



China is portrayed by many as the world's economic powerhouse but what are the risks inherent in this picture of exceptional growth? Can the momentum be maintained and what risks, if any, does China pose to the world economy and foreign traders and investors?

While foreign companies are rarely exposed to terrorism, war or sovereign risk in China, the spectre of strikes, riots and civil commotion is beginning to cast a long shadow. In the longer term China's population will not be the engine of growth

that it is now, because the country's fast-rising proportion of elderly people may eventually drag down the economy – with each individual worker effectively supporting two parents in their old age. One of the ensuing challenges will be maintaining a non-democratic political system in conjunction with a capitalist society.

Looming much larger than exposures traditionally associated with the insurance industry, however, are the broader business perils characteristic of enterprise-wide risk management. These include business interruption risk, supply chain vulnerability and the proliferation of legal and regulatory actions that are inconsistent because the relations between the central and local authorities are ill-defined.

Pervasive perils

“Ultimately any risk is a business risk and in China the key risk, apart from intellectual property, is business interruption since that impacts the P&L directly,” says Peter Hacker, Head of Communications & Technology at Jardine Lloyd Thompson. Hacker advises risk managers and treasurers to focus on value creation and not the identification of narrowly defined traditional sources of loss. Traditional business interruption insurance cover typically protects a company against loss of profits or fixed charges. “But by focusing on value creation, companies should worry

Focus on China

Optimising business opportunities in China means effectively navigating a whole host of additional risks, market nuances and complexities.

By Elizabeth Fry

more about avoiding cash flow and revenue reduction problems, covering any increased cost of working and smoothing out any kind of failure to comply with a component supplier or a customer,” he says.

Increasingly service-related companies are moving to China to join the more established production-based firms, and the main issue for them is increased variable costs. “Failure to service results in revenue and reputation loss,” says Hacker.

China is generally competing on price, rather than quality, safety or the integrity of the supply chain. Business continuity is, in essence, all about supply chain resilience, and this should be a high priority for multinationals dependent on China for materials or components.

It is important to consider the potential revenue loss caused by project delay, says Chris Rigby Smith, Head of Business Continuity at Jardine Lloyd Thompson. “Advance profits insurance can be arranged as an extension to an existing business interruption insurance programme or as a separate policy included with construction insurance cover.”

Protecting intangible assets is especially tough in China. The absence of viable intellectual property rights protection and an enforcement system is a huge challenge. “Fortune 500 companies are not particularly concerned in China about patent invalidity because the value would have likely been depreciated over the years,” says Hacker. “For smaller companies at an earlier stage of development though, patent invalidity is much more serious.

“The wrong-doer can insure against damages incurred in a claim, or legal expenses,” according to Hacker. “Or launch a pre-emptive action and agree royalty payments over a certain amount of time to prevent an injunction which would stop the service. If someone has infringed your patent in China,” he concludes, “enforcement cost cover is unlikely to succeed.”

While the Central Government has begun to address the problem, its resolution remains some way off; it is working hard to improve the legal environment in other sectors.

Stable local insurance market

Although the banking and broader capital markets are immature, the country’s insurance industry regulator is moving swiftly to develop the sector by protecting the rights and interests of the insured and the beneficiary.

China’s Rmb2.6 trillion insurance market is maturing so rapidly that global risk

managers are opting for stand-alone China programmes rather than arranging for fronting policies to be issued for master-controlled global programmes, which are themselves subject to reinsurance restrictions in China.

In China, offshore insurance cover is largely illegal, so it is necessary to issue a local insurance policy to satisfy legal requirements. According to Alex Yip, Head of Jardine Lloyd Thompson’s Guangzhou-based China office, while most global risk managers still choose to duplicate, or support, the global policy by buying locally issued paper to meet regulatory requirements, others are under pressure to re-examine the stand-alone China programmes from local insurers.

