3.756	3.273	6.214	4	3.167	**
Current local market demand		3.341	3.545	3.5	3.4	2.5	
Government guidance/persuasion		3.293	3.545	3.071	3.8	2.5	
Government restriction		3.244	3.364	3.214	3.4	2.833	
Consumer risk awareness and demand for insurance products		3.244	3.182	3.286	3.2	3.333	
Accessibility to major financial markets in China		3.195	3.455	3	3.3	3	
The availability and convenience of telecommunication facilities		3.171	3.091	3.214	3.1	3.333	
Proximity to PBOC branch		3.22	3.273	3.643	2.8	2.833	
The availability and convenience of travel facilities		3.024	2.909	3	3	3.333	
The availability of specialised labour and financial service		2.902	3	2.786	2.6	3.5	
Financial incentive		2.707	3.182	2.571	2.4	2.667	
Location of a suitable joint venture partner		2.683	3.182	1.817	3.2	2.286	***
Proximity to advisory services		2.659	2.182	2.929	2.6	3	
Proximity to major competitors supplying similar services		2.61	2	3.286	2.3	2.667	*
Limited local provision of insurance products		2.488	2.727	2.429	2.5	2.167	
Manpower costs		2.293	2.455	2.071	2.3	2.5	
Office rental charges		2.244	2.182	2.071	2.2	2.833	

Note: * denotes $p < 0.1$; ** denotes $p < 0.05$; *** denotes $p < 0.01$

These results suggest that the European and US insurers are more interested in the local market, whilst the Japanese are much more interested in their established clients, at least at this initial stage of foreign participation in the China's insurance market. Apart from the political connections which are the common pursuit of insurers

from all the three nationality groups, the Japanese insurers are distinctively motivated by “client-following”. Furthermore, their significantly stronger propensity to locate in proximity to major competitors supplying similar services may well reflect a concentration of their corporate customers in China, or the ‘follow-the-leader’ behaviour that has characterised much Japanese FDI all over the world. In the same vein, it is interesting to note the much higher weight given to advisory services, perhaps indicating traditional Japanese concerns with the detail of their overseas ventures. In contrast, the Japanese pay very little attention to “the location of a suitable joint venture partner” in making their location decision. This research finding is echoed in the findings on partner selection, where the Japanese are found to be least interested in the complementary capabilities Chinese partners can provide in gaining quick local market entry.

In line with the Japanese “client-following” motivation, the comparison of the mean scores by business category of the respondents delivered the expected results with regard to general insurer’s predominant interest in their established international clients. They attach significantly more weight to “proximity to major clients”, “proximity to major competitors supplying similar services”, and significantly less weight to “local market growth potential”. In addition, significantly less importance is accorded to “location of a suitable joint venture partner” by general insurance respondents than their life insurance counterparts, provided that a Sino-foreign joint venture is not imperative for foreign general insurance licenses, at least for the time being. The results of the mean score comparison by business category is reported in Table 6.9.

As regards the favoured locations within China, the respondents were asked to provide scores on the basis of each of the nineteen factors for each of the following ten cities: Beijing, Chengdu, Dalian, Guangzhou, Shanghai, Shenyang, Shenzhen, Tianjin, Xiamen, and Xian. Shanghai was the preferred choice on the basis of fourteen of the nineteen factors: the exceptions were proximity to PBOC headquarters (Beijing), proximity to advisory services (Beijing), limited local provision of insurance products (Xian), manpower costs (Xian), and office rental charges (Xian).

An overall ranking of the relative desirability of each city by nationality and by business category of the respondents — see Table 6.10 and Table 6.11 respectively — may be obtained by weighing the scores on each factor (on the 10-point scale) for each city by the relative importance (on the 5-point scale) accorded to that factor by each respondent. This overall ranking shows Shanghai to be the most favoured location, followed by Beijing, Guangzhou and Shenzhen. Tianjin and Dalian achieve rather lower overall ratings, but still score markedly higher than Xiamen, Chengdu, Shenyang, and

Xian. And the only difference between the weighting by nationality and by business category is that Chengdu is above Shenyang by nationality, but below Shenyang by business category.

Table 6.10 Favoured Locations for Representative Offices, Analysed by Nationality of The Respondents

City Sample Size	Mean 33	Europe 16	US 9	Japan 8	Sig.
Shanghai	1.327	1.278	1.331	1.453	
Beijing	1.252	1.216	1.293	1.289	
Guangzhou	1.224	1.197	1.237	1.281	
Shenzhen	1.146	1.126	1.132	1.219	
Tianjin	1.002	1.01	0.984	1.008	
Dalian	1.000	0.993	0.922	1.133	
Xiamen	0.839	0.858	0.887	0.712	
Chengdu	0.762	0.806	0.736	0.679	
Shenyang	0.750	0.779	0.761	0.653	
Xian	0.700	0.736	0.719	0.572	

Note: The two responses from Canada and Australia were omitted from the analysis.

Table 6.11 Favoured Locations for Representative Offices, Analysed by Business Category of The Respondents

City Sample Size	Mean 33	Life 9	General 9	Composite 9	Intermediary 6	Sig.
Shanghai	1.681	1.364	1.474	1.322	1.31	
Beijing	1.581	1.283	1.319	1.295	1.21	
Guangzhou	1.557	1.276	1.267	1.293	1.182	
Shenzhen	1.418	1.141	1.195	1.158	1.129	
Tianjin	1.233	0.986	0.986	1.03	1.017	
Dalian	1.227	0.968	1.073	0.978	1.014	
Xiamen	1.009	0.838	0.782	0.817	0.807	
Shenyang	0.891	0.725	0.663	0.714	0.809	
Chengdu	0.888	0.7339	0.656	0.735	0.759	
Xian	0.828	0.685	0.585	0.659	0.764	

Note: 8 respondents were omitted due to invalid responses.

No significant differences were found between the responses of the European, US and Japanese insurers/insurance intermediaries, though some favouring of Dalian and Shanghai by the Japanese insurers is apparent.

Likewise, no significant differences were reported when comparing the mean scores of the rankings by business category of the respondents (Table 6.11).

THE PERCEPTION OF THE MAJOR OPERATING PROBLEMS IN CHINA

China possesses both vast potential and high risks. Notwithstanding the rapid growth of the insurance market, the industry is immature in terms of its legal framework, market infrastructure, and market demand and insurance consciousness. The realisation of the market potential, therefore, demands a clear understanding of the problems involved in China operation.

The often cited factors that adversely affect the growth of China's insurance market can be broadly grouped into three categories: the inadequacy of the existing regulatory framework; the lack of market infrastructure; and the lack of insurance awareness and demand for insurance products.

As discussed in chapter 3, there are many discrepancies between the stipulations of the Insurance Law and those of the Shanghai Measures, and there is also a lack of detailed implementing regulations to make the principles laid down by the Insurance Law more enforceable. On the one hand, the confusion and uncertainty resulting from the discrepancies may well have nullified the benefits of the transparency gained by of the enactment of the Insurance Law, and thus may be detrimental to the growth of foreign insurance business in China (Clifford Chance, 1995). On the other hand, the lack of detailed implementing regulations may well have left the Insurance Law as a skeleton or framework without flesh. Whilst the passing of the first Chinese Insurance Law is a very welcome development, there are still numerous areas which have to be covered by further detailed regulations (Taylor, 1996). The full extent or direction of the stipulations of the Law will not be defined in detail until implementing regulations are announced (Lancaster, 1997c). The problem is compounded by the inefficient implementation of the Insurance Law and the related regulations owing to the shortage of experienced insurance regulators. The inadequacy of the existing regulatory framework may well have been detrimental to foreign insurance business in China.

The growth of foreign insurance business may be held back by the lack of market infrastructure, such as the severe shortage of well trained or qualified work force, underdeveloped capital markets, lack of risk awareness and demand for insurance products, lack of insurance intermediaries, and lack of information on natural hazards (Taylor, 1996; Reactions, 1996a; O'Connor, 1997; Lancaster, 1997a, 1997b). Although natural hazards are reasonably well documented in China, most of the available data relates to the traditionally populated, coasted areas. There is very little information about the seismic and climatic conditions in the under-populated provinces,

which is a worry in that these are the areas where new factories and plants are being set up (Reactions, 1996a). The severe deficiency of the market infrastructure may have serious implications for foreign operations in China. Among other things, the limited income, and the painstaking process of developing and managing a distribution network, both demand a long-term approach to the Chinese market. This approach, however, would be hard to reconcile with the other objectives of an international insurer/insurance intermediary worldwide.

While the lack of local expertise gives the international insurers/insurance intermediary competitive edge, it may well add to the difficulty in identifying the right joint venture partner. The low level of competition in most local markets and the lack of exposure to international standards suggest the limited experience of domestic insurers. In the areas of products, marketing and management, there is enormous scope to improve the technique employed (Taylor, 1996). There is a large gap between domestic and foreign insurers in terms of market practices. In areas such as policy wordings and rates, the domestic non-life insurance market is struggling to keep up with international standards (Reactions, 1996a). In addition, the immaturity of the market means that domestic firms face a problem of lack of experience in selling individual, rather than group, life policies (Reactions, 1996a).

In view of the negative effect inflation has upon the insurance operation, high inflation is also included in the list of factors for concern. Inflation causes insurance companies' operating expenses to rise, and the negative impact is most acutely felt when this occurred at a time when premium income is static or declining. Meanwhile, inflation can cause cash-flow problems for insurers at a time when high inflation rates and resulting high interest rates cause existing and prospective policyholders to question whether insurance products can offer sufficient value and flexibility, and thus divert premium dollar to other better perceived savings and investment media (Black and Skipper, 1994). And it is in response to inflation pressures that insurance companies came up with such "innovative" insurance products as universal life insurance and universal variable life insurance whose yields are competitive with returns on other investments. Inflation pressures and the questioning of the real benefits and returns of insurance policies is prevalent in China, and it has been dampening the public interest in insurance protection (Liu, 1996).

Table 6.12 and Table 6.13 provide an overall ranking of the main perceived operating problems by nationality and by business category of the respondents. The top three in the league table are all relating to the regulatory framework of China's insurance industry. It shows that legal/political considerations, rather than market

infrastructure and insurance awareness and the demand for insurance products, are the overriding concern for foreign insurers and insurance intermediaries. Detailed implementing regulations, clarification of the guiding regulatory framework, and efficient implementation of the Insurance Law and related regulations are what foreign insurers and insurance intermediaries require most for their successful operation in China. The second biggest problem as far as China's investment environment is concerned is the "severe shortage of well-trained or qualified work force". Without sufficient insurance professionals, foreign insurers' operation and expansion plans in China will be held back. And the delayed operation will have detrimental effect upon their profitability, which will be difficult to reconcile with their operation plans elsewhere and the expectation of the shareholders. Compounded to the problem is "the lack of risk awareness and demand for insurance products", which is the third biggest concern. The other market infrastructure problems that are of concerns are "the under-developed capital markets", "lack of information on natural hazards", and "lack of insurance intermediaries". Here, the only difference between the ranking by nationality and by business category is that "the lack of information on natural hazards" is ranked above "the lack of insurance intermediaries" by nationality, but ranked below "the lack of insurance intermediaries" by business category. In the bottom of the league table are "high inflation and difficulty in identifying a right joint venture partner". It suggests that the legal/political environment, market infrastructure and the public awareness and demand for insurance have bigger impact on the operation of foreign insurers and insurance intermediaries in China than the overall economic environment and the feasibility of joint venture entry mode. Moreover, the bottom ranking of "the difficulty in identifying a right joint venture partner" shows that the availability of a suitable joint venture partner is what the foreign insurers and insurance intermediaries are least concerned about. These findings echo the survey results regarding the selection criteria of joint venture partners in that the choice of partner in the Chinese insurance industry is, in many instances, not really a choice but a requirement. It is also consistent with the findings concerning foreign insurers' predominant requirement of the Chinese partners' "willingness to accept foreign management control of the venture" and the main determinants of the wholly-owned venture mode of entry. It suggests that the concern over the compatibility of Chinese partners in management culture and trustworthiness outweighs the demand for the complementarity of Chinese partners in contact with the central/local authorities and easy market access.

Table 6.12 Perceived Major Operating Problems in China, Analysed by Nationality of The Respondents

Nationality Sample Size	Mean 40	European 18	US 10	Japan 12	Sig.
Lack of detailed implementing regulations	3.875	4.056	3.7	3.75	
Confusion and uncertainty resulting from the discrepancies between the Insurance Law and Shanghai Measures	3.932	4.079	3.8	3.283	*
Inefficient implementation of the Insurance Law and related regulations	3.75	3.944	3.5	3.667	
Severe shortage of well-trained or qualified work force	3.525	3.778	3.2	3.417	
Lack of risk awareness and demand for insurance products	3.45	3.778	3.2	3.167	*
Under-developed capital markets	3.425	3.722	3.4	2.917	*
Lack of information on natural hazards	3.325	3.667	2.9	3.25	*
Lack of insurance intermediaries	3.25	3.556	2.9	3.083	
High inflation	3.15	3.278	3.1	3	
Difficulty in identifying a right joint venture partner	3	3.056	2.9	3	

Note: * denotes $p < 0.1$

A comparison of the mean scores of the ranking of the main perceived operating problems by nationality of the respondents shows significant differences between European, US and Japanese insurers/insurance intermediaries in four out of the ten listed factors. European and US insurers/insurance intermediaries accorded significantly more weight than their Japanese counterparts to the following three factors: "confusion and uncertainty resulting from the discrepancies between the Insurance Law and Shanghai Measures", "lack of risk awareness and demand for insurance products", and "under-developed capital markets" (Table 6.12). The Japanese' lack of concern over "the uncertainty and confusion resulting from the discrepancies between the Insurance Law and Shanghai Measures" may be explained by their lack of interest in governmental contact, and in market access brought by Chinese partners. This may be ascribed to their greater familiarity with the Chinese culture background than their Western counterparts. Likewise, the Japanese are significantly less concerned over "the lack of risk awareness and demand for insurance products" and "under-developed capital markets": this may be attributed to their distinctive "client-following" motivation as discovered by their significantly lower interest in the use of the local partners' market network, as well as the significantly lower weight they attached to "local market growth potential", "location of a suitable joint venture partner" and "the accessibility to major financial markets in China", and significantly more weight to "proximity to major clients", "proximity to major competitors supplying similar products" in making their location choices than their Western counterparts.

Table 6.13 Perceived Major Operating Problems in China, Analysed by Business Category of the Respondents

Nationality Sample Size	Mean 41	Life 11	Gener 14	Composit e 10	Intermediar y 6	Sig.
Lack of detailed implementing regulations	3.962	6.273	3.643	6.1	3.833	
Confusion and Uncertainty resulting from the discrepancies between the Insurance Law and Shanghai Measures	3.938	6.277	3.675	4.0	3.824	
Inefficient implementation of the Insurance Law and related regulations	3.83	4	3.786	3.7	3.833	
Severe shortage of well-trained or qualified work force	3.651	3.818	3.286	4	3.5	
Lack of risk awareness and demand for insurance products	3.568	3.455	3.286	3.7	3.833	
Lack of information on natural hazards	3.352	3.182	3.357	3.7	3.167	
Under-developed capital markets	3.495	6.1	3.286	3.757	3	**
Lack of insurance intermediaries	3.362	3.153	3.176	3.3	6.275	**
High inflation	3.242	3.364	3.071	3.2	3.333	
Difficulty in identifying a right joint venture partner	3.082	3.546	2.714	2.9	3.167	

Note: ** denotes $p < 0.05$

Lastly, it is interesting to note that the European and Japanese insurers/insurance intermediaries deem “the lack of information on natural hazards” significantly more serious than their US counterparts. This is probably because the American insurers have acquired more information on China’s natural hazards through their bigger and longer commercial presence in China. Overall, the European insurers/insurance intermediaries seem to have the least confidence in China’s investment/business environment, which is probably due to their more limited commercial presence in China and their more remote cultural/psychic distance from China than their US and Japanese counterparts.

