China's Insurance Companies Step Up Outbound Portfolio Investment

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I. Introduction

China lifted its ban on outbound portfolio investment by Qualified Domestic Institutional Investors (QDII) in April 2006.[1] The more advanced commercial banks and fund management companies[2] designated as QDII were given approval to make overseas investments until end-2006 of $13.1 billion for the former and $500 million for the latter, for a total of $13.6 billion (equivalent to ¥1.63 trillion)[3] (Figure 1). This amount remains higher, and the approval process was quicker, than the $9.045 billion[4] (¥1.08 trillion) in inbound portfolio investment, the ban on which was lifted in November 2002, that is allowed until end-2006 by Qualified Foreign Institutional Investors (QFII).

This opening of QDII in April 2006 also includes higher investment allowances for China's insurance companies, which were already investing overseas in a limited manner, although the details were not made clear at the time. On 21 December 2006, the China Insurance Regulatory Commission (CIRC)[5] announced the draft (request for public comments) version of the Provisional Measures on Administering Outbound Portfolio Investment of Insurance Funds (the "draft measures").[6]

We begin this paper with an overview of China's insurance market in Chapter II, summarize the key points of the draft measures in Chapter III, and then close in Chapter IV by presenting our outlook for the future.

1 For more on China's QDII trends, see Eiichi Sekine, *Ugokihajimeta Chugoku no Taigai Shouken Toushi* (China's outbound portfolio investment gains momentum), *Capital Market Quarterly*, Fall 2006 issue (in Japanese).
2 Companies that manage investment trusts.
3 This and all yen-dollar conversions in this report use the TTS rate at Bank of Tokyo-Mitsubishi UFJ on 4 January 2007 of ¥120.42=$1.
4 Xinhua release dated 7 January 2007.
5 The CIRC was established in November 1998 to take over the function of monitoring the insurance industry from the People's Bank of China (the central bank).
6 Public comments were accepted until 10 January 2007.

Figure 1 QDII investment limits and approval status for banks and fund management companies

1. Banks (Units: $ billions)

Bank name	Approval date	Limit on foreign currency-denominated
Bank of China	21-Jul-06	2.5
Industrial & Commercial Bank of China	21-Jul-06	2.0
Bank of East Asia	21-Jul-06	0.3
China Construction Bank	27-Jul-06	2.0
Bank of Communications	27-Jul-06	1.5
HSBC	10-Aug-06	0.5
China Merchants Bank	5-Sep-06	1.0
China CITIC Bank	18-Sep-06	0.5
Citi Bank	27-Sep-06	0.5
Hang Seng Bank	27-Sep-06	0.3
Industrial Bank	18-Oct-06	0.5
Standard Chartered Bank	24-Oct-06	0.5
China Minsheng Banking	8-Nov-06	0.5
China Everbright Bank	23-Nov-06	0.5
Total		13.1

Note: Figures for HSBC based on media reports, because its Forex division has not disclosed foreign currency-denominated purchasing limits or approval dates.

2. Fund management companies

Company name	Approval date	Investment limit
Huaan Fund Management	6-Sep-06	0.5

Source: Nomura Institute of Capital Markets Research, based on data from SAFE and others

II. China's insurance market

1. Rapid increase in revenue from insurance premiums

Under China's insurance laws, there are two categories of insurance depending on what is being insured: property insurance (property and casualty, etc.) if the object of the insurance is property, and personal insurance (life insurance, health insurance,[7] accident insurance, etc.) if the object is a person. Data announced by the CIRC and the Insurance Industry Association of China (IIAC) shows double-digit growth in insurance premium revenue every year since 1999 for both property and personal insurance (Figure 2). In 2005, property insurance premiums totaled 123 billion yuan (¥1.864 trillion)[8] and personal insurance premiums totaled 369.7 billion yuan (¥5.6 trillion). Both of these figures had already been surpassed after the first 11 months of 2006.

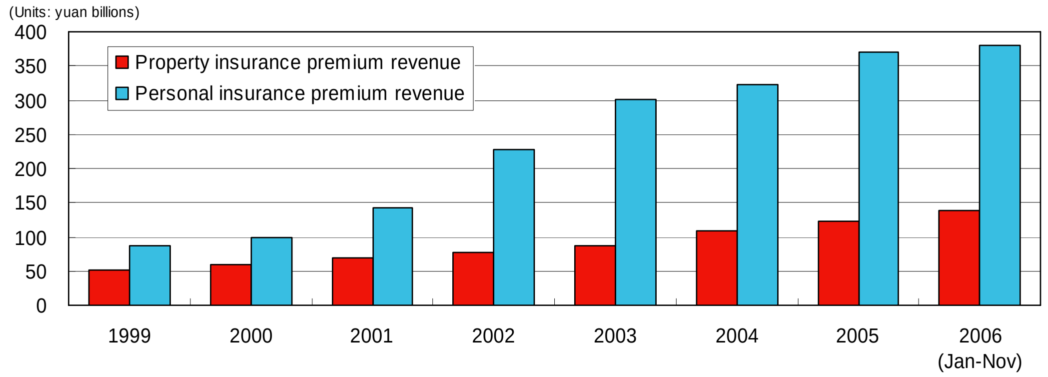
7 Equivalent to medical insurance. The CIRC promulgated the Health Insurance Law on 14 August 2006.

8 This and all yen-yuan conversions in this report use the mid-rate announced by the State Administration of Foreign Exchange (SAFE) on 4 January 2007 of ¥100=6.5955 yuan (1 yuan = ¥15.16).

