



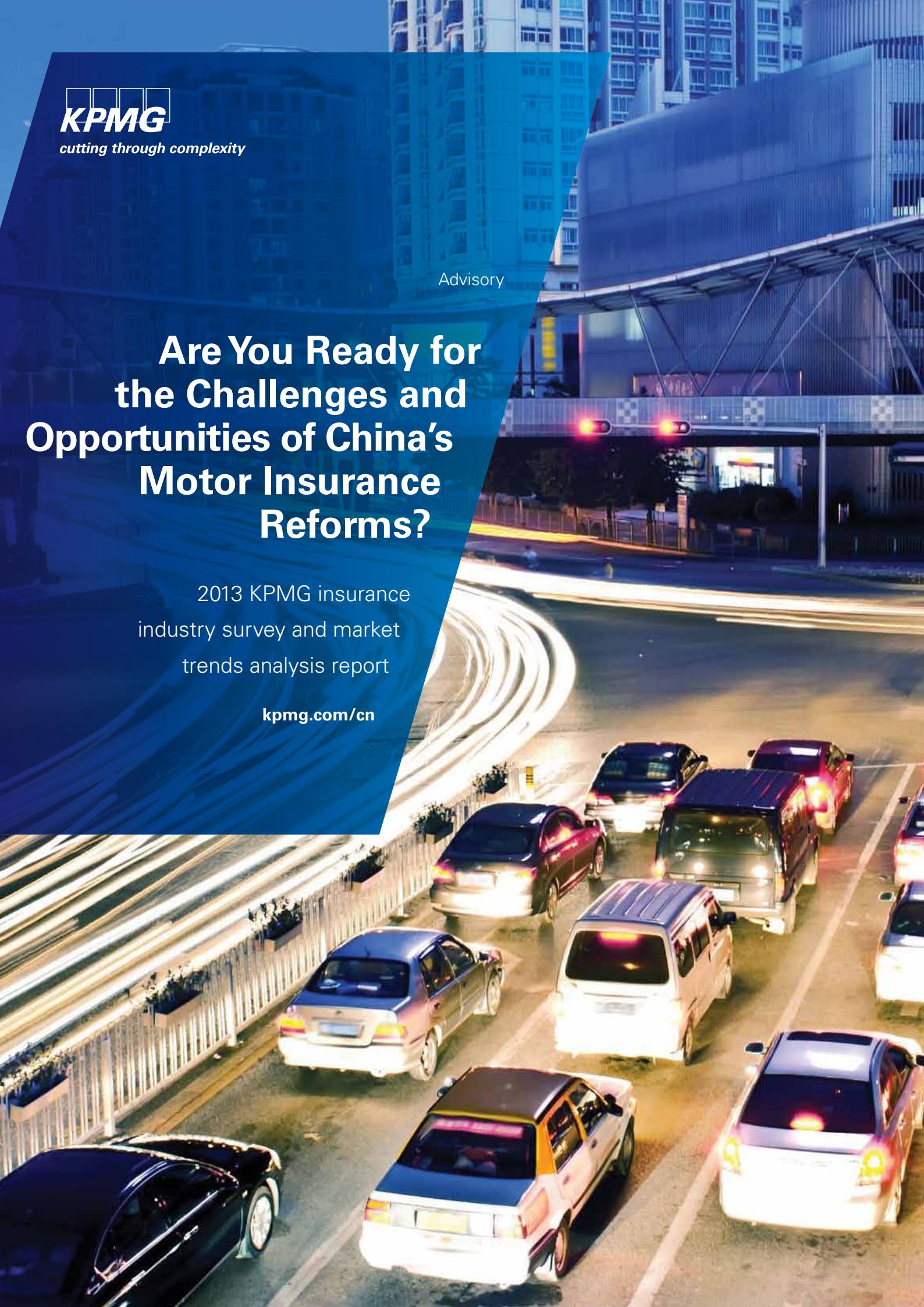
*cutting through complexity*

Advisory

# Are You Ready for the Challenges and Opportunities of China's Motor Insurance Reforms?

2013 KPMG insurance  
industry survey and market  
trends analysis report

[kpmg.com/cn](http://kpmg.com/cn)





## Executive Summary

The China non-life insurance market continues to evolve rapidly as the liberalisation of motor pricing and opening of compulsory motor liability insurance to foreign insurers taking their shapes. Over the course of the past twelve months, we have observed stabilising premium growth rate with some lines with governmental policy support (e.g., agricultural insurance) experiencing swift expansion. The market is still dominated by motor (over 70% of total premium), coupled with very high but gradually easing market concentration level. Direct distribution channels, led by telesales of motor insurance, are booming and have started reshaping the insurance distribution system in the country. Cross-selling and internet sales through either insurers' own online platform or third-party price comparison websites are becoming norm for the industry. Seeing China as one of the most promising insurance market in the world, foreign-owned insurers have grown their participation through writing the compulsory motor liability insurance that is newly available to them, or by acquiring stakes in existing domestic market players.

In the mean time, underwriting profitability appears to have entered a downward cycle due to a number of factors. Irrational competition has driven up commission levels, claim cost has been rising as a result of higher car repair cost and labor rate, as well as the increasing compensation amount for injuries and the proliferation of claim related litigations. On the other hand, the current system of nearly uniform motor insurance premium rates and policy clauses has limited insurers' ability to react to market developments. As a preemptive measure to reduce unreasonable reserving practices, the regulator recently introduced new requirements that aim to strengthen data quality, internal control, as well as the adequacy and reasonableness of insurance reserve, with punitive measures attached for material adverse reserve development. However, our analysis of publicly available data indicates that the overall industry reserve adequacy level has declined and the trend could be worsening as more insurers are facing short-term profitability pressure.

On a more positive note, our recent industry survey with input from 90% of the non-life market has revealed that the industry is investing more in risk segmentation, new distribution, product innovation, and customer services. Facing a variety of challenges such as data quality and skill shortage, the industry's demand for outside advisors to assist in modeling, process improvement, IT enhancement and other areas are rising. Insurers remain optimistic about the market growth and industry development trend. They are also paying more attention to developing niche market that offers higher margin and is better aligned with their own strength.

As China's economy continues to grow and the urbanisation accelerates, we expect to see increased demand for insurance and higher expectation of services from consumers. The government is also committed to grow

the insurance sector, which provides key support for its policy goals. These factors have created highly favourable conditions for sustained growth of the China non-life insurance market.

Despite possible delays, motor and other insurance product pricing will gradually become market-driven. Companies will continue investing in more sophisticated pricing, underwriting, marketing, customer retention, and claims management models, in order to improve management decision-making and gain advantage in an increasingly competitive market. The anemic growth in developed insurance markets and the need for capital, technology, talent and experience from small and medium size domestic insurers should increase merger and acquisition activities in the near future.

As part of the transformation to more customer-oriented operating model, insurers will focus more on internet sales, in-bound telesales, cross-selling, and claim service quality improvement. Empowered by the fast digitisation of the Chinese society, it is likely that motor insurance premium generated through direct distribution channels will be on par with that generated through traditional channels in a few years.

We are certain that China's motor insurance development will continue to thrive and become one of the world's most important non-life insurance markets. As a trusted advisor to the insurance sector, KPMG believes that companies successful in the following key areas, be they big or small, are poised to become the future market leaders.

-  Channel development and transformation
-  Data analysis and risk segmentation
-  Product innovation
-  Customer centric transformation
-  Claims modelling and leakage management
-  Expense control and budget management
-  Risk and capital management
-  Reserve management





## **Development of China motor insurance reform and introduction of KPMG industry survey**

The non-life insurance market in China is dominated by motor insurance as shown by its high percentage of the total premium (over 70 percent). Compulsory motor third-party liability insurance (CTPL) was introduced in July 2006 to provide minimum liability coverage, while commercial motor insurance (CMI) is voluntary and offers wider coverage and increased liability limits. Since then, China has adopted a regime based on essentially uniform premium rates and policy clauses, and this regime has played an important role in stabilising the industry development and keeping stiff price competition at bay. It is also one of the key factors contributing to the record-high non-life insurance profitability in 2011.