Price competition has a lot to do with this trend as these policies can cost substantially less than policies purchased by

the locally-licensed foreign insurers. Price, of course, is just one part of the equation. It is no bargain to pay lower premiums for lower-quality coverage.

China’s insurance market is dominated by three very large Chinese insurers – the Hong-Kong listed PICC Property & Casualty, Ping An Insurance, and the soon-to-be-listed China Pacific. Together, these established players have a stranglehold on traditional lines in China.

The positive news, according to Yip, is that the big Chinese insurers are financially sound. The trouble is they are not yet rated by Standard & Poor’s. As such, many foreign corporates are forced to deal with locally-licensed foreign insurers.

There has been a significant increase in foreign company presence in the sector. Their competitiveness though is hampered by regulations that require that they be licensed on a city-by-city basis. Thus, most operate only in Shanghai, Shenzhen, Guangzhou and Beijing.

Locally-issued policies can cost substantially less than those purchased by the locally-licensed foreign insurers.”

Improving local coverage

According to Yip, Chinese insurers can now write every type of cover. While the coverage might not be as comprehensive as the global policy in some cases, the contrast between global and Chinese insurance products is not as marked as it was only a few years ago.

The Chinese market is now focusing on the provision of more innovative services, according to Yip. Multinationals want them to introduce specialist lines and local >>>>

RAPIDLY EVOLVING REGULATIONS

The rapid development of the Chinese economy over the past ten years has required new legislation on practically everything. This includes insurance, reinsurance and broking.

The central government appears deeply committed to institutionalising the political and legal systems and a body of business law is rapidly being developed. But while China’s legal and political systems are no longer based on the traditional concept of ‘rule by man’, the progression to ‘rule of law’ has not yet happened.

While the Government

has promised harsher enforcement of rules to safeguard the stability of the insurance market, regulatory consistency is patchy and political interference with the courts means there are few safety nets.

The efficiency of the Government continues to be hindered by a large, ineffective bureaucracy where the relations between the central and municipal authorities are blurred.

Although a move to a well-regulated market is welcome, for John Cheung, Group Financial Controller of San Miguel Brewery, the speed with which

regulations are changing, coupled with the different interpretations of the rules by the various municipalities is a nightmare.

“Each province has its own interpretation of the law and policy regulations,” he says. “For a multinational like us, understanding each of the regulations, tax, customs and local risk management requirements has been very challenging. To standardise and consolidate the various regional policies into one policy which we can eventually link into our global programme has been extremely difficult.”

»»» insurers are starting to get some major reinsurers to support them. “You have specialty players setting up all over China and in the next few years the Chinese market will compete with the foreign companies,” he believes.

So as they move into China, risk managers are finding that the model that has worked so well for them in the past is being challenged. Many ensure the stand-alone programme is protected by using their master policy to fill coverage gaps and provide for differences in conditions and additional limits that cannot be obtained in the local admitted policies.

Also they are encouraged by the enormous capacity local insurers have for the standard lines of business in China. Global industry reinsurance heavyweights like Munich Re, Swiss Re and China Re are committed to supporting the development of China’s insurance industry.

Where there is insufficient capacity available in the global reinsurance market due to claims, premium rates, terms and conditions, some Chinese markets have started to participate in those global multinational programmes. “It’s not common but some Chinese insurers are underwriting a small portion of global programmes and gaining experience,” says Yip.

The purchase of a stand-alone China programme is often dictated by how much control the global corporate has over its China operations. China-domiciled joint venture partners often insist on insuring with domestic insurers.

The choice to buy cover in China from a local insurer should be based on a thorough analysis of the company’s needs and the insurance markets available to meet them, says Rory MacLeay, Partner responsible for JLT Network™. “Looking at the entire cost of risk, rather than just insurance premiums and the claims assessment process, is essential,” he explains.

Despite the interest in stand-alone China policies, MacLeay is not yet seeing the sophisticated buyers go for Chinese products. “Risk managers properly focused on due diligence and the insurance buying process would not be relying on cost advantages,” he says.

Unproven claims track record

Companies should be aware of China’s track record when it comes to making claims. “China suffers around five typhoons each year along its southern and eastern coasts, as well as floods, earthquakes, droughts, tsunamis and land subsidence,” warns



Gansu province

Risk managers will focus on value creation in their companies – not the identification of narrowly defined traditional loss.”

MacLeay. “Yet, there have been no major insured catastrophes and no large claims so how can you be sure that the Chinese reinsurance market is robust?” He notes too that full reinsurance is not always available under Chinese policies which means, in essence, some risk remains in China.

According to MacLeay, local policy due diligence is extremely important whether it is purchased through a foreign licensed insurer or a local insurer. “You need to ensure the local insurance coverage is watertight with a recognised insurer and that your master programme offshore protects your interests.”

One area of worry is dispute resolution. Yet according to Yip, who has worked in China for 17 years, claims are generally being paid. He has yet to see a dispute where a claimant is rejected out of hand. “You might come across inexperienced people and there might be some debate,” he says, “but whether you are insured by a local or foreign licensed insurer, you still have to go through the same legal system.”

It is rare that a business interruption claim is not contentious, however – whether

it is in China, the United States or the United Kingdom. “They’re very difficult claims to settle because you’re always trying to predict future performance had the business continued to operate,” says Rigby Smith.

Conclusion

The risk of doing business in China is high. A slowdown in demand, a depreciating renminbi, war, avian flu epidemic, social uprising, regulatory upheaval, shortage of skilled workers and an infrastructure that lags economic growth – are all pretty complicated issues.

Yet the solution is uncomplicated enough. Understand what the risks are and have a clear strategy for managing those risks prior to entering any kind of agreement.

The product recall fiasco faced by Mattel, which had hitherto been considered something of a model of outsourcing, characterises the need for a robust risk management system. In recent months the US manufacturer, which makes more than two-thirds of its toys in China, announced a series of recalls of over 20 million products due to both design flaws and allegedly hazardous levels of lead in the paint. Despite blaming outside contractors in a testimony to US Congress, Mattel was then forced into a humiliating apology in Beijing, “to the Chinese people and all of our customers” – causing massive reputational damage. **RS**

i Rory_MacLeay@jltgroup.com

Elizabeth Fry is Editor of *Australia China Connections*, and a regular contributor to *CFO magazine* and the international business press.

China's risk rating

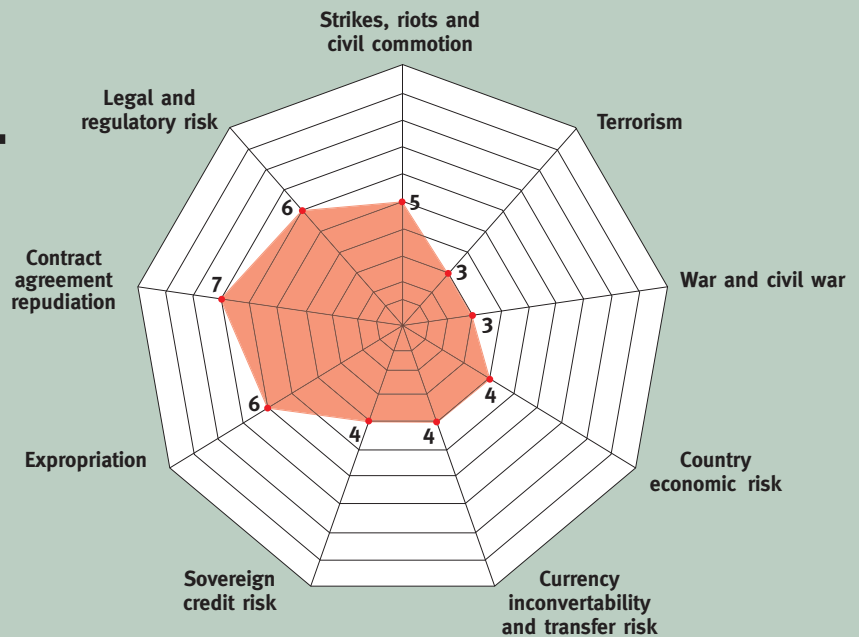
Analysis from Jardine Lloyd Thompson's World Risk Review™ reveals contractual agreement repudiation to be the single biggest threat to foreign companies in China, giving it a risk rating of 7. "You can sign a contract with a regional authority, the validity of which may later be challenged by central government if not consistent with central dictates," says Dr Elizabeth Stephens, Political Risk Analyst at Jardine Lloyd Thompson, "and you might subsequently find the enforceability of your contract in dispute at a critical stage and in an environment where depending upon the judicial process to fairly resolve disputes is not a comfortable position to be in." A step short of expropriation, the repudiating of all or part of the obligations under contracts, has occurred regularly in South America, Russia and in parts of Central Asia.