Looking more closely at personal insurance premiums (Figure 3), health insurance premiums grew by nearly 9x from the 3.7 billion yuan (¥56 billion) in 1989 to 33.5 billion yuan (¥500 billion in 2006 (January-November). This is probably a reflection of the rapid increase in the Chinese people's interest in health and medical care in step with the country's impressive economic growth.

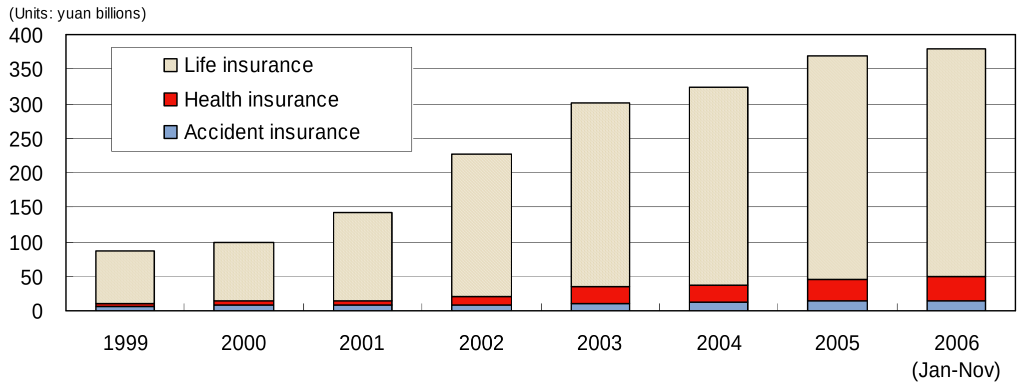
In January-November 2006, life insurance premiums accounted for about 87% of all personal insurance premiums, which equates to growth of 4.3x relative to life insurance premium revenue in 1999. This probably reflects the growing need for insuring against death in step with increases in income and improvements in living standards over the past several years, as well as a growing understanding and awareness among the Chinese people that life insurance is a way beside public welfare assistance to prepare for old age and also a method of investing assets.

Figure 2 Insurance premium revenue



Source: Nomura Institute of Capital Markets Research, based on materials from the CIRC and IIAC.

Figure3 Composition of personal insurance premium revenue



Source: Nomura Institute of Capital Markets Research, based on materials from the CIRC and IIAC.

2. Shares of the insurance premium market, which is no longer an oligopoly

China's major insurance groups include the People's Insurance Company of China (PICC) Group and China Life Group (both of which began as China People's Insurance), the Ping An Insurance Group established in Shenzhen in 1988, and the China Pacific Insurance Group established in Shanghai in 1991 (Figure 4). When China People's Insurance was broken up, PICC Group took over the casualty insurance business and China Life Group took over the life insurance business, but currently both groups, like the other groups, include both property and personal insurance arms.

We look next at market share based on premium revenue from property and personal insurance. Figure 5 shows the property insurance market share for each insurance company over the past three years. The three largest property insurers, PICC Property and Casualty, China Pacific Property and Casualty, and Ping An Property and Casualty combined own roughly a 70% share of the market. The largest of the three, PICC Property, has seen a declining trend in its share, however, with the gains going to Chinese insurers other than the big three property insurers. There has been no significant change in the share of foreign-capitalized insurers. Likewise, Figure 6 shows the personal insurance market share for each insurer over the past three years. Here also, the three largest personal insurance carriers, , PICC Life, China Ping An Life, and China Pacific Life have roughly a 70% share of the market, and the largest, PICC Life, is losing market share to Chinese insurers outside of the big three life companies. Within the past three years, the noticeable increase in both insurance premiums and market share posted by foreign-capitalized insurers in 2005 can probably be attributed to several one-off factors peculiar to that year.[9] Overall, the data suggests that the dominance by just a few major players of both the property and personal insurance markets has begun to break down. A ranking by recent (January-November 2006) premium revenue of the top ten foreign-capitalized insurers[10] is shown in Attachments 1 (property insurance) and 2 (personal insurance).

9 According to the China Insurance Almanac, this can be attributed to several factors, including that five foreign-capitalized personal insurance companies launched their China businesses in 2005.

10 Please note that under the statistical categories used by the CIRC, an insurance company with less than 25% foreign equity is classified as a China-capitalized rather than foreign-capitalized insurer.

Figure 4 China's insurance groups

	PICC Group	China Life Group
Holding company	PICC Holding	China Life Holdings
Property insurance company	PICC Property and Casualty (Largest property insurer)	China Life Property & Casualty
Personal insurance company	PICC Life Insurance (Joint venture with Sumitomo Life and others)	China Life Insurance (Largest life insurer)
Health insurance company	PICC Health Insurance (Joint venture with German insurer DKV and others)	-
Asset management company	PICC Asset Management	China Life Asset Management
History	Parent company is PICC, established in 1949. With the enactment of the 1995 Insurance Law, which prohibited the same company from engaging in both the life and non-life businesses, reorganized to take over the non-life business.	Parent company is PICC, established in 1949. With the enactment of the 1995 Insurance Law, which prohibited the same company from engaging in both the life and non-life businesses, reorganized to take over the life insurance business.

	Ping An Insurance Group	China Pacific Insurance Group
Holding company	China Ping An Insurance (Group)	China Pacific Insurance (Group)
Property insurance company	China Ping An Property & Casualty	China Pacific Property & Casualty
Personal insurance company	China Ping An Life Insurance	China Pacific Life Insurance Pacific Antai Life Insurance (Joint venture with German insurer ING)
Health insurance company	China Ping An Health Insurance	
Asset management company	Ping An Asset Management	
History	Established in Shenzhen in 1988. Companies in the group outside of the insurance business include China Ping An Trust & Investment, Ping An Bank, and Ping An Annuity Insurance. In 2002, HSBC took a stake in the Ping An group as a strategic investor.	Established in Shanghai in 1991. In 1999, the Bank of Communications transferred its holdings to the Shanghai city government, and the China Pacific group became an independent insurance company.

