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Amendments to the People's Republic of China *Insurance Law*: Time for a Complete Overhaul or Simply a Consolidation?

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Amendments to the People's Republic of China *Insurance Law*: Time for a Complete Overhaul or Simply a Consolidation?

On 28 February 2009, the Standing Committee of the National People's Congress of the People's Republic of China passed an amended version of the *Insurance Law*, which will take effect on 1 October 2009. The revised *Insurance Law* contains many significant changes, reflecting the fast-paced development of China's insurance industry along with its regulatory regime. This client note highlights some major changes in the *Insurance Law* in the context of China's insurance regulatory regime -- implemented by the China Insurance Regulatory Commission ("**CIRC**") -- and discusses areas where insurance industry players may need to re-examine current operations to ensure compliance and minimise risk.

1. INSURANCE BUSINESS PRACTICES

A number of changes to the *Insurance Law* may have an impact on the business practices of insurers in China. Coping with these changes may involve revisiting insurance contracts, revising sales practices and employee training programs, speeding claims investigation processes, and strengthening controls on underwriting.

1.1 Limits on insurers' ability to terminate policies due to misrepresentation

The revised *Insurance Law* places additional limits on the ability of insurers to unilaterally terminate policies, effectively increasing the importance of sound underwriting practices. Under the revised law, insurers can only terminate if the policyholder breaches the duty of full and honest disclosure through gross negligence or intentional misrepresentation, *and* the missing information would impact the insurer's decision to underwrite the risk or set the premium. (Previously, mere negligent of omission of such information by the insured was enough to trigger the insurer's right to terminate.)

Additionally, the revised law provides new time limits for insurer-initiated termination of policies: the insurer's right to terminate expires thirty days after the day the insurer is aware that the policyholder has breached the duty of disclosure. Even if the insured omits or misrepresents information to obtain a favourable policy, the insurer will not be able to terminate the contract if (1) the insurance contract has been in force for more than two years, or (2) the insurer was actually aware of the undisclosed information at the time of underwriting.

These changes are intended to prevent insurers from abusing their right to terminate policies and create new incentives for insurers to be diligent when underwriting new business. Since the new law does not contain a "grandfather" clause exempting existing contracts, it would be prudent for insurers to review old policies before the new revisions take effect to ensure that premiums and risks are properly balanced.

1.2 Using boilerplate terms and exemption from liability

The revised *Insurance Law* requires insurers to incorporate boilerplate terms in the insurance proposal form and explain any clauses exempting the insurer from liability in the insurance contract. Though insurers were already required to explain the content of clauses which could exempt the insurer from an obligation to pay benefits, the revised *Insurance Law* adds a requirement that insurers include notice of these exemptions in the insurance proposal form, the insurance policy and any other insurance certificate in a way that attracts policyholders' attention. Failure to properly notify customers of these exemption clauses will render them void.[1]

Under Article 19 of the revised *Insurance Law*, boilerplate clauses exempting the insurer from statutory obligations, increasing the insured's obligations, or excluding any legitimate rights enjoyed by the insured, will also be void. Since insurance policies are often complex and highly technical documents (and generally use standard language drafted by the insurer), it will be important to revisit proposal forms and properly train salespeople and agents to adequately explain policies to potential customers. In practice, it may be wise to require salespersons to complete itemised checklists with new customers, whereby the customer signs off that each key clause has been explained clearly, providing a written record of this process. Because the revised *Insurance Law* does not specify how previous contracts entered into without following these practices will be handled, it may be prudent to provide such explanations in writing to existing policyholders before the revisions take effect.[2]

1.3 Claims settlement process

The revised *Insurance Law* also aims to accelerate the claims settlement process by providing insurers with only "one shot" to request additional supplementary materials from the insured while investigating claims, and creating time limits for insurers during the claims process. (Previously, there were no explicit time limits, though insurers were required to request information in a timely manner.)

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[1] The revised *Insurance Law*'s provisions on standard terms are stricter than those in Articles 39 and 40 of the *Contract Law* (effective 15 March 1999), which merely require that a party using its own standard terms must call the other party's attention to those terms, explaining them upon request.