Despite the above, the tariffed regime fails to reflect the different risk characteristics of various insurance customers. It also becomes a disincentive for insurers to develop innovative products, and gives rise to a disguised "price war" that competes in terms of insurance commissions, as well as the controversial industry practices of insuring vehicles at their new car value but paying claims at actual cash value, or refusing to pay claims when the insured is not at fault in an accident



by relinquishing subrogation rights. To facilitate the development of more professional and sophisticated insurance market, as well as to safeguard the lawful rights of policyholders and encourage the innovation of motor insurance products, China Insurance Regulatory Commission (CIRC) started a new wave of policy reforms.

During the first half of 2012, CIRC and the State Council (cabinet of China central government) respectively promulgated two regulations with far-reaching effects on the motor insurance market:

1) Circular on the Strengthening of the Management of CMI Rates and Insurance Policy Clauses

- Provides the criteria for insurers to be qualified to adopt new CMI rates based on their own experience data<sup>1</sup> ;
- Abolishes the controversial industry practices of insuring vehicles at their new car value but paying claims at actual cash value and refusing to pay claims when the insured is not at fault in an accident by relinquishing subrogation rights

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1. At least three years of CMI experience  
Complete corporate governance structure and effective internal control data  
< 100 percent combined ratio in each of the last two years  
> 150 percent solvency ratio in each of the last two years  
> 300,000 motor vehicle experience data  
Specialised CMI product development team, effective business processes, and data system  
Other requirements set by the CIRC.

- Requests for the Insurance Association of China (IAC) to compile model policy clauses and industry motor insurance loss ratios for the use of insurers that do not meet the aforesaid criteria.

2) Decision of the State Council on the Revision of Regulations on Compulsory Third-party Liability Insurance for Motor Vehicles

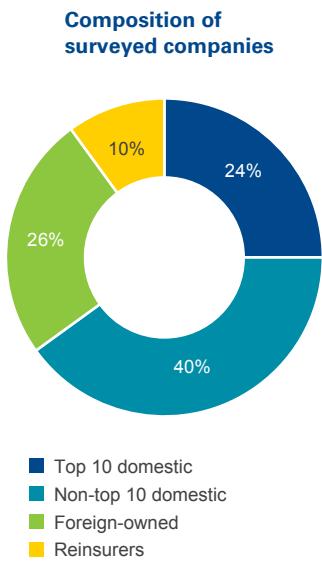
- Opens the CTPL market to foreign-owned insurers.

To understand insurers' perspective and response on recent motor insurance reforms, we invited 12 non-life insurers to participate in our industry survey in 2012. Our survey covered the potential impact from the recent liberalisation of CMI pricing; the readiness of insurers to adopt their own CMI rates; potential impact from the opening of the CTPL market to foreign insurers; intention and action by foreign insurers to enter the CTPL market and its expected impact on non-life insurance growth and profitability. A survey report entitled *A Collision in the Motor Insurance Industry* was published in July 2012 and was well received in the sector. Many of the market participants have requested us to continue using the survey platform to analyze the latest developments of the China motor insurance market, as well as the outlook on this sector.

Over the past year, the de-tariffication of CMI and the opening of CTPL market to foreign-owned insurers have been steadily taking place. During the first half of 2012, IAC issued the *Model Policy Clauses of Commercial Motor Insurance*. In December 2012 and February 2013, CIRC issued two *Circulars on Further Deepening the Reform of the Management of Commercial Motor Insurance Rates and Policy Clauses (Exposure Draft)* to consult non-life insurers on the implementation of the liberalisation of CMI rates. These consultation papers established the industrial standard of insuring vehicles at actual cash value and a phased motor insurance reform in three steps:

- Step one: adopt the IAC model policy clauses and accumulate operating data through the motor insurance information platform as the basis for measuring industry loss ratio under the IAC's model policy clauses
- Step two: study and measure the industry loss ratio under the IAC clauses for the reference and use of insurers
- Step three: qualified insurers can offer wider liability coverage than that offered by IAC clauses and adopt new clauses and rates based on their own experience data

While the reform of CMI policy clauses and rates gradually reveals its details, it is still uncertain when the new system will be implemented after several postponements.



Foreign-owned insurers have formally started their CTPL business since November 2012. As at June 2013, nine foreign insurers have obtained the approval of CIRC to engage in the CTPL business, seven of which have started writing CTPL policies<sup>2</sup>. On 21 June 2013, the *Cross-strait Agreement on Trade in Services* signed in Shanghai also encourages qualified Taiwan insurers to engage in the CTPL business.

To keep abreast of the latest developments of the motor insurance reform, and to support the industry in overcoming the reform challenges we once again conducted a survey on the motor insurance reform in 2013 and widened the scope of our interviewees and questionnaire. 40 domestic and foreign insurers as well as reinsurers responded to our survey (see the chart on the left), to whom we would like to express our gratitude for their generous support.

This report not only features our survey results, but also reviews and analyses key recent development of non-life insurance market, such as premium growth, underwriting profits, distribution innovation, and reserving. With insights from KPMG and external industry experts, we summarize our view on market trends and make our recommendations on focus areas for insurers in coming years.

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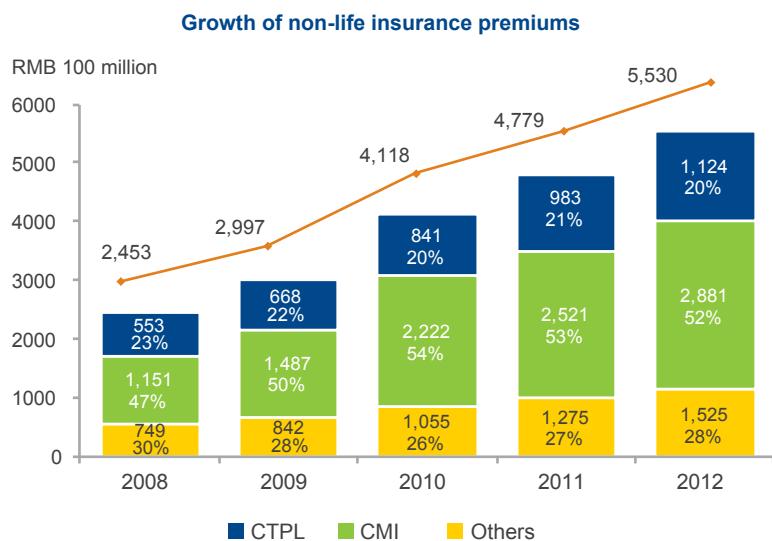
2. Liberty Mutual, AIG, Allianz China, Groupama AVIC Insurance, Hyundai, Fubon, Cathay, Samsung, Zurich; seven of them have started writing CTPL policies.

## Development of the China non-life insurance market since 2012

### Stabilising non-life premium growth with declining percentage of motor insurance

In 2012, the China non-life insurance industry posted total direct premium income of RMB 553.0 billion (USD 88 billion), or a 15.7 percent year-on-year (yoY) growth. As China increasingly focuses on the social function of insurance and with the introduction of the agricultural insurance subsidy, guarantee insurance, credit insurance, agricultural insurance and health insurance each recorded a premium growth of more than 20 percent. While enterprise property insurance, engineering insurance, cargo insurance, and hull insurance, which are more vulnerable to the impact of macroeconomic slowdown, experienced a much slower premium growth or even a premium decline. Foreign-owned insurers recorded premium income of RMB 6.7 billion, or a 28.9 percent yoy growth.