Source: Nomura Institute of Capital Markets Research, based on materials from the CIRC, the IIAC, and others.

Figure 5 Property insurance: Market share by company (premium revenue)

	2004		2005		2006 (Jan-Nov)	
	Amount (yuan billions)	Share (%)	Amount (yuan billions)	Share (%)	Amount (yuan billions)	Share (%)
PICC Property and Casualty	65.3	58.1	66.0	51.4	66.1	45.7
China Pacific Property & Casualty	13.8	12.3	14.5	11.3	16.5	11.4
China Ping An Property & Casualty	10.6	9.5	12.7	9.9	15.4	10.7
Other Chinese insurers	21.3	18.9	33.5	26.1	44.9	31.0
Foreign-capitalized insurers	1.4	1.2	1.7	1.3	1.7	1.2

Source: Nomura Institute of Capital Markets Research, based on the China Insurance Almanac and data from the CIRC.

Figure 6 Personal insurance: Market share by company (premium revenue)

	2004		2005		2006 (Jan-Nov)	
	Amount (yuan billions)	Share (%)	Amount (yuan billions)	Share (%)	Amount (yuan billions)	Share (%)
China Life Insurance	176.2	55.2	160.7	44.0	172.5	46.2
China Ping An Life Insurance	54.9	17.2	58.9	16.0	62.9	16.8
China Pacific Life Insurance	34.5	10.8	36.2	10.0	33.6	9.0
Other Chinese insurers	45.4	14.2	76.4	21.0	83.2	22.3
Foreign-capitalized insurers	8.4	2.6	32.4	9.0	21.0	5.6

Source: Nomura Institute of Capital Markets Research, based on the China Insurance Almanac and data from the CIRC.

3. Diversifying domestic investment of insurance funds

An important business challenge for the insurance companies is raising the yield of their invested assets. Figure 7 shows insurers' invested assets based on data provided by the CIRC and IIAC. China enacted its Insurance Business Law on 1 October 1995, and initially insurance companies were only allowed to invest their assets in such safe vehicles as bank deposits, government bonds, and policy bank bonds.[11] Investments have become more diversified since then, in step with the gradual lifting of restrictions on investments in corporate bonds, securities funds, and domestic equities, as well as investments in basic infrastructure (Figure 8). Of the 1.4136 trillion yuan (¥21.43 trillion) in invested assets at end-2005, 524.1 billion yuan (¥7.945 trillion) were held in bank deposits, 358.5 billion yuan (¥5.43 trillion) in government bonds, 109.9 billion yuan (¥1.66 trillion) in securities funds and ¥420.7 billion yuan (¥6.37 trillion) in other assets. In recent years, bank deposits and government bonds have accounted for a declining share of these investments, while securities funds and other products have accounted for a growing share. Specifically, the share of invested assets held in bank deposits declined from 51.0% in 1999 to 37.1% and that held in government bonds declined from 37.3% to 25.4%, while the amount of assets invested in securities funds increased from 0.8% to 7.8%, and that invested in other products increased from 10.9% to 29.8%.

According to the latest statistics[12] for 2006, the insurance companies had invested assets at end-November 2006 of 1.71 trillion yuan (¥25.92 trillion), 33.2% of which were held in bank deposits, down 3.44 percentage points from January 2006. The cumulative amount of stock acquired (including nonpublic shares), in contrast, increased 3.37 percentage points from January to 4.59% of invested assets, or a total of 77 billion yuan (¥1.16 trillion).

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[11] Bank debentures issued by the China Development Bank and the China Export Import Bank. Commercial banks have been allowed to issue subordinated debt since 2004 and bank bonds since 2005.

[12] *China Securities Net* dated 27 December 2006.

Improving the return on insurance companies' invested assets is also a critical issue for the government from several perspectives: developing and growing the insurance industry as well as improving the welfare of the Chinese people. In the State Council's "Several Opinions Regarding the Reform and Development of the Insurance Industry (the "State's Ten Articles") issued on 27 June 2006, one of the articles covered reform of rules governing the investment of insurance assets. This included recommendations to raise allocations to the capital market, expand investment in securitized products, invest in real estate and startup firms, acquire stock in commercial banks, and invest overseas. Risk controls, of course, are a major prerequisite to any reform of rules regarding the investment of insurance assets.[13]

Recent news related to the diversification of investments promoted by the State's Ten Articles include PICC Life's acquisition of shares in China Southern Power Grid,[14] its investment in the Bo Hai Industrial Investment Fund,[15] and its investment in the Beijing Shanghai Expressway project[16] and other core infrastructure projects. The CIRC has taken the position that it is important to invest insurance funds into projects that are critical to the state's strategy and to regional development, specifically expressway projects and environmental preservation, transportation, and telecom projects related to urban development.[17]

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[13] On 7 November 2006, the CIRC issued its Opinion Regarding the Strengthening of Risk Control for Insurance Funds to each of the insurance companies and insurance asset management companies.