Legal and regulatory risk is rated 6 as the interpretation of laws and regulations can be highly subjective in China and as such the risk remains high.

Strikes and riots are likely to intensify and will become a more immediate danger to the interests of foreign investors. Currently rated 5 on the World Risk Review™ watch-list, Stephens believes that the rating may rise fuelled by rural-urban income disparity, urban unemployment, land seizures by local Party officials and widespread concerns about corruption. Currently managed by the authorities, the level of strike activity is definitely increasing – even the official figures for 2006 showed a higher incidence of unofficial stoppages and protests than ever before.

As a developing country, China's sovereign credit risk is rated 4 despite very strong reserves.

An overheating economy may lead to a bubble-burst in property and the stock market. Broader issues of income disparity and wealth redistribution are also factors which Stephens says puts China's country economic risk on a rating of 4. In the short term, inflationary pressure and an underdeveloped currency may affect economic performance. In the long term, China's most significant economic, and ultimately political, issue will be the ageing



World Risk Review™ ratings for China

population caused by the one child policy.

Currency inconvertibility and transfer risk are also rated 4. There are very tight controls on currency remittance inward and outward of China and thus there is always a risk. However China is a major international trading nation and as it is increasingly integrated into the world economy the incentive for the Government to use currency transfers as an economic or political tool should diminish.

Terrorism is rated 3. There is only one state level terrorist organisation operating in China, the East Turkistan movement, which targets the military. Small explosions using

homemade incendiary devices do occur but these are isolated incidents that do not impact on western investors.

The risk from Islamic terrorism is minimal as China has remained outside the US war on terror. The risk of war is low across most of China and is slightly higher in Tibet and Xinjiang. The risk of war between the mainland and Taiwan remains and may be perceived to intensify due to the nationalist rhetoric from Taiwanese politicians in the build-up to the general elections in January 2008. Both sides will try to avoid an escalation of the conflict in view of the US security guarantees to Taiwan.

World Risk Review™

The World Risk Review™ provides short- to medium-term assessments of the level of risk associated with a range of political and economic perils that may impact upon business.

The risk review rates nine perils in 197 countries, captured under the broad categories of political violence, the trading environment and the investment environment.

The model is designed to enable companies to

effectively identify the perils that may impact on their business and deliver an understanding of the relative level of risk associated with each peril using a rating scale of 1 (low) to 10 (high).

The model incorporates independently verifiable data from 53 international sources, drawn from Europe, North America, Australia, Asia and the Middle East. The diversity and breadth of the data sources is intended

to reduce, to the greatest extent possible, cultural bias, political influence and personal interpretation.

This approach contributes significantly to the robustness and integrity of the model and recognises that most country risk ratings available to business have traditionally been heavily influenced by western bias reflecting the historical dominance of western foreign investors and trading businesses.

For more details and to register for this free service go to www.jltgroup.com/worldriskreview