Despite the above-average growth rate of premium income, the market share of foreign insurers is very low (1.2 percent). The premium ranking in terms of geographical distribution remains substantially unchanged with the top four provinces being Jiangsu, Guangdong, Zhejiang and Shandong respectively, but the central and western provinces such as Ningxia, Sichuan, Henan, Xinjiang, Guizhou, have the highest growth rates. This is attributed to the economic shift from eastern China to central and western China, and the latter region's low insurance density and great development potential.



Source: China Insurance Yearbook, CIRC, IAC

In 2012, motor insurance posted a premium income of RMB 400.5 billion (USD 64 billion), or a 14.3 percent yoy increase, which has been the lowest growth rate since 2009. Motor insurance accounts for about 72.4 percent of the non-life insurance premium in total, which is 1 percent lower than the figure at the end of 2011. The slowdown in the premium growth of motor insurance is mainly due to stagnant new car sales in China which can be attributed to slowing GDP growth and various vehicle plate registration restrictions in major cities across the country. As shown by the following chart, in 2012 nearly 20 million new cars were sold in China, a 4.3 percent growth as compared to 2011. Though higher than the record-low growth in 2011, the growth rate in 2012 is modest as compared to the booming 2009 and 2010.

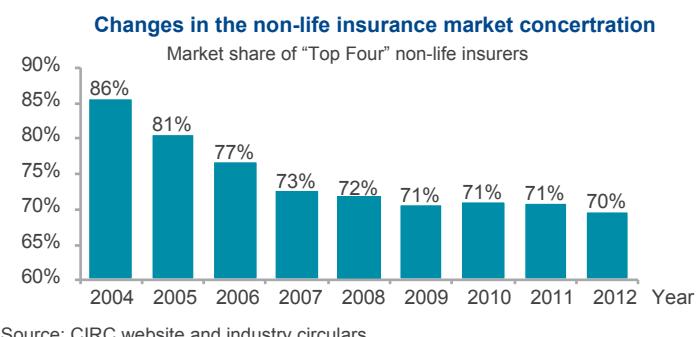


Source: China Association of Automobile Manufacturers

During the first half of 2013, the non-life insurance industry recorded direct premium income of RMB 327.0 billion (USD 53 billion), a yoy growth of 16.6%. Agricultural insurance continues to expand rapidly (yoY growth of 35%), while motor insurance has maintained a healthy but slower (yoY 13%) growth rate.

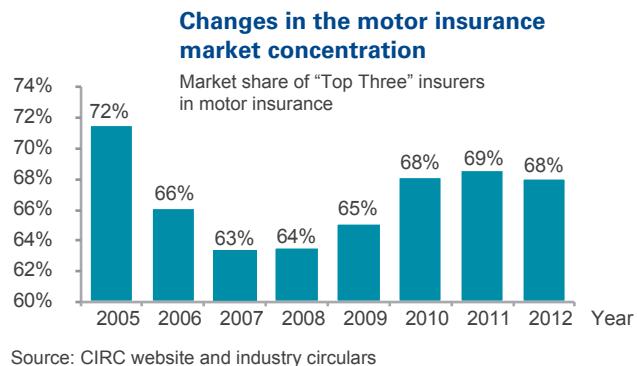
## High market concentration but gradually decreasing

The China non-life insurance market has been opening up and developing for more than 20 years. The non-life insurance market was originally a monopoly, and later transformed into a market dominated by the three incumbents (PICC Property and Casualty, China Pacific Property Insurance and Ping An Property & Casualty) while numerous domestic insurers compete with their foreign counterparts. As at the end of 2012, there were 62 non-life insurers in China, 41 of which were domestic and the rest were foreign-owned. With the continuous increase in the number of market participants, and the rise of "tier-2" domestic insurers (such as China Life Property & Casualty, Taiping General Insurance), market concentration has been gradually decreasing. However, the largest four non-life insurers still had a market share of 69.8 percent in 2012, despite a decrease of 1.2 percent. The market share is significantly higher than that of the top four non-life insurers in developed economies (UK 38 percent, France 32 percent, Germany 25 percent, Italy 36 percent, USA 29 percent).



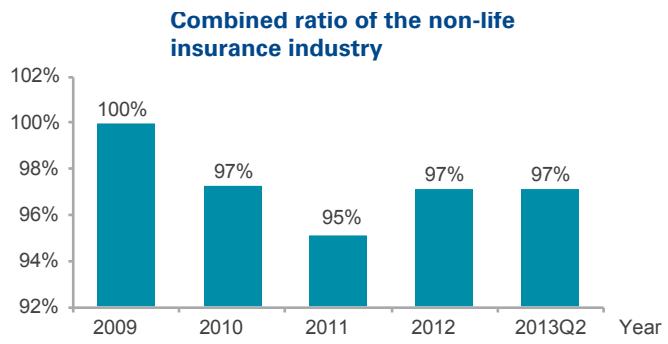
Unlike the non-life insurance market, the motor insurance market concentration increased as the top three insurers' market share grew from 63.4 percent in 2007 to 68.6 percent in 2011. This is due to the advantage of the three incumbents in leading the trend of motor insurance telesales, and also the economies of scale in their direct marketing and their pricing power. In 2012, as the telesales competition intensified, the rise in the market share of the top three insurers in motor insurance was finally reined in and their market share dropped slightly to 68.1 percent at the end of 2012.





## Deteriorating underwriting profitability

The profitability of the China non-life insurance industry reached a record high in 2011, but the downward underwriting cycle soon started in 2012. The combined ratio of the industry reached 97.2 percent in 2012. Of 62 non-life insurers across the country, 37 or nearly 60 percent of the insurers suffered an underwriting loss. The situation has been worsening in 2013 as the half-year industry combined ratio rose to 96.8 percent compared with 94.3 percent for the same period of 2012. Many non-life insurers suffered an underwriting loss while the underwriting profits of most insurers fell. It is expected that motor insurance is already experiencing an underwriting loss in 2013. The slowing premium growth in motor insurance, which accounts for more than 70 percent of China non-life insurance business, its increasing claim cost and a widening loss of the CTPL business are the main reasons for the China non-life insurance industry's downward cycle in profitability.





To cope with slower car sales, large automobile manufacturers and car dealers ask for higher commission by taking advantage of their own distribution network to maintain operating profits. It was reported in the press that many insurers offer commission that exceeds the local IAC self-disciplinary limit to achieve business growth target. In Shanghai, CMI commission ratio approached to 20 percent to 30 percent, a level significantly higher than the CMI limit of 15 percent and CTPL 4 percent imposed by the self-disciplinary protocol. CMI commission ratio have surged to as high as 30 percent to 50 percent and even the CTPL commission rate may have exceeded 30 percent in certain regions.

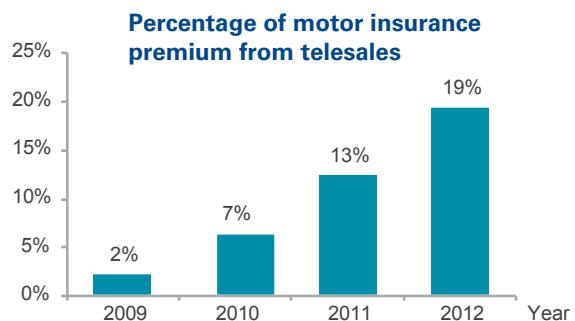
Meanwhile, cost of car repair parts and hourly labor rate imposed by large automobile manufacturers continue to increase. In 2012, cost of car repair parts and hourly labor rate soared by more than 10 percent in the eastern coastal region, with some reaching 20 percent; even the central and western region recorded increase rates from 5 to 10 percent. On top of these, the increasing compensation amount for injuries and the proliferation of claim related litigations have led to the ever-increasing compensation for personal injuries, which is a great challenge faced by the insurance industry.

Intensified competition in the new distribution channels and marketing gimmicks such as offering cash coupons and holding lucky draws on top of the 15 percent discount offered through telesales and internet sales also contributed to the dwindling average per policy premiums.

