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How the Foreign Financial Institutions Play a Role in China's Insurance QDII Business

By Sandra Lu and Lily Luo

China Insurance Regulatory Commission ("CIRC") publicly promulgated Implementing Rules for the Interim Measures for the Administration of Overseas Investment of Insurance Funds ("Implementing Rules") on 22 October 2012. Based on the Interim Measures for the Administration of Overseas Investment of Insurance Funds ("Measures for the Overseas Investment") issued in 2007, Interim Measures for the Administration of the Utilization of Insurance Funds and Circular on Issues regarding Adjusting Policies for Insurance Funds Investment (the "Circular") issued in 2010, Implementing Rules provides detailed guidance on various aspects of opening up overseas investment of insurance funds, including constitution of insurance funds available for overseas investment, qualifications for foreign participants and permitted investment channels and regions, etc. Foreign financial institutions now have more access to QDII business of insurance funds in the PRC ("Insurance QDII Business") and thus share the business opportunities of global allocation of insurance funds. Below we brief on the content of Implementing Rules closely related to foreign financial institutions by taking into account of the provisions in Measures for the Overseas Investment.

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Clarifying Constitution of Insurance Funds Available for Overseas Investment

It is provided in Article 3 of Measures for the Overseas Investment that "insurance funds" refers to the insurance institutions' (i.e., the principal's) self-owned foreign exchange, foreign exchange converted from renminbi and the assets accrued from overseas investment of the aforementioned funds, and in Article 3 of *Interim Measures for the Administration of the Utilization of Insurance Funds* that "insurance funds" refers to the capital base, provident funds, undistributed profit, various forms of reserves and other funds that are denominated in RMB or foreign currency of the insurance group (holding) companies or insurance companies.

Pursuant to the provisions of Measures for the Overseas Investment and Implementing Rules, the balance of overseas investment by an insurance institution shall not exceed 15% of its total assets by the end of the previous year, while for the investment in emerging markets, the ratio is 10%. According to the statistics released by CIRC, the total amount of insurance assets as of December 2011 was up to RMB 6 trillion, and this amount has increased to RMB 6.9 trillion as of September 2012. Therefore, around RMB 1 trillion of insurance funds are available for overseas investment.

Specifying the Qualifications for Offshore Investment Managers

An insurance institution may, at its own discretion, directly entrust its insurance funds to one or more domestic or offshore investment managers to make overseas investment. The investment managers shall, on the premises of complying with applicable laws and regulations, investment management agreement and investment guideline, have discretionary power to make overseas investment. In comparison with the allowable role as offshore investment advisor for QDII products offered by fund management companies or securities companies, offshore asset management entities may accomplish much more by playing a significant role as investment manager in Insurance QDII Business.

Article 6 of Implementing Rules prescribes detailed qualifications for offshore investment manager. An offshore asset management institution, purposing to act as the offshore investment manager, shall meet the following conditions:

- It has practiced in the international asset management for at least five years and in pension or insurance asset management for no less than three years;

- Its paid-up capital or net assets shall be no less than USD 30 million in the most recent financial year;

- It has an average assets under management ("**AUM**") of USD 30 billion or above in the most recent year, among which the assets entrusted by its non-connected persons shall be not less than 50% of the total AUM or USD 30 billion, and the AUM of its parent company or of its group companies carrying on asset management can be counted. As an exception, the offshore investment manager engaging in special asset management business can be exempted from the above AUM requirements by only having an AUM not less than USD 5 billion, among which at least 70% of the AUM are the assets under special management, and having generally recognized professional reputation and outstanding track records in special asset management;

- It is staffed by investment professionals who comply with the practicing requirements of the country or region where it locates, and have at least five years of experience on average, while the key investment management personnel shall have at least eight years of experience;

- It has well-performed track records.

Besides the above, the offshore investment manager shall also satisfy the conditions provided in Article 11 of Measures for the Overseas Investment, such as being an independent legal person, engaging in the assets management business according to law, having sound corporate governance, optimized internal and risk control system, plenty of professionals, steady financial status, good credit standing, required risk monitoring indicators and relevant liability insurance appropriate to the scale of its AUM, while not having any record of major violation against laws and regulations in the most recent three years, and the financial regulators of its location having executed regulatory cooperation documents with PRC financial regulators.