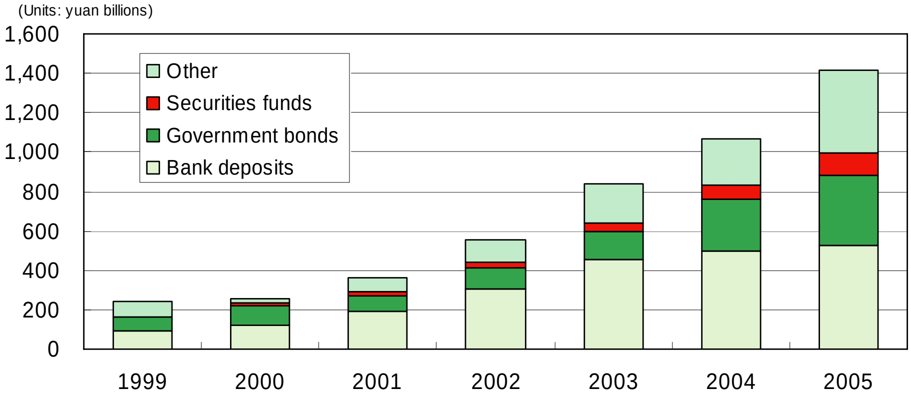
[14] PICC Life acquired a 32% stake in China Southern Power Grid for 35 billion yuan, making it the power company's second largest shareholder behind the Guangdong provincial government (*Financial News China*, dated 8 December 2006). PICC Life is China's largest life insurance company. The PICC Life Group, including new group members, owned 45.4% (850 billion yuan) of the 1.8782 trillion yuan in insurance assets nationwide as of end-November 2006 (*China Securities Net*, dated 27 December 2006). China Southern Power Grid, a joint venture electric power provider established by the provincial governments of Guangdong and Hainan, has plans to list its shares soon.

[15] This is a yuan-denominated investment fund established by the government on 31 December 2006 and aimed at industrial development of the City of Tianjin and other areas surrounding the Bo Hai Bay. The PICC Life Insurance Group also plans to become a shareholder. The fund totals 20 billion yuan. The Bo Hai Industrial Investment Fund Management Company was established at the same time.

[16] The State Council has already agreed in principle to allow the investment of insurance funds in the Beijing-Shanghai Expressway project, and the Ministry of Railways and the CIRC have exchanged memorandums. It appears that negotiations over investment terms have begun. The 11th Five-year Plan (2006-2010) includes construction of 17,000 kilometers of new railway requiring funds of 1.25 trillion yuan (*Financial News China*, dated 25 December 2006).

[17] From a statement by Sun Jiangyong, head of the CIRC's Finance and Accounting Department, at the Fourth China Investment Climate Forum held in Hangzhou, Jiangsu province, on 12 November 2006 (*China Securities Journal*, dated 12 November 2006).

Figure 7 Invested assets of life insurers



Source: Nomura Institute of Capital Markets Research, based on data from the CIRC and IIAC.

Figure 8 Diversifying domestic investment of insurance assets

	1995	1999	2000	2003	2004	2005 (see Note 2)	2006
Bank deposits	○	○	○	○	○	○	○
Government bonds	○	○	○	○	○	○	○
Policy bank bonds	○	○	○	○	○	○	○
Corporate bonds	×	△ (Central company bonds with domestic rating of at least AA+, limited to 10% of total assets)	△ (same as to left)	△ (Company bonds with domestic rating of at least AA+, limited to 15% of total assets)	△ (same as to left)	△ (Limited to 30% of total assets)	△ (same as to left)
Securities funds	×	△ (Limited to 5% of total assets)	△ (Limited to 10% of total assets)	△ (Limited to 15% of total assets)	△ (same as to left)	△ (same as to left)	△ (same as to left)
Domestic stocks (A shares)	×	×	×	×	△	△ (Limited to 5% of (total assets less a fixed amount))	△ (same as to left) (Note 3)
Investment in basic infrastructure construction	×	×	×	×	×	×	△ (Note 4)

Notes 1. ○ means investment allowed, △ means investment allowed with conditions, and × means investment not allowed.

2. In 2005, the rules were revised to accommodate the emergence of new types of issues, including central bank notes, policy bank subordinated debt, commercial bank bonds, commercial bank subordinated debt, yuan-denominated bonds from international development institutions (Panda bonds), and commercial paper (Provisional Measures Governing Bond Investments by Insurance Institutional Investors, promulgated on 22 August 2005.

3. Acquisition of shares in commercial banks (including nonpublic shares) is limited to 3% of total assets (Circular on Investments by Insurance Agencies in Commercial Bank Shares)

4. Limited to 5% of total assets for life insurance companies, 2% for non-life insurers (Test Administrative Rules Concerning the Indirect Investment of Insurance Funds in Basic Infrastructure Construction, promulgated 22 March 2006).

Source: Nomura Institute of Capital Markets Research, based on data from Nomura Securities Beijing Office, and from Nomura Securities Financial & Economic Research Center

III. Key points of the draft measures

1. Overseas investment limits and expansion of eligible investments

Three of China's insurance companies have listed their shares in Hong Kong: PICC Property on 6 November 2003, PICC Life on 18 December 2003, and China Ping An Insurance on 24 June 2004. Based on the need to invest the funds (foreign currency) procured from these listings, the CIRC and the People's Bank of China promulgated the Provisional Measures on Overseas Use of Foreign Exchange Insurance Funds (the "old measures") on 9 August 2004, and the CIRC further announced Detailed Rules on the Provisional Measures on Overseas Use of Foreign Exchange Insurance Funds (the "old rules") on 11 September 2005, allowing overseas investments on a limited basis (Figure 9).

The Chinese government had also promoted the overseas investment of insurance funds in the State's Ten Articles noted earlier, but a comparison of the draft measures with the old measures and old rules reveals the following differences.

First, under the old measures and rules, a maximum of 80% of the outstanding foreign currency holdings at the end of the previous year could be invested overseas, but the draft measures change that to a maximum of 15% of total assets at the end of the previous year. They also expand the investment limit by making it possible for the companies to not only invest their own foreign currency holdings but also to convert yuan into foreign currency for investing in overseas securities. Based on total insurance assets of approximately 1.87 trillion yuan (¥28.3 trillion) at end-November 2006, the new maximum of 15% under the draft measures sets the investment limit at approximately 280 billion yuan (¥4.24 billion).