Since 2009, the CTPL business has suffered an underwriting loss for four consecutive years. In 2011, the operating loss of CTPL business amounted to RMB 9.2 billion. Though the 2012 final figure has not been released yet, it is expected that a loss of similar magnitude will be recorded. The CTPL claim ratio climbed from 70.1 percent in 2008 to 81.9 percent in 2011 and is estimated to remain at a high level of over 80 percent in 2012. The incessant loss incurred by the CTPL business can be mainly attributed to the tariffed rates as they can neither reflect the inflationary pressure of general price level, personal injury compensation and car repair costs, nor the costs of car owners with different risk level and in different geographic locations.

## Booming new distribution channels

Insurance telesales has been expanding rapidly in China since 2007, when Ping An Property & Casualty first introduced motor insurance telesales products. The telesales recorded the highest growth rates for three consecutive years from 2010 to 2012, and the premium income generated by motor insurance telesales rocketed by an average annual rate of 150 percent from RMB 5 billion in 2009 to RMB 78 billion in 2012. The percentage of motor insurance premium generated by telesales also leaped from 2.4 percent in 2009 to 19.5 percent in 2012. Despite the impressive growth rate of motor insurance telesales, there is still great potential for the development of direct marketing in China as compared to western economies such as the UK and USA, where the percentages of direct marketing ranges from 25 percent to 45 percent.



Source: Financial News

The scale of internet sales of motor insurance products is still modest compared with the rapid growth of telesales. With the increasing percentage of 30- to 40-year-old car owners and the rise of e-consumption, insurance purchase via internet is gaining popularity. Young car owners tend to be more sensitive to price and coverage differences of motor insurance, which gives rise to price comparison websites that help car owners identify the most cost-effective insurers and the most suitable product package.

Internet sales is currently processed at insurers' own websites or through third-party websites. Eight out of top 10 non-life insurers have established their own internet sales platform. A number of leading insurance groups have even started integrating group resources to set up internet sales entities offering non-life insurance, life insurance and other financial products. Internet sales platform of motor insurance products can offer quick quotes, online premium discounts and recommend the most suitable product based on the information provided by car owners. Third-

party websites, such as baoxian.taobao.com, baoxian.com, soobao.cn and zgchxw.com, distribute motor insurance products of several insurers and are able to help car owners identify the best product by comparing offerings from various insurers.

Cross-selling is also becoming increasingly popular in the motor insurance sector and a key driver in enabling large insurance groups to achieve better than industry growth rates. To insurers who lead the trend of cross-selling, selling motor insurance through channels such as subsidiary banks, life insurance agencies, etc. has already generated more than 10 percent of their premium income. An increasing number of smaller insurers are also catching up with the trend by developing or implementing their own cross-selling strategies. Encouraged by policymakers, large automobile manufacturers and car dealers are also setting up their own professional insurance intermediaries while insurers are establishing professional insurance sales entities. All these developments will set the momentum for diversification and professionalism in the motor insurance distribution system.

## More stringent regulatory requirements on reserving, but lowering reserve adequacy

In 2012, CIRC introduced a number of regulatory requirements that aim to strengthen data quality, internal control, as well as the adequacy and reasonableness for non-life insurance reserve.

In March 2012, CIRC announced the Internal Control Standards on Basic Data, Evaluation and Accounting of Reserve for Non-life Insurance Business of Insurance Companies. The regulation aims to strengthen the regulation of basic data, internal control, and key performance indicators of claims handling for non-life insurers, and set higher standards for the data quality and evaluation process of non-life insurance reserving<sup>3</sup>. In May 2012, CIRC announced the *Administrative Measures for Retrospective Analysis of Reserves for Non-life Insurance Businesses of Insurance Companies* that requires non-life insurers to conduct quarterly retrospective analysis of reserves and submit formal retrospective analysis report to CIRC. The regulation emphasises the importance of reserve adequacy and aims to encourage non-life insurers to have more prudent reserving, and impose stricter standards on external auditors and independent actuaries as the watchdog to ensure reserve adequacy of non-life insurers<sup>4</sup>. CIRC have also issued warnings and imposed penalties on several insurance companies and relevant personnel for irregularities such as inadequate reserve and false data.

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- 3. For example, actuaries have to verify the basic data used for evaluation, including overall reasonableness verification, data sampling and direct verification of irregular data.
- 4. For example, if there are material adverse developments to reserve evaluation of a non-life insurer for two consecutive years, and the insurer engages the same accounting firm as its external auditor who continuously issues unqualified auditor' reports during the period, the insurer must change its external auditor. If there are adverse developments to the reserve evaluation result in the insurer's financial statements for two consecutive years, or if there are material adverse developments to reserve evaluation result at the end of one of the last two years, the insurer must engage an independent actuary to review the reserve evaluation result for two consecutive years starting from the year when adverse developments are first identified.

In addition to the aforesaid regulations, CIRC also announced the *Circular on Clearing Backlogs of Outstanding Property Insurance Claims* in March 2012 that requires non-life insurers to clear backlogs of outstanding insurance claims to safeguard consumers' lawful rights and enhance the service quality and public image of the insurance industry. Again in May 2013, CIRC issued the *Circular on Regularly Clearing Backlogs of Outstanding Property Insurance Claims* to expedite the backlog clearing since 2012, and establish a system of regular backlog clearing to reduce the number of outstanding insurance claims.

Thanks to the above regulations and the coordinated effort of the sector, data quality, reserve evaluation approach and process of non-life insurers were significantly enhanced over the past year. However, we find that industry loss reserve at the end of 2012 may be less adequate than that of the previous year through our analysis of the latest publicly available data.

In our analysis, we used the ratio of net outstanding loss reserve to net earned premium ("outstanding claim ratio") during the period from 2010 to 2012 to measure the reserve adequacy. We note that outstanding claim ratio is only one of the indicators for reserve adequacy, other factors such as an insurer's mix of business, premium growth level, reinsurance arrangements, and claims handling policies should also be considered in forming a full picture. As the China non-life insurance industry recorded a stable growth of premium income during the period from 2011 to 2012, and the majority of non-life insurance businesses are short tail<sup>5</sup> in nature (like motor insurance), we believe the outstanding claim ratio can offer insights into the adequacy of outstanding loss reserve.

We found that the reserve adequacy for the entire non-life insurance sector improved slightly in 2011 (outstanding claim ratio rose from 41 percent at the end of 2010 to 42 percent at the end of 2011), while the outstanding claim ratio at the end of 2012 fell to 39 percent. The decline in 2012 may be partially attributed to the aforesaid clearing of backlogs of outstanding claims and the growth of business with extremely short tail such as agricultural insurance, but more likely it is due to the release of part of the prudent reserves accumulated over the past few years in 2012. such releases lowered the reserve adequacy at the end of 2012, while enhanced the underwriting profitability for calendar year 2012.

The following chart further elaborates the change of outstanding claim ratio over the past two years. We classified 62 insurers into three groups: top 10 domestic (top 10 in premium volume), non-top 10 domestic and foreign-owned insurers. We then calculated the weighted average, maximum and minimum outstanding claim ratios of each group of insurers during the period from 2010 to 2012. The general movement of outstanding claim ratio can be easily observed across the three groups (upward in 2011, downward in 2012), and the reduction of outstanding

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5. It refers to the short length of time between claim occurrence and the settlement of claims (usually within one year).

claim ratio for non-top 10 domestic is the most significant in 2012. Foreign-owned insurers have the highest outstanding claim ratio across the three years due to their low volume of motor business, high sensitivity to large claims and more prudent reserving practice.



Source: Annual reports of insurance companies

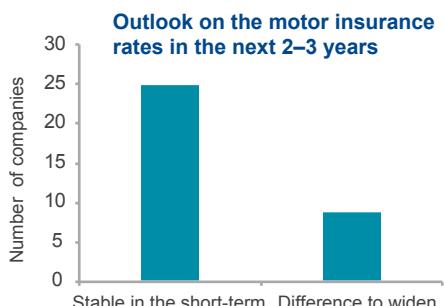
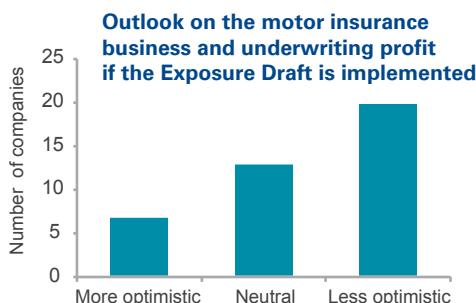
The outstanding claim ratios within each insurer group vary greatly, which reflects the industry's diversity in business mix, maturity, reinsurance arrangements, as well as the insurers' different reserving practice. Only one of the top 10 domestic insurers raised its outstanding claim ratio in 2012 (six in 2011), the other nine recorded a decline as high as 13 percentage points. Over 80 percent of non-top 10 domestic insurers had lower outstanding claim ratios in 2012, which was significantly worse than the movement in 2011 (about 40 percent of the insurers' outstanding claim ratios decreased). There were also more foreign-owned insurers having a lower outstanding claim ratio in 2012, but not to the extent of their domestic counterparts.



## Analysis of industry survey results

As mentioned earlier, 40 insurers responded to our survey this year and we obtained data from the whole spectrum of the non-life market participants including domestic and foreign insurers of various scales<sup>6</sup>, as well as major reinsurers in the market. Our interviewees are mainly personnel in product development, actuarial and finance functions, as well as members of frontline operations and senior executives. Our questionnaire mainly covers:

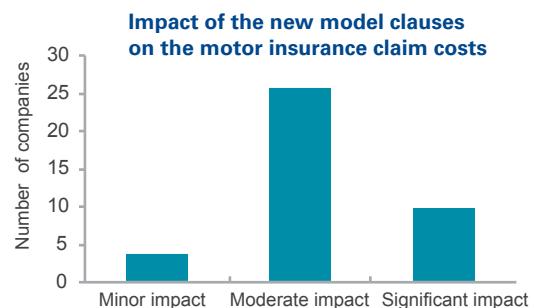
- Potential impact from the recent CMI reform
- Progress of risk-based pricing analysis and applications
- Impact from the opening of the CTPL market to foreign insurers and the view on the expansion of foreign insurers in China's non-life insurance market
- Development of innovative motor insurance products
- Development and challenges of new distribution channels for insurance products
- Challenges faced by the motor insurance business in process management, cost management, and market competition
- Outlook on the development of lines of business other than motor insurance
- Forecast on the premium growth and profitability of the non-life insurance market in coming years
- Impact of other non-life insurance regulatory policy changes on motor insurance and the China non-life insurance market as a whole.



In December 2012 and February 2013, CIRC solicited comments twice from non-life insurers and the IAC on its *Circular on Further Deepening the Reform of the Management of Commercial Motor Insurance Rates and Insurance Policy Clauses (Exposure Draft)*. The majority of the surveyed companies are less optimistic or remain neutral on the growth of motor insurance business and prospect of underwriting profit if the new policy is implemented. Only a small number of surveyed companies are more optimistic. However, most companies believe that the pricing will remain stable in the short term.

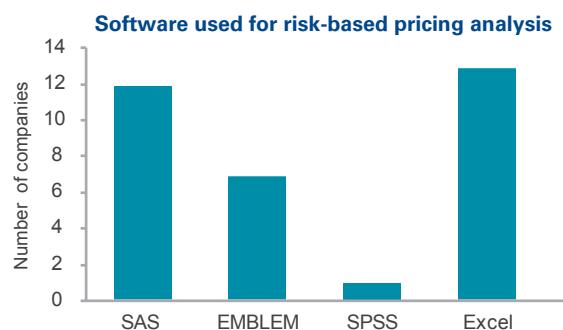
6. Data obtained from the survey cover approximately 90 percent of the China non-life insurance market by premium and 60 percent of the market in terms of the number of companies.

As the new industry model clauses have established new rules dealing with insuring vehicles at new car value but paying claims at actual cash value and prohibiting the practice of refusing to pay claims when the insured is not at fault in an accident by relinquishing subrogation rights, the insurance coverage is broadened. Most respondents expect the new industry model clauses, when they become effective, to have moderate or significant impact on motor insurance loss costs and industry profitability.



The liberalisation of CMI pricing will effectively provide large domestic insurers with another tool to potentially grow their market share through better risk selection, lower prices, and better insurance coverage. Small insurers will have to follow industry loss ratio in setting their price and use the industry model clauses, which could put them at a competitive disadvantage. Three-quarters of respondents share this view. Many companies, however, also believe that small and medium insurers can better adapt to rapid change in the market, thanks to their shorter decision-making process and faster response speed. In addition, small and medium insurers may be able to better focus on certain niche markets.

We discussed in last year's report that in addition to formulating their own CMI premium rates, insurers have many other ways that make use of information obtained through risk-based pricing analysis to improve their business. Therefore, this year we have asked the surveyed companies whether they have started to conduct regular risk-based pricing analysis for their motor insurance business. We are delighted to see that 64 percent of the surveyed companies have started doing so, compared to merely 33 percent in last year's survey, showing that insurers have attached greater importance to risk-based pricing analysis.

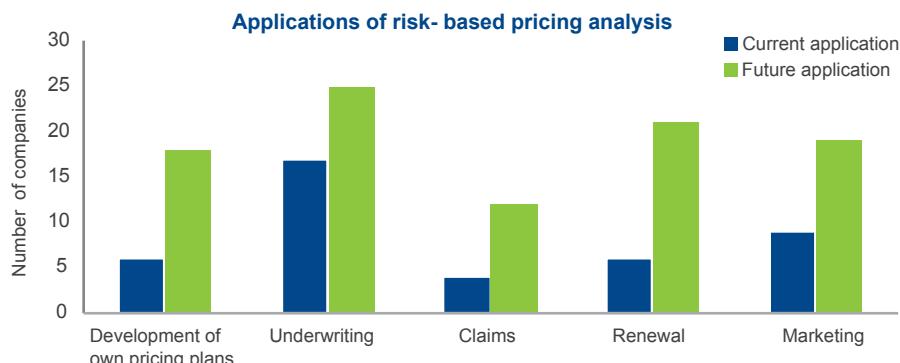


The tools used by companies to conduct more sophisticated pricing analysis also vary significantly, and the most popular software for risk-based pricing analysis are SAS and EMBLEM, while Microsoft Excel remains to be the choice by many insurers.

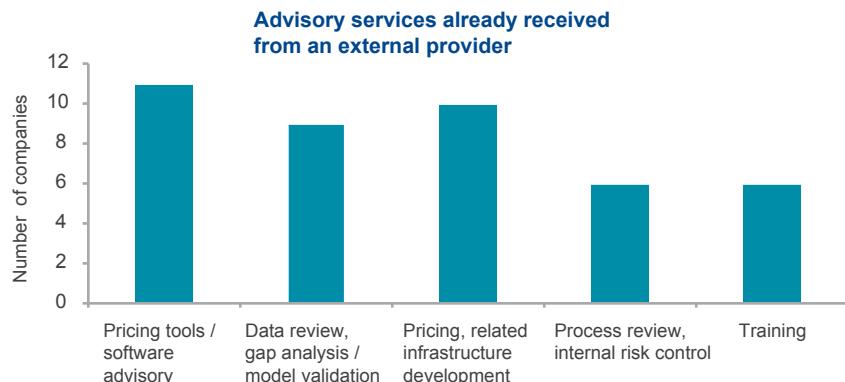
Applications of the risk-based pricing analysis are also increasingly diversified. It is now mainly used for underwriting and marketing purposes, but many companies intend to use the analysis results for other purposes such as retention, claims management and formulation of their own pricing plans. When conducting pricing analysis, most insurers are faced with data-related challenges, mostly due to lack of data and poor data quality. Some companies have insufficient professionals or lack of internal capability, or are concerned about the uncertainty in regulatory development. Many



surveyed companies believed that regular risk-based pricing analysis will benefit insurers in the long term and many insurers are investing more in the development of actuarial and product development teams as well as the communication and coordination between actuarial, product departments and frontline business units.