In the event that insurance funds invest in a private equity fund, the equity investment entity who launches and manages the private equity fund shall satisfy such conditions as having a paid-up capital or net assets of USD 15 million or above, a cumulative AUM of USD 1 billion or above, outstanding track records and being in good standing.

Clarifying the Qualifications for Wholly Foreign-owned Banks and Branches of Foreign Banks Acting as the Custodian

Pursuant to Measures for the Overseas Investment, the banks incorporated or registered in PRC, including Chinese banks, Sino-foreign equity joint venture banks, wholly foreign-owned banks and branches of foreign banks, can act as the custodian of insurance funds. Each insurance institution may only appoint one custodian for its insurance funds of overseas investment. Article 12 of Measures for the Overseas Investment prescribes the qualifications for the custodian, such as having sound corporate governance, optimized internal and risk control system, plenty of professionals, the capital adequacy ratio of 10% at least and the core capital adequacy ratio of 8% at least by the end of the previous year, steady financial status, good credit standing, required risk monitoring indicators and the qualification for settlement and sale of foreign exchange, while not having any record of major violation against laws and regulations in the most recent three years.

It is further required in Implementing Rules that (a) the paid-up capital or net assets of the custodian shall be no less than RMB 30 billion, and the assets under its custody shall be no less than RMB 200 billon (in the case that the custodian is a wholly foreign-owned bank or a branch of a foreign bank, the paid-up capital, net assets and the assets under custody of its parent company (headquarter) can be counted as an alternative, provided that the parent company (headquarter) satisfies the aforesaid requirements and procures to jointly and severally assume the liabilities ascribed to the custodian under the custody agreement); (b) the custodian shall have a long-term credit rating of Class A or above (as to the branches of foreign banks, the requirements of capital adequacy ratio, core capital adequacy ratio and credit rating shall apply to its parent company (headquarter) instead); (c) there are at least six professionals working on the custody of insurance funds.

Clarifying the Legal Relationship between Involved Parties and the Applicable Laws of Relevant Agreements

- Principal and investment manager

  The principal and the investment manager shall enter into investment management agreement, investment guidelines and other necessary documents to formulate a contractual relationship (other than a trust) between each other. Both parties will enjoy rights and perform obligations based on the signed agreements. The default party shall be liable for its breach of contract.

- Custodian and its custody agent

  With the consent of the principal, the custodian may select commercial banks or specialist custody institutions as its overseas agents as long as they meet the requirements set forth in Article 13 of Measures for the Overseas Investment, including engaging in custody business according to law, having sound corporate governance, optimized internal and risk control system, plenty of professionals, steady financial status, good credit standing, required risk monitoring indicators and the capital base and the assets under its custody as required by CIRC, while not having any record of major violation against laws and regulations in the preceding three years, and the financial regulators of its location having executed regulatory cooperation documents with PRC financial regulators. Offshore custodian institutions may keep good cooperation relationship with the onshore custodian banks so as to be appointed as their custody agents. Implementing Rules further specifies that the custodian shall be liable for the loss of insurance funds incurred by the fault or negligence of its custody agent in performance of duties. Obviously, the principal-agent relationship exists between the custodian and its custody agent.

- Principal and custodian, custody agent

  An insurance institution, as the principal, must enter into a written custody agreement with the custodian bank. No direct legal relationship exists between the principal and the custody agent. It is set forth in Implementing Rules that none of the following connected relationships shall exist between the principal and the custodian or between the principal and the custody agent: (a) directly or indirectly having over 10% shareholding in the other party; or (b) over 10% of each parity' equities being directly or indirectly held by the same third party.

- Applicable law and requisite legal opinion

  The principal shall respectively enter into a written agreement with the investment manager and with the custodian, which sets out the rights and obligations of each party. Article 26 of Implementing Rules specifically indicates that PRC law or Hong Kong law shall apply to the aforesaid agreements. The disputes incurred thereby shall be submitted for arbitration by the arbitration authorities in mainland China or Hong Kong. Meanwhile, it is required by CIRC that the aforesaid agreements must be supported by the legal opinions issued by the lawyers having practiced in asset management area for at least three years.

Clarifying CIRC's Power of Inquiry and Supervision on Relevant Parties

It is noteworthy that, as provided for in Article 10 of Implementing Rules, the parties of Insurance QDII Business (including the principal, the domestic or offshore investment manager, and the custodian) shall make report to CIRC while applying for conducting relevant business and commit to response to CIRC's inquiry on overseas investment of insurance funds. CIRC encourages insurance funds to share development benefits of overseas markets and simultaneously puts emphasis on risk control and effective supervision.