Second, relative to the old measures and rules, the draft measures provide a clearer breakdown, and expands upon, the major governments eligible for investment based on having an A or higher credit rating from the international rating agencies (Figure 10). After the draft measures are finalized and promulgated, the CIRC plans to separately issue detailed rules on issuers and allocations per product, as was outlined in the old measures and rules.

Third, the draft measures allow for investment in financial derivatives for hedging purposes.[18] Expressly included are forward contracts, swaps, options, and futures.[19]

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18 Investment in financial derivates for hedging purposes by fund management companies that are designated QDII are also regulated by SAFE.

19 There were reports that in 2005, a revaluation of the yuan that year caused the three insurers listed overseas, PICC Property, PICC Life, and China Ping An Insurance Group, to suffer exchange losses totaling 1.3 billion yuan (¥19.7 billion) (*China Securities Journal*, dated 21 November 2006).

Figure 9 Overseas investment guidelines for insurance companies under the old measures and rules

Covers	Rules
Deposits	· Chinese banks and foreign banks rated at least A by overseas agencies · Deposits in same bank up to 30% of foreign currency-denominated investment limit
Foreign government bonds, Bonds issued by international financial institutions, Foreign corporate bonds	· Bonds rated at least A by overseas agencies · Investment in A-rated bonds up to 30% of foreign currency-denominated investment limit (on book-value basis) · Investment in AA-rated bonds up to 70% of foreign currency-denominated investment limit (on book-value basis) · Investment in same company's bonds up to 10% of foreign currency-denominated investment limit (on book-value basis)
Bonds issued by Chinese government or Chinese companies	· Outstanding investment capped by foreign currency-denominated investment limit (on book-value basis)
Money market products	· Bonds rated at least AAA by overseas agencies · Investment in structured products up to 5% of foreign currency-denominated investment limit · Investment in MBS up to 20% of foreign currency-denominated investment limit
Stocks	· Stocks listed on overseas securities exchanges · Up to 10% of foreign currency-denominated investment limit · Investment in each company up to 5% of outstanding shares

Source: Nomura Institute of Capital Markets Research, based on Provisional Measures on Overseas Use of Foreign Exchange Insurance Funds and Detailed Rules on the Provisional Measures on Overseas Use of Foreign Exchange Insurance Funds.

Figure 10 Expansion of eligible overseas investments under the draft measures

Eligible overseas investments	Specific products	Differences with old measures and rules
Money market products	CP	Although investment in CP was allowed under the old measures and rules, the draft measures list the names of specific products.
	CDs	
	Repos and reverse repos	
	Money market funds	
Fixed-income products	Bank deposits	Although investment in structured products and MBS was allowed under the old measures and rules, the draft measures further expand the bond funds and trust-type products and lists them.
	Structured deposits	
	Bonds	
	Convertible bonds	
	Bond funds	
	Securitized products	
	Trust-type products	
Equity products	Stocks	Although investment in stocks was allowed under the old measures and rules, the draft measures further expand the list of eligible investments to include equity funds, private equity, and private equity-related products.
	Equity funds	
	Private equity	
	Private equity-related products	
Other	Products approved by the CIRC	

Source: Nomura Institute of Capital Markets Research, based on the draft (request for opinions) version of the provisional regulations on controlling outbound portfolio investment of insurance funds

2. Continuation of checks and balances from concerned entities

The draft measures related to QDII insurance companies distinguish between the roles of the different entities involved with investment just as the old measures and rules did, with the idea being to allow a system of checks and balances to continue to work. Specifically, it establishes rules related to the entity that entrusts the overseas investment, the entity being entrusted with the overseas investment, and the custodian that manages the assets related to the overseas investment. The trustor is defined as the domestic Chinese insurance company established pursuant to approval by the CIRC. The trustee is defined as the domestic Chinese insurance asset management company established pursuant to approval by the CIRC, the overseas managing institution,[20] or other managing institution approved by the CIRC. The custodian is defined as the domestic Chinese commercial bank qualified to serve as custodian for insurance assets. This definition of commercial banks goes beyond only Chinese banks to include joint-venture banks, 100% foreign-capitalized banks, and the local branches of foreign-capitalized banks[21] (Figure 11).

In addition, the examination procedures related to awarding QDII status to insurance companies consists of the CIRC first examining qualifications and then SAFE approving the investment limits. In this respect, the examination procedures are similar to that for awarding QDII status to commercial banks.[22]

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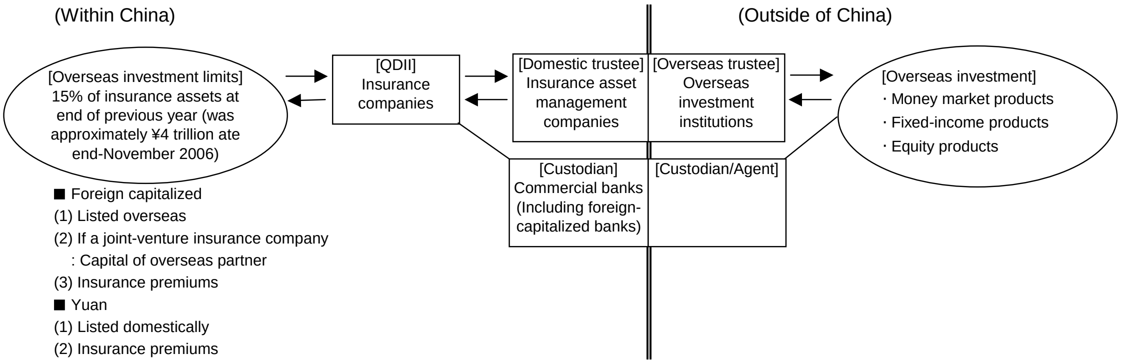
20 The original document actually says "specialized investment management institutions."