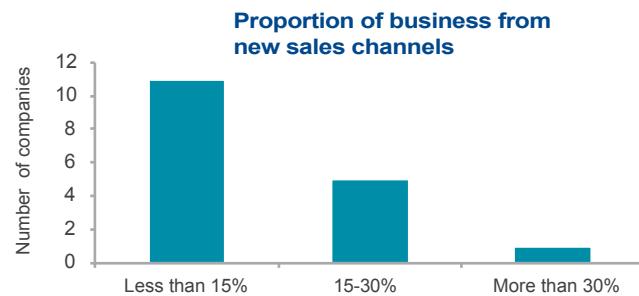


External advisors with strong capability and extensive experience can provide insurers with a wide range of consulting services related to motor insurance. We found that about two-thirds of the companies surveyed have already engaged external advisors to provide motor insurance related services, including pricing tools/software, data review, gap analysis, model validation, automatic underwriting systems, process streamlining, internal risk control, and training. In addition, many companies have set up plan and budget to engage more external consultants in the next year.

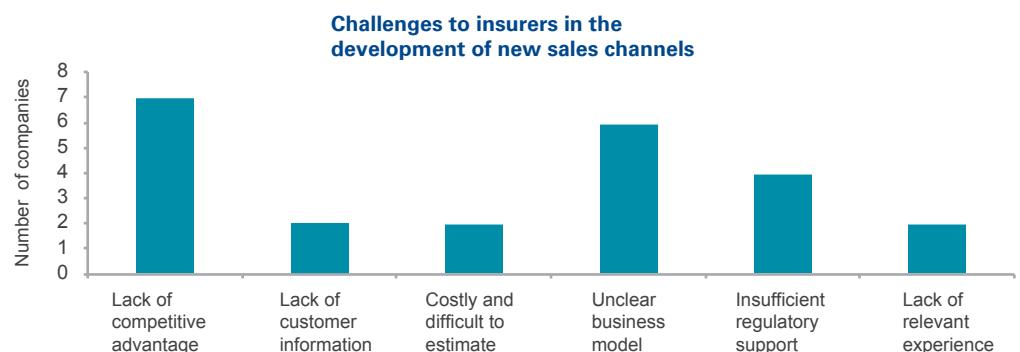


In addition to the traditional risk-based pricing analysis, some companies have begun to develop more sophisticated and innovative motor insurance products and pricing models. For example, telematic devices installed in vehicles, are coupled with GPS and mobile communication technologies to collect, transmit, and analyse driving behaviour data in order to calculate an accurate and fair premium. This has become a major trend in developed insurance markets in recent years. Our survey found that about one in four insurers in China have started developing similar motor insurance products, including some small and medium domestic companies. This shows that an increasing number of insurance companies are seeking to better leverage customer data and new technology to gain a competitive advantage in the market.

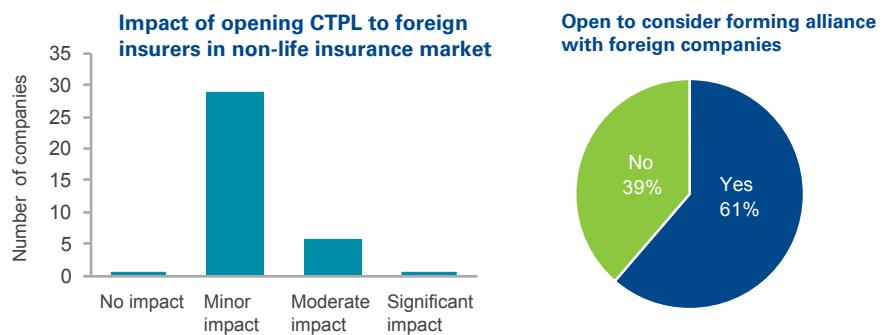
By the end of 2012, around 20 insurance companies were granted a telesales licence for motor insurance. An increasing number of insurance companies are pushing aggressively for internet sales and half of the companies surveyed have started implementing a cross-sell strategy. Sales generated by these new channels account for less than 15 percent of most insurance companies' business, but the growth is fast.



When asked about the main difficulty in developing new sales channels, surveyed companies pointed to a proliferation of competitors entering the market, leading to homogeneity and making it increasingly difficult to obtain competitive advantages. Rigorous regulatory approval process, huge upfront costs and unclear operating and profit models also cannot be ignored.

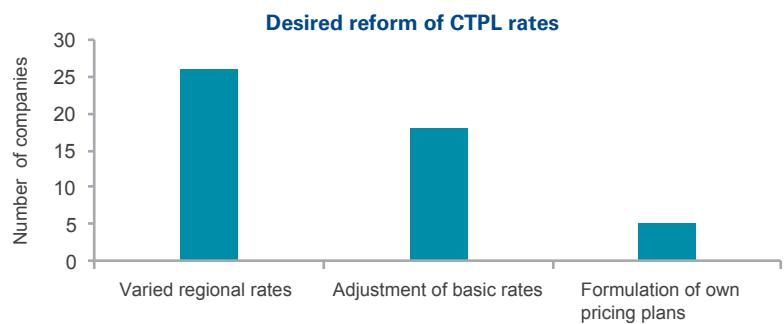


Since CTPL was opened to foreign insurers, nine companies have been granted a licence to conduct CTPL business and seven of them have officially started underwriting CTPL policies. Most survey respondents, however, said that the opening of CTPL to foreign insurers will not have a significant impact on the competitive landscape of China's non-life insurance market in the next two to three years, which is similar to our survey result last year. The current small market share, inadequate branch structure, limited distribution capability, and the inability to fully leverage their underwriting/pricing capability due to current regulation are the top reasons quoted by the surveyed companies.

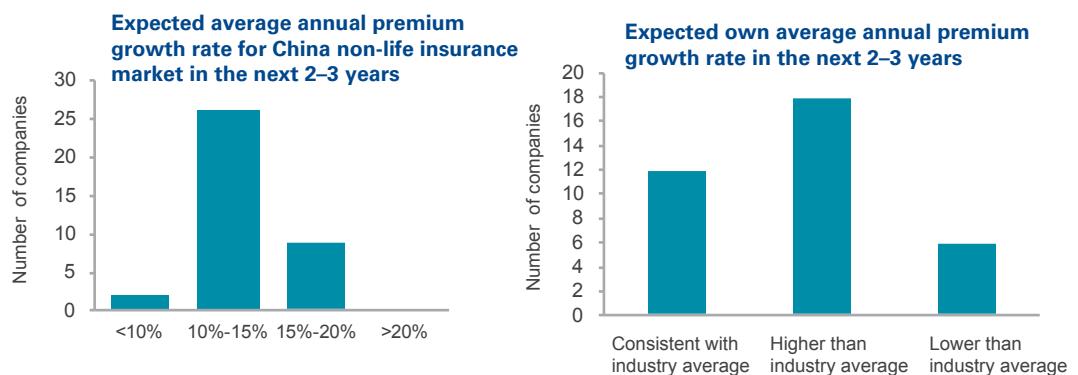


The majority of survey respondents welcome the further opening of China's non-life insurance market to foreign investors, and expect to see better service quality and more advanced operating models from foreign insurers. Increased competition will motivate insurers to enhance their corporate governance, operational efficiency, management skills, and overall competitiveness. Most respondents also welcome the idea of forming alliance with foreign insurers (as a financial or strategic investor).