In addition, the comparison of the mean scores by business category of the respondents reveals that common perceptions of the operating problems are shared by foreign life insurers, general insurers, composite insurers, and insurance intermediaries, with the exception of two factors. On the one hand, significant differences are reported on the ranking of “under-developed capital markets”, where life

insurers and composite life insurers expressed significantly more serious concerns of this factor than their general insurance and insurance intermediary counterparts. This is probably because the restrictions placed upon the investment vehicles available to insurers by the Insurance Law are more acutely felt by the life insurers as long-term institutional investors. On the other hand, "lack of insurance intermediaries" is ranked consistently lower by life insurers, general insurers and composite insurers. It suggests that, to the foreign insurers, the lack of insurance intermediaries and the subsequent slow building-up of insurance distribution network as discussed in the chapter 3 is of secondary importance for their China operation compared with the overriding concerns over the perfection and unification of the regulatory framework.

CONCLUDING REMARKS

This chapter reports the results of a questionnaire survey which sought responses *inter alia* on the strategies pursued by foreign insurers/insurance intermediaries in pursuit of the licenses, their criteria for the selection of Chinese partners in joint ventures, their criteria in deciding where to locate within China, and their perception of the main operating problems in China. The results suggest that political/legal requirements and/or considerations have the overriding influence on foreign insurance participation in China's insurance industry. The results also suggest some interesting differences among foreign insurers/insurance intermediaries of different nationality groups and of different business categories.

The importance of good relations with the Chinese authorities emerged strongly from the analysis of strategies to obtain the sought-after licenses, with the promotion of good relations with PBOC and between the respective governments considered paramount important by the foreign insurers/insurance intermediaries. The predominate impact of the authorities was also detected in the examination of the selection of a Chinese partner in a joint venture, and the choice of location.

The findings concerning joint venture partner selection criteria confirmed what has been discussed from the theoretical perspective in chapter 4 in that compatibility in objectives is more important than complementarity in function. The joint top ranking of the factors related to Chinese Government/authorities' restrictions and the willingness of the partner to accept foreign management control of the venture suggests that compatibility in objectives is the overriding concern, and that the choice of a Chinese partner is not really a choice but a requirement of the government, especially in the case of life insurance. The wholly-owned venture entry mode is the corporate

preference for many foreign insurers/insurance intermediaries as a result of their concerns over the compatibility in objectives with the Chinese partners in corporate management. Under the overriding compatibility concerns, the complementarity functions of the Chinese partners in their contacts with the central/local authorities and their market network are most desirable by the foreign insurers/insurance intermediaries, given that “guanxi” is the lifeblood of business in China and that country-specific knowledge of the customers of the Chinese insurance-buying public are needed for China operation. Moreover, if they may find life difficult without the political contacts and quick market access gained from local partners, foreign insurers/insurance intermediaries can have successful operation without the inputs from the local partners in technological, managerial, and financial capabilities.

The location choice criteria revealed by the survey support the theoretical argument. Factors related to government influence and market demand far outweigh those related to operating costs, competition and the availability of inputs. And relations with the Supervisory Authority are the most important of all as far as location choice is concern. Under the scrutiny of such selection criteria, Shanghai, Beijing, Guangzhou and Shenzhen come up as the favoured locations for foreign insurers/insurance intermediaries. The question of location choice is examined again in chapter 7.

In line with the political considerations which has dominated their strategic decisions and choices, legal/political considerations were singled out as the most serious stumbling block to foreign insurers/insurance intermediaries' operation in China. The top concerns of foreign insurers/insurance intermediaries are those over the lack of implementing regulations, the uncertainties created by the discrepancies between the Insurance Law and Shanghai Measures, and the inefficient implementation of the Insurance Law and related regulations. The demand for detailed implementing regulations, clarified guiding regulatory framework, and efficient implementation of the Insurance Law far outweighs the demand for enhanced market infrastructure (e.g. better supply of insurance professionals, insurance intermediaries, and information on natural hazards, and improved capital markets), and insurance awareness. It suggests that the market's full potential can not be realised if the deficiency of the legal/political environment is not tackled urgently. This finding echoes the conclusion drawn from the review of the regulatory framework governing China's insurance industry and foreign participation in chapter 3 — the perfection of the regulatory framework and the establishment of a regulated market are the top priorities for China's fledgling insurance industry.

On the whole, the legal/political environment, market infrastructure, and the public awareness and demand for insurance products and risk management are deemed more important for the successful operation in China's insurance market than the overall economic environment and the feasibility of joint venture entry mode. Moreover, the lack of concern over the feasibility of the joint venture entry mode verifies the research findings that concerns over the compatibility of Chinese partners' management culture and trustworthy overrides the demand for the complementarity of Chinese partners in governmental contacts and market access. The choice of a joint venture entry mode by a foreign insurer/insurance intermediary is, to a great extent, the outcome of political/legal requirement instead of corporate preference.

While the overall ranking of the factors of various aspects of the strategic decision/choice were studied, Kruskal-Wallis tests were undertaken to see if there were any significant differences in the importance attached to the factors by the European, the US and the Japanese respondents in the sample. Similar tests were taken to detect the differences among life insurers, general insurers, composite insurers and insurance intermediaries.

The analysis by nationality consistently revealed the distinctive client-following motivation by Japanese in their pursuit of operating licenses, in location choice, in the selection criteria of Chinese partners for joint ventures, and the perception of the main operation problems in China. The Japanese were found to attach the least importance to joint venture strategy in the license pursuit and being the least interested in the joint venture entry mode. The Japanese "client-following" market approach was evidenced by their favouring of Dalian and Shanghai, where much Japanese manufacturing investment is concentrated. The Japanese client-following motivation was also evident in their marked differences from their Western counterparts in the perception of the main operating problems. The Japanese were significantly less concerned over the lack of local risk awareness and demand for insurance products, and over the underdeveloped capital markets. In contrast, the European and US respondents were more local market-oriented, more interested in the complementary functions of the Chinese partners in governmental contacts and market access, and more concerned about the lack of local insurance awareness/demand and the lack of capital markets. All in all, the European insurers/insurance intermediaries displayed the least confidence in China's investment/business environment, which is probably due to their limited acquaintance with China's cultural/business background and their more remote cultural/psychic distance from China than their US and Japanese counterparts.

On the other hand, the analysis by business category indicates the marked differences between life insurers and general insurers in the strategies to obtain operating licenses, in the selection of a Chinese partner for a joint venture, in the choice of location and in the perception of the main operation problems in China. Life insurers gave the highest endorsement of joint venture strategy to win the license battle, showed the greatest interest in establishing joint venture with Chinese partners, accorded the highest weights to Chinese partners' market network and the location of a suitable joint venture partner in the ranking of partner selection criteria and location choice respectively, and expressed the most serious concerns over the impact of the under-developed capital markets on China operation. In contrast, general insurers displayed the least interest in the joint venture entry mode, the strongest client-following motivation in being close to major clients, major competitors supplying the similar services and paying marked less attention to the local market growth potential. Apart from their different client base and nature of business as discussed in chapter 4, the significant differences between foreign life insurers and general insurers may be ascribed to the different legal requirements with regard to the entry modes. Whilst the joint venture mode has been made an imperative by the Chinese authorities for foreign life insurers, foreign general insurers are still exempted from such a restriction. Here again, the overriding concern over the compatibility of objectives with the Chinese partners is taking its toll. Life insurers and general insurers, together with composite insurers and insurance intermediaries, all displayed their corporate preference for the wholly-owned venture entry mode by ranking partners' willingness to accept foreign management control of the venture the single most important partner selection criteria. Therefore, life insurers' marked inclination towards joint venture entry mode and partners' complementary function again may well have been the product of the political/legal requirement and consideration.

CHAPTER 7 THE LOCATION OF FOREIGN INSURANCE COMPANIES IN CHINA

INTRODUCTION

The determinants for FDI location choice were examined by a brief review of the existing literature in chapter. However, although some empirical researchers have studied the distribution of FDI within China (Cheng and Zhao, 1995; Head et al, 1995; Broadman and Sun, 1997), none has analysed quantitatively the location determinants of foreign insurance companies.

The majority of the representative offices of foreign insurance companies/insurance intermediaries in China were established after 1992, *i.e.* in the aftermath of the promulgation of the Shanghai Measures and the approval of AIA licenses which led to a surge of foreign interest in China's insurance market. Although only two cities (*i.e.* Shanghai and Guangzhou) are currently open for foreign insurance operation, foreign representative offices are allowed in many more cities. Given China's particular political/legal/economic/social circumstances, the criteria for choosing where to locate in China's urban centres are uniquely different from Western mature markets.

This chapter provides an in-depth analysis of the key strategic decision which foreign insurers/insurance intermediaries have to make in their China operation — location choice. The major determining factors of the location of foreign insurance companies and insurance intermediaries are identified and assessed empirically. Foreign insurance representative offices are used as our sample of analysis in view of the very limited number of foreign insurers/insurance intermediaries granted licenses in China, assuming that foreign insurers/insurance intermediaries will operate in those cities where their representative offices are located. Included in the sample are 138 representative offices of foreign insurance companies set up in Beijing, Tianjin, Dalian, Shanghai, Guangzhou and Shenzhen during the period of 1992-1996: 52 in Beijing, 48 in Shanghai, 16 in Guangzhou, 10 in Shenzhen, 7 in Tianjin and 5 in Dalian (see Table 7.1). The national representations of the insurers/insurance intermediaries included are 46 American, 31 Japanese, 44 European (including 27 British, 4 Germany, 3 Netherlands, 3 France, and 7 Switzerland), and 17 other countries/regions (including 7 Canadian, 5 Australian, 2 Hong Kong, and 3 South Korean) (see Table 7.2). Those representative offices established outside the period or outside the six cities are excluded because of insufficient sample size (see Table 7.3). Also excluded

are those representative offices whose dates of establishment are not available. Hypotheses of the major deciding factors of the location of foreign insurance companies are brought up on the basis of a theoretical review. The hypotheses were tested using maximum likelihood estimation of a conditional logit model.

Table 7.1 Distribution of Representative Offices/Branches by Location in The Sample

City	No. of Offices/branches	Percentage (%)
Beijing	52	37.7
Shanghai	48	34.8
Tianjin	7	5
Guangzhou	16	11.6
Dalian	5	3.6
Shenzhen	10	7.3

Source: Insurance in China (monthly faxed newsletter), London: Reactions Publishing Group Ltd; Asia & Pacific Insurance Newsletter (1995).

Table 7.2 Distribution of Representative Offices/Branches by Nationality in The Sample

Country	No. of Offices/branches	Percentage (%)
US	46	33.3
Japan	31	22.5
European	44	31.9
British	27	19.6
Other European	17	12.3
Other Countries	17	12.3

Source: Insurance in China (monthly faxed newsletter), London: Reactions Publishing Group Ltd; Asia & Pacific Insurance Newsletter (1995).

Table 7.3 Distribution of Representative Offices/Branches by The Year of Establishment in The Sample

Year	No. of offices/branches
1992	7
1993	20
1994	33
1995	51
1996	27

Source: Insurance in China (monthly faxed newsletter), London: Reactions Publishing Group Ltd; Asia & Pacific Insurance Newsletter (1995).

THEORETICAL REVIEW

Location Choice of FDI in China

Given the earlier opening of manufacturing sector to foreign investors, the existing studies are predominately on the location choice of FDI in the manufacturing industry.

Zheng (1993) studied the determinants of the geographical pattern of FDI in China over the period 1979-86 and suggested that regions with a favourable government policy towards inward FDI enhanced the propensity of foreign investment to locate there. Regions with greater administrative autonomy in approving FDI projects and with greater tax incentives were significantly more attractive than the other regions. Apart from the supply of a large pool of labour, the attractiveness of regions with good industrial bases and export potential to foreign investors lies in the better export prospects which in turn give foreign investors better access to preferential treatment specially granted to export-oriented investment.

This positive linkage between FDI location and the location's policy incentive and openness to foreign investment was confirmed by more recent studies by Cheng and Zhao (1995), Head and Ries (1996), and Broadman and Sun (1997). Cheng and Zhao (1995) revealed that Special Economic Zones (SEZs) were very significant in attracting FDI, though their competitive advantages were diminishing over time. The positive linkage between SEZs and inward investment was confirmed by Head and Ries (1996) using a monopolistic-competition model. In their study of the impact of agglomeration externalities on the location choice of manufacturing FDI in China, they found that agglomeration externalities generated by policy incentives and increased openness to foreign investment made FDI a self-reinforcing phenomenon. In other words, there was a significant link between FDI location and a city's policy incentives and openness to foreign investment. And the arrival of FDI in a city would stimulate entry by specialised suppliers. Growth of this upstream sector in turn made a city more attractive to subsequent foreign investors by the increased agglomeration. In Broadman and Sun's (1997) opinion, being granted special investment incentives set the coastal regions apart from the inland regions in attracting FDI. Furthermore, research has also found that the most significant factor for FDI location was market size (measured by GNP per capita) (Cheng and Zhao, 1995; Broadman and Sun, 1997).

Factors Affecting Insurance Operation in China

The general policy environment is often reported as one of the most important determinants of the distribution of FDI in China (Cheng and Zhao, 1995; Head and Ries, 1996; Wu, 1996; Wu and Strange, 1997; Broadman and Sun, 1997). And the impact of government policy is often studied with regard to the geographical area under preferential policies, local policy incentives, the level of local government FDI project approval autonomy, *etc.* (Cheng and Zhao, 1995; Head and Ries, 1996, for example). Given the fact that the operation of foreign insurance companies in China is under severe government restrictions both in terms of license availability and geographical location, consideration must be given to the effects of government policy restrictions on foreign insurance companies in deciding the locations of their affiliates in China.

As discussed in chapter 6, the recent questionnaire survey by the author suggested that government regulations and restrictions, local market-seeking, and international client-following were the key determinants of the location choice of foreign insurers/insurance intermediaries in China. Of secondary importance were insurance consciousness, telecommunications facilities, financial market accessibility, and the availability of specialised quality labour. Manpower costs and office rental charges were the least important as far as location choice was concerned. In general, factors relating to government influence and market demand far outweigh those relating to operating costs, competition and the availability of inputs (Wu and Strange, 1998).

Others have suggested that infrastructure quality, rather than cost, and market development method are the focus of attention, with staffing, infrastructure leadtime, insurance product distribution channel highlighted as some of the main obstacles to foreign insurance operation in China (Taylor, 1996; Lancaster, 1997a, 1997b). The importance of advisory services for foreign operation has also been emphasised (Insurance in China, 1995).

What seems to concern foreign insurers is the anticipated fierce competition over good staff (Taylor, 1996; Lancaster, 1997). "Insurance is people business and without good people insurance operations will not succeed" (Lancaster, 1997b:15). At the current PICC growth rate and with the same staffing model, PICC will need a million people by the year 2003⁷⁰. Compounded with the staffing requirement of the other rapidly expanding Chinese insurers, the competition for good people will be enormous and training costs will be substantial for foreign insurers. Infrastructure leadtime means that there is a possible gap between the training of local staff and

operation (Lancaster, 1997b). The competition over staff thus appears to have much more to do with the supply of pools of specialised and educated labour in the city and much less to do with the inter-city variation of the general level of salary of insurance employees. This is especially the case when the lack of mobility means that it is not always easy to get staff to move to other locations as many prefer to stay close to relatives and friends (Lancaster, 1997b).

Law firms, accountancy, consultancy, *etc.* are called upon to give advice on insurance practice, accounting standards or legal terms. And more often than not, for these and other diversified skills and services they need, they use who they know — the companies that their head offices use in their home countries. In this regard, the cumulative tertiary FDI from the home country may affect foreign insurers/insurance intermediaries' location choice.

In addition, the advantages of distribution systems enjoyed by Chinese insurance companies will be hard for foreign insurers to tap into. But without an effective distribution system, it will be difficult for foreign insurers to grow effectively. In this respect, Beijing, Shanghai, Shenzhen and Guangzhou, with their relatively developed insurance distribution systems, have more to contribute to foreign insurers than any other Chinese cities.

The main distribution methods available in the current Chinese market are agents (part-time agents, specialised independent agents, and individual agents), brokers, and direct marketing. With direct mailing having proven difficult for lack of mailing lists and telephone networks, insurance intermediaries (agents and brokers) have an important part to play in China's insurance market (Wei, 1997). Recent statistics showed that agents have become important distribution channels for insurance products, generating over 40 percent of the total premium over the past ten years (Qiao, 1997). And figures for the developed Southern regions are even higher, running up to 80 percent⁷¹. Individual agents are new to China. No up-to-date data for all the six cities are yet available, but recent statistics suggests that the metropolitan centres in southern China are in the lead, championed by Shanghai with some 20,000 life agents thanks to the pioneering work of AIA (Insurance in China, 1997a). Meanwhile, there is still no licensed domestic broker in China's insurance market. Sedgwick of the UK is the only foreign insurance broker licensed with three offices and a few staff in Beijing, Shanghai and Shenzhen. And the seventeen or so representative offices of insurance brokers are also concentrated in Beijing, Shanghai and Shenzhen. On the whole, Beijing, Shanghai, Shenzhen and Guangzhou possess relatively more developed insurance distribution systems than Dalian and Tianjin.

It takes time for China to standardise the traditional part-time agent system and build up the specialised independent agent system. Taking advantage of its strong political connections, PICC has managed to build up its national part-time agent network with heavy administrative interference. PICC's example was later followed by Ping An and China Pacific. Independent agents are growing in China's coastal regions, but are very small in number with the existing ones facing the inevitable shake up to meet the standards set up by the Insurance Law and the Interim Provisions. Nobody should underestimate the difficulties involved in keeping politics and administrative interference away from insurance distribution⁷².

HYPOTHESES AND EXPLANATORY VARIABLES

It is assumed that the location of a foreign insurance representative office is chosen to minimise the transactions costs and maximise future profit. Future profit depends on a number of variables which affect future revenue and cost. These variables which are grouped below determine the attractiveness of a Chinese city as a potential location for foreign insurance companies/insurance intermediaries.

- General Policy Environment
- Market Demand and Economic Development
- Historical Record of Inward FDI and Insurance Consciousness
- Infrastructure Sophistication
- Cost Structure

General Policy Environment

The location of PBOC (the Regulatory Authority) headquarters (PBOC): A significant *positive* relationship is expected between the location of the headquarters of the Regulatory Authority and a city's appeal to foreign insurers as a favourable location. A dummy variable is introduced with 1 assigned to Beijing which hosts the headquarters of the PBOC, and 0 to the other five cities.

The city where foreign insurance operation is allowed (OP): Given the profit-driven motivation of foreign insurers, it is expected that there is a significant *positive* relationship between the openness of a city to foreign operation and its chance of being chosen. Under current policy regime, only two Chinese cities are opened to foreign insurance operation: Shanghai since the promulgation of the 1992 Shanghai Measures and Guangzhou since late 1995 when AIA's operating license was extended to Guangzhou and its surrounding areas. Guangzhou's recent openness is not

considered by the current study, given that the sample included are those representative offices which were set up between 1992-1996 and that a one year lag is introduced to capture the time difference between the information and the decision. A dummy variable is thus introduced with Shanghai taking on the value of 1, while Beijing, Tianjin, Guangzhou, Shenzhen and Dalian assuming 0.

Market Demand and Economic Development

Premium income per capita (PI) and Savings deposit per capita (SAVINGS): It is expected that the location choice of foreign insurers is *positively* related to the insurance market opportunities in the location. Premium income per capita (PI) and savings deposit per capita (SAVINGS) of the municipality or the province where the chosen city is located are alternative measures which are used to estimate the impact of local insurance demand and the level of discretionary income on a city's chance of being chosen.

Historical Record of Inward FDI and Insurance Consciousness

The cumulative utilised FDI per capita (FDIU): The degree of insurance awareness is allegedly concentrated in companies that either have foreign investment, or are export-oriented. The cumulative utilised FDI per capita in the municipality or province where the chosen city is located is used to demonstrate the combined effect of insurance awareness and client-following on the location choice of the representative offices. And a significant *positive* sign is expected.

Infrastructure Sophistication

Ownership of telephone per 10 population (PHONE): The location of foreign insurers is expected to be *positively* related to the ownership of telephones in the city.

University enrolment per 1,000 population (ENROLL): To the extent that university enrolment in the chosen city reflects a pool of educated labour, it is expected that university enrolment per 1,000 population of a city is *positively* related to the city's probability of being chosen.

The location of major capital markets in China (CM): Under cash-value life insurance, the insurer retains portions of the premiums paid during the early policy years and accumulates them, together with investment earning on them, towards the payment of benefits in the later years. As the rates of return on invested assets increases, other

things being equal, the company can lower the premiums it charges for new or existing policies, or increase the dividends or other non-guaranteed benefits it credits on existing policies, or both (Black and Skipper, 1994). As custodians of large pools of premium funds, investment income generated is thus vital for the profitability of insurance companies, given that premium rates and net costs are important competitive considerations (Black and Skipper, 1994; O'Connor, 1997). The effect of the accessibility to major capital markets in China on the location choice of foreign insurance companies is measured by a dummy variable of the location of major capital markets in China, with 1 assigned to Shanghai and Shenzhen, and 0 to the other four cities. It is expected that this variable is *positively* related to a city's attractiveness as a favoured destination.

Utilised tertiary FDI as a percentage of total utilised FDI in the city (TERFDI): Since data on utilised tertiary FDI categorised by home country is not available, utilised tertiary FDI as a percentage of the total amount of utilised FDI in the city is employed as a proxy of the availability of foreign advisory services there. It is expected that this variable will be *positively* related with foreign insurers' location choice.

Cities where insurance distribution systems are relatively developed (DIS): The level of the development of a city's insurance distribution system is expected to be *positively* related with its chance of being chosen. As no hard information on the number of agents or brokers in the six cities is yet available, a dummy variable is introduced, with 1 assigned to Shanghai, Beijing, Shenzhen, and Guangzhou, and 0 to Tianjin and Dalian.

Cost Structure

Average wage of employees in banking and insurance sector in the city (WAGE): The cost of labour is expected to exert a *negative* impact on the location choice of foreign insurance companies/insurance intermediaries.

Average rental charges per square meter of prime office buildings in the city (OFFICE): Both the responses to the questionnaire survey and the FDI literature have suggested that cost structure is of less pronounced importance to FDI in services in general, and financial services industry in particular, than to FDI in manufacturing industry. No strong negative impact is thus expected of the rental costs on location choice. This variable is omitted for lack of information on renting charge rate of prime offices in the six cities over the period examined.

The above hypotheses are summarised in Table 7.4

Table 7.4 Summary of The Hypotheses

Independent Variables	Definition	Expected Impact
PBOC	The location of PBOC headquarters	+
OP	The city where foreign insurance operation is allowed	+
SAVINGS	Savings deposit per capita in the municipality or province	+
PI	Premium income per capita in the municipality or province	+
FDIU	Cumulative utilised FDI per capita in the municipality or province	+
PHONE	Ownership of telephones per 10 population in the city	+
ENROLL	University enrolment per 1,000 population in the city	+
WAGE	Average wage of employees in banking and insurance sector in the city	-
CM	The location of capital markets in China	+
TERFDI	Utilised tertiary FDI as a percentage of total utilised FDI in the city	+
DIS	Cities where insurance distribution systems are relative developed	+

Note: All variables (except the dummy variables) are expressed as natural logarithms. For data sources, see appendix 5.

THE CONDITIONAL LOGIT MODEL

The hypotheses were tested by the conditional logit model pioneered by McFadden (1974) using maximum likelihood estimation. The foreign insurance company/insurance intermediary i faces six possible choices. And the profit that each individual insurer/insurance intermediary derives from locating in a city can be expressed as a function of the attributes of that city and a disturbance term:

$$\pi_{ij} = \beta' X_{ij} + \varepsilon_{ij}$$

where π_{ij} is the expected profit earned by foreign insurance company i if it is located in city j ; X_{ij} is a vector of observable characteristics for city j ; $\beta' X_{ij}$ is $\sum \beta_{ij} X_{ij}$, where β_{ij} is the regression parameter to be estimated; and ε_{ij} is a random disturbance term denoting the unobservable (by the researcher) unique profit advantage to firm i from locating in city j .

The probability of selecting a specific city depends on the attributes of the selected city that affect profitability relative to those of all the other five cities in the choice set. That is, if the insurance company/insurance intermediary i choose city j , the expected future profit of π_{ij} is the maximum among the all the other five cities' profit functions.

$$P(\pi_{ij} > \pi_{ik}) \text{ for all other } k \neq j$$

According to McFadden (1974), if (and only if) the six disturbances are independent and identically distributed with Weibull distribution

$$F(\varepsilon_{ij}) = \exp(e^{-\varepsilon_{ij}})$$

Then

$$P(Y_i = j) = P_{ij} = \frac{\exp(\beta' X_{ij})}{\sum_{k=1}^6 \exp(\beta' X_{ik})}$$

Here, the measured dependent variable Y_i is the city chosen by each foreign insurer/insurance intermediary. And each representative office of a foreign insurer/insurance intermediary forms a separate observation comprised of six choices. For conditional logit model with individual observations (as opposed to repeat observations), the most suitable estimation technique is maximum likelihood.

The likelihood function for the current study is as follows:

$$L(\beta) = \prod_{j=1}^6 P_{ij} = \prod_{j=1}^6 \frac{\exp(\beta' X_{ij})}{\sum_{k=1}^6 \exp(\beta' X_{ik})}$$

The objective of the maximum likelihood function, as the name indicates, is to find parameter estimators for β' which make it most likely that the choices in the sample would have occurred. The estimators of β' are obtained by differential calculus. That is, we differentiate the log-likelihood function $\ln(\beta)$ with respect to β' ; set the result to zero, and solve for β' . The mathematical complexity of the maximum likelihood estimation is made manageable by specialised computer programmes. TSP is used in the current study to estimate the parameter estimators.

In order to interpret the marginal effect of the continuous variables on the probability of representative office location, the variables are expressed in natural logarithms form. In addition, a lag of one year is used for all explanatory variables to capture the delay between location appraisal and approval, as well as the lag of investment response to policy changes. Furthermore, since it is the real market size and cost structure we are concerned about, both market size variables (SAVINGS and PI) and the cost variable (WAGE) are expressed at 1992 constant prices. Moreover, savings deposit per capita, domestic premium income per capita, and cumulative utilised FDI per capita are employed to minimise heteroscedasticity⁷³.

EMPIRICAL RESULTS

Pursuant to the empirical review, the variables for government regulations and restrictions, local market size and growth potential, the historical record of FDI, and insurance awareness [*i.e.* PBOC, OP, SAVINGS (PI), FDIU] are included in all the variants with different combinations of the other variables that are expected to be of secondary importance. The test results are presented in Table 7.5 (placed at the end of the chapter), which show that individual coefficients of the explanatory variables all carry the expected signs with all key variables significant. The variables expected to be of secondary importance are, however, statistically insignificant, except for telecommunications facilities (PHONE) which is significant at the 10% level.

The variables testing the impact of government regulations and restrictions, PBOC and OP, are consistently significant at or above the 10% level throughout with one exception, when CM is added into the model and OP which is significant at the 20% level. The variable measuring the current local market size, PI, is significant at the 5% level or 10% level. Likewise, the variable gauging the market growth potential, SAVINGS, is significant mostly at or above the 10% level, with two exceptions. Its significance decreases to the 20% level when TERFDI is included into the equation, and dropped further to insignificance with the inclusion of CM. The variable examining

following-the-client-phenomenon and the degree of insurance awareness, FDIU, is largely significant at the 10% level or the 20% level.

The test results seem to suggest that, among the criteria of secondary importance, the availability and convenience of telecommunications facilities carries the greatest weight in location choice. All the other criteria relating to the availability of inputs or cost structure are all of insignificant importance.

For the conditional logit models, the marginal effects of continuous variables on the probability of foreign insurance representative office location can be obtained by the following elasticity equation:

$$\frac{\partial \ln P_i}{\partial \ln X_k} = \beta_k (1 - P)$$

where P_j is the probability of locating in the city, P is the average probability of locating in the six cities, X_k is the independent variable concerned, and β_k is the estimated coefficient (Greene, 1990). The average probability for all the six cities is 1/6 (or 0.167). Thus, $1-P = 0.833$ for the sample. Checking through the models reported, we found that the marginal effects of the key variables on the probability of foreign insurance representative office location are considerably larger than those variables of secondary importance. A 1% change in savings deposit per capita gives rise to a 1.11% to 1.64% change in the location probability, while the marginal effect of domestic premium income per capita results in around 1.16% change in a city's chance of being chosen. The elasticity of a city's historical record of utilised FDI and its level of insurance awareness is larger, ranging between 1.79% to 3.73%. The marginal elasticity of the availability and convenience of telecommunication facilities is about 0.6%. And the yields of 1% change of the other three continuous explanatory variables are as follows: around 0.15% for the availability of specialised labour pools (ENROLL), -0.12% to -0.8% for manpower costs (WAGE), and about 0.043% for the availability of advisory services.

A good overall fit of the models is provided by McFadden's likelihood ratio index. This likelihood ratio index is often used as a preferable alternative to R^2 as a measure of goodness of fit for models of qualitative choice (Pinkdyck and Rubinfeld, 1991). The likelihood ratio index is

$$\rho = 1 - \frac{L(\text{Max})}{L(0)}$$

where $L(0)$ is the value of the log-likelihood function when all of the parameters are equal to 0, and $L(Max)$ is the value of the log-likelihood function when it has been maximised. The log-likelihood index ranges from 0 to 1, just as R^2 does. Like R^2 , it is unlikely to be close to 1 when qualitative choices are involved, and it is not surprising to obtain a low ρ . As suggested by Hensher and Johnson (1981) in their comprehensive review of discrete choice models, ρ values ranging between 0.2 and 0.4 represent very good fits. Checking against the test results of the current study, the computed values of ρ vary from 0.201 to 0.209, demonstrating a good overall fit of the models.

In addition, the overall significance of the models is indicated by the results of the likelihood ratio tests shown in Table 7.5. For discrete choice models, the likelihood ratio test is similar to F-test in that it jointly considers the effects of all the parameters. The likelihood ratio test provides the following test statistic:

$$\lambda = 2[L(Max) - L(0)]$$

where $L(Max)$ is the value when the log-likelihood function has been maximised without any restrictions, and $L(0)$ is the value of the log-likelihood function when all the parameters are restricted to zero. If the sample size is large, it can be shown that the test statistic λ follows the chi-square (χ^2) distribution with degrees of freedom equal to the number of restrictions imposed by the joint null hypotheses. The idea behind the likelihood ratio test is that if a prior restriction is/prior restrictions are valid, the value of the restricted and unrestricted log-likelihood function should not be different, in which case λ will be zero. But if that is not the case, the two log-likelihood functions will diverge. The likelihood ratio test compares the value of the likelihood function of an unrestricted equation with the one that has been restricted by the joint null hypothesis and set to find out if the divergence is statistically significant. If the two likelihood functions are significantly different, then the joint null hypothesis can be rejected because the imposition of the hypothesis has significantly reduced the fit. If the two likelihood functions are not significantly different, then the joint null hypothesis can not be rejected. As indicated by Table 7.5, the likelihood ratio test results for the models in the current study are all significant, and the joint null hypotheses can be rejected.

DISCUSSION AND CONCLUSIONS

This chapter examines the discrete location choices of foreign insurance companies/insurance intermediaries for their representative offices in China. In tandem with the questionnaire survey results discussed in chapter 6, the test results of the

conditional logit models confirm the prior assumption that location choice of foreign insurance companies/insurance intermediaries is primarily determined by the location specific advantages in terms of government accessibility and open status to foreign operation, local market size and growth prospect, historical record of inward FDI, and the degree of openness and insurance consciousness. Overall, factors related to government influence and market demand far outweigh those related to operating costs and market infrastructures (e.g. the supply of insurance professionals, insurance distribution systems, and capital markets). The outstanding appeal of Beijing and Shanghai to foreign insurance companies/insurance intermediaries, to a great extent, could be ascribed to their political importance and opening status respectively. What is unique to China, however, is that a location's accessibility to the Regulatory Authority and its status (open or closed) for foreign insurance operation is the top consideration for foreign insurers/insurance intermediaries. And such political/legal considerations are even more important than a prospective location's market size and growth potential.

The paramount importance of political/legal considerations and the secondary importance of market infrastructures are testament of the early stage of foreign entry in the tightly controlled Chinese market. At this stage, good relations with the Regulatory Authority are of critical importance to obtain the sought-after licenses. This may also reflect the lack of marked differences among the six Chinese top cities in market infrastructures.

