

Amended Insurance Law of the People's Republic of China

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Background Information

The Insurance Law of the People's Republic of China ("Insurance Law") was amended for the second time by the National People's Congress on February 28, 2009, and will become effective on October 1, 2009.¹

The Insurance Law was first promulgated on June 30, 1995, and was first amended on October 28, 2002 partly in response to China's accession into the World Trade Organization ("WTO") in 2001. The Insurance Law borrowed rather heavily from the English and German insurance laws at the time, and has generally come to be viewed as inadequate to address the current challenges posed by the fast-growing domestic insurance market. For example, there are more types of market participants and innovative products in the Chinese insurance market than what have been expressly provided for by the Insurance Law, thanks in part to the opening up of the domestic insurance market and the active participation of international players. The recent global trend to move toward a risk-based capital regime has also prompted the insurance regulator, the China Insurance Regulatory Commission ("CIRC"), to adopt a series of regulations aiming to improve its supervision over insurance companies' corporate governance and risk/solvency management practice, but due to lack of clear authority from the Insurance Law, many of the regulations had to take the form of provisional or trial measures, and may potentially be subject to challenge as being inconsistent/in conflict with the published law. Recent developments in other areas of laws, such as the Company Law, the Securities Law and the Enterprise Bankruptcy Law, also necessitated technical amendments to the Insurance Law to remove conflicts and to clarify ambiguities.

The Amended Insurance Law

The amended Insurance Law seeks to (i) grant CIRC more power and authority to follow international best practice and assert effective

¹This *Client Alert* does not constitute any opinion or determination on, or certification in respect of, the application of laws of the People's Republic of China (the "PRC").

supervision over the insurance industry; (ii) give insurance companies more latitude in offering services and making investments, but also provide for a more risk-based supervision scheme to improve their competitiveness and ensure the healthy growth of the market; and (iii) offer more protections to the insured through amending provisions relating to the insurance contract.

I. Empowering CIRC and Strengthening Governance

The most substantive change comes in the form of empowering CIRC to adopt a regulatory scheme more focused on the risk management of insurance companies. To this end, CIRC has issued various regulations to adopt a risk-based capital supervision scheme in practice (the so-called “categorized supervision scheme,” which is similar to the “supervisory ladder” concept of proportionate supervision underpinning the Solvency II Framework Directive²) and the amended Insurance Law formally codifies this practice (but on a more general level, leaving detailed implementation to the CIRC).

We highlight the key changes below:

- Solvency: The solvency standard has been amended to reflect the risk-based capital approach CIRC adopted last year (i.e., the outdated concepts of “actual asset/liabilities” have been replaced with the new concepts of “recognized asset/liabilities”). A new article 139 is inserted to allow CIRC to take various measures against an insurance company failing to meet the solvency requirement, such as requiring an increase in capital or ceding the risks through reinsurance, limiting business scope and dividend payment, or prohibiting the company from accepting new business. Severe solvency problems are also a basis for CIRC to take over the management of the insurance company under the new article 145. By comparison, the previous version only expressly authorized CIRC to take over the management of an insurance company whose non-compliance would potentially materially affect or has already materially affected its solvency, but was silent on the authority of CIRC to take other measures to prevent an insurance company from slipping into insolvency.

² The European Union (EU)’s ambitious proposal to modernize insurance and reinsurance supervision across the EU.

- Corporate governance: There are “new” requirements³ on insurance companies to establish more comprehensive internal controls (such as the requirements to report and disclose affiliated transactions), compliance, operational and risk management systems, and to provide CIRC with solvency reports, financial accounting reports, compliance reports and actuarial reports on a regular basis. CIRC is also given the authority to take certain actions against directors, supervisors, senior management and even shareholders of an insurance company (such as limiting executive pay, limiting dividend payment, applying to the courts to limit the transfer or disposal of such persons’ assets, and working with other government agencies to restrict a person from leaving the country) where their actions have brought harm or severe risks to the insurance company.

- Market conduct: In response to newly emerged problems that are plaguing the insurance market, such as misappropriation of premiums, entrusting an unlicensed person to sell insurance products or disparaging competitors by fabricating or spreading false rumors/information, CIRC is also given broader power to prescribe regulations to address such problems and take appropriate regulatory actions. The amended Insurance Law also imposes more obligations on insurance companies to manage their agents, such as keeping a good record of registration of sales agents and setting up a training program for agents.