[2] The Supreme People's Court's *Draft Opinion on Interpretation for Reviewing Insurance Disputes* (published for public comment on 8 December 2002) proposed that if the law changes during the term of an insurance contract, courts should apply the new law only if its application would benefit the insured or beneficiary. Though this draft opinion was not formally adopted, it illustrates the potential risk insurers could face as a result of legal ambiguity.

As before, insurers have a general obligation to investigate claims in a timely manner. The new time limits introduced by the revised *Insurance Law* are as follows:

(a) if the insured event is complex, the insurer should complete the assessment within thirty days, unless otherwise agreed in the insurance contract; and

(b) for an insured event covered by the policy, the insurer should fulfil its obligation to indemnify the insured within ten days after reaching an agreement of indemnity.

Once an insurer determines that an event is not covered by the insurance policy, the revised *Insurance Law* requires insurers to notify the insured or beneficiary of the claim rejection with a written explanation within three days of completing the claims investigation.

1.4 Assignment of the insured subject matter

The revised law provides additional guidance on handling assignment or transfer of the insured subject matter: as before, the insurer must be notified upon such a transfer, but the revised law also requires insurers to decide whether to adjust the premiums or cancel the policy (subject to the insurance contract's terms) within thirty days of receiving notice of the assignment. If the insurer terminates the contract, it must refund any premiums already received corresponding to risk coverage for the period after termination. If the insurer is not notified of the assignment *and* the clearly increased risk created by the assignment causes an insured event to occur, the insurer will not be liable to pay under the policy. This phrasing could potentially result in insurers facing liability following an assignment of which they were unaware if a Chinese court decides that the transfer did not clearly increase risk.

1.5 Constructive notice of insured events

While the revised *Insurance Law* still requires beneficiaries or insureds to notify the insurer upon occurrence of an insured event, it also includes a new provision covering instances where insurers have actual notice that an event has occurred. Generally, the insured or beneficiary has a duty to notify the insurer of a claim in a timely manner: if timely notice is not given (due to intentional omission or gross negligence by the claimant), the insurer will not be liable to pay for the portion of damages whose cause cannot be determined. Following the revisions, it is clear that insurers will not be exempt from liability in such cases if they knew or should have known about the insured event through other sources. For example, insurers might be presumed to know about major earthquakes or hurricanes and cannot escape liability due to lack of individual notice from claimants. This is understood to be, at least in part, a response to insurers' attempted rejection of claims on similar technical grounds following the Sichuan earthquake in 2008.

2. REINSURANCE BUSINESS

Preferential treatment for domestic reinsurers has been removed from the revised *Insurance Law*, which only requires insurance companies to abide by CIRC regulations when ceding insurance business, and to select reinsurers prudently. In contrast, Article 103 of the currently effective *Insurance Law* requires domestic insurance companies to provide a preference to domestic reinsurance companies. Currently, the *Provisions on Administering the Reinsurance Business* (effective 1 December 2005) still require domestic insurance companies to favour domestic reinsurers by: (1) requiring insurance companies to make first offers to at least two specialized reinsurance companies within China; and (2) requiring the aggregate proportion of business ceded out under such offers to domestic reinsurers be no less than 50% of the business ceded.

While it is anticipated that CIRC regulations on reinsurance business will also be updated to eliminate this mandatory preference, foreign reinsurance companies still should not expect to receive equal treatment as their Chinese counterparts. The *Insurance Company Solvency Reporting Principles No. 15: Reinsurance Business* ("**Reinsurance Solvency Principles**", published on 8 April 2009 and effective 1 January 2010) create new incentives for insurance companies to favour domestic reinsurers over foreign competitors. Under the Reinsurance Solvency Principles, insurance companies ceding business to domestic reinsurers with a solvency ratio over 100% may record those reinsurance reserve receivables on their books as recognised assets equal to 100% of their book value. In contrast, only 90% of the book value of reinsurance reserve receivables from foreign reinsurance companies (regardless of their solvency) will qualify as recognised assets. This 10% edge should continue pushing insurance companies to seek domestic reinsurers before resorting to their foreign competitors.

The Reinsurance Solvency Principles also contain an explicit warning to domestic insurers dealing with foreign reinsurers: if the CIRC determines that an offshore reinsurer is "taken over" by a regulatory authority in its home jurisdiction, or that offshore home jurisdiction is experiencing a "financial crisis", the CIRC may declare that all assets relating to contracts with that foreign party are not recognisable. Since the Reinsurance Solvency Provisions do not specify how the CIRC may decide which companies have been "taken over" by regulators or which foreign countries are in a "financial crisis" (or whether these decisions will be publicised), it may be difficult to observe how the CIRC

chooses to wield this new authority. However, this risk could lead Chinese insurance companies to avoid contracts with troubled foreign reinsurers (such as AIG) which have received government aid with strings attached.

3. BUSINESS SCOPE

3.1 Expanded business scope

The business scope of insurance companies is expanded under the revised *Insurance Law*, explicitly permitting insurance companies to write "guaranty insurance" (a category not listed in the previous law) and other types of insurance as approved by the CIRC. Though guaranty insurance (where an insurance company guarantees repayment of an insured's contractual debt obligation to a third party) was not listed in the previous law, it has already been introduced to China's insurance market, and is particularly common for consumer automobile purchases.[3] In practice, this rewording merely formalises the development of new insurance products which have already been authorised by other recent CIRC rules. For instance, the *Administrative Measures for the Examination, Approval and Record-filing of Personal Insurance Products* (effective 1 July 2004) sets out the application and approval process for newly-developed personal insurance products, and life insurance companies and specialized pension insurance companies can manage enterprise employee retirement fund annuities under the *Measures on Administering Pension Insurance Business of Insurance Companies* (effective 1 January 2008).

3.2 Increased responsibility for activities of intermediaries

Insurance companies should ensure that they are not entrusting unlicensed institutions or individuals to carry out insurance sales activities, as required by Article 116 of the revised *Insurance Law*. Under the same article, insurance companies may also be held responsible for using agents, brokers and insurance asset evaluation organisations to carry out illegal activities (such as generating illegal profits by unjustifiably cancelling policies).

Insurance companies must register their agents and provide them with professional and ethics training under Article 112 of the revised *Insurance Law*, however this training requirement has already been detailed in the *Provisional Measures on Continuing Education for Insurance Intermediary Personnel* (effective 1 May 2005) and the *Interim Measures for Administering Insurance Agencies Operating in Multiple Businesses* (effective 4 August 2000).

3.3 Separation of business in the financial sector confirmed

Article 8 of the revised *Insurance Law* adds a reiteration of the principle of separation of business in the financial sector by providing that the insurance, banking, securities and trust sectors shall be operated and regulated separately, and that insurance companies, banks, securities institutions and trust institutions should be established separately, unless otherwise provided by law. This formula is also recited verbatim in Article 6 of the *Securities Law* (revised effective 1 January 2006).[4]

Despite this separation, there appears to be a trend toward further integration of regulation of the insurance and banking sectors, and increased cooperation between the CIRC and the China Banking Regulatory Commission ("**CBRC**"). In January 2008, the State Council reportedly approved a joint application by the CIRC and CBRC to create a pilot program allowing commercial banks and insurance companies to invest in each other, subject to State Council approval. Although this document has not been published, news reports indicate there is no fixed cap on cross-investment under the proposal. Later that month, the two agencies agreed to a *Memorandum on Strengthening In-depth Cooperation and Understanding of Joint Regulation*. In 2009, the CIRC and CBRC have also reportedly been coordinating efforts to further regulate bancassurance to improve risk assessment, create systems for addressing conflicts of interest between banks and insurance companies, prevent misleading sales activities, and ensure that premium payment methods comply with relevant laws and regulations. Efforts at regulatory cooperation in this area build on the jointly issued *Circular on Standardising the Bancassurance Industry* (effective 15 June 2006), requiring banks selling insurance products to apply for CIRC approval and stipulating that relevant bank sales personnel must pass the CIRC qualification exam for insurance agents and receive specialised insurance training.

4. CORPORATE GOVERNANCE

4.1 Appointment and qualifications requirements

While the previous version was silent on qualification requirements for directors, supervisors and senior management personnel, Article 81 of the revised *Insurance Law* provides that senior management of insurance companies must be approved by the CIRC before assuming their positions. Moreover, the directors, supervisors and senior management must be familiar with China's rapidly

[3] See, for example, the CIRC's *Notice on Criteria for Guaranty Insurance for Consumer Automobile Loans* (effective 15 April 2004) regulating providers of such insurance.

[4] The wording "unless otherwise provided by law" leaves open the possibility of future gap-filling laws and regulations allowing further cross-ownership between financial institutions in different sectors.

proliferating insurance laws and regulations.

This new provision highlights the recent CIRC trend of more closely regulating corporate governance of insurance companies by issuing detailed rules such as the:

(a) *Provisional Guiding Opinions on Reinforcing Corporate Governance of Insurance Companies (effective 5 January 2006);*

(b) *Provisions on Administrating Qualifications for Directors and Senior Management Personnel of Insurance Companies (effective 1 September 2006);*

(c) *Interim Measures on Administrating Independent Directors of Insurance Companies (effective 6 April 2007);*

(d) *Provisional Guidelines for the Risk Management of Insurance Companies (effective 1 July 2007);*

(e) *Guidelines for the Compliance Management of Insurance Companies (effective 1 January 2008);*

(f) *Measures on Administrating Chief Actuaries of Insurance Companies (effective 1 January 2008);*

(g) *Guidelines for the Operation of Boards of Directors of Insurance Companies (effective 1 October 2008); and the*

(h) *Provisions on Administering Qualifications of Chief Financial Officers of Insurance Companies ("**CFO Qualifications Rules**", effective 1 February 2009) and the subsequent Notice on Implementing the CFO Qualifications Rules (effective 27 February 2009).*[5]

For example, under the CFO Qualifications Rules, an individual performing duties equivalent to those of an insurance company CFO must have an established residence in China, working fluency in Chinese, and satisfy various other criteria. In addition, the CFO may only be appointed with CIRC approval (which may take 20-30 working days and involve a personal interview), and if the insurance company wants to fire the CFO, it must provide a written explanation to the CIRC. During his or her tenure, the CFO is subject to further CIRC supervision and must attend CIRC training courses.

Similarly, another recent CIRC measure aimed at deputising insurance company management was announced at the March 2009 Joint Conference for Board Secretaries of Insurance Firms held in Shenzhen, where news reports quoted a CIRC official who announced that secretaries of the board of directors will be subject to regular CIRC interviews, and responsible for ensuring corporate compliance. This will effectively provide the CIRC with a window into insurance company board meetings.

4.2 Executive compensation

Although the revised *Insurance Law* does not include new general provisions on remuneration of senior management in insurance companies, Article 91 provides that the salaries of directors, supervisors and senior management of an insurance company which has been declared bankrupt shall be calculated to equal the average wage of employees at the company.[6] Article 139 of the revised law further provides that the CIRC may limit executive compensation at insurance companies with an inadequate solvency ratio (see Section 5.1 below). These changes follow the CIRC *Circular Regarding Remuneration of Senior Management of Insurance Companies* on 5 December 2008, directing majority Chinese-owned insurance companies to suspend implementation of all equity incentive plans and employee stock ownership plans. Moreover, news reports indicate that the CIRC is currently formulating guidelines on remuneration of directors and senior managers of insurance companies.

5. SOLVENCY AND SUPERVISION MEASURES

5.1 Solvency supervision

For insurance companies with inadequate solvency ratios, Article 139 of the revised *Insurance Law* authorizes the CIRC to take any of the following measures, at its discretion:

(a) ordering an increase of capital or ceding of business to a reinsurer;

(b) limiting the scope of business;

(c) restricting dividend distributions to shareholders;

(d) limiting the purchase of fixed assets or the scale of operational costs;

(e) limiting the form and proportion of asset allocation;

(f) limiting the establishment of additional branch offices;

(g) ordering an auction of non-performing assets or transfer of insurance business;

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[5] Though the regulation refers to "财务责任人" rather than "首席财务官" (the latter being the usual translation for CFO), the position's responsibilities include those typically assigned to CFOs, such as signing off on the company's solvency reports, risk assessment reports and other key financial documents.

[6] Provisions on bankruptcy in the revised *Insurance Law* have also been modified, following the passage of the *Enterprise Bankruptcy Law* ("**Bankruptcy Law**", effective 1 June 2007). Article 90 of the revised *Insurance Law* reiterates the authority provided by Article 134 of the Bankruptcy Law, allowing the CIRC to directly initiate bankruptcy filings against insurance companies qualifying for liquidation under Article 2 of the Bankruptcy Law. As before, the CIRC must agree before any insurance company bankruptcy filing can proceed to the People's courts.