In line with the questionnaire survey results, the location choice of foreign insurance companies/insurance intermediaries is also significantly correlated with local market size and growth potential and the proximity to major international clients. The test results not only corroborate the foreign insurance companies' burning desire to tap the potential promised by the Chinese insurance markets, but also the compelling need for insurance companies to become globalised in today's changing insurance market. After all, when customer needs are becoming increasingly globalised, the creation of globalised size and spread in order to keep up with the changing needs of customers is the key to success for insurance companies.

It is equally important to point out the differences between life insurers and non-life insurers in location choice criteria as revealed by the author's questionnaire survey (Wu and Strange, 1998). Whilst significantly more weight is accorded to "proximity to major clients" by general insurers, significantly more weight is attached to "local market size and growth potential" by their life insurance counterparts. Further research is required to test the different effect of "local market size and growth potential" and "client

following” on life and non-life insurers’ local choice, as such research is currently prevented by the insufficient sample sizes available.

Further research is also recommended to test the differences in location choice criteria between foreign insurance companies/insurance intermediaries of different nationality groups. As revealed by the questionnaire survey, there are marked differences between insurance companies/insurance intermediaries of different nationality groups in their ranking of the main determinants of location choice. While Japanese insurers are significantly more interested in being “proximity to major clients”, their Western counterparts are significantly more inclined to “local market size and growth potential”. With the continuing influx of foreign insurance companies/insurance intermediaries into China, further research in this respect may be feasible in the future. Finally, as noted above, the overriding concerns over policy environment in making location choices may be changing with the gradual liberalisation of China’s insurance market for international business. Additional research will, therefore, be necessary to assess how location determinants change with the evolution of China’s political/legal framework governing foreign insurance participation in China.

Finally, as noted above, the overriding concerns over policy environment in making location choices very much reflect the early stage of foreign insurance participation in China’s insurance market. The focus of attention, however, may be changing with the gradual liberalisation of China’s insurance market for international business. Additional research will, therefore, be necessary to assess how location determinants change with the evolution of China’s political/legal framework governing foreign insurance participation in China.

Table 7.5 Conditional Logit Model: Maximum Likelihood Estimates

Variant No.	PBOC	OP	SAVINGS	PI	FDIU	PHONE	ENROLL	WAGE	CM	TERFDI	DIS	p	λ	L(Max)
1	1.068 ^a (2.90)	1.190 ^a (3.99)	1.475 ^d (1.686)		3.487 ^e (2.034)							0.201	99.374	-197.576
2	0.862 ^d (1.898)	0.925 ^a (2.717)	1.97 ^e (2.182)		2.267 (0.981)	0.59 ^d (1.708)		-0.666 (-0.879)				0.208	102.7	-195.913
3	0.927 ^d (1.909)	1.123 ^a (3.395)	1.562 ^d (1.75)		3.505 ^e (2.047)	0.155 (0.435)						0.201	99.564	-197.481
4	0.93 ^c (1.992)	0.918 ^e (1.543)	1.336 (1.187)		4.477 ^e (2.028)			-0.964 (-0.601)	0.275 (0.366)			0.202	99.874	-197.326
5	0.889 ^d (1.94)	1.079 ^a (3.246)	1.452 ^e (1.56)		4.06 ^e (2.017)			-0.143 (-0.15)		0.054 (0.519)		0.202	100.006	-197.260
6	1.018 ^a (2.589)	1.136 ^a (3.426)	1.451 ^d (1.656)		3.477 ^e (2.011)						0.124 (0.355)	0.201	99.502	-197.512
7	1.221 ^a (3.393)	1.061 ^a (3.417)		1.416 ^b (2.44)	2.145 (1.226)	0.194 (0.546)						0.208	102.718	-195.904
8	1.209 ^a (3.618)	1.042 ^a (3.348)		1.42 ^b (2.462)	2.845 ^e (1.431)			-0.509 (-0.6773)				0.208	102.888	-195.819
9	1.174 ^a (3.442)	1.02 ^a (3.254)		1.362 ^e (2.3)	2.835 ^e (1.428)			-0.241 (-0.254)		0.048 (0.467)		0.209	103.104	-195.711

Note: t-statistics are in parentheses

^a denotes significance at the 1% level; ^b denotes significance at the 2% level; ^c denotes significance at the 5% level; ^d denotes significance at the 10% level; ^e denotes significance at the 20% level.

No of choosers: 138; No of choices: 6; L(0): 247.263.

Units of measurement: SAVINGS (RMB 1,000); PI (RMB 100); FDIU (RMB 100); WAGE (RMB 1,000).

PBOC: the location of PBOC headquarters; OP: the city where foreign insurance operation is allowed; SAVINGS: savings deposit per capita in the municipality or province; PI: Premium income per capita in the municipality or province; FDIU: cumulative utilised FDI per capita in the municipality or province; PHONE: ownership of telephone per 10 population in the city; ENROLL: university enrolment per 1,000 population in the city; WAGE: average wage of employees in the banking and insurance sector in the city; CM: the location of capital markets in China; TERFDI: utilised tertiary FDI as a percentage of total utilised FDI in the city; DIS: cities where insurance distribution systems are relative developed.

CHAPTER 8 CONCLUSIONS AND RECOMMENDATIONS FOR FUTURE RESEARCH

INTRODUCTION

Insurance has an indispensable part to play in China's economic restructuring process. The development of commercial insurance is required not only by the current pension crisis in China's SOEs but also by the inevitable demographic transition to an ageing population with a shrinking working population. As a risk transfer mechanism, insurance can effectively alleviate the consequences of natural disasters on the economy. Moreover, as institutional investors, insurance companies are well placed to facilitate the much-needed development of the country's capital markets, both for the sake of the restructuring of SOE ownership, but also for the very success of the pension and social welfare system reform. The critical role that insurance can play in China's economic reform and development has resulted in the introduction of competition to stimulate its healthy development.

On the one hand, the market has started to grow at an exponential speed in the past 16 years since the early years of China's open-door policy, which gives rise to some of the most distinctive features of the market. There is a severe shortage of insurance professionals in all disciplines and a shortage of the awareness of insurance among the general public. The market is very much underdeveloped with vast potential projected by steady economic growth, huge population and far-reaching economic/social reforms. The potential can not be realised, however, without insurance education both for the practitioners and for the general public, and without policy realisation of long-term investment vehicles available for insurance companies.

On the other hand, PICC's long-term monopoly in the market place has been broken by the aggressive campaigns of domestic newcomers, and by the presence of foreign insurance business. The foreign insurance business presence, however, has been carefully controlled by the Chinese authorities, and tolerated to the extent that it helps to modernise the local insurance industry and to bring the regulatory framework to internationally recognised standards, but not to compete with local insurance companies. The approval of trading licenses is totally at the discretion of the Chinese

authorities, with trading licenses being restricted to Shanghai and Guangzhou and a specific type of business (life or non-life insurance)⁷⁴. The fear of foreign domination and the need to secure know-how transfer without losing market shares has also prompted the authorities to restrict foreign life insurance licenses to Sino-foreign joint ventures only.

Pursuant to the features of China's insurance market and the its regulatory framework, foreign insurers have formulated corresponding strategies to win the sought-after license battle, to select the entry modes, to decide their operating locations, and to choose their prospective joint venture partners. They have also perceived the operating problems accordingly.

The development of China's modern insurance industry and the issues/strategies surrounding foreign insurance business in China warrant a systematic and empirical study. The studies on China so far have, nonetheless, been concentrated on the Chinese economy as a whole with little attention to financial services, and to insurance services in particular. This study provides an in-depth analysis of the strategic issues confronting foreign insurers/insurance intermediaries with special reference to the choice of entry, partner selection, location choice criteria, as well as determinants of life insurance demand in China. The findings of the study have important strategic implications for foreign insurance business in China, as well as the policy implications for the Chinese Government for the healthy development of China's insurance industry. The study also provides suggestions and recommendations for future research on the Chinese insurance market, and on foreign insurance business in China.

SUMMARY OF THE MAIN FINDINGS

The necessity of FDI in insurance has been examined with a detailed analysis of the distinctive features of the insurance industry, its limited tradeability, and government restrictions on cross-border trade in insurance. The prevalence of FDI in insurance is the product of the interaction between the limited impact of information technology on the tradeability of insurance services, government restrictions on international transactions of insurance services, and the high transactions costs associated with non-equity modes of entry.

The distinctive nature of the insurance industry with respect to the need for proximity, and for often instantaneous interaction between the insurer and the insured, has led to the restriction of the unbundling of functional tasks and their geographical

dispersion to labour-intensive back office operations, such as data processing and claim processing, rather than the provision of insurance which requires the expertise and managerial skills to assess risks. Local presence is further warranted by the need to reap full quasi-rent from ownership advantages and to save transactions costs in such a skill- and information-intensive service industry as insurance. And local presence is often made mandatory by government regulations/policies which prohibit local residents from placing insurance with foreign insurers. It has, therefore, been concluded that FDI, rather than exporting or non-equity arrangement through licensing, will continue to be the prime mode of international transaction of insurance business in the immediate future, despite the revolutionary advances in information technology.

The impact of government policy on the choices of entry mode, partner and location are illustrated not only by a close examination of the effects of government policy on FDI in insurance but also by a detailed review of the regulatory framework governing foreign insurance business in China.

The Choice of Entry Mode and Selection Criteria for Partners in Joint Ventures

The findings on entry mode choices and partner selection criteria verify the hypotheses from the theoretical perspective. It is found that the wholly-owned venture mode is the corporate preference for many foreign insurers/insurance intermediaries, as a result of their needs to exercise management control and their concerns over the compatibility in objectives with the Chinese partners in corporate management. With respect to the joint venture mode of entry, it may well have been a forced choice for foreign insurers/insurance intermediaries to conform to the Chinese Government's preferences.

For those foreign insurers/insurance intermediaries "forced" into the joint venture mode of entry by the policy of the Chinese Government, the overriding concern is to ensure their management control and the compatibility of the partners' management objectives. Despite marked differences in their interest in the joint venture entry mode, life insurers and general insurers, together with composite insurers and insurance intermediaries, all show their corporate preference for the wholly-owned venture entry mode by attaching the greatest importance to partner's willingness to accept foreign management control of the venture in their ranking of partner selection criteria. Under such prerequisites, partners are selected on the basis of their complementary skills and resources in such areas as their contacts with the central/local authorities and their market network. Unsurprisingly, whilst partner's

complementary skills and resources in “guanxi” and quick market access are required for the competitive success of the venture, partner inputs in technological, managerial, and financial capabilities are not as desired.

In addition, the study also reveals some interesting differences between Japanese insurers and their Western counterparts, as well as the differences among life insurers, non-life insurers and insurance intermediaries. Whilst the “client-following” Japanese insurers show the least interest in the joint venture entry mode, the more “local market-oriented” European and US counterparts are interested in the complementary functions of the Chinese partners in governmental contacts and market access. On the other hand, life insurers have the greatest interest in establishing joint ventures with the Chinese partners and accord the highest scores to Chinese partner’s market network in their ranking of partner selection criteria, whilst general insurers are least interested in the joint venture entry mode.

The significant difference between life insurers and general insurers is underlined by their different client base and nature of business. Whilst local trust-building and market access is very much required for selling life insurance product to their major clients, the local population who have limited knowledge of the insurance market, it is not as urgently needed for general insurers whose main client base, at least for the time being, is foreign or Sino-foreign joint ventures with which foreign insurers have advantages over local insurers in market access. The marked differences may well also be underpinned by the mandatory requirement for joint venture entry mode for foreign life insurers and the current exemption from such requirement for foreign general insurers, at least for the time being.

Location Choice Criteria

For foreign insurance companies/insurance intermediaries which decide to engage in FDI, the immediate task is to decide where to locate their operation. Both survey results and the conditional logit model results confirm the theoretical hypotheses that location choice is primarily governed by the location specific advantages in terms of local market size and growth prospect, the historical record of inward FDI, and the degree of openness and insurance consciousness.

What is unique in China where foreign participation in the insurance market is at its very early stage and under tight governmental control is that a prospective location’s policy environment in terms of its accessibility to the Regulatory Authority and its legal restrictions on foreign insurance operation is the top consideration for foreign

insurers/insurance intermediaries. And such political and policy considerations are even more important than a prospective location's market size and growth potential. In contrast, significantly less weight is accorded to a prospective location's operating costs (e.g. manpower costs and office renting charges), as well as the availability and convenience of agglomeration economies and market infrastructure (e.g. the supply of insurance professionals, insurance distribution systems, and capital markets, etc.).

Overall, factors related to government influence, market potential and proximity to international clients are more significant than those related to operating costs and the availability of inputs. What is more, given its information-, skill- and experience-intensive nature, the quality of "soft" infrastructure is found to be of greater importance for business profitability than the cost factors. The outstanding appeal of Beijing and Shanghai to foreign insurance companies/insurance intermediaries, to a great extent, could be ascribed to their political importance and open status respectively.

Significant differences are also identified in the survey results between European, US and Japanese insurers, as well as between life insurers and general insurers. Whilst Japanese insurers demonstrate the strongest inclination for client-following in their location choice, their Western counterparts are more concerned about the local market, and are more anxious about local insurance awareness and the underdeveloped capital markets in China. On the other hand, life insurers deem the location of a suitable joint venture partner significantly more important than general insurers. Among insurance companies of various business categories, general insurers display the strongest international client-following motivation in being close to major clients and major competitors, and pay the least attention to the local market growth potential. Here again, the marked differences between life insurers and general insurers could be the result of different entry mode requirements, different client bases and the different nature of the businesses.

Strategies for Winning Licenses and Perceptions of Their Operating Problems

In line with their overriding concerns over accessibility to and connections with the government authorities in making their location choices and selecting their partners, foreign insurers/insurance intermediaries consider good relations with the Chinese authorities as the most important license-winning strategy. It is suggested that the promotion of good relations with PBOC, the Supervisory Authority, and between the respective governments is of paramount importance as far as a foreign operating license in China is concern.

Likewise, the policy environment is perceived as the most serious operating problem in China. What concerns foreign insurance companies/insurance intermediaries most is the lack of implementing regulations, the uncertainties created by the discrepancies between the Insurance Law and the Shanghai Measures, and the inefficient implementation of the Insurance Law and related regulations. All in all, the concern over the policy environment, insurance professionalism, and public insurance awareness outweigh the concern over the general economic environment and the feasibility of the joint venture entry mode. And the lack of concern over the feasibility of the joint venture entry mode confirms that, to a great extent, the choice of the joint venture entry mode is a "forced" one rather than corporate preference.

Significant differences among national groups and business categories were also discovered by the study. The survey results showed that, whilst Japanese insurers attach the least importance to joint venture strategy in their license campaign, their Western counterparts, especially the European insurers/insurance intermediaries perceive the Chinese investment/business environment as far more problematic. European's lack of confidence may be ascribed to their lesser acquaintance with the Chinese cultural/business background and more remote cultural/psychic distance from China.

The Regulatory Framework

The main operating problems revealed by the survey results regarding the deficiencies of the policy environment for foreign insurance business have their roots in the discrepancies between the regulatory framework for domestic insurers and that for foreign participation. At present, there are numerous discrepancies between the Insurance Law and the Shanghai Measures which leave a large gap between the Chinese regulatory framework and GATS principles. Confusion and uncertainty for the foreign insurance companies/insurance intermediaries are inevitable, given the fact that there is no unified and clear law for foreign insurance participation in China at the present. We, however, have to recognise that the development of the insurance industry in China and, in particular, the perfection of its legal framework is a steady and lengthy process. And the discrepancies between China's insurance regulatory framework and GATS principles can only be expected to be phased out at a cautiously controlled pace compatible with the maturing of China's domestic insurance market (Wu and Dou, 1996).

The other features of the regulatory framework that have serious policy and strategic implications are the stringent liquidity requirements, the restricted provisions on investment vehicles, as well as the local presence requirement and the preference for/requirement of Sino-foreign joint venture entry mode.

The Insurance Law bans non-admitted insurance, and puts severe restrictions on overseas reinsurance by prohibiting insurance companies from placing reinsurance business with insurance companies outside China and from underwriting reinsurance business on the overseas market. The Insurance Law requires insurance companies to maintain high levels of liquidity, which include no less than four types of reserve funds, a number of protection funds, minimum margins of solvency, upper limits of retained premiums, and reinsurance. In the event that an insurance company fails to meet its minimum solvency margin, it will have to inject further capital to make good the shortfall. Moreover, the application of funds by an insurance company is limited to bank deposits, trading of government and financial bonds, as well as other forms of fund application stipulated by the State Council. Further, insurance companies are prohibited from investing in institutions engaged in securities or in enterprises.

Determinants of Life Insurance Demand

Given the paramount importance of market size and potential in motivating FDI in insurance and in deciding the location choice of foreign insurance companies/insurance intermediaries in China, a partial adjustment dynamic model of the main determinants of life insurance demand in China has been developed and examined. The findings support the theoretical hypotheses that life insurance demand is significantly and positively related with income and economic development level, the degree of insurance consciousness/awareness, the supply of insurance services in the market, and life expectancy. It is significantly and negatively related with the anticipated inflation rate.

Moreover, the empirical results suggest that the Chinese life insurance purchasing behaviour is more determined by old-age income protection and support than by the concern for dependant income protection against breadwinner's premature death. As a result, there is serious concern over the real cost of life insurance. And the need for an alternative to the traditional family unit for old-age welfare is stronger than the concern over/need for dependant income protection against the premature death of the breadwinners. The stronger inclination of retirement savings and income protection is further supported by the insignificant relations between life insurance demand and

parental dependency, the positive (though insignificant) relations between life insurance and the extent of old-age support and the average age of the working population, as well as the negative (though insignificant) relations between life insurance demand and average size of the household.

Finally, to the extent that the coefficient of adjustment is small, the study suggests that life insurance demand in China is constrained by supply, and it takes time for the life insurers to meet the market demand for flexible, transparent, interest-sensitive and/or investment return-linked savings oriented life insurance products. The low income elasticity may be ascribed to the combined effect of the lack of long-term investment vehicles for insurers, the lack of competent life insurers in the market, and high inflation. It is, therefore, necessary for the Chinese Government to further liberalise the insurance market, ease the control over the investment vehicles for insurance companies and bring inflation under control. It is also necessary for foreign insurance companies/insurance intermediaries to take a long-term approach to their China business.

STRATEGIC IMPLICATIONS FOR FOREIGN INSURANCE COMPANIES

Under the general context of China's insurance market and China's deep concern about foreign dominance, it is important for the foreign insurers/insurance intermediaries to note that the Chinese authorities will not speed up their market opening process until they feel confident that domestic insurers can compete on an equal footing with foreign insurers (Wu, 1996). The underlining principle for the carefully-controlled and slow opening-up of China's insurance market has serious strategic implications for foreign insurance companies.

A local presence in China is required by the regulatory framework which outlaws non-admitted insurance and restricts overseas reinsurance. The need to be on the ground is also compelled by the need to follow the client abroad and become globalised in today's changing face of the insurance market. After all, the key to success in a globalised industry will be, as it always has been, the ability to adapt to the changing needs of customers (Taylor, 1997). The mergers between Sun Alliance and Royal Insurance, as well as Eagle Star and Zurich Insurance, are prime examples of the general trend to merge with a like-minded insurer to create the globalised size and spread that is so essential in the changing world of insurance.

In addition, the entry mode of foreign insurers is further circumscribed to joint venture or branch office for foreign non-life insurers and joint venture for foreign life

insurers by the regulatory framework. The Chinese Government's preference for joint venture undoubtedly has had a major impact on the entry mode choice for foreign insurers/insurance intermediaries. And in the case of life insurers, there is no other alternative but to adopt the joint venture entry mode. It is important for the foreign insurers/insurance intermediaries to understand the reason for the Chinese authorities' love affair with the joint venture entry mode. Joint venture is the preferred entry mode for the Chinese authorities because this approach makes the foreign insurers/insurance intermediaries easier to control, and enables domestic companies to increase their industry knowledge without substantial start-up investment or a prolonged learning curve. It can bring timely development of insurance in China, providing security to individuals who are moving away from the government-provided safety nets (Wu, 1996).

Here again, the underlying intention is that foreign insurers are welcomed so as to facilitate the modernisation of China's insurance industry and to enhance the competence/competitiveness of China's domestic insurers. Under no circumstances will the foreign insurers be allowed to dominate the Chinese insurance market, or to crush the domestic insurers in their infancy. It is advisable, therefore, for the foreign insurers to demonstrate their co-operation with the Chinese domestic insurers, instead of seeming to be a threat to the indigenous insurers. It may be noted that the aggressive approach of AIA in the Shanghai life insurance market may only have exacerbated the Chinese fear over foreign dominance, and may have slowed down the already prolonged opening process.

We, nevertheless, have to recognise that joint venture is like a long-term marriage and not just for winning the license battle. It is probably because of the uncertainty over the long-term viability of the Sino-foreign joint venture regarding the compatibility of the partners in management control and management culture that has prompted many insurers/insurance intermediaries to opt for the wholly-owned venture mode, despite the Chinese authorities' preference for the joint venture entry mode.

In addition, it is important for foreign insurers to understand the strategic implications of the opportunities and challenges they face in the Chinese market, especially those underpinned by the Insurance Law and its implementing regulations.

Although the Insurance Law was primarily designed to control the development of China's domestic insurance industry, rather than to encourage the openness of the industry for foreign participation, it creates a more certain environment embracing international practice and thus prepares the conditions necessary for foreign participation. The provisions on qualification/professionalism of insurance

companies/insurance intermediaries, provisions on the promotion of fair competition, as well as the development of loss control and risk management skills, will certainly be beneficial for foreign insurance operation in China.

The Insurance Law and the implementing regulations, however, have created challenges for foreign insurers in terms of their operating profit, innovation, capital injection, and the speed of branching out.

Firstly, high capital injection is required to meet not only the high minimum registered capital levels but also the high level of liquidity required by the Insurance Law. Secondly, the standardised tariff might affect foreign insurers' innovative approach and protect the least efficient. Thirdly, the conservative approach to investment might restrict their opportunities for creative or innovative investment strategies and hamper the trading results (operating profit/loss) of foreign insurance companies. Investment income will, therefore, be limited, and foreign insurers would have to rely more on underwriting profit. Fourthly, the acute shortage of qualified insurance agents, the lack of insurance professionalism, and the underdeveloped nature of the insurance intermediary system in China, would result in an expensive and time-consuming process to develop and manage the distribution network for the foreign insurance companies. And lastly, the slow licensing process and the restrictive geographic confinement mean the expansion of foreign operations has to be slow and patient, innovation will be geographically limited in accordance with the regulatory framework.

In addition to all these serious strategic challenges, the considerable confusion and uncertainty stemming from the considerable discrepancies between the Insurance Law and the Shanghai Measures, may well also hamper the success of foreign insurance business in China.

All these challenges require the foreign insurers to have a long-term commitment to the Chinese market. The long-term commitment, however, has to be reconciled with shareholders' demand for quick and improving returns, and the competing opportunities in other emerging markets. The reconciliation is especially difficult when foreign insurers' global profitability has been hard hit by prolonged unprofitable results and exposures to major global catastrophes and when there is a limited amount of reinsurance cover to insulate global insurers from catastrophic loss.

Moreover, as Taylor put it, "opening new offices is the easy part. Understanding where the opportunities lie, the needs and expectations of the local markets, and how to develop relationships with different cultures is the difficult bit. But it is what

determines success" (Taylor, 1996: 9). The Chinese strong propensity to purchase life insurance for old-age income support and protection suggests that the retirement savings market is set to become one of the greatest new markets in the future. In tandem with pension reform and the surge of retirement savings demand, other life insurance demand, such as medical insurance, unemployment insurance, single child insurance, are also set to grow strongly in the future. And the design and provision of life insurance products in accordance with these market trends are strongly advised.

It is also important for foreign insurers to understand the key to entry into the Chinese market — politics. As has been highlighted by the main findings of the study, relations with the Regulatory Authority and bilateral relations between China and the foreign insurer/insurance intermediary's home countries are of paramount importance for winning the license battle. The delay in the granting of a license to Allianz of Germany was due to the friction with the German Parliament over the issue of human rights. Political rows have also cast long shadows over the license application of British insurers/insurance intermediaries. It is, therefore, the top priority for any foreign insurers/insurance intermediaries serious about winning the fierce license battle to maintain long-term good relations with the Regulatory Authority and to obtain the co-ordinated promotion by the foreign insurer's national government.

The best way for foreign insurers to establish a good rapport with the Chinese authorities, as revealed by the study, is to demonstrate their long-term commitment to the Chinese market by contributing to the modernisation of China's insurance industry. The typical example is the active investment in insurance training and education programs for the domestic insurance industry. By doing so, foreign insurers may not only promote their relations with the Chinese authorities, but also have a pool of ready trained staff to employ when the licenses are granted.

POLICY IMPLICATIONS FOR THE CHINESE GOVERNMENT

It has been suggested both by the analysis of foreign insurers' perceptions of the main operating problems in China and by the review of the regulatory framework that the market's full potential can not be realised if the deficiency of the policy environment is not tackled on an urgent basis. The perfection of the regulatory framework and the establishment of a regulated market are the top priorities for China's fledgling insurance industry (Wu, 1996). The further implementation of the Insurance Law and the establishment of a fair basis for competition in this rapidly transforming market are not just for foreign participation and China's integration with the world

economy, but more importantly for the competitiveness of the Chinese domestic insurers. The competitiveness of the domestic insurers can only be achieved when a properly regulated market which embraces fair competition rules is in place (Wu, 1996).

It is, nevertheless, important for the Chinese authorities to maintain the delicate balance between the protection of the competitiveness of the domestic insurers against foreign dominance and the need to upgrade the technicalities of the insurance industry to keep up with economic development. If the authorities hold back the development of the (insurance) industry — in order to maintain balance between the domestic and the foreign companies — while the rest of their economy surges forward, they run the risk of failing to provide adequate or sufficiently professional cover for the myriad new risks that their economic development will undoubtedly produce. On the other hand, if they allow the jostling queue of foreign insurers to flood in too soon, they risk a permanent imbalance in their insurance industry with potential internal political implications (Reactions, 1996a). In fact, there is deep concern that Chinese domestic companies could easily be crushed by capital-rich and technologically-advanced foreign insurers, if the Chinese insurance market is opened too hastily before domestic companies have fully matured. This concern is shared by the Chinese authorities who have been opening the insurance market at the slowest possible, carefully-controlled pace (Wu, 1996).

Another delicate balance for the Chinese authorities to maintain is between insurance companies' observance of high liquidity and the provision of long-term investment vehicles for insurance companies to realise the term transformation of long-term savings and to ensure the very success of the reform of China's ailing pension system. A central task of the Chinese authorities is to ensure that insurance companies maintain a high level of liquidity. It is because of this concern that insurance companies are only allowed to invest in treasury bonds and bank deposits. They are prevented from increasing their profits by investing in the stock market and property. These austerity measures will contribute to enhanced safety records of insurance companies, but the severe restrictions over insurance companies' long-term investment vehicles may well hinder the realisation of the vast potential of the insurance market and jeopardise the very success of the restructuring of the economic system in general and the restructuring of the pension system in particular.

RECOMMENDATIONS FOR FUTURE RESEARCH

Although the study is the first ever comprehensive empirical study of China's insurance industry and foreign insurance business in China, it has several limitations mainly due to the constraints of time, finance and data. A number of further areas of research are, therefore, recommended pending the availability of data.

Firstly, though the questionnaire survey obtained first-hand "hard" data on various issues and strategic decisions regarding foreign insurance business in China, it has a number of potential limitations. It would have been ideal to interview *all* the respondents in China who completed the questionnaire in order to minimise misinterpretation of data. Time and financial constraints, however, prevented this ideal approach.

Secondly, the empirical study on the location choice criteria of foreign insurance companies/insurance intermediaries did not provide a comparison of the differences in location choice criteria between foreign insurance companies/insurance intermediaries of different nationality groups and different business categories. This was due to insufficient sample sizes. It would be interesting to analyse further differences between Japanese insurers and their Western counterparts, as well as between life insurers and general insurers, in their ranking of the main determinants of location choice as revealed by the questionnaire survey. It is, for instance, useful to further the research by verifying if there are indeed significant differences between the Japanese insurers and their Western counterparts with regard to "proximity to major international clients" and "local market size and growth potential". Similar empirical work is also recommended for examining the significant differences between foreign life insurers and general insurers.

It should be emphasised that current data constraints and the subsequent limitations of the current study are the inevitable result of the very early stage of foreign insurance business in China. China has been opening-up for limited foreign insurance participation only since 1992 when the Shanghai Measures were introduced. Since then the foreign insurance presence has been growing, but very slowly under the close supervision and control of the Chinese Supervisory Authority. More sophisticated strategic analysis will be feasible in the future when a further influx of foreign insurance companies/insurance intermediaries provide larger sample sizes.

Thirdly, further research is also recommended to examine how foreign insurers' perceptions of the main operating problems and how their location choice criteria

change with the evolution of China's regulatory environment and insurance industry/market.

Moreover, with regard to the empirical study of the determinants of life insurance demand in China, there were problems with the measurement of the variables of parental dependency (DR and P), the degree of old-age support (RW), the average size of the household (H), and the average age of the working population (A). Similar measurement problems were also encountered with life expectancy. These measurement problems were due to the aggregate data which made it impossible to test the separate effects of the components of pure insurance protection, savings and various options on the demand for life insurance in China. At the moment, the lack of disaggregated data restricts the analysis. The test results indicate the importance of distinguishing between the pure insurance protection and savings components in the life insurance demand model.

Detailed research is recommended in the future to study the determinants of conventional life insurance business, insured pension plans, the insurance protection in life and pension business, and pure savings element. Such detailed studies will provide a good base for the comparative study of the determinants of life insurance demand for different components of life insurance policies and, therefore, provide more constructive business guidance for both foreign and Chinese insurance companies/insurance intermediaries. These detailed studies, however, are not feasible when pertinent disaggregated life insurance premiums are not available.

In addition, more complete data are required for comparing the rates of return, tax shield and policy options. The lack of data renders it impossible to estimate the price elasticity of life insurance demand and its substitute, the comparative rates of return generated by life insurance policies and other financial assets. Given the importance of price elasticity and comparative return for the estimation of life insurance demand, further research is needed to test the impact of price elasticity, comparative rates of return, tax shield and options package built in life insurance policies on life insurance demand in China when some of the pertinent data are available.

Furthermore, further research is needed to examine the relations between income distribution and the demand of life insurance in China.

Last and perhaps most importantly, future research is also needed to illustrate how political lobbying affects the opening up process of China's insurance industry and the development of foreign insurance business in China. The paramount importance of political factors has been demonstrated throughout the thesis. It has been examined

and highlighted by interviews with executives working for the Chinese and foreign insurance companies, a questionnaire survey, and econometric models. It has been found that relations with the PBOC, the Supervisory Authority, and governmental relations are the most important factors influencing foreign license approvals. It is also understood that insurers of different interest groups have been pressing for different courses of action by the PBOC, with foreign insurers pushing for a speedy opening-up while Chinese domestic insurers have been trying to hold back the opening process in protection of the national industry.

As the Supervisory Authority, the PBOC controls the pace of China's opening up process for foreign insurance participation. It not only decides on new operating licenses, but also guides and restricts partner selection and location choice by foreign insurers. It is, therefore, of paramount importance for foreign insurers to promote good relations with the Chinese authorities in order to obtain the sought-after licenses. One of the most important ways is for the foreign insurers to demonstrate their long-term commitment to the Chinese market. Several foreign insurers who are finding the door to the Chinese insurance market firmly shut are using the provision of training/education as a valuable bargaining tool in forcing the door open. In fact, the lack of insurance-related training and education in the Chinese insurance market is providing an unexpected opportunity for foreign insurers vying for an operating license to steal a march on their competitors. On the other hand, Chinese insurers have been urging the Chinese Government to open up the market at the slowest possible pace. Comparing unrestricted foreign competition to asking a baby to race against a giant, they have been trying to persuade the Chinese Government that unrestricted foreign competition will destroy the national industry in its infancy

Although a detailed account of the political lobbying process was beyond the scope of the current study, it would be very worthwhile to follow up the current research findings with a close examination of both the decision-making process of the PBOC, and the lobbying activities of foreign and domestic insurers. This could include face-to-face interviews with those involved in the approval of operating licenses for foreign insurers, the lines of business and geographic areas open for foreign operation, and the legal framework governing foreign insurance participation. Given the critical role that political factors play in the development of foreign insurance business in China, there is an urgent need for greater understanding of these processes and activities.