21 The Chinese government implemented the Administrative Ordinance on Foreign Financial Institutions in China effective 11 December 2006. Until now, the only yuan operations allowed by foreign-capitalized banks have been for foreign-capitalized firms, foreigners and Chinese firms. This administrative ordinance requires that for foreign-capitalized banks to offer retail services to Chinese individuals, they must establish a local subsidiary, either wholly owned or through joint venture, with minimum capital of 1 billion yuan. Yuan services offered to Chinese individuals by these local branches are limited to time deposits of at least 1 million yuan per account.

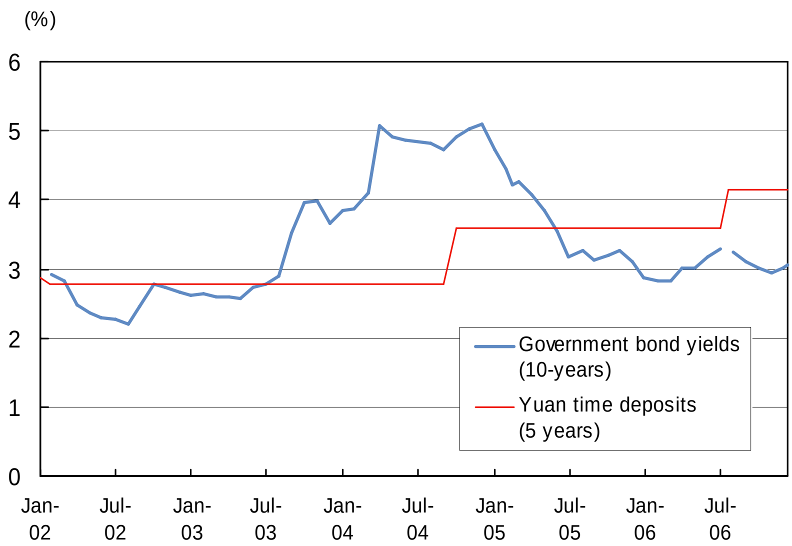
22 The People's Bank of China, the China Banking Regulatory Commission (CBRC), and SAFE jointly promulgated on 17 April 2006 Provisional Measures Governing the Management of Overseas Assets by Commercial Banks on behalf of Customers, whereby the examination procedures were set, with the CBRC examining the qualifications of commercial banks and SAFE approving the investment limits. The China Securities Regulatory Commission (CSRC) has yet to finalize the regulations concerning QDII that are fund management companies. We have heard at interviews with the Chinese subsidiaries of securities firms that SAFE, which has jurisdiction over capital transactions, has been aggressively promoting QDII, but that the CSRC, which is concerned over the impact it could have on domestic capital markets, is in no rush to grant QDII approvals.

Figure 11 Diagram of entities involved with overseas investment by insurance companies



Source: Nomura Institute of Capital Markets Research, based on data from CIRC, the draft measures, and others

Figure 12 Yuan and government bond yields



Source: Nomura Institute of Capital Markets Research, based on data from Wind Information and the People's Bank of China

IV. Outlook

Figure 12 shows the yield on 10-year government bonds and the interest rate on 5-year time deposits[23] over the past five years. Following a period of monetary tightening in 2004, the yield on government bonds has been in the neighborhood of 3% since 2005, which is not an interest rate environment that promises high returns. In fact, the investment yield on insurance funds declined from 4.3% in 2001 to 2.68% in 2003, and although it then climbed back up to 2.87% in 2004 and 3.6% in 2005,[24] management efforts to improve investment yields will remain essential moving forward. Consequently, as explained before, although gradual progress has been made in diversifying the domestic investments of China's insurance funds, with share prices posting record highs over dependence on domestic stock investments is an issue, as is the difficulty in identifying superior assets, despite infrastructure investments now being allowed. All of which suggests that the domestic investment climate should probably be considered a risk factor for China's insurers. Accordingly, the insurance companies are turning their attention to overseas capital markets to exploit domestic/international interest rate differences while flexibly hedging against Forex risk, and they likely have a substantial need to invest in the type of credit available in relatively deeper markets but hard to obtain in China. As noted above, if the draft measures become law, it would raise the limit on overseas investment to about 280 billion yuan (¥4.25 trillion), and this would likely provide institutional impetus to QDII insurance companies. This should also provide foreign-capitalized financial institutions with new business opportunities, specifically in the role of trustee or custodian.

In this context, how should one view the expectation that the new limits on overseas investing by QDII will actually be used? Although sales by the more advanced commercial bank QDII have been sluggish, the biggest reason for this is the uncertainty over the future direction of the exchange rate.[25] Nevertheless, one difference between the commercial banks and the insurance companies is that the former can accept the deposit of customer funds off balance sheet to purchase a structured bond overseas, but the same scheme done by the latter would be

[23] The deposit rates and loan rates that Chinese financial institutions offer their customers are legally set by the People's Bank of China. The maximum maturity for time deposits is five years, but "agreed deposits" based on negotiations between the concerned parties, which are time deposits with over five years maturity, can be offered to China-capitalized insurance companies.

[24] From the *China Insurance Almanac*, 2006.