(h) limiting the remuneration of directors, supervisors and senior management;

(i) restricting commercial advertisements; and

(j) prohibiting the company from accepting new business.

These administrative measures are essentially similar to those the CIRC may take against insurance companies with solvency ratios below 100% under the *Administrative Provisions on the Solvency of Insurance Companies* (effective 1 September 2008) and its related solvency reporting rules, as well as under the *Circular on Classifying and Supervising Insurance Companies* (effective 1 January 2009).

5.2 General supervision measures

Article 155 of the revised *Insurance Law* provides additional details on the investigative measures which the CIRC and its local branches may conduct in the course of regulating the industry.[7] Upon approval by the local CIRC branch director, CIRC officials may carry out on-site inspections to investigate and obtain evidence, inspect and take copies of materials connected with the event under investigation, and request a court order to seize or freeze assets which might be transferred, concealed or destroyed. With central-level CIRC approval, officials may make enquiries about individual or insurance company bank accounts if there are suspected illegal business operations. CIRC officials may also question persons of concern relating to the event under investigation and examine and copy financial registration documents. In all such administrative actions, there must be at least two CIRC officials present and they must present their identification on request (otherwise the object of the investigation has the right to refuse to comply). These far-reaching investigative powers give the CIRC significant authority to supervise the insurance industry, while also delineating which actions require approval from higher-level agency officials. Clarifying the division of responsibility within the CIRC should help reduce the potential for arbitrary investigations by low-level officials.

6. INVESTMENT OF INSURANCE FUNDS

The revised *Insurance Law* expands the investment possibilities for insurance funds by permitting investment in fixed assets in Article 106. According to an interview with a CIRC official, fixed assets mainly refer to property, land and infrastructure.[8] It is expected that detailed rules on the solvency requirements for investors in fixed assets and the portion of insurance company assets which may be invested in fixed assets will soon be enacted to provide more detailed guidance in this area. The *Draft Administrative Measures on Operation of Insurance Funds* (published on 1 June 2007), has already proposed to allow investment of insurance assets in a wider range of real estate assets (including infrastructure), fixed income assets (deposits, bonds, bond-linked funds, securitization instruments, preferred shares), equity assets (public-traded shares, equity-linked funds, transferrable bonds, direct equity investments), and derivatives. However, this proposal has not yet been enacted.

Allowing insurance funds to be invested in fixed assets continues the trend over the past few years of rapid liberalisation of the scope of investments permitted for insurance companies and insurance asset management companies. Some key developments include the:

(a) *Circular on Increasing the Types of Bonds Available for Insurance Institution Investment* (effective 19 March 2009), opening new investment horizons for insurance institutions, including local government bonds issued by the Ministry of Finance on behalf of local governments, and certain types of debenture bonds such as medium-term loan notes issued in domestic markets, bonds issued by large-sized State-owned enterprises in Hong Kong, and convertible bonds;

(b) *Tentative Measures on Administering Overseas Investment of Insurance Funds* (effective 28 June 2007), allowing insurance funds to be invested in mature global markets and hard currencies.

(c) *Circular on Investment in Commercial Bank Equity by Insurance Institutions* (effective 16 October 2006), allowing insurance companies and insurance asset management companies to invest in domestic State-owned commercial banks, including city-level banks which are not yet publicly listed; investments exceeding 5% of the capital stock or the paid-in capital of the target commercial bank require CIRC approval;[9]

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[7] These enforcement measures are largely similar to those found in the *Securities Law* and the *Banking Supervision Law* (effective as revised on 31 October 2006).

[8] 21st Century Economic Reports, "CIRC Explains the 3d Major Revisions to the Insurance Law, Adding Protections for Insureds", http://finance.people.com.cn/GB/1040/59941/8896992.html.

[9] Though this circular allows all insurance companies and insurance asset management companies (presumably including foreign invested companies) to invest in banks, in practice it has been difficult even for major State-owned insurance entities to receive approval for such investments. In March 2008, Xinhua News quoted the CEO of PICC, stating that the uncertainty of the regulatory approval process for cross-investment in the financial services industry had hampered the development of integrated companies. Further proposals allowing bank investment in insurance companies are discussed in Section 3.3 above.

(d) *Provisional Measures on Bond Investments by Insurance Institutional Investors* (effective 17 August 2005), allowing insurance companies to invest in enterprise bonds, government bonds, and financial bonds offered by domestic issuers; and

(e) *Trial Measures for Insurance Fund Indirect Investment in Infrastructure Projects* (effective 6 March 2006) allowing insurance entities to purchase infrastructure bonds.

Since the revised *Insurance Law* was published at the end of February, the CIRC has continued rapidly liberalising insurance-related investment regulations by issuing the *Notice to Strengthen the Build-up of Assets Management Capacity* (effective 19 March 2009), the *Circular on Regulating Stock Investments of Insurance Institutions* (effective 18 March 2009) and the *Notice for the Investment of Insurance Funds in Infrastructure Debt Investment Plans* (effective 19 March 2009). For example, under these recently enacted rules, insurance companies may now simply file a record of their stock investments with the CIRC (whereas previously CIRC approval was required for direct and indirect investments by insurance companies).

7. OTHER ISSUES

7.1 Related-party transactions

The revised *Insurance Law* includes new provisions specifying the CIRC's powers to intervene when insurance companies conduct related party transactions that are not concluded on arms-length terms. If a shareholder of an insurance company seriously damages the interests of the company through related-party transactions, endangering the company's solvency, the CIRC is entitled to order the shareholder to modify or unwind the transaction under Article 152. Before the shareholder corrects the transaction as ordered, the CIRC may restrict the exercise of the shareholder's rights, and, if the shareholder refuses to correct the previous transaction, the CIRC may order the shareholder to transfer his shares in the insurance company.[10] The questions of how or to whom the shares would be transferred, however, are not addressed in the law.

The focus on related party transactions, which were not addressed in the previous version of the *Insurance Law*, demonstrates continued and focused legislative and regulatory attention to this issue. Some previous CIRC rules on the subject are found in the *Interim Measures on Administering Related Party Transactions of Insurance Companies* (effective 6 April 2007), creating detailed rules on corporate governance procedures for evaluating related party transactions and disclosing major related party transactions to the CIRC: these rules are reflected in Articles 108 and 109 of the revised *Insurance Law*. The *Provisional Implementation Measures on Special Tax Adjustments* (issued by the State Administration of Taxation on 8 January 2009, and retroactively effective from 1 January 2008) also address related-party transactions and transfer pricing issues and provide additional tax penalties for companies engaging in related party transactions which do not follow the arms-length principle.

7.2 Qualification requirements for major shareholders and change in shareholding

The revised law includes new, stricter (and somewhat subjective) "qualifications" for major shareholders establishing a new insurance company. Article 68 requires major shareholders to have the ability to make sustainable profit, good reputation, no record of material violations of law or regulations in the last three years, and net assets of at least RMB 200 million. However, the definition of a "major shareholder" in this context is not found in the revised law. In addition, the threshold for CIRC review and approval of changes in an insurance company's shareholding structure has been halved from 10% to 5% under Article 84 of the revised *Insurance Law*, enlarging the CIRC's authority in this area. The law does not specify whether shareholders acquiring stakes in insurance companies must also satisfy the standards in Article 68, and it is possible that the CIRC could apply these criteria in the course of reviewing an application for a transfer of shares.

8. CONCLUSION

China's regulatory and legal regime governing the insurance industry is complex and changing quickly to adapt to the rapidly growing insurance market. The recent amendments to the *Insurance Law* reflect trends in the variety of areas mentioned above, and illuminate issues of importance to the CIRC -- and therefore also to insurance companies.

This round of revisions appears to be inspired largely by the need to consolidate, with clear areas of regulatory focus emerging, including greater emphasis on the corporate governance of insurance companies and on identified problem areas (such as related party transactions). The CIRC has also been formally provided with a greater set of tools for supervising the market, enforcing compliance and policing market entry.

[10] These specific administrative powers to rectify certain related party transactions go far beyond the general provisions on related party transactions in the *Company Law* (effective 1 January 2006), which primarily address a company's internal procedures for approving related party transactions when a company's management, supervisors, directors, shareholders or actual controllers have a conflict of interests.

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