The Enlightenment to the Chinese Insurance Business

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Abstract: - Since the American sub-debt crisis has erupted, has caused US's entity economy and even the whole world capital market fluctuation, Its influence effect does not allow to look down upon. The American International Group (AIG) takes the world insurance and the financial service leader, also has paid the huge price. Regarding China, the immediate influence which the crisis brings is limited The insurance business as the financial service industry's important composition department, This article thought that has the necessity to study it to our country insurance business enlightenment.

Key-Words: Sub-debt crisis, American Group International, Chinese insurance business, CDS, CDOs, Financial supervision

1 Introduction

With the deteriorating of the U.S. sub-debt crisis, the world’s top finance and insurance group, American International Group (AIG) , which has up to 89 years of operating history and more than 1,000 billion dollars of total assets, is on the verge of bankruptcy. By the end of June this year, AIG has loss 25 billion dollars in the Credit Default Swaps (CDS) business and 15 billion dollars in other business. By Sept.30, AIG has used the 61 billion dollars of the transition bandwidth 85 billion promised by the Federal Reserve. On Oct. 8, the Fed announced another injection of 37.8 billion dollars. On Sept. 16, the Federal Reserve provide a 85 billion emergence loan to AIG though the NY Federal Reserve Bank, and hence the U.S. government will effectively get a 79.9% equity stake in the insurer in the form of warrants called equity participation notes. In other words, the U.S. government has seized control of AIG. Since the main victims of the sub-loan crisis are investment banks, AIG is the only bust insurance company. Why does it happen?

2 Analysis of the Loss of AIG in the Sub-Debt crisis

2.1 From the point of Micro-Analysis
Participants in the market have paved the way for the crisis. The borrowers’ loan-to-super-act stimulates the mortgage market supply. Concerning more profits, banks and credit companies relax the credit rating review on borrowers and reduce the amount of down payment radio. These acts result in the increase credit risk of low-income borrowers. In the term of mortgage securitization, investment banks use lower sub bonds to support the asset quality to meet demand of high-yield customers. Moreover, investors overestimated the quality of the assets of sub bonds and put too much of them in their portfolio.

2.2 From the Point of Macro-Analysis
The low interest rates and relaxed lending standards in U.S lead a constantly increase in the sub bond issuance. However, many borrowers –especially those low-income borrowers, made their decision recklessly. The economic bubble doesn’t show up when the real estate market is booming. However, since the Federal Reserve has risen the interest rates 17 times in a row (from 1% to 5.25%), the costs are too huge for the borrowers to bear. Besides, such situation is unexpected by the investment banks.

2.3 From the Point of the Management of AIG
Firstly, AIGFP, a subsidiary of AIG, surfaced the major lost in the financial crisis. AIGFP possesses an unduly autonomy. AIG has relaxed the management of AIGFP since 2005.
Secondly, the monitoring mechanism in AGI didn’t play its role. After the accounting crisis in 2005, AIG established two committees (Complex Structured Finance Transaction Committee and Transaction Review Committee) to estimate its transaction. Although Bernard Connolly, a global strategist who works for AIG warned the danger of CDOs and CDS the two committees didn’t pay adequate attention. In addition, AIG has unacceptable flaws in the valuation of CDS. PricewaterhouseCoopers, AIG’s external accountant believed that AIG used Market-to-Market to value the CDS business, which inflated the value of CDS. Contracts in AIG’s CDS contained various credit levels, those contracts may devalue rapidly when the U.S economy drops. If value those assets through the opening market, the valuation could hardly catch up with the devaluation. Indeed, AIG’s profits will be over-estimated and thus affect the fairness of the financial report.

3 Lessons for Chinese Insurance Industry
As the capital markets and banking open late, the influence of Sub-debt crisis on China’s insurance market is extremely limited. However, through careful analysis of the crisis on the U.S. insurance industry and the government, regulators response, China can still have a very useful inspiration.

3.1 Always Adhere to the Principle of Insurance Investment Security
The principle of security is the necessary condition to achieve the full amount of insurance funds, for returning reliable and the guarantee of payment, which is decided by the nature of the insurance funds. The majority of countries conduct more stringent supervision over the investment activities of the insurance companies. For example, to set the specific investment ratio of specific capital, to make higher requirements of high-risk investments, and so on. The security of return is the prerequisite for the usage of Insurance funds otherwise they will affect the insurance function of the realization of economic compensation, thus affecting the stability of insurance companies operating as well as social stability. Therefore, in the insurance investment management, to ensure the safety of the funds are often placed on the first of many factors.

Since we are increasing channels to expand the use of insurance funds in China, security is the first principle when the insurance companies develop their own investment strategy so that they can control investment risks.