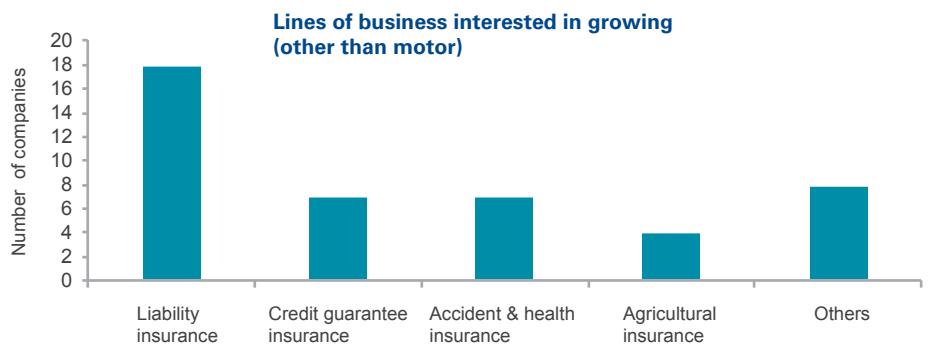
Even though CMI pricing reform is the current focus, survey respondents told us that CTPL rates should start to reflect territorial variation in claim cost and the adjustment of basic CTPL rates is badly needed. The current rate structure (largely uniform rates across the country) does not reflect geographical cost differences and therefore results in unfair subsidies between provinces. Meanwhile, the basic rates of CTPL have not been adjusted for years but the compensation level has been rising every year, leading to wider losses on the CTPL business and greater pressure on non-life insurers.



When asked about their expected average annual premium growth rate for China non-life insurance market in the next two to three years, the majority of respondents believe that the premium growth will remain healthy (average 10–15 percent p.a.), and a few are even more optimistic and expect annual growth of 15–20 percent. Interestingly, the vast majority of respondents expect their own premium growth to be on par with or higher than the industry average.



Nearly 80 percent of respondents expect the profitability of China's non-life insurance market to continue worsening in 2013 and 2014. Companies plan to adopt different approaches in response to unfavourable market movements, including more stringent underwriting policies, focused selection of quality business, cost reduction, development of new products, strengthened claims management, and adjustment of prices and clauses. In addition to motor insurance, many are also bullish about the growth prospects for liability insurance, credit guarantee insurance, and accident and health insurance in the next few years, and they have plan to expand these businesses segments.



We also asked how surveyed companies view other recent regulatory reforms, such as reserve internal control standards and retrospective analysis, the new risk-based solvency regulation system being developed, new investment policies and tiered supervision of companies, and how these reforms will impact the motor insurance market and the entire China non-life insurance market. These reforms have been applauded by the vast majority of the respondents, who think that, at this stage of insurance market development, new regulatory measures on a macro level, will expedite the marketisation and specialisation process of non-life insurance, regulate market actions, and prevent systemic risk in the industry. On a micro level, they will prompt insurance companies to strengthen risk management and internal control, enhance their development model, expand investment channels, and provide actuaries and other professionals with a better platform and more effective support.



## Outlook on the China non-life insurance market

Similar to last year's report, the table on the right summarises our expectations for the evolution of China non-life insurance market over the next few years. As China's economy continues to grow, the urbanisation process in the third and fourth tier cities is set to boost car sales while the trade-up needs of consumers in the first and second tier cities will drive sales of mid- to high-end vehicles. Therefore, despite a slowdown in premium growth in the past two years, we expect the motor insurance premiums on average to grow by 10 percent or more each year over the next three to five years. We also expect increased demand for insurance and higher expectation of services, thanks to consumers' increased per capita income and better understanding of insurance products. In addition, the socio-economic development is likely to see the introduction of additional compulsory insurance and expansion of insurance coverage (e.g. liability insurance and workers compensation insurance). The government will provide further support to lines of business with social functions such as agricultural insurance and health insurance. All these factors help create highly favourable conditions for sustained growth of the China non-life insurance market.

Despite the delays, we expect the CMI pricing reform to progress steadily in the next two to three years. Large and medium insurance companies that meet CIRC's requirements to adopt their own CMI rates can improve customer segmentation and risk selection, which in turn may drive better than industry average growth and profitability levels. The critical question these insurers must address, however, is the alignment between the development, implementation of their own pricing plans and their sales and customer service models.

For insurers that are not allowed to set their own CMI rates, they are advised to develop, as early as possible, a solid framework for risk-based pricing analysis and rate competitiveness/markets analysis, and apply their research findings in areas such as underwriting, marketing, customer retention, and claims management. This will effectively help them improve management decision-making and gain advantage in an increasingly competitive market. Our survey shows that more insurance companies are buying into this and have therefore increased investment in related research and development in the past year. Notably, it is now common practices in the industry to hire external advisors to help insurers identify and solve problems, leveraging the advisor's experience and resources while taking advantage of the relevant technology and knowledge transfer.

For small and medium insurers, the key to their success in the next few years rests on whether they are able to maximise their strengths such as a shorter decision-making process and faster response and execution, to actively develop niche markets and products that leverage their strength, and to break out of the old cycle of homogeneous products and services in the industry.

Current state	Regulatory & market changes	Next five years
Annual growth rate of motor insurance premium slows down to 15 percent from previous 25 percent	Economic growth will slow to a moderate pace and car sales continue to increase steadily	<b>Customer-centric business model</b> <ul style="list-style-type: none"> <li>Enhanced customer segmentation</li> <li>Product development tailored to customer needs</li> </ul>
CTPL rates are largely uniform across the country. CMI have standard policy clauses and rates	<p>Customers' increased demand for insurance and service quality</p> <p>Liberalisation of CMI pricing, and further opening of CTPL market to foreign-owned insurers</p>	<b>Evolving insurance sales channels</b> <ul style="list-style-type: none"> <li>More business generated by telesales, cross-selling and online sales; online sales to develop faster</li> <li>Agency channel to become more concentrated and professional</li> <li>Channel difference between first tier cities and other regions to narrow</li> </ul>
The market is highly concentrated but is expected to decline gradually. The top three insurers underwrote two-thirds of the premiums in 2012, and the foreign and second tier domestic insurers' market share will gradually increase	<p>Implementation of risk-based solvency regulation system (C-ROSS)</p> <p>Insurance data quality gradually improved, and more diverse data types are available</p>	<b>More professional and sophisticated insurers</b> <ul style="list-style-type: none"> <li>Improved internal control and analysis for reserving and pricing</li> <li>Increased M&amp;As and joint activities</li> <li>Adapting to China Risk Oriented Solvency System</li> <li>Improved cost control and budget management</li> <li>Enhanced risk management and performance assessment</li> </ul>
Sales through agency force (direct or independent) is the dominant channel. Rapid growth of telesales, cross-selling, and online sales	Insurance products and channels to feel the impact of new technologies such as mobile communications, internet and big data	
The solvency issue has been alleviated as different companies have developed their own solutions	Insurance investment becomes more diverse, and management becomes more demanding	





Due to persistent losses, some in the industry suggest that CTPL should be exempted from premium tax or taxed at lower rates to turn the business around. We believe, however, that the substantial losses of CTPL can only be reversed when CTPL pricing reform is initiated in which territorial variation of loss costs and changes in compensation level are fairly reflected, and more market driven mechanisms are introduced.

As an increasing number of foreign insurers enter China's CTPL market, competition will intensify and small and medium domestic insurers are set to feel more pressure. The limited distribution network will remain a major obstacle for foreign insurers until they can develop a direct proposition, particularly viable internet sales channels. Buying stakes in, acquiring or forming a strategic partnership with domestic insurers will continue to be another option for foreign insurers to rapidly expand their market share. The anemic growth in developed insurance markets and the need for capital, technology, talent and experience by small and medium size domestic insurers will encourage more merger and acquisition activities in the near future.