CONCLUDING REMARKS

“If the banks can not be effective intermediaries, another way must be found to tap the savings pool”⁷⁵. The answer is the development of the capital markets and the realisation of insurance companies as leading institutional investors. In the wake of the Asian financial crisis, the key to keeping Chinese economic growth high without devaluing the RMB is to boost domestic demand. The effective term transformation of the huge stock of savings in China is critical for the success of economic reform measures, including the restructuring of SOEs. Most of Chinese savings are in the bad debt-ridden State-owned banks which can not realise the appreciation of the pools of savings effectively. The alternative intermediaries are the non-bank financial institutions, such as pension funds, which can effectively aggregate small private savings, support the development of a domestic capital market, and can finance the much-needed infrastructure projects. The effective role insurance companies might play would not only boost domestic demand, but also help the Government’s plan to recapitalise the banking system by making it easy for individual companies to raise money on the bond market instead of solely relying on the banks.

The successful experience of Chile shows the complementarity between pension funds and capital markets. The Asian financial crisis may make the Chinese authorities more cautious about relaxing the investment mechanisms for insurance companies. The recent approval by the State Council of regulations for establishing mutual investment funds, however, indicates that the Government is aware of the critical role of insurance companies in China’s economic reform and growth. How to strike a balance is hard for the Chinese authorities to work out. We, nevertheless, have to stress that “China has an opportunity to modernise its economy that it must not miss”⁷⁶.

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APPENDIX 1

Representative Offices & Branches of Foreign Insurance Companies in China

Institute	Place of Incorporation	Representative office/Branch	Year/month of establishment	Trading History with China
Aetna International	USA	Beijing	1992	
Aetna International	USA	Shanghai	1993	
Aetna International	USA	Shenzhen	1995	
Aetna International	USA	Guangzhou	1996	
Alexander & Alexander	USA	Beijing	1995	
Alexander & Alexander	USA	Shanghai	1995	
Allianz AG	Germany	Beijing,	1993	
Allianz AG	Germany	Shanghai	1994	
Allianz AG	Germany	Guangzhou	1994	
American International Group	USA	Beijing		1920s
American International Group	USA	Shanghai (branch),	Sept. 1992	1920s
American International Group	USA	Guangzhou (branch)	Oct. 1995	1920s
American International Group	USA	Shenzhen		1920s
American International Group	USA	Shenzhen		1920s
American Reinsurance Co.	USA	Beijing	Nov. 1994	
American Reinsurance Co.	USA	Shanghai	1995	
American Reinsurance Co.	USA	Shenzhen	1996	
Aon Corporation	USA	Beijing	Jan. 1996	
Asahi Mutual Life Insurance Co.	Japan	Shenzhen	July 1995	
Asia Insurance		Shenzhen		
Assicurazioni Generali	Italy	Beijing	1996	
Assurance Generales de France International (AGF)	France	Shanghai	Nov., 1995	
AXA-UAP	France	Beijing		
China-American Insurance		Beijing		
Chiyoda Fire & Marine Insurance Co.	Japan	Beijing		
Chiyoda Fire & Marine Insurance Co.	Japan	Shanghai	April 1994	
Chiyoda Fire & Marine Insurance Co.	Japan	Tianjin	1996	
Chiyoda Mutual Life	Japan	Beijing		
Chiyoda Mutual Life	Japan	Shanghai		
Chiyoda Mutual Life	Japan	Tianjin		
Chubb (Federal Insurance Co.)	USA	Beijing	April 1994	
Chubb (Federal Insurance Co.)	USA	Shanghai	Sept. 1995	
Chubb (Federal Insurance Co.)	USA	Shenzhen	Nov. 1995	
CIGNA International	USA	Beijing	March 1994	
CIGNA International	USA	Shanghai (Pudong)	Aug. 1995	
CIGNA International	USA	Guangzhou	1997	
CIGNA International	USA	Shenzhen	pending	
Colonial Mutual	Australia	Shanghai	May 1995	1990s
Colonial Mutual	Australia	Beijing		1990s
Commercial Union	UK	Beijing	May 1994	1863
Commercial Union	UK	Guangzhou	August 1995	1863
Commercial Union	UK	Shanghai	June 1996	1863
Continental Insurance	USA	Beijing		
DAI-ICHI Mutual Life	Japan	Beijing		
Eagle Star	UK	Beijing		1908
Eagle Star	UK	Shanghai	Oct. 1992	1908
Fuji Fire & Marine Insurance Co.	Japan	Shanghai	April 1995	
Gan SA	France	Beijing	Aug. 1994	
General Accident	UK	Beijing	March 1994	1908
General Accident	UK	Shanghai	April 1995	1908

General Accident	UK	Guangzhou	1997	1908
Gerling Konzern Allgemeine Versicherungs AG	Germany	Beijing	Nov. 1995	
Great Eastern Life	Singapore	Shanghai	1997	
Guardian Royal Exchange	UK	Beijing	1996	
Gui Jiang Insurance Co.	HK	Beijing	June, 1993	
Hyundai Insurance Co.	South Korea	Beijing		
Internationale Nederlanden Group	Netherlands	Beijing	1993	1886
Internationale Nederlanden Group	Netherlands	Shanghai	May, 1993	1886
Internationale Nederlanden Group	Netherlands	Guangzhou	Nov. 1994	1886
Internationale Nederlanden Group	Netherlands	Shenzhen		1886
Internationale Nederlanden Group	Netherlands	Shenyang	1995	1886
Internationale Nederlanden Group	Netherlands	Dalian		1886
ITT Hartford Insurance	USA	Xiamen	April 1995	
John Hancock Mutual Life Insurance Co.	USA	Beijing	1994	
John Hancock Mutual Life Insurance Co.	USA	Shanghai	Oct. 1995	
John Hancock Mutual Life Insurance Co.	USA	Tianjin	Oct. 1995	
Koa Fire & Marine Insurance Co.	Japan	Beijing		
Koa Fire & Marine Insurance Co.	Japan	Shanghai	Feb. 1995	
Kyoritsu Ltd	Japan	Shanghai	Oct. 1995	
Lincoln National Corporation	USA	Beijing	Jan. 1994	
Lincoln National Corporation	USA	Shanghai	Sept. 1995	
Lincoln National Corporation	USA	Guangzhou	May 1996	
London Insurance Group	Canada	Beijing	May 1994	
Lucky Insurance Group	South Korea	Tianjin	Feb. 1995	
Lucky Insurance Group	South Korea	Shanghai	pending	
Lucky Insurance Group	South Korea	Beijing	pending	
M Thai Insurance Ltd.	Thailand	Shanghai		
Manulife Financial	Canada	Beijing	1992	1893
Manulife Financial	Canada	Shenzhen	1993	1893
Manulife Financial	Canada	Shanghai	1994 (rep. office); May 1996 (JV)	1893
Manulife Financial	Canada	Chengdu	Nov. 1994	1893
Manulife Financial	Canada	Guangzhou	1995	1893
Meiji Mutual Life Insurance Co.	Japan	Beijing	July 1995	
Metropolitan Life Insurance	USA	Beijing	1997	
Ming An Insurance Co. Ltd.	HK	Shanghai		
Ming An Insurance Co. Ltd.	HK	Shenzhen		
Mitsui Marine & Fire Insurance Co.	Japan	Beijing	1981	
Mitsui Marine & Fire Insurance Co.	Japan	Dalian	1993	
Mitsui Marine & Fire Insurance Co.	Japan	Shanghai	1993	
Mitsui Marine & Fire Insurance Co.	Japan	Shenzhen	1994	
Mitsui Marine & Fire Insurance Co.	Japan	Guangzhou	Feb. 1996	
Mitsui Marine & Fire Insurance Co.	Japan	Tianjin,	Nov. 1995	
National Mutual Asia	Australia	Beijing	Nov. 1993	
National Mutual Asia	Australia	Guangzhou	March 1995	
National Mutual Asia	Australia	Shanghai	1995	
National Mutual Asia	Australia	Chengdu	pending	
National Mutual Asia	Australia	Wuhan	pending	
National Mutual Asia	Australia	Dalian	pending	
New York Life Insurance	USA	Shanghai	1994	
New York Life Insurance	USA	Guangzhou	1996	
Nichido Fire & Marine	Japan	Beijing		
Nippon Life Insurance Co.	Japan	Beijing	1987	
Nippon Life Insurance Co.	Japan	Shanghai	1994	
NTUC Income Co-operative Insurance Co.	Singapore	Beijing	1995	
Principal Mutual Life Insurance Co.	USA	Beijing	June 1995	
Prudential Corporation Plc.	UK	Beijing		
Prudential Corporation Plc.	UK	Guangzhou	Nov. 1994	
Prudential Corporation Plc.	UK	Shanghai	Nov. 1994	
Prudential Insurance Company of America	USA	Shanghai	June 1995	

Royal & Sun Alliance	UK	Beijing	1992 (Sun Alliance) Sept. 1995 (Royal Insurance)	
Royal & Sun Alliance	UK	Dalian	April 1994	
Royal & Sun Alliance	UK	Shanghai	1995	
Samsung Fire & Marine Insurance Co.	South Korea	Beijing	April 1995	
Samsung Life Insurance Co.	South Korea	Beijing	April 1995	
Ssangyong Insurance Co.	South Korea		pending	
Standard Life	UK	Shanghai	1996	
Sumitomo Marine & Fire Insurance Co.	Japan	Beijing	Sept. 1982	
Sumitomo Marine & Fire Insurance Co.	Japan	Guangzhou	Sept. 1993	
Sumitomo Marine & Fire Insurance Co.	Japan	Shanghai	Nov. 1993	
Sumitomo Marine & Fire Insurance Co.	Japan	Dalian	Dec. 1993	
Sumitomo Marine & Fire Insurance Co.	Japan	Shenzhen	Nov. 1994	
Sun Life Insurance Co.	Canada	Beijing	May 1995	1930s
Sun Life Insurance Co.	Canada	Shanghai	August 1995	1930s
Swiss Life Insurance and Pension Co.	Switzerland	Beijing	August 1995	
Swiss Reinsurance	Switzerland	Beijing	1996	
Swiss Reinsurance	Switzerland	Shanghai	1996	
Toho Life Insurance	Japan	Beijing		
Tokio Marine & Fire Insurance Co.	Japan	Beijing	July 1980	
Tokio Marine & Fire Insurance Co.	Japan	Shanghai (branch)	Jan. 1993 (rep. office); Sept. 1994 (branch)	
Tokio Marine & Fire Insurance Co.	Japan	Guangzhou	June 1993	
Tokio Marine & Fire Insurance Co.	Japan	Dalian	Dec. 1993	
Tokio Marine & Fire Insurance Co.	Japan	Shenzhen	Jan. 1994	
Tokio Marine & Fire Insurance Co.	Japan	Tianjin	Feb. 1996	
Tokio Marine & Fire Insurance Co.	Japan	Nanjing	1997	
Top Glory Insurance Co.	HK	Beijing	1996	
Transamerica Occidental Life Insurance Co.	USA	Beijing	1993	
Transamerica Occidental Life Insurance Co.	USA	Tianjin	1995	
Transamerica Occidental Life Insurance Co.	USA	Shanghai	1996	
Travelers/Smith Barney		Beijing		
Union Des Assurance De Paris (UAP)	France	Beijing	Feb. 1995	
Unipol	Italy	Beijing	1996	
Winterthur Swiss Insurance Co.	Switzerland	Beijing	March 1994	1970s
Winterthur Swiss Insurance Co.	Switzerland	Tianjin	July 1994	1970s
Winterthur Swiss Insurance Co.	Switzerland	Shanghai	March 1995 (rep. office); Jan. 1997 (branch, non-life)	1970s
Winterthur Swiss Insurance Co.	Switzerland	Guangzhou	1996	1970s
Yasuda Fire & Marine Insurance Co.	Japan	Beijing	1981	
Yasuda Fire & Marine Insurance Co.	Japan	Dalian	1993	
Yasuda Fire & Marine Insurance Co.	Japan	Shenzhen	1993	
Yasuda Fire & Marine Insurance Co.	Japan	Shanghai	1994	
Yasuda Mutual Life Insurance Co.	Japan	Beijing	Sept. 1995	
Zurich Insurance	Switzerland	Beijing	1980	

Sources: Insurance in China (monthly faxed newsletter), London: Reactions Publishing Group Ltd; Asia & Pacific Insurance Newsletter (1995).

Representative Offices & Branches of Foreign Insurance Brokers in China

Institute	Place of Incorporation	Representative office/Branch	Year/month of establishment	Trading History with China
Aon Corp.	USA	Beijing		
Bain Clarkson	UK	Beijing	1986	
Houlder Insurance Far East	USA	Beijing	pending	
Houlder Insurance Far East	USA	Shanghai	pending	
Inchcape	UK	Beijing	1987	
Inchcape	UK	Shanghai		
Jardine CMG Life	UK	Beijing		
Jardine CMG Life	UK	Shanghai		
Johnson & Higgins	USA	Beijing	1995	
Johnson & Higgins	USA	Shanghai	1996	
Marsh & McLennan	USA	Beijing	April 1994	
Marsh & McLennan	USA	Shanghai	1996	
Sedgwick	UK	Beijing	1981 (rep. office); 1993 (branch)	1970s
Sedgwick	UK	Shanghai	1994	1970s
Sedgwick	UK	Shenzhen		1970s
Willis Corroon	UK	Beijing	1994	1926
Willis Corroon	UK	Shanghai	1994	1926

Sources: Insurance in China (monthly faxed newsletter), London: Reactions Publishing Group Ltd; Asia & Pacific Insurance Newsletter (1995).

APPENDIX 2 DEFINITION OF VARIABLES (CHAPTER 5)

(1) Y_{it} is domestic life insurance premium income per capita in province/autonomous region/municipality i in year t measured at 1985 constant prices

$$Y_{it} = \frac{C_{it}}{P_{it}POP_{it}}, \text{ where}$$

C_{it} = domestic life insurance income in province/autonomous region/municipality i in year t

P_{it} = price index in province/autonomous region/municipality i at 1985 constant prices

POP_{it} = population in province/autonomous region/municipality i in year t

(2) LE_i is the life expectancy of men/women at the midpoint of the age group 15-64 in province/autonomous region/municipality i . In other words, LE_i is the life expectancy of men/women who were 40 in province/autonomous region/municipality i in 1990 based on 1990 population census.

(3) DR_{it} is the dependency ratio in province/autonomous region/municipality i in year t

$$DR_{it} = \frac{P_{dit}}{P_{wit}}, \text{ where}$$

P_{dit} = 0-14 age population in province/autonomous region/municipality i in year t

P_{wit} = 15-64 age population in province/autonomous region/municipality i in year t

(4) A_{it} is the average age of potential buyers of life insurance in province/autonomous region/municipality i in year t based on 1990 national census, and 1987, 1993, 1995 1% population sampling survey.

$$A_{it} = \frac{\sum_{j=1} x_{jit}n_{jit}}{P_{wit}}, \text{ where}$$

x_{jit} = midpoint of age group j in province/autonomous region/municipality i in year t

n_{jit} = number of people in age group j in province/autonomous region/municipality i in year t

P_{wit} = total population aged 15-64 in province/autonomous region/municipality i in year t

(5) P_{it} is the percentage of the population which is likely to have dependants in province/autonomous region/municipality i in year t

$$P_{it} = \frac{P_{wit}}{POP_{it}} \times 100, \text{ where}$$

P_{wit} = population age 15-64 in province/autonomous region/municipality i in year t

POP_{it} = the total population in province/autonomous region /municipality i in year t

(6) RW_{it} is retirees as a percentage of the work forces in province/autonomous region/municipality i in year t

$$RW_{it} = \frac{P_{rit}}{P_{wit}E_{it}} \times 100, \text{ where}$$

P_{rit} = population 65 and over in province/autonomous region/municipality i in year t

P_{wit} = 15-64 age population in province/autonomous region/municipality i in year t

E_{it} = employment rate in province/autonomous region/municipality i in year t

(7) EDU_{it} is the percentage of adult population with higher education in province/autonomous region/municipality i in year t based on 1981 and 1990 national census, and 1987, 1993, 1995 1% population sampling survey.