It is the only way to guarantee sustainable and smooth development of the insurance investment activities.

3.2 To Broaden the Field of Insurance Business
To promote the insurance industry and capital market integration and make Insurance funds to operate efficiently is an inevitable choice for the development of China’s insurance industry’s innovation. Learn from the experience of the Western insurance business, combined with China’s realities, with improvement the solvency as the core, ensuring the efficiency of the use of insurance funds as the target, risk-management techniques as a means, the operation and administration of the funds which is made according to the structure and characteristics of the Insurance capital and under help to form a virtuous circle of operation and promote sustainable and innovative development, is a major strategic choice in the new period of the development of Chinese insurance industry.

There is no bond insurance in China yet, however, there are a lot of business such as liability insurance, agricultural insurance, banking insurance which are all of new business areas. The regulatory bodies must address these new business developments of the special nature of the special regulatory rules, track and analysis of new business market and take the appropriate adjustment measures to solve them in time. Only in this way, small problems will not be accumulated to form the system risk, the insurance market be able to develop healthily.

It is true that new financial products’ appearance can increase the operating efficiency of financial markets. But financial
innovation is a double-edged sword. In the process of innovation we can not ignore the financial security, it is necessary to grasp the balance between safety and efficiency. If not handled properly, the financial instruments for prevention of financial risks are also likely to bring new financial risks. During the innovation in the insurance business, we should consider not only its own products and systems for insurance risk, but also take into account that its real economy may be risk factors. If we only pursue of innovation and efficiency and ignore the safety, in the event of a crisis, not only reduce the efficiency of financial innovation, but also may have hurt the economic entities and effect the efficiency of economic operation.

The sub-debt crisis show that, today, financial markets globalize increasingly, financial innovations have become increasingly popular, financial products are increasingly complex. Traditional financial-market has been to play down the boundaries between, cross-market financial products become increasingly common. The financial institution and the number of which innovative products related have been increased.

3.3 About the Establishment of a Deposit Insurance System in China

The so-called deposit insurance system means that for the absorption of funds from the public to engage in the business of financial institutions to establish an insurance agency, the members of the financial institutions pay premiums to insurance agencies, financial institutions, members of the payments crisis or facing bankruptcy to operate, the insurance institutions by protection of the deposit accounts of principal and interest payments to give all or part of the security system. In the sub-debt crisis in the U.S, traditional deposit insurance system has played a limited role.

In our country we have been operating implicit deposit insurance system; it is unrealistic to introduce a deposit insurance system immediately. The deposit insurance system in the banking system is the last line of firewalls, from the current situation of the affected financial institutions, our country did not hurry to introduce this system, we can learn from the experience of the crisis, to improve the system more rational.

Now the world economy is in a financial panic, China's economy is entering a downward track, big ups and downs in the stock market, real estate is full of stormy uncertainties of the current rush the introduction of a deposit insurance system, it may be counter-productive. If you have to be introduced, at least a few years of grace period to allow banks and depositors of the system to have a step-by-step process of digestion and adapt in order to give better play to the functions of a deposit insurance system to safeguard the security of the financial system.

3.4 To Establish a Flexible, Comprehensive Coverage of the Monitoring System

The fact of the U.S. loan crisis in the bond insurance market, shows that the capital market in the chain of financial institutions have close ties, the market is not omnipotent, supervision is particularly important. To achieve seamless monitoring is extremely difficult. To this end, the regulator should not have been as much as possible to improve the current regulatory system should also pay attention to "monitor the border" to make it more flexible and more comprehensive.

Shang Fulin, chairman of the SFC pointed out that the financial system, financial security can not be ignored forever. The financial supervision should be adjusted and optimized according to the development of the market. Modern financial system, the regulatory function and supervision in advance should be strengthened. To enhance the uniformity of international regulatory standards is also needed. Different regulatory standards will lead to regulatory arbitrage market emerged. China's banking, insurance, securities regulatory standards are gradually walking to the international line.

At present, the financial supervision and monetary policy authorities and the majority of cases are distinguished from, so our country and other countries in addition to the attention of monetary policy co-ordination between, we also have to pay attention to the domestic regulatory
information, communication, and the central bank’s cooperation.

Through the sub-debt crisis in the U.S, it should be noted that in China’s financial industry actively and steadily push forward the opening to the outside world at the same time, the global financial system, the risk can not be ignored. Of particular importance is that China’s banking financial institutions must deepen reform, improve risk management capacity and enhance overall competitiveness. China’s financial regulators should draw lessons from similar circumstances should have early warning capability. In short, China should learn something from the sub-debt crisis in the United States to promote China’s economics’ sustainable development.

References: