

## New Regulations Attempt to Alleviate Uncertainty for Foreign Insurance Companies Starting and Operating a Representative Office in China

December 12, 2008

*Circular Regarding the Publication of Interpretations for Certain Issues under the Administrative Measures for Representative Offices of Foreign Insurance Entities by China Insurance Regulatory Commission (the "Interpretations")*

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### **Background Information**

When China agreed to open up its insurance market in accordance with its entry into the WTO in December 2001, at least one barrier to free market entry was allowed. This concession, the so-called "2-3-5" seasoning requirement on foreign insurers seeking to operate or invest in an insurance entity in China, requires that a foreign insurer must satisfy the following requirements prior to opening a branch, entering into a joint venture or creating a wholly-owned subsidiary<sup>1</sup>:

- (1) The foreign insurer must have a representative office in China for at least two years;
- (2) The foreign insurer must have been in continuous operation for over 30 years in a WTO-member jurisdiction; and
- (3) The foreign insurer must have year-end total assets of at least \$5 billion (or equivalent in other currencies) for the year prior to the application.<sup>2</sup>

Many foreign insurers have opened representative offices in China to start the two-year clock running, and later successfully established China operations through branches, joint ventures and/or wholly owned subsidiaries. According to CIRC, more than 100 foreign insurance entities have established 139 representative offices and a total of 43 foreign insurers have established 134 business entities and alliances in China as of the end of 2007.

<sup>1</sup> An alternative to enter the Chinese market is to acquire a less than 25 percent interest in a Chinese insurance company, in which case the insurance company is treated as a domestically funded insurance company. In such case, the 2-3-5 rule does not apply to the foreign investor.

<sup>2</sup> Note that these requirements are imposed by China Insurance Regulatory Commission ("CIRC"), the governmental entity in charge of insurance supervision in China. CIRC requires each applying insurer to meet the requirements of the 2-3-5 rules independently; e.g., assets of a parent or other affiliate of an applicant may not be taken into account in order to satisfy the minimum assets requirement.

The rules currently governing the establishment and operation of a representative office in China (*i.e.*, the *Administrative Measures for Representative Offices of Foreign Insurance Entities*, issued by CIRC on June 12, 2006 and effective on September 1, 2006, hereinafter referred to as the "2006 Rules") have been criticized for creating significant uncertainty in the initial establishment and operations of a representative office.

As in the case with many other Chinese regulations, the 2006 Rules contain certain ambiguous catch-all phrases that effectively give CIRC broad discretion in approving a foreign insurer's application to establish a representative office. For example, when setting forth the conditions (qualifications) to be met by an applicant wishing to set up a representative office in China, the 2006 Rules provide that, in addition to the three expressly laid-out conditions<sup>3</sup>, the applicant must meet other discretionary conditions that CIRC may impose. In addition, with respect to the documents to be submitted in the application package, the 2006 Rules require the foreign insurer to provide, among other specified documents, "other documents CIRC requires [it] to submit."

Ambiguities in the 2006 Rules have also caused uncertainty with regard to the ongoing operation of the representative office. In general, representative offices of foreign insurance companies are prohibited from conducting business operation activities. There is, however, no definition of the term "business operation activities." The ambiguity created by this broad prohibition understandably has put foreign insurance companies on the defensive and many representative offices limit their scope of operations to liaising with the regulator and conducting market research, two types of non-business operation activities expressly mentioned in the 2006 Rules.

### **The Interpretations Attempt to Create More Certainty**

The Interpretations have been issued to attempt to address certain ambiguities under the 2006 Rules. The most significant clarification is the one regarding the types of "discretionary conditions" CIRC may impose when reviewing an application to set up a representative office. The Interpretations provide that the applicant must have year-end total assets exceeding \$2 billion for the year prior to the application. This requirement is designed to preserve CIRC's limited resources by eliminating applications by enterprises that are not likely to be able to meet the \$5 billion threshold even after the representative office has been operational for at least two years. Despite such an attempt to introduce an objective standard (hence more certainty), the Interpretations still give CIRC significant discretionary power. For example, an applicant must, among other things, demonstrate: (1) the "necessity and feasibility" of setting up the representative office; (2) that the pro-

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<sup>3</sup> These three conditions are: (1) the applicant must be in sound operational condition; (2) it must have 20 years of operational history (if engaging in the insurance business) or 20 years of existence (if not engaging in the insurance business); and (3) it must have no record of material violation of law or regulations for the three years prior to the application.

This memorandum is intended only as a general discussion of these issues. It is not considered to be legal advice. We would be pleased to provide additional details or advice about specific situations. For additional information on this important topic, please feel free to call upon your Dewey & LeBoeuf relationship partner.

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posed chief representative has a good knowledge of the insurance business and relevant laws and regulations regarding the operation of the representative office, the determination of which will be appraised by CIRC; (3) that the applicant's home jurisdiction has stable political and economic conditions, as well as a comprehensive and effective financial regulatory system; and (4) that the applicant and its affiliates have a sound corporate governance structure and an effective internal control system, operate in compliance (with relevant laws) and have "steady" growth.

CIRC also attempted to clarify its position regarding the prohibition of "business operation activities" by the representative office. In the Interpretations, CIRC stresses that whether or not the representative office makes a gain/profit is immaterial when assessing this issue. This takes away a common defense made by certain representative offices of foreign insurers when confronted by CIRC with allegations that a representative office had engaged in prohibited activities. In such cases the representative office would frequently argue that because it made no profit, the office was not engaged in business activities. It further explains that any direct or indirect engagement or participation in business operation activities, including providing any sort of assistance to facilitate others' engagement or participation in business operation activities, is prohibited. CIRC's position regarding operational compliance now appears to leave even less room for a representative office to operate than before. By stating that any sort of "indirect" assistance may be found to constitute prohibited activities, CIRC may have narrowed the scope of activities that were previously permitted by the 2006 Rules prior to release of the Interpretations.

### **Concluding Remarks**

To the extent that the Interpretations fill in certain gaps and clarify certain ambiguities in the prior regulations, or codify certain preferred practice developed in the past two years, they help both prospective applicants and foreign insurance entities with existing representative offices to better navigate through the often hazy regulatory environment in China. However, a key question that has troubled many, if not all, representative offices in the past (*i.e.*, what constitutes prohibited business operation activity), still has not been clearly answered. With the Interpretations purporting to cover even "indirect assistance," more confusion is likely to arise in practice and could result in raising the barrier of entry for foreign insurers contemplating establishing operations in China. Further guidelines and precedents will need to be developed to create greater clarity.

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