(8) GDP_{it} is Gross Domestic Product per capita in province/autonomous region/municipality i in year t at 1985 constant prices

$$GDP_{it} = \frac{GDP_{it}}{P_{it}POP_{it}}, \text{ where}$$

GDP_{it} = Gross Domestic Product of province/autonomous region/municipality i in year t

P_{it} = price index of province/autonomous region/municipality i at year t at 1985 constant prices

POP_{it} = the population of province/autonomous region/municipality i in year t

(9) EC is a dummy variable for monopolistic market structure. EC is 1 for Eastern and Central Provinces, including Beijing, Tianjin, Hebei, Liaoning, Shanghai, Jiangsu, Zhejiang, Fujian, Shandong, Guangdong, Guangxi, Shangxi, Inner Mongolia, Jilin, Heilongjiang, Anhui, Jiangxi, Henan, Hubei and Hunan. EC assumes 0 for monopolistic market structure for Western provinces, including Sichuan, Guizhou, Yunnan, Shanxi, Gansu, Ningxia, Qinghai and Xinjiang.

(10) EX_{it} is Export as a percentage of GDP in province/autonomous region/municipality i in year t ,

$$EX_{it} = \frac{EXPORT_{it}E_i}{GDP_{it}} \times 100, \text{ where}$$

$EXPORT_{it}$ = export value of province/autonomous region/municipality i in year t

GDP_{it} = GDP of province/autonomous region/municipality i in US\$ in year t

E_i = the average exchange rate of US\$ for RMB in RMB in year i

(11) RIR_{it} is the real investment return for life insurance companies in province/autonomous region/municipality i in year t ,

$$RIR_{it} = GB_t - I_t, \text{ Where}$$

RIR_{it} = real investment return for life insurance companies in province/autonomous region/municipality i in year t

GB_t = three-year yield on government bonds in year t

I_t = the rate of inflation in province/autonomous region/municipality i in year t

(12) AIR_{it} is anticipated inflation rate in province/autonomous region/municipality i in year t , based on the average inflation rate in province/autonomous region/municipality i over the past three years.

$$AIR_{it} = \frac{I_{i(t-1)} + I_{i(t-2)} + I_{i(t-3)}}{3}, \text{ Where}$$

AIR_{it} = anticipated inflation rate in province/autonomous region/municipality i in year t ,
 $I_{i(t-1)}$, $I_{i(t-2)}$, $I_{i(t-3)}$ are the inflation rates of the past three years respectively for province/autonomous region/municipality i .

(13) SAV_{it} is the savings deposit per capita of urban and rural residents in province/autonomous region/municipality i in year t measured at 1985 constant prices.

$$SAV_{it} = \frac{SAVINGS_{it}}{P_{it}POP_{it}}, \text{ Where}$$

$SAVINGS_{it}$ = savings deposit of urban and rural residents in province/autonomous region/municipality i in year t

P_{it} = price index in province/autonomous region/municipality i at 1985 constant prices

POP_{it} = population in province/autonomous region/municipality i in year t

APPENDIX 3 SOURCES OF DATA (CHAPTER 5)

- (1) The China Statistical Yearbook (various issues) for GDP, POP, I, AIR, H and E.
- (2) The Almanac of China's Finance and Banking (various issues) for annual life premium income during 1985-1992, and 1994⁷⁷, for three-year yield of government bond, for savings deposit of urban and rural residents during 1990-1995.
- (3) The Almanac of China's Foreign Economic Relations and Trade (various issues) for EX.
- (4) China Provincial Statistics 1949-1989 [1993, Hsueh, T, Li, Q. and Liu, S. (eds.), Colorado: Westview Press Inc.] for savings deposits of urban and rural residents during 1985-1989.
- (5) 1990 National Population Census in China Population Statistics Yearbook (various issues) for EDU, A and LE.
- (6) 1987, 1993, 1995 1% National Population Sampling Survey in China Population Statistics Yearbook (various issues) for EDU and A⁷⁸.
- (7) 1987, 1992, 1994, 1995 1% National Population Sampling Survey in China Population Statistics Yearbook (various issues) for DR, P, RW⁷⁹.

APPENDIX 4 CORRELATION MATRIX (CHAPTER 5)

	LNGDP	LNEX	EC	RIR	LNAIR	LNLE	LNRW	LNA	LNH	LNDR	LNP	LNEDU	LNLGY
LNGDP	1.000	-	-	-	-	-	-	-	-	-	-	-	-
LNEX	0.577	1.000	-	-	-	-	-	-	-	-	-	-	-
EC	0.400	0.485	1.000	-	-	-	-	-	-	-	-	-	-
RIR	-0.049	0.065	0.008	1.000	-	-	-	-	-	-	-	-	-
LNAIR	0.151	0.208	0.042	0.415	1.000	-	-	-	-	-	-	-	-
LNLE	0.454	0.506	0.267	-0.025	0.093	1.000	-	-	-	-	-	-	-
LNRW	0.387	0.412	0.415	-0.004	0.060	0.607	1.000	-	-	-	-	-	-
LNA	0.099	0.014	-0.017	-0.028	0.037	0.075	0.117	1.000	-	-	-	-	-
LNH	-0.644	-0.488	-0.442	-0.018	-0.215	-0.386	-0.475	-0.106	1.000	-	-	-	-
LNDR	0.628	-0.493	0.398	-0.012	-0.212	-0.341	-0.325	-0.101	0.612	1.000	-	-	-
LNP	0.533	0.365	0.340	0.020	0.222	0.207	0.094	-0.071	0.533	-0.548	1.000	-	-
LNEDU	0.924	0.394	0.199	-0.015	0.216	0.324	0.270	0.115	-0.526	-0.547	0.474	1.000	-
LNLGY	0.504	0.516	0.250	0.083	0.374	0.267	0.292	-0.098	0.557	-0.521	0.400	0.368	1.000

APPENDIX 5 SOURCES OF DATA (CHAPTER 7)

- (1) Almanac of China's Foreign Economic Relations and Trade (various issues) for cumulative utilised FDI of the six metropolitan cities and provinces: various issues.
- (2) The Dalian Statistics Yearbook (various issues) for phone per 10 population, university enrolment per 1,000 population, wage of banking and insurance employees, and population in the city: various issues.
- (3) The Guangzhou Statistics Yearbook (various issues) for phones per 10 population, university enrolment per 1,000 population, wages of banking and insurance employees, and population in the city: various issues.
- (4) The Shenzhen Statistics Yearbook (various issues) for phones per 10 population, university enrolment per 1,000 population, wages of banking and insurance employees, and population in the city: various issues.
- (5) Almanac of China's Finance and Banking (various issues) for savings deposit per capita and premium income per capita of the six metropolitan cities/provinces: various issues.

NOTES

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- ¹ Large line capacity refers to an insurer's ability to provide a high limit of insurance on a single loss exposure. Regulations often prohibit an insurer from writing net for its own account an amount of insurance in excess of 10 percent of its policyholder's surplus on any loss exposures. Through reinsurance, an insurer may write a large line by keeping its retention within a reasonable relationship to its capital and surplus and reinsuring the balance; Likewise, reinsurance also provide the reinsured surplus relief — the reduction of surplus drain for a growing insurer that results from having to recognise all expenses when they are incurred. For detail, see Webb (et al, 1992).
 - ² There are two ways to achieve the withdrawal from a territory or a class of business. The insurer could merely cancel the unwanted policies and refund the unearned premiums to its policyholders. This process is unwieldy, expensive, and likely to create ill will among policyholders, producers and Regulatory Authority. By reinsuring the unwanted businesses with an insurer or reinsurer, an insurer can not only avoid the ill will resulting from cancellation, but also saving costs. Because it is quite possible that the cost of reinsurance may be less than the cost of processing and paying return premiums on cancelled policies.
 - ³ Life insurance policy which generates a savings element. Cash values are critical to a permanent life insurance policy. The size of a cash value buildup differs substantially from company to company. In many instances there is no correlation between the size of the cash value and premiums paid. In some cases there is even an inverse relationship. Everything the policyowner wishes to do with this policy while living is determined by the size of the cash value.
 - ⁴ Ching Chi Tao Pao (22nd September, 1997).
 - ⁵ Under the present medical guarantee system established in the 1950s, all medical expenses are borne by the State, institutions and enterprises. This system lacks an effective mechanism to impose restrictions on both the hospitals and the patients. Doctors in some hospitals often over-prescribe medicine or write out the so-called human relationship prescription. Employees' families and relatives obtained medicine easily because of their entitlement to public health services. This resulted in huge losses. Economic reform requires the establishment of a unified social medicare security system that combines overall social planning funds with contributions from personal savings. A rational mechanism is built into the system to raise social medical

funds and encourage individuals to raise their own funds. A call for the acceleration of the reform of medical guarantee system has been voiced by the Director of the Distribution and Social Security Department of the State Commission. See *Asia Cover* (1997).

- ⁶ The proportion of workers' monthly wage paid as pension insurance premium to pension fund.
- ⁷ Replacement rate is the value of a pension as a proportion of a worker's wage (net of individual worker's contribution to the pension system) during certain base period, such as the last year or two before retirement or the entire lifetime average wage.
- ⁸ The emphasis of the two alternative plans are, however, different, with plan I on individual accounts and plan II on social pooling (mandatory basic benefits).
- ⁹ Though the authority admits that to reach rural workers working in out of the places will take considerably longer time. See *Insurance in China* (1997b).
- ¹⁰ Defined contributions is a pension plan in which the periodical contribution is prescribed and the benefits depends on the contributions plus the investment returns.
- ¹¹ Demographic transition is the historical process of changing demographic structure that takes place as fertility and mortality rates decline, resulting in an increasing ratio of older to younger persons.
- ¹² Minimum pension guarantee is a guarantee provided by the Government to bring pensions to some minimum level, possibly by "topping up" the capital accumulation needed to fund the pensions.
- ¹³ An analysis of historical rates of return (Chow, 1993) found that average rates of return for four sectors (industry, construction, transportation, and commerce) were 14 percent for 1980-85. More recently, Yu (1995) estimated pretax profits to asset ratio in China to be 13 percent for 1986-93. World bank assisted investment projects in China have a consistent record of earning more than 10 percent real rate of return.
- ¹⁴ It is suggested that the investment upper bound should be in line with international standards in life insurance sector: corporate bonds, 41 percent; mortgages, 20 percent; government security 14 percent; stocks, 10 percent; loans, 4 percent; real estate, 3 percent; and miscellaneous investment, 8 percent, as in the case of the US life insurance industry in 1990.
- ¹⁵ *Financial Times* (10th October, 1997).
- ¹⁶ The underwriting ratio is the profit or loss achieved by the insurer, calculated as premium income less the cost of claims and the insurers' expenses in connection with

business. It is common for insurers to make underwriting losses, but these are usually offset by the investment income which accrues from the holding of premiums prior to their disbursement to meet claims. The insurer's overall trading result is then the underwriting profit/loss plus the investment income. The trading ratio is the trading result expressed as a percentage of premium income.

¹⁷ Bao, X. and Duan, Q. (China Insurance News, 22nd August 1997).

¹⁸ Ibid.

¹⁹ ACII stands for Associateship of Chartered Insurance Institute. It is the highest professional insurance qualification that can be gained by examination in the UK.

²⁰ Financial Times (18th March, 1998); Financial Times (20th March, 1998).

²¹ Financial Times (20th March, 1998).

²² Xinhua News Agency (3rd September, 1997).

²³ Article 4 authorised the PBOC to formulate policy, approve the establishment of other insurance companies, direct and supervise the activities of insurance business, set the rates and clauses within the insurance agreements, and audit insurance companies.

²⁴ According to Article 12 of the Regulations, these insurance businesses were restricted solely to the PICC, unless otherwise allowed by the law. Competition from newly-established insurance companies had forced these reservations to be lifted before the Insurance Law took effect.

²⁵ According to the survey, 50 percent of US joint ventures in China did not purchase insurance coverage from Chinese insurers, even though Chinese law prevented them from buying coverage from overseas.

²⁶ There were 8,000 professional individual agents in Shanghai by the end of August 1995, with AIA accounting for 5,000 of them. See Di (1995).

²⁷ The Insurance Law covers:

Chapter One: General Principles

Chapter Two: Insurance Contracts

Section One: General Provisions

Section Two: Property Insurance Contracts

Section Three: Life Insurance Contracts

Chapter Three: Insurance Companies

Chapter Four: Rules for the Conduct of Insurance Business

Chapter Five: Supervision and Administration of the Insurance Industry

Chapter Six: Insurance Agents and Brokers

Chapter Seven: Legal Liabilities

Chapter Eight: Supplementary Provisions

²⁸ Clifford Chance (1996b).

²⁹ See, for example, the Procedures for The Registration and Administration of Resident Representative Offices of Foreign Enterprises in China, promulgated by the State Administration for Industry & Commerce, and effective from 15th March 1983; the Provisional Regulations of Shanghai Municipality Concerning The Control of Representative Offices of Foreign Enterprises, promulgated by the municipal government of Shanghai, and effective from 1st September 1986; and the PBOC Procedures for The Administration of The Establishment of Resident Representative Offices in China by Financial Institutions with Foreign Investment, promulgated on 15th June 1991. Article 6 of the 1991 Procedures stipulated that the Head Office of PBOC is responsible for the supervision, inspection and regulation of the resident representative offices stationed in Beijing, while its branches are responsible for supervision, inspection and regulation of the local resident representative offices in other cities.

³⁰ Article 3 of the 1983 Procedures stipulated that representative offices of foreign enterprises shall be understood as those engaging in non-direct-profit making operations.

³¹ According to EIU (1997), foreign representative offices are increasingly able to get around the non-profit making constraints by funnelling revenue generated in China back to overseas offices. Others carry out business in China but have their home country headquarters bill customers for China-related business.

³² The 14 open cities are Dalian, Qinhuangdao, Tianjin, Yantai, Qingdao, Lianyungang, Nantong, Shanghai, Ningbo, Wenzhou, Fuzhou, Zhanjiang, Guangzhou, and Beihai.

³³ Guarantee reserve: According to Shanghai Measures, joint venture insurance companies are required to allocate 20 percent of their paid up capital, which is half of the amount required by the Insurance Law, bearing in mind the 50 percent paid up capital requirement in the Shanghai Measures; With respect to branches of insurance companies, the allocated amount is US\$4 million, which equals to the amount

- required by the Insurance Law; Reserve for unexpired liabilities: Although it carries the same requirement for non-life insurance companies, the Shanghai Measures is inconsistent with the Insurance Law in the provision for life insurance companies. Whilst the Insurance Law required life assurance to set aside an amount equivalent to total net value of life assurance policies, the Shanghai Measures required life assurance an amount equals to total net policy value of long-term policies plus 50 percent of retained premiums of one year or less; Reserve for outstanding claims: the equivalent reserve in the Shanghai Measures is general reserve fund; Social reserve fund: Under the Insurance Law, insurance companies were required to set aside social reserve funds in accordance with relevant regulations of the Joint Venture Law concerning the establishment and maintenance of accumulation funds, State laws, regulations and the rules of accounting and finance (Article 95). In comparison, the Shanghai Measures provided concrete figures, whereby a foreign insurance company must assign 25 percent of its after-tax profit to a "reserve fund" annually until its paid up capital and reserve fund double its registered capital; Employees reward and welfare fund, and corporate development fund: It is unique to the Shanghai Measures; Protection funds: This is not applicable to the Shanghai Measures.
- ³⁴ Unit risks: Whereas the Insurance Law required insurance companies to arrange reinsurance if a risk unit amounts to over 10 percent of the actual capital assets and social reserve funds, the Shanghai Measures defines a risk unit as 10 percent of the net assets of foreign insurance companies; Reinsurance: Unlike the Insurance Law, where the compulsory reinsurance requirement does not apply to life insurance business, Shanghai Measures required foreign insurance companies to procure reinsurance for 30 percent of *all* risks, life and non-life insurance business alike.
- ³⁵ In contrast to the provision of separating life and non-life insurance business in the new Insurance Law, the Shanghai Measures allowed foreign insurance companies to engage in composite insurance business.
- ³⁶ Whilst the Insurance Law provided only two types of insurance companies — joint-stock company and wholly State owned companies, the Shanghai Measures provided two other types of corporate form— branches of overseas registered insurance companies, and joint ventures insurance companies between overseas registered insurance companies and domestically registered insurance companies (or other approved institutions).
- ³⁷ The Insurance Law authorised the Supervisory Authority to take over the administration of insurance companies which violate the provision of the Law, damage public interest

or undermine their margins of solvency. The Shanghai Measures, however, did not provide the Supervisory Authority with such power.