- Screening investors: The amended Insurance Law also raises the bar for investing in an insurance company. In addition to the usual shareholder qualifications such as having a good reputation and a clean record of no material violation of laws and regulations, a major shareholder is also required to have net assets of not less than RMB200 million (about USD29 million). However, the amended Insurance Law does not define what constitutes a “major shareholder”; and it is expected that subsequent CIRC regulations will clarify this

³ These are new requirements to the extent that they do not appear in the previous version of the Insurance Law. However, after China overhauled its Company Law and Securities Law in 2005, CIRC has gradually introduced a set of regulations to improve the corporate governance of insurance companies (such as a series of provisional/trial regulations on internal audit, independent director and affiliated transactions in 2007, guidelines on articles of association of an insurance company and on operation of the board in 2008), and it has also followed international best practice to require insurance companies to set up actuarial and compliance systems (such as the regulations on chief actuary and guidelines on compliance system in 2007, and rules standardizing insurance data in 2008) as part of the effort to move toward a risk-based capital regulatory regime.

concept. In addition, the amended Insurance Law provides that a change in 5 percent or more in shareholdings in a stock insurance company is subject to CIRC approval, whereas under the previous version the threshold was 10 percent. This could make more deals subject to CIRC approval.

II. Giving More Latitude to Insurers

Overall, the amended Insurance Law gives more room for insurance companies to provide insurance and related services and engage in product innovation. However, consistent with the shift of regulatory emphasis towards risk management, more requirements are imposed on insurance companies to establish a good corporate governance structure and a sound risk management system (see relevant discussions in the preceding section). The key changes are summarized below:

- Business scope: A new clause is added to allow insurance companies to engage in any *insurance-related* business as approved by the insurance regulator. This paves the way for insurance companies to offer insurance-related support/outsourcing services in more complicated transactions (e.g., providing consulting, adjustment or policy administration services to others, or playing a more active role in pilot projects that are encouraged by the government to reform the healthcare systems in rural areas).
- Consumer credit insurance and other guaranty insurance: The business scope of a property and casualty insurance company is expanded to include “guaranty insurance,” in recognition of the emergence in the last few years of many new repayment guaranty insurance products, such as mortgage repayment insurance and auto-loan repayment insurance, during the boom in the housing and car sales markets in China. In theory, a property and casualty insurance company could start offering financial guaranty cover for bond repayment obligations (similar to financial guaranties offered by monoline insurers in the US) now that it is authorized to offer guaranty insurance. However, under the current regulatory regime in China, the bond markets are primarily regulated by such regulators as the People’s Bank of China (the inter-bank bond market regulator), China Securities Regulatory Commission (the securities market regulator, “CSRC”), and China Banking Regulatory Commission (the banking regulator), and these regulators will need to work together with CIRC to determine whether a financial guaranty provided in conjunction with a bond issuance is better structured as a financial guaranty offered by a credit institution

(such as a bank or a new type of financial guaranty company created for this purpose) or as an insurance product offered by insurance companies.

- Asset management: The amended Insurance Law enables insurance companies to set up asset management companies, subject to approval of CIRC and CSRC. Major Chinese insurers have been allowed to set up insurance asset management companies under provisional rules, but there was debate as to how to best regulate these companies. The amended Insurance Law makes it clear that such entities are mainly regulated by CIRC, but their securities investment activities are required to comply with the Securities Law (thus subject to CSRC regulations).
- Investment channels: Insurance companies are now allowed to invest in securities such as bonds, stocks and fund units, as well as real/immovable property. By comparison, the previous version of the Insurance Law only referred to two types of securities (government bonds and financial bonds) as permitted investments for insurance companies. In practice, CIRC had issued provisional rules to allow direct investment in the domestic stock markets and in offshore financial markets (through a qualified domestic institutional investor (QDII) scheme) in 2004 (the latter regime was overhauled in 2007), but had not given its nod to direct investment in real/immovable property. Even under the amended Insurance Law, however, insurers still have to wait for CIRC to issue detailed rules (such as investment ratio, risk management guidelines, etc.) before they can start investing in real/immovable property.
- Reinsurance: Previous provisions requiring insurance companies to prefer domestic retention and authorizing CIRC to limit or prohibit cross-border reinsurance arrangements have been deleted. Under the amended Insurance Law, an insurance company is required to comply with CIRC regulations and select a reinsurer on a prudent basis. As existing CIRC regulations still prescribe requirements in favor of domestic retention and contain stringent requirements for selecting an offshore reinsurer, the immediate impact of the amended Insurance Law on cross-border reinsurance arrangements is still far from clear.
- New forms of insurance provider: The previous version of the Insurance Law provided for only two forms of insurance company – state-owned and joint stock companies, although foreign invested insurance companies could take the form of a limited liability

company under relevant foreign investment laws. The amended Insurance Law does not prescribe any specific form(s) for an insurance company or entity, provided that they comply with laws and administrative regulations of China. Despite a lack of specific provision in the amended Insurance Law, with proper authorization from the State Council (the highest executive branch of the Chinese government, which issues administrative regulations), new forms of insurance companies or entities such as mutual insurers and Lloyd's (which was required to set up a subsidiary company in China under existing law) may be allowed to conduct insurance business in China.

III. Protecting the Insured and Increasing Responsibility of Insurers

The amended Insurance Law also contains extensive amendments dealing with insurance contract interpretation issues, many of which are based on previous regulations and clarifications given by CIRC in the past few years based on market and international practices. As such, these changes should not come as a “surprise” to insurers (both domestic and foreign funded ones) in China, although we expect that many insurers may have to fine-tune or amend their existing policies and practices to comply with the new requirements. We list below a few of the key amendments:

- Clarification of “insurable interest”: The previous version of the Insurance Law merely provided that an insurance applicant shall have an insurable interest in the subject matter of insurance. The amended Insurance Law clarifies that in a life insurance contract, the insurance applicant shall have an insurable interest in the insured at the time of applying for coverage, and in a property/casualty insurance contract, the insured shall have an insurable interest in the subject matter at the time when an insured event occurs. In addition, an employment relationship is now recognized as an insurable interest where an employer procures insurance coverage for its employees, provided that the beneficiaries are the employee or his/her close relatives.
- Limitation on the insurer’s right to terminate a contract: As a general rule, once the parties enter into an insurance contract, the insurer may only terminate the contract on limited grounds (e.g., a material misrepresentation by the insurance applicant). Under the amended Insurance Law, even if there is a legal basis for the insurer to terminate a contract, its rights will be extinguished if it does not exercise its right within 30 days upon learning of the facts giving rise to the exercise of such rights. Moreover, if the contract has been in

force for more than two years (therefore more likely to be a life insurance contract), the insurer may not terminate the contract. In addition, the doctrine of “estoppel” found in common law jurisdictions is also “imported” to prevent an insurer from terminating the contract if it had actual knowledge of the insurance applicant’s misrepresentation at the time of entering into the contract.

- Standard form contract provided by the insurer: If the parties are using the standard form contract provided by the insurer, any provision that (1) exempts the insurer from its legal obligations or increases the responsibilities of the insurance applicant and the insured, or (2) excludes legal rights of the insurance applicant, the insured or the beneficiary, is void. The insurer is also required to provide sufficient notice and explanation (written or oral) regarding any liability exemption/exclusion clauses.⁴
- More insured-friendly claims procedures: Once a claim is filed, an insurer is allowed only one opportunity to seek further information regarding or related to the claim from the insurance applicant (e.g., an employer relating to employer provided insurance for its employees), insured or beneficiary (as the case may be), in a timely manner, if it requires more proof or supporting material regarding the claim. In other words, it may not delay the claims process by repeatedly asking for supplemental information. The insurer is also required to verify the claim in a timely fashion (even for complicated matters a 30-day default rule is to be applied⁵), and, if it intends to deny the claim, the insurer must notify the claimant of its decision within three days after the completion of the verification. If an insurer fails to comply with these requirements, it will be required to pay the claim in full and to indemnify the insured or the beneficiary (as the case may be) of any loss he or she suffers as a result of the insurer’s failure to comply with these requirements.

The Road Ahead

In the next few months, we expect to see relatively extensive changes in the insurance regulatory framework as CIRC revises its regulations to comply with, support and implement the amended Insurance Law

⁴ As a matter of contract law, the written or oral explanation is meant to clarify, but cannot contradict or override, the express meaning of the relevant contract provision.

⁵ The parties may mutually agree to a period of more than 30 days in the contract if, and only if, complicated matters are involved.

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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(although in many instances, the fundamentals of existing regulations will not likely change because the amended Insurance Law merely codifies what CIRC has already put in place on a provisional or trial basis for some time).

On balance, we believe that the amended Insurance Law will eventually create a stronger business environment for large domestic Chinese and international insurance companies as systemic risk will be better managed and weaker companies will not be able to artificially undercut pricing over the medium to long-term. Companies who have not already adopted international best practices will need to accept a higher cost base as a result of newly adopted laws and regulations such as the new capital adequacy rules and compliance reporting requirements.

If you have any questions regarding this note or on any Asia insurance related matters please contact any of the following people in the Asia Insurance Practice Group: Paul Chen (Hong Kong) at +852 3697 7008, Heng Loong Cheong (Hong Kong) at +852 3697 7019, Bill Marcoux (London) at +44 20 7459 5001, Hugh McCormick (New York) at +1 212 259 8219, and Ingrid Zhu-Clark (Beijing) at + 86 10 6583 9688.

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