[25] There have been reports that of the $13.1 billion (approximately 104.8 billion yuan) investment limit for commercial bank QDII, only about 2.9% (approximately 3 billion yuan) has actually been sold/absorbed. Because of this, it appears that the relevant authorities in China (the CBRC and SAFE) consulted with their counterparts in Hong Kong (the Hong Kong Monetary Authority and the Securities and Futures Commission) from end-November to early December 2006 to come up with a plan to deal with this in the future. The relevant authorities in China directed commercial bank QDII to guarantee the US dollar-denominated principal of their products, but some market participants argue that when taking into account yuan appreciation and currency conversion costs, there is a need to ease somewhat the restrictions on designing products in order to ensure sufficient returns (*China Securities Journal*, dated 5 December 2006).

considered investing on own account. To get a better idea of the direction that insurance company QDII may take, it would probably be instructive to look at examples of overseas asset management by Japan's life insurance companies since the 1980s. Japan's life insurers had difficulty finding investments in the 1980s, a time when domestic interest rates were low and demand for capital spending in the corporate sector was weak, and their response was to invest overseas, targeting the domestic/overseas interest rate gap and investment products that were unauthorized domestically at the time (Figure 13). These companies carried huge valuation losses in the late 1980s and early 1990s as a result of the rapid appreciation of the yen, but rather than suspend their overseas investment activity they continued with the objective of investment diversification. One of the motives of the Chinese authorities is to artificially create an environment that encourages the QDII to sell yuan for foreign currency as a way to relieve upward pressures on the yuan, but apart from that it is still quite significant that the draft measures raise the CIRC's overseas investment limit and broadens the products eligible for investment in that it broadens insurance companies' investment opportunities.

China's QDII status for financial institution is still in its infancy, but we heard numerous times when interviewing local securities companies and the regulatory authorities that "QDII is currently serving as a training ground for financial institutions to gain experience investing overseas. The initial investment focus will be on fixed-income products in Hong Kong, a market that is geographically familiar for China."[26] Things may proceed as we hear in our interviews initially, but over the medium to long term we think it likely that QDII will start to look at investing in the capital markets of the leading industrial countries. In fact, the National Social Security Fund (NSSF),[27] which started investing overseas earlier than the financial institutions, is already looking at global investments. There is now discussion in China, now that commercial banks, fund management companies, and now insurance companies can

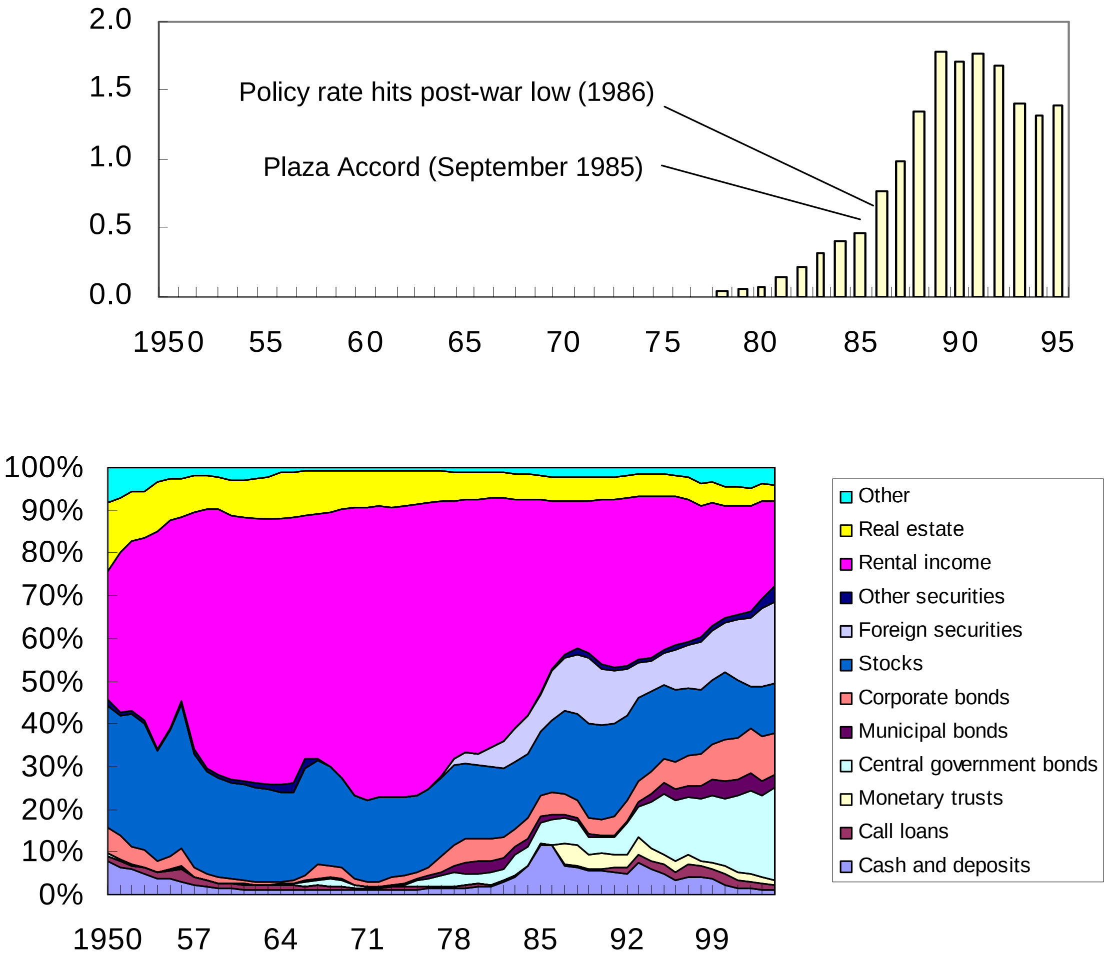
26 The PICC Life Group's PICC Life Asset Management announced that its Hong Kong subsidiary, China Life Insurance Asset Management, received approval from the SFC to conduct the asset management business (based on that company's website on 11 December 2006: http://www.clamc.com). This marked the first case of a mainland Chinese insurance company earning asset management business qualifications in Hong Kong. Subsequently, China Life Insurance Asset Management decided to accept equity participation from strategic investor US-based Franklin Templeton (*Financial News China*, dated 10 January 2007). The China Ping An Group announced on 29 June 2006 that it had established a Hong Kong subsidiary, Ping An Asset Management (Hong Kong).