³⁸ As indicated by Chen Yaoxian, Deputy Governor of the PBOC, at the China Summit on 14th November 1996.

³⁹ As one of the founding members of GATT, China became a contracting party on 21st May 1948. China's GATT membership was withdrawn by the deposed Kuomintang government on 5th May 1950.

⁴⁰ According to the EU, the Geneva Accord will offer solid access commitments covering nine-tenths of the world's financial business: around US\$20,000bn of world banking assets and a further US\$20,000bn of deposits; US\$2,000bn of world insurance premiums; US\$10,000bn world stock market capitalisation; and US\$10,000bn worth of market value of listed bonds. See Williams, F. (Financial Times, 27th July 1995).

⁴¹ The US refused MFN treatment for financial services because it was dissatisfied with the offers of a handful of developing countries, including Brazil and several Asian countries. Under the Geneva Accord, the US will not take on the obligation of MFN for new activities in banking, insurance and other financial services, and new entrants will be treated on a reciprocal basis according to how their home countries treat US companies. Bearing in mind the US reservations, Renato Ruggiero, director-general of WTO, described the Interim Accord "a very good second best".

⁴² The US had been running alarming trade deficit with China for several consecutive years (US\$6276million in 1993, US\$7491 million in 1994; US\$8593 million in 1995, for instance). In line with its reciprocity-based strategy in the Geneva Interim Accord, the US argued that if it grants developing countries "double standard" treatment based on multilateral principles with full market access, whilst these countries only pledge restricted market entry, it will stand to lose in the long run by being excluded from these markets. It is not surprising that the US maintains an "all-or-nothing" approach towards China and insists that it should be treated as a developed country.

⁴³ The six areas include: the opening of China's service sector. China is urged to speed up its opening process for the participation of foreign banks, insurance companies and other service-oriented businesses; Trading rights. China has proposed staged liberalisation over 8 years. Its negotiating partners required restrictions on the rights of companies to engage in foreign trade liberalised in three years; Non-tariff measures. China's offer of a phased elimination was not deemed far enough; Price controls. China is under pressure to reduce categories where controls are applied; Subsidies. China is being asked to provide greater transparency of export subsidies on

agricultural products and to agree to their phasing out; Safeguards. China remains adamantly opposed to any discriminatory safeguards in the protocol. Its negotiating partners have insisted on these safeguards to protect themselves against expected "surge" of Chinese exports of such items as textiles and footwear into their home markets.

⁴⁴ In contrast, property insurance losses are paid quickly. This, combined with the unstable losses from year to year as a result of catastrophes, necessitate an insurer that writes mostly property insurance to hold very stable and liquid investments so they can be converted quickly to cash to pay losses. Conversely, life insurers can hold investments that are less liquid, because their losses are even more stable and their insurance contracts are for longer term.

⁴⁵ It was found that the liquidity requirements promulgated by the Insurance Law have not yet been effectively implemented. In fact, the compulsory reinsurance of any unit risk which exceeds ten percent of the actual assets plus accumulated funds has been hardly supervised, while supervision has been skewed towards twenty percent compulsory reinsurance. Consequently, in their fight for market shares, it is not uncommon for some domestic companies, and new insurers in particular, to divert reserves and accumulation funds into underwriting liabilities which are sometimes more than ten times their actual assets and accumulation funds. As a result, the guarantee fund (twenty percent of an insurance company's registered capital) for repaying the debts of the company upon liquidation will be a far cry from saving an insurance company from bankruptcy once struck by natural or man-made catastrophes. On the other hand, premium rebates and commission fees have been pushed up to an exceptionally high level by insurance companies competing for market shares. The commission fee for airlines acting as part-time agents for travel insurance, for instance, can be as high as 80%, which is four or five times the international standard. In addition, among other misconduct, some of the insurance companies have been writing up documentation, whereby policy conditions are extended by non premium bearing endorsements. And these documents are hidden from the Supervisory Authority in separate files. What is more, despite the ban of placing insurance with non-admitted insurers and the encouragement of reinsurance with admitted companies by the Insurance Law, perhaps less than half of the insurance for foreign owned or foreign controlled joint ventures was purchased locally. Most of it is arranged offshore with non-admitted insurers. See Wu (1996) and Lancaster (1997a) for details. And the problem is so severe that a China Insurance Convention was concluded in Beijing, with the participation of 13 national and regional

domestic insurance companies, to combat the violation of the provisions and strengthen self-regulation of the insurance profession. For detail, see *China Insurance News* (12th September, 1997).

- ⁴⁶ An insurer or reinsurer underwrites the risks located in other countries and export its insurance services abroad. For a detail discussion, see Carter and Dickson (1992)
- ⁴⁷ It was revealed that increased tradeability relies significantly on heavy capital investment such as advanced mainframe computer processing and telecommunications facilities. In addition to insufficient telecommunication facilities, many developing countries will probably sustain the considerable gap between international telecommunications tariffs and domestic tariffs, due to the importance of income from international calls for local post and telegraph administrations and the high rate of inflation in many economies. See UNCTAD (1994).
- ⁴⁸ The terms and conditions include price, specification of the goods or service to be supplied, control over use made of the goods or service supplied, as well as frequency and timing of deliveries (including inventory and warehouse costs).
- ⁴⁹ For a detail discussion of the U.S. international insurance companies using these three methods, see Bickelhaupt and Bar-Niv (1983).
- ⁵⁰ Good examples are the cross-border transaction and division of labour between United States insurance companies and their affiliates in Ireland. The Ireland offices of the United States insurance companies are typically connected to computer centres in the United States, with Irish subsidiaries performing on-line data entry for claim-processing. For detail, see United Nations (1993: 22-24).
- ⁵¹ One important exception is international insurance brokers in their handling of large commercial and industrial risks.
- ⁵² The six types of producer services (business services) covered by the survey were: engineering consultants; management and business consultants; related business services (e.g. accountants, lawyers, executive search companies); computer and information-technology services; trade and finance; and other manufacturing services. Banking and insurance, however, were excluded from the survey.
- ⁵³ The survey conducted by Price Waterhouse found that the internationalisation of industrial and commercial customers was the biggest influence that drove the internationalisation of the insurance industry. See Price Waterhouse (1991).

- ⁵⁴ Even though some research (OECD, 1983; UNCTC, 1989, for instance) suggested otherwise — developed and under-developed countries prefer subsidiaries to branches. Branches are sometimes subject to special deposit requirements designed to protect policyholders.
- ⁵⁵ Prior research on life insurance consumption has typically used premium expenditures as the measure of insurance consumption, e.g. Hammond et al, 1967; Ducker, 1969; Ferber and Lee, 1980; Burnett and Palmer, 1984; Beenstock et al, 1986, and Browne and Kim, 1993. Premium data have been widely used as a proxy for life insurance demand primarily because of their availability. In the present study, the provincial life insurance premium for 1993 and 1995 are estimated on the basis of the percentage of life premium in total provincial premium income in 1994. In addition, Hainan and Tibet are excluded from the study, because Hainan was not granted provincial status until 1988 and information on Tibet is generally not available.
- ⁵⁶ The positive relationship between the proportion of population who are likely to have dependants and the demand for life insurance can also be examined in the light of the potential insurance buyers being prospective pensioners (Beenstock et al, 1986).
- ⁵⁷ The net present cost of insurance coverage when no policy loans are undertaken, per 1,000 present-valued units of insurance expected to be in force over time period [0, τ], is given by

$$NPC = \frac{\tau i}{1 - \exp(-i\tau)} [P_\tau - D_\tau - TD_\tau - DB_\tau - CV - TDD] \quad (A1)$$

$$\text{where } P_\tau = \sum_{t=1}^{\tau} \frac{S_{t-1}P_t}{\frac{1}{(1+i_0)} \prod_{j=0}^{t-1} (1+i_j)} \quad (A2)$$

$$D_\tau = \frac{S_{t-1}d_t}{\prod_{j=1}^{\tau} (1+i_j)} \quad (A3)$$

$$TD_\tau = \sum_{t=1}^{\tau} \frac{S_{t-1}q_t d_t}{\prod_{j=1}^t (1-i_j)} \quad (A4)$$

$$DB_\tau = \sum_{t=1}^{\tau} \frac{S_{t-1}q_t 1000}{\frac{\sqrt{1+i_t}}{(1+i_0)} \prod_{j=0}^{t-1} (1+i_j)} \quad (A5)$$

$$CV_{\tau} = \frac{S_{\tau} CV_{\tau}}{\prod_{t=1}^{\tau} (1 + i_t)} \quad (A6)$$

$$TDD_{\tau} = \frac{S_{\tau} td_{\tau}}{\prod_{t=1}^{\tau} (1 + i_t)} \quad (A7)$$

and where

i_t is an appropriate discount rate in year t for after-tax cash flows occurring during the year, adjusted only for default risk; P_t is the premium payable at the beginning of year t , per 1,000 dollar of insurance in force; CV_t is the cash value at the end of year t , per 1,000 dollar of insurance in force; τ is the year of intended policy surrender; d_t is the dividend payable in year t , per 1,000 dollar of insurance in force; td_t is the terminal dividend payable at the end of year t [(or during year t in the event of policy surrender [or death]); S_t is the probability of survival through the end of year t ; and q_t is the probability of death in year t given survival through year $t-1$.

In equation A1, all of the cash flows, be they in the form of premiums, dividends, terminal dividends, surrender cash values, or death benefits, are adjusted in accordance with the probability of the insured incurring or receiving them. (A1) is an adjustment factor for rendering the declining present value of insurance in force over time into an average present value of 1,000 dollar. (A2) is the present value of premiums that are expected to be paid through year τ . These premiums are paid contingent upon survival of the insured. (A3) gives the present value of expected dividends to be received as long as the policy remains in force. (A4) and (A7) represent the present value of the expected terminal dividend, which is available in some policies that have been in force for 10 years or more and received either upon death of the insured or policy surrender respectively. In (A5), the present value of expected insurance indemnification is given, while (A6) gives the present value of the cash value to be received upon policy surrender, adjusted for the likelihood of survival through year τ .

If policy loans are taken into account, equations (A5) and (A6) are replaced by (A8) and (A9) listed below:

$$\sum_{t=1}^{\tau} \frac{S_{t-1} [(cv_t - cv_{t-1}) - (1 - \kappa)rcv_{t-1}]}{(1 + i_0) \prod_{r=0}^{t-1} (1 + i_r)} \quad (5.8)$$

$$\sum_{t=1}^T \frac{s_t - i q_t (1000 - cv_t)}{e^{\frac{\sqrt{1+i_t}}{(1+i_0)}} \prod_{\tau=0}^{t-1} (1+i_\tau)} \quad (5.9)$$

where κ is the effective tax bracket of the policy-owner, r is the interest rate charged on policy loans, and the cash values for the first years are ignored for purposes of obtaining policy loans. For detail discussion, see Babbel and Staking (1983) and Babbel (1985).

- ⁵⁸ Policy loan is the amount that the owner of a life insurance policy can borrow at the interest from the insurer, up to the cash surrender value. If interest is not paid when due, it is deducted from any remaining cash value. When the cash value is exhausted, the insurance ceases. If the insured dies, any outstanding policy loan and interest due are subtracted from the death benefit. The policy-owner may repay the loan in whole or in part at any time or continue the loan, as long as the interest plus the principal of the loan does not equal or exceed the cash value (in essence only the interest on the loan must be serviced) or until the policy matures. The value of policy loan option primarily arises from the interest rate guarantees, whereby the policy-owner sells the policy for its cash value when market interest rates are above the policy loan rate and buy it back at a guaranteed price when interest rates are below the loan rates. That is, increasing market interest rates create profitable arbitrage opportunities for individuals holding life insurance contracts bearing low interest rate policy loan provisions. See Cummins (1975), Day and Henderschott (1977) and Smith (1982) for the detail discussion of the policy loan phenomena (e.g. interest arbitrage opportunities).
- ⁵⁹ Guaranteed mortality rates is the option for the policy-owner to make additional purchase of life insurance such as extended term insurance of lifetime income at guaranteed premium rates without having to take a physical examination or show other evidence of insurability (guaranteed insurability). The other guarantees provided by options that are riders endorsed by life insurance policies are such as waiver of premium for disability, accidental death benefit, cost-of-living adjustment (COLA), other insured, children's insurance, transfer of insureds. On the one hand, an option to purchase additional insurance at guaranteed rates is likely to be exercised if the insured is in poor health; On the other hand, a beneficiary in excellent health may elect a lifetime income as an optional mode of receiving a death claim unless the interest rate implied in the guarantee is too low to make the income guarantee attractive.
- ⁶⁰ Surrender is the action of the owner of a cash value life insurance policy to relinquish it for its cash surrender value. A policy-owner will surrender a contract if the additional

rate of return earned as a result of the surrender more than compensates for the loss of the policy's options.

⁶¹ According to "Chinese Statistical Yearbook", dependency ratio refers to the ratio of youth, children and the aged to the population aged between 15-64. Here, the youth and children refer to population aged 0-14, and the aged refers to population 65 and over. In order to distinguish from the retiree to work force ratio defined under the determinants of savings in life insurance and pension policies, the dependency ratio defined here under the determinants of insurance protection in life insurance policies is narrowly defined as the ratio of the population in age group 0-14 to age group 15-64.

⁶² China Economic Times (9th March, 1998).

⁶³ It is adjustable life insurance under which (1) premiums are flexible, not fixed; (2) protection is adjustable, not fixed; (3) insurance company expenses and other charges are specifically disclosed to a purchaser. This policy is transparent in that its three basic elements (investment earnings, pure cost of protection, and company expenses) are separately identified both in the policy and in an annual report to the policyholder. After the first premium, additional premiums can be paid at any time (provided the cash value account balance is sufficient to pay the pure cost of protection each month and any other expenses and charges). Universal life insurance is interest-sensitive in that the calculation of life insurance premiums and benefits are based on current interest and mortality rates, rather than historical rates. When interest rates are high, benefit projections (such as cash values) are high. When interest rates are low, these projections are not as alluring.

⁶⁴ Policy combining features of universal life insurance and variable life insurance in that excess interest credited to the cash value account depends on investment results of separate accounts (equities, bonds, real estates, etc.). The policyholder selects the accounts into which the premium payments are to be made. This product can be considered as a replacement for universal life insurance when interest rates are low. It is a life insurance product which provides a hedge against inflation, because it is believed that over the long term the investment experience of common stocks supporting the policies would increase with inflation.

⁶⁵ DR, P, H and A are all highly insignificant with expected signs, and are dropped from the equation.

⁶⁶ 13 were British, 3 were Swiss, and 1 each were from Germany and the Netherlands.

- ⁶⁷ From the Chairman's speech on the November 1996 London conference on 'China and India: the Insurance Potential', organised by Reactions Publishing Group Ltd.
- ⁶⁸ Speech by Dean T. Chiang of the Taiwanese law firm, Lee & Li, to the October 1996 conference on 'Strategic Issues 2000' in Kuala Lumpur.
- ⁶⁹ Ibid.
- ⁷⁰ PICC currently has 110,000 staff for US\$6 billion in premium — US\$54,000 per staff. And the current growth rate of PICC is 40%. See Lancaster (1997b).
- ⁷¹ Li, G. (China Insurance News, 8th August 1997).
- ⁷² Li, G. (China Insurance News, 1st April 1997).
- ⁷³ The city population data used in the study are registered population data, with the exception of Shenzhen. In view of the distinctive feature of Shenzhen in terms of its sheer size of transit population (transit population is about 3.5 times the size of registered population), transit population instead of registered population data was used.
- ⁷⁴ The only exception is AIA.
- ⁷⁵ Financial Times (10th March, 1998).
- ⁷⁶ Ibid.
- ⁷⁷ 1995 life premium is derived by multiplying the annual insurance premium by the percentage of life insurance in total premium for the year 1994.
- ⁷⁸ Both EDU and A for the year 1986, 1988, 1989, 1991, 1992 and 1994 are estimated by running regression using 1987, 1990, 1992 and 1995 data.
- ⁷⁹ DR, P, RW for the year 1986, 1988, 1991 and 1993 are estimated by running regression using 1987, 1990, 1992, 1994 and 1995 data.