Rapid development of the telesales channel has resulted in a hike in complaints about insurance telesales. In response, CIRC issued the *Circular on Issues Concerning Prompt Containment of Telesales Disturbance* in early 2013 in order to regulate the telesales practice. CIRC requires insurers to develop an effective system for the blocking of telesales numbers, strengthen the management of the telesales process, investigate and penalise irregularities, and help local insurance associations to establish a telesales "no-call list" system and a shared database so that a customer is not called by another insurer after one is blocked.

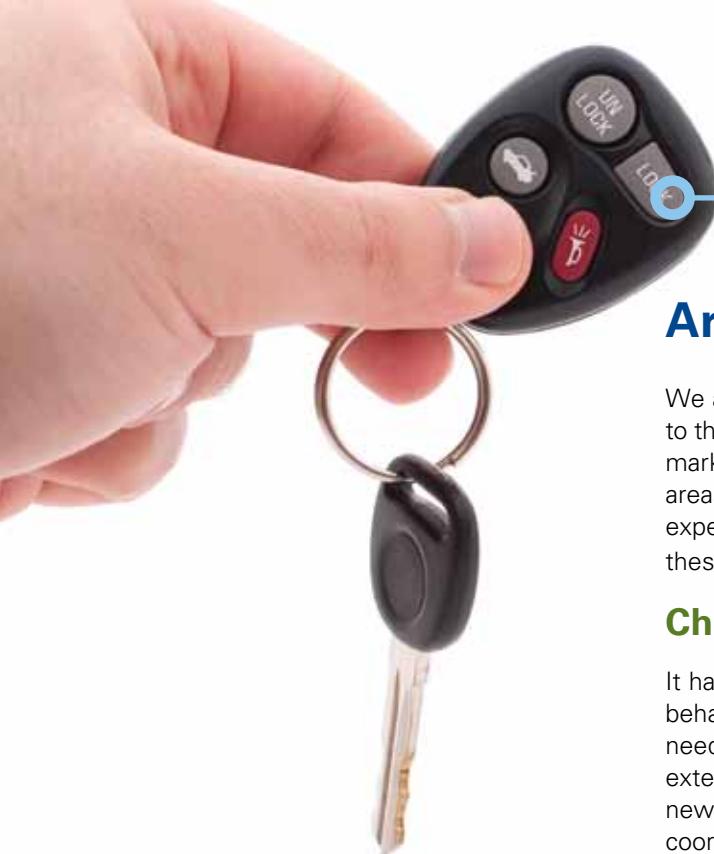
We believe that such requirements will have some impact on out-bound telesales, thus prompting the direct distribution channels to focus more on internet sales, in-bound telesales, cross-selling, and service quality improvement. Compared to traditional agency channels, direct distribution is characterised by its high efficiency, low cost and wide reach, as well as potential for further development. Therefore, motor insurance premium generated through direct distribution channels are expected to be on par with that generated through traditional channels in a few years.



Although small and medium insurers are at a competitive disadvantage in terms of branding and resources, they can take advantage of the increasingly popular price comparison websites to offer the best insurance deal for customers and win high-value customers. This may be an effective way for them to develop internet sales faster.

The recent liberalisation of insurance investment and development of China's risk-based insurance solvency regulation system (C-ROSS) are hot topics in the insurance industry. All insurance companies are faced with the challenge of responding promptly to an ever-changing market environment while keeping up with investment, capital and risk management.

The breakneck development of mobile communications and social networks, a new era of big data, and e-commerce companies entering the financial service sector have created huge challenges for the insurance industry whose core competitiveness is derived from data analysis and application. We expect these revolutionary new technologies and models to become catalyst for changes in insurance products, sales, services and management. Companies that respond to customers' fast-changing lifestyles and purchasing behaviour through innovations, be they big or small, are poised to become the future market leaders.



## Are you ready?

We are certain that China's motor insurance development will continue to thrive and become one of the world's most important non-life insurance markets. As a trusted advisor to the insurance sector, KPMG notes key areas for an insurer's success over the next few years. Our team of experienced insurance specialists are on hand to help you tackle any of these issues.

### Channel development and transformation

It has become imperative to gain a better understanding of customer behaviour and develop a distribution model to match their ever-changing needs by leveraging new technology, and by integrating internal data and external "big data". Expanding the potential customer base, increasing new customer conversion rate and reducing acquisition cost all require coordinated sales channels including internet, telephone, banks and consumer-facing businesses. Insurers can also improve customer retention and obtain higher customer lifetime value through enhanced service models and precision cross-selling.

### Data analysis and risk segmentation

Data analysis and risk segmentation can be achieved by improving data collection and analysis through continued investment in technology, analytical database development, and personnel with solid analytical skills. This will allow better risks to be targeted and poor risks to be avoided. Even in the current regime pricing variation based on risk profile can be applied to aid risk selection. These can be done in tandem with the application of data mining and predictive modelling by making use of internal and external data in pricing, underwriting, claim management, and customer service.

### Product innovation

Product innovation refers to developing new products and service models targeting selected consumer segments with unique features, by focusing on customer needs and innovation, and to help build your brand. An insurer should pursue higher margin niche markets and develop targeted insurance products by giving full play to its own advantages and taking advantage of government policy support.

### Customer-centric transformation

We strongly believe that organisations that put customers first and at the centre of everything they do will be the mid and long term winners in competitive markets like insurance. Winners are already proven, Apple, Amazon and Progressive Insurance to name just a few. The three above areas are all aspects of serving the customer better, all through technology. These should be combined and lead a transformation to customer-centricity. It's not hard to see that new

technologies and the digitisation of the consumer markets are leading the way. Smart insurers will embrace digitisation and customer demand and transform to wrap their sales, service and retention model around the customer guarding and developing the customers they have acquired and pulling in more as a natural consequence.

## Claims modelling and leakage management

There is an increasing need to drive down claims costs, not just to improve results but to allow lower premium levels to the customers. Insurers need to make a goal of significantly improving claims supply chain efficiency and squeezing 'leakage' out of the claims system. More sophisticated use and control of repair networks and partners is called for, and the larger insurers may have the scale to invest in their own repair networks. Additionally, just like for precision selling, product development and risk selection, data analytics and predictive modelling can be used to identify potential and root-out actual fraud from the claims system, both claimant and repair service fraud. We have seen insurers with successful claims modelling and anti-leakage transformations achieve 2-5 percentage savings in their combined ratio.

## Expense control and budget management

With a rising loss ratio, reduction of the expense ratio is becoming increasingly important in achieving the target underwriting profit. Sophisticated insurance companies are using shared service centre as a key part of their centralised and efficient operating model that offers both lower cost and better customer service. Advanced comprehensive budget management incorporating tools such as internal service pricing schemes and competition are also gaining popularity.

## Risk and capital management

The development of C-ROSS represents higher demand from regulators for insurers' risk management. A risk-based regulatory capital system also encourages the insurance industry to embrace economic capital tool to achieve better capital allocation and performance assessment scheme based on a risk adjusted rate of return approach. Expected accounting changes for insurance contracts and financial instruments (IFRS 4 and IFRS 9) are likely to increase volatility of future financial performance, and their impact thus cannot be ignored.

## Reserve management

When industry earnings go down, reinforced management of reserve to ensure its adequacy is key to maintain insurers' financial strength. In addition, a full understanding of profitability of each subsidiary and product line as well as the future development trend of reserves, obtained through more rigorous reserve analysis will help insurers better formulate development strategies (such as expense budget) and achieve sustainable development.

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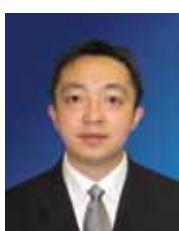
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