27 The National Social Security Fund was established in August 2000 for the purpose of dealing with future funding shortfalls in social insurance programs, including the base pension. The funding will come from government subsidies and investment profits. The government subsidy includes 10% of the funds procured when a state-owned enterprise does an initial or secondary offering overseas, which in turn is used to fund overseas investment. The amount of foreign currency added was over $1.57 billion as of end-March 2006. For details, see Eiichi Sekine, *Jijodoryoku wo Unagasu Chugoku no Nenkin Seido Kaikaku* (China's pension reforms promote self-help efforts), *Capital Market Quarterly*, Fall 2006 issue (in Japanese).

gain QDII status, of opening up the QDII path for trust & investment companies[28] and securities firms.[29] QDII trends in China should continue to merit watching.

Figure13 Outbound portfolio investment by Japan's life insurance companies

(Units: ¥ billions)



Note: Total is for domestic life insurers until 1990.
Base data is from the IIAC and the Ministry of Finance, Annual Report of the International Finance Division

Source: Nomura Institute of Capital Markets Research

28 There have been reports that two companies, CITIC Trust & Investment and Shanghai International Trust & Investment, have been approved as trust & investment company QDII on a trial basis (*China Securities Journal*, dated 3 December 2006).

29 The media reports that CITIC Securities has already applied for QDII status for a related division. Additionally, it appears that both China International Capital Corporation(CICC) and China Merchants Securities have become prime candidates for QDII approval (*China Securities Net*, dated 27 December 2006, and the *China CBN*, dated 29 December 2006).

Attachment 1 Premium revenue for foreign-capitalized property insurers (Jan-Nov 2006, Top 10)

Rank	Local insurance subsidiary (foreign capitalized)	Form of entry Joint venture partner	Premium revenue (yuan thousands)	Domestic share (%)
1	AIU Insurance (US-based AIU)	Branches (Shanghai, Guangzhou, Shenzhen, Foshan)	640,685	0.44
2	Tokio Marine & Nichido Fire Insurance (Tokio Marine & Nichido Fire Insurance)	Branches (Shanghai)	263,129	0.18
3	Mitsui Sumitomo Insurance (Mitsui Sumitomo Insurance)	Branches (Shanghai)	159,757	0.11
4	Samsung Fire and Marine Insurance (China) (Samsung Fire and Marine Insurance)	Initially entering with branch (Shanghai), later converting to subsidiary	120,727	0.08
5	Allianz Insurance (Germany-based Allianz)	Branches (Guangzhou)	106,390	0.07
6	BOC Insurance (Bank of China Group (Hong Kong))	Initially entering with branch (predecessor was the Shenzhen Branch of BOC Group (Hong Kong) Insurance), later converting to subsidiary	104,408	0.07
7	Royal and Sun Alliance Insurance (UK-based Royal and Sun Alliance)	Branches (Shanghai)	92,647	0.06
8	Sompo Japan Insurance (Sompo Japan)	Initially entering with branch (Dalian), later converting to subsidiary	59,378	0.04
9	Federal Insurance (US-based Chub)	Branches (Shanghai)	58,684	0.04
10	Winterthur Insurance (Asia) (Switzerland-based Winterthur)	Branches (Shanghai)	53,107	0.04

Source: Nomura Institute of Capital Markets Research, based on data from the CIRC and China Insurance Almanac.

Attachment 2 Premium revenue for foreign-capitalized property insurers (Jan-Nov 2006, Top 10)

Rank	Local insurance subsidiary (foreign capitalized)	Form of entry Joint venture partner	Premium revenue (yuan thousands)	Domestic share (%)
1	AIA China	Branches (Shanghai, Guangzhou, Shenzhen, Foshan, Beijing, Suzhou, Dongguang, Jiangmen)	6,235,980	1.67
2	Generali China Life Insurance (Italy-based Generali)	Joint venture (with China National Petroleum (CNPC))	4,628,580	1.24
3	CITIC Prudential Life Insurance (UK-based Prudential)	Joint venture (with CITIC group)	1,390,430	0.37
4	Allianz China Life Insurance (Germany-based Allianz)	Joint venture (initially with Shanghai Motors, later restructuring as joint venture with CITIC Trust & Investment)	1,102,970	0.30
5	Aviva-COFCO Life Insurance (UK-based Aviva)	Joint venture (with COFCO)	966,060	0.26
6	Manulife-Sinochen Life Insurance (Canada-based Manulife)	Joint venture (with Sinochen)	791,720	0.21
7	PICC Life Insurance (Sumitomo Life and others)	Joint venture (with PICC Holding)	671,020	0.18
8	Pacific Antai Life Insurance (Netherlands-based ING)	Joint venture (wtih China Pacific Insurance (Group))	567,510	0.15
9	CIGNA and CMC Life Insurance (US-based CIGNA)	Joint venture (with China Merchants group)	519,800	0.14
10	Skandia-BSM Life Insurance (Sweden-based Skandia Life)	Joint venture (with Beijing State-owned Assets Management)	464,070	0.12

Source: Nomura Institute of Capital Markets Research, based on data from the CIRC and China Insurance Almanac.