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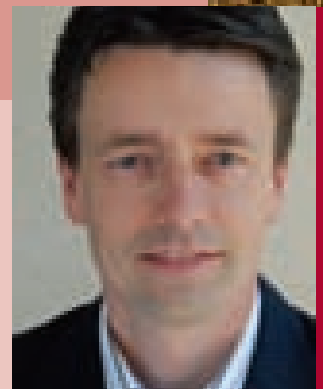
Liability Insurance in China – Attractive Business, or Is It?

Rob van Horssen



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Rob was born in The Netherlands, where he studied Econometrics and Actuarial Science. He has over 15 years of experience in the insurance industry in The Netherlands, Hong Kong, Singapore and China. He is a non-life actuary and

a member of the Dutch Actuarial Society. He has been with Gen Re since 1999, where he started as part of the actuarial consulting team. In 2004, he moved to Shanghai to join the China Treaty team as Account Executive,

whereafter he took responsibility for Greater China. In 2009, he transitioned to underwriting, as the Treaty Chief Underwriter for Asia.

rvanhor@genre.com
Tel. +86 21 6100 6365



China is a country on the move. Its image has changed in the last 30 years from a rather secluded society to an opening and developing society, where the economy is thriving, albeit in a socialist framework. The reality is that the Chinese people have not changed their preferred way of living, but they have had more chances to express those preferences as compared to the previous period. To insiders, it is a widespread expectation that in another 20 to 30 years, China will be on equal footing with the United States and Europe when it comes to economical and political clout. The question is not if or when, but how it gets there.

Within this changing landscape, the non-life insurance market is flourishing – at least, if you consider the large and continuing increase in insurance premiums as a good thing. Certainly, it is a good thing for the government, which wants to see the insurance community actively contributing to a healthy and harmonious development of the economy. This is also true for the regulators and the insurance company stakeholders, who want to see business growing. The focus on volume also creates challenges in trying to obtain a sufficient return on shareholders' investments. Currently the insurance market is not producing the results that would be expected in

a stable environment, and given the very low and still reducing premium rates, it is questionable whether this will change in the near future.

Within the non-life insurance landscape, Liability business takes an interesting position. With around a 4% market share overall, it is not a very influential class of business, and insurance companies struggle to significantly increase volumes, as many potential clients still have to be convinced of the necessity to insure themselves for such intangible risk. At the same time, Liability is one of the few lines of business that are still

The Liability market

When we talk about Liability, we can identify several main classes of business. The largest classes in terms of premium volume are Employer's Liability, Public Liability, Product Liability and Passenger Carrier Liability. The latter is a compulsory Public Liability cover for long-distance buses. As a compulsory class of business, only domestic companies are allowed to write it. Product Liability is not as big an area for local insurers, but it is a major topic for most of the foreign companies. Besides those main classes, other

years.² This is fuelled by an increasing demand as more and more local companies understand the benefits of being insured; moreover, they see the potential risks from well-publicised cases, such as the melamine scandal and the issues with exported toys. At the same time, local insurance companies are putting more emphasis on Liability business as an alternative to the more problematic classes such as Motor and Property.

Tail risk in China is significantly lower than in most other parts of the world. There is very little movement in incurred losses after

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profitable, and it has been reasonably stable in this regard. It is also one of the few areas where foreign insurers have an advantage, due to their specific expertise and existing relationship with multinationals. In this article, we examine the landscape of Liability in China in more detail.

products include Professional Indemnity, D&O, as well as Credit and Surety. Motor TPL, Engineering TPL and PA are not allocated to the Liability line. In recent years, several emerging products have come into the market. Examples of these are Production Safety Liability (for hazardous occupations), School Liability and Medical Malpractice.

the policy expires, and losses are generally fully paid within four years of the loss happening. This leads to a situation where ultimate loss ratios are known relatively quickly.

The profitability of the Liability business in general has been good. "Simple" loss ratios³ have been around 40% from 2005 to 2008.⁴ Even when incorporating reserve changes during this period, Gen Re estimates that ultimate loss ratios have been around 45%.⁵ Loss ratios of Public and Product Liability have been consistently better than those of Employer's Liability and Passenger Carrier Liability. Since expenses (including commission) account for roughly 30% of the premiums,⁶ this means that ultimate combined ratios have been relatively stable, around 75%. This is in contrast to the larger lines of Motor and Property, which have combined ratios at or above 100%. It is therefore no surprise that insurance

The premium development of Liability classes has been in line with the development of the non-life insurance business in general. Premiums have grown from roughly RMB 4.5 billion in 2005 to RMB 8.2 billion in 2008, an average growth of 22% a year.¹

It is expected that this growth will continue at a similar pace in the next few





companies are looking to increase their Liability portfolio. As a result of this increased focus, particularly of local companies, average premium rates dropped by 3%–8% in recent years.⁷ We also see that companies are starting to develop more risky Liability lines, such as Environmental Liability, Medical Malpractice and Copyright Protection Insurance. It might be only a matter of time before the Liability market loses its profitability advantage.

An additional concern is the potential for increasing insurance losses. In comparison with most other countries, China has seen very low court awards and very few large Liability cases. The largest Liability claim paid in at least the last 10 years was in the amount of USD 10 million, with the second largest ever being USD 4 million.⁸ Both cases concerned Liability claims settled in the U.S. Local case awards above USD 1 million are extremely rare.

In 2006, China had only one lawyer per 10,000 citizens, as compared to seven in Hong Kong and 16 in Germany. This results in only a small number of cases actually being brought to court, and even in those cases the judge will generally try to get the parties to agree on a settlement out of court. The cases that do end up being disputed in court tend not to result in large court awards, as there is no precedence for such large court awards. The existing socialist economic principles do not encourage large monetary compensation for wrongdoing.

Claims severity risk

Having said that, the low level of litigation and compensation leaves plenty of “potential” for increases in insurance payouts. The legal framework is being enhanced almost on a monthly basis, as the recent introduction of tort law has shown. Tort law in China is different from

other countries in the way that it is a national law (as compared to provincial or state regulations), and it is still very much regulated, in contrast to other countries where tort law is derived from a long history of case law. While the elements of tort law are generally not new to the legal system, they have now been brought together into one law, leading to a clearer framework. The clear mentioning of punitive damages, pain and suffering, as well as the possibility to sue for environmental damage, are several examples of areas where we might see more activity in coming years. The general consensus in the legal profession is that we will not see an immediate impact on claims, but that a significant upward trend will probably come to the fore several years from now. Once the insurance community has realised this, it will be too late to adjust premiums. It could then take several years for the situation to stabilise, as we have seen in other parts of the world.

Another argument supporting this forecast is the general claims inflation that can be expected. While the overall consumer price inflation figure has so far been kept at a still reasonable 3% in 2010, producer price inflation has been considerably higher.⁹ Average wages in recent years have gone up by some 15% per year,¹⁰ with an even larger increase for the urban population. The quality of goods and medical care is also on the rise, with some hospitals already using state-of-the-art technology. Higher quality also leads to higher cost, and some local underwriters are said to experience medical inflation of over 20%.

Claims frequency risk

Premier Wen Jia Bao once said, “A small issue when multiplied by a population of 1.3 billion becomes a huge issue.” Translating this into the insurance environment, there is definitely the potential for large aggregate claims that are the result of a relatively small claim being made by a huge number of people. Examples could lie in such areas as: medical care (by the end of 2004, 580,000 workers had contracted silicosis in China; this number is growing by an estimated 10,000 every year); Environmental Liability (the toxic spill into a river after a chemical explosion left the city of Harbin without potable water for a week in 2005); or Product Liability (Chinese drywall was installed in

over 100,000 houses in the United States in the aftermath of hurricane Katrina; it later turned out the drywall contains toxic substances, and several major legal battles are underway).

It is actually quite amazing that so far we have not seen any significant insurance losses from such events. One major reason is that Liability insurance is seen as an expensive luxury, and rarely bought by individuals and local companies. Also, the heavy involvement of government authorities keeps cases outside of the media and out of the courts. Class-action suits are also discouraged. A final reason is the absence of a culture that seeks hefty monetary compensation for wrongdoings.

Product recalls

One specific issue that has gathered worldwide media attention is that of product recalls of Chinese goods. One example that affected mostly Chinese households is the melamine scandal, i.e., milk, baby formula and pet food contaminated with the chemical. Local media reported that six children died, and 300,000 others were sickened. While the people affected paid dearly for this scandal, some of them with their life, the authorities did not allow major court cases to demand monetary compensation. This is a direct result of the far-reaching government control and the necessity of maintaining a harmonious society.



Most other examples concern cases outside China, where Chinese products are involved. In addition to the drywall case mentioned above, toys and counterfeit medicines have also been at the center of controversy. The list is long, and 56% of all product recalls in Europe in 2008 concerned products manufactured in China.¹¹ As these are cases handled in non-Chinese courts with non-Chinese defendants, and normally the target is an importer or seller, the cases do not actually have any effect on the local Liability insurance market. But it goes to show that the risk of inferior products “made in China” is certainly not small, and negative health effects from certain locally made goods could appear more often in China as well.

Are we seeing ghosts?

While several risks exist, there are also several “mitigating factors”. For one, when seeing the many recalls of Chinese goods, we have to recognise that China is by far the largest exporter of products that have a higher risk of recall,





such as children’s toys, electrical household appliances and clothing. Therefore, it is not surprising that most of the recalls are for Chinese-manufactured goods. Furthermore, a large part of the attractiveness of Chinese goods lies in their low cost, and low cost often means inferior product quality and fewer checks. That is not to say that China could not produce high-quality products. Many luxury brands produce much of their products in China, only to ship them to Europe, add a few bells and whistles, and complete the package with a “Made in Italy” sticker.

One also has to realise that when we talk about small court awards, and therefore large potential for increase, the awards are not at all that small in a local context. Outside of the major cities, the average annual income is around RMB 18,000 (RMB 1,500 per month). Therefore, a RMB 200,000 award would be more than 10 years of income for an average person. While average wages are increasing by an annual 15% overall, the income disparity is also growing, meaning that average wages outside the major cities are not increasing as much, and subsequently court awards may not increase as much either.

Another factor is that the significant government control isn’t going to go away very soon. There seems to be little opposition against government intervention by the majority of the population, and pressures to change this practice seem to come mostly from outside of China. As the influence of foreign lobbying groups on local policy is weakening, it cannot be expected that things will change drastically in years to come. And nobody is really waiting for U.S. court practices to blow into China. So far, government control has kept court awards very low, so why would that not continue to be the case?

Conclusion

Insurers and reinsurers in China are fully aware of the risk that the low litigation environment will one day trend upward. Yet opinions differ over when such trend would start, and how fast it would go. Frankly speaking, without the experience of similar markets’ behaviour in the past, it is really anyone’s guess as to how this is going to evolve in the near future. Whatever happens, Gen Re will be there to find out.

- ¹ Source: CIRC (China Insurance Regulatory Commission) Yearbook 2009.
- ² Gen Re’s China Liability Survey 2010 shows that local companies’ underwriters expect growth of 28% in the next 12 months.
- ³ Simple loss ratio = paid loss/written premium.
- ⁴ China Liability Survey 2010.
- ⁵ Cf. endnote 1.
- ⁶ Cf. endnote 4.
- ⁷ Ibid.
- ⁸ Ibid.
- ⁹ Source: National Bureau of Statistics in China.
- ¹⁰ Ibid.
- ¹¹ Source: Rapex Notifications, ec.europa.eu/consumers/dyna/rapex/rapex_archives_en.cfm.



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