Given that Measures for the Overseas Investment and Implementing Rules have set forth considerably strict standards for the parties of Insurance QDII Business in respect of their establishing relevant systems, ongoing operation in compliance with the law, duties of information disclosure and reporting, etc., it is suggested that the foreign financial institutions should seek advice from the professional counsels in process of application and ongoing operation, so as to conduct the business in compliance with applicable laws and regulations.

Adding the Provisions of Selecting Counterparties and Overseas Brokers

It is required in Implementing Rules that the investment manager shall be responsible for formulating and implementing the standard of selecting counterparties subject to the consent of the principal. The counterparties selected by the investment manager shall have a Class A or above credit rating except for the transactions settled in delivery versus payment terms. As to the selection of overseas securities brokers, the investment manager shall, adhering to the principle of best execution, select brokers in normative operation and good reputation. The investment manager shall make disclosure of such details as the brokerage fees and soft dollar to the principal.

Broaden the Scope of Investment

Prior to the promulgation of Implementing Rules, only stocks and bonds listed on the main board of Hong Kong securities markets can be invested pursuant to the Circular. Implementing Rules enlarges the investment scope of insurance funds by covering such instruments as money market instruments, bonds, stocks, equities, funds and real estates in 25 developed countries (see Annex 1 of Implementing Rules for details) and 20 emerging countries (see Annex 1 of Implementing Rules for details) with both virtual economy and real economy involved. Specifically, the investment instruments include:

- Money market instruments, including but not limited to commercial bills, bank notes, negotiable certificate of deposits that mature within one year, reverse repurchase agreements, short-term government bonds and overnight lending;

- Fixed income products, including but not limited to bank deposits, government bonds, government-backed bonds, bonds issued by international financial organizations, corporate bonds and convertible bonds;

- Equity products, including but not limited to common stocks, preferred stocks, global depository receipts, American depository receipts and equities of unlisted enterprises, among which, stocks and depository receipts shall be listed and traded on the main board of the stock exchanges of the countries or regions as prescribed in Annex 1, direct investment in equities of unlisted enterprises shall be limited to the areas of finance, pension, medical treatment, energy, resource, automobile services and modern agriculture;

- Real estate, mainly referring to the mature commercial and office real estates which can produce stable income and locate in heart of metropolis of the developed countries or regions as prescribed in Annex 1;

- Overseas securities investment funds, authorized or registered by the securities regulatory authorities of the countries or regions as prescribed in Annex 1;

- Overseas private equity funds, whose investment target shall be at its growing or mature stage or worthy of acquisition, and the scale of subscription, the investment team and the equity investment entity launching and managing the private equity fund complying with the requirements as provided for in Implementing Rules; and

- REITs, listed and traded on the exchanges of the countries or regions as prescribed in Annex 1.

Besides the above, Implementing Rules also sets out detailed requirements of various investment vehicles' credit ratings, qualifications for fund managers, track records and investment ratios. Please look up the full text of Implementing Rules for details.

Furthermore, investment in financial derivatives, solely for hedging purpose other than for speculation, becomes allowable since the promulgation of Implementing Rules. Specific requirements in respect of the scope, categories, risk exposure and OTC counterparties are provided for in Implementing Rules.

Prohibited Investments

Pursuant to Article 16 of Implementing Rules, insurance funds shall never:

- purchase physical commodities, precious metal or certificates of precious metal, or commodities derivatives;
- do margin trading through securities brokers or do short selling without underlying assets; or
- borrow funds in any form except for the purpose of clearing transactions.

Also applying to financial products denominated in renminbi and QDII products

Implementing Rules shall also apply to insurance funds investing in overseas financial products denominated in renminbi or all kinds of QDII products.

Annex 1 to Implementing Rules

Allowable Markets for Insurance QDII Business

I Developed Markets		
Australia	Hong Kong,	Portugal,
Austria	Ireland	Singapore
Belgium	Israel	Spain
Canada	Italy	Sweden
Denmark	Japan	Switzerland
Finland	Netherlands	United Kingdom
France	Luxembourg	United States of America
Germany	New Zealand	
Greece	Norway	
II Emerging Markets		
Brazil	Indonesia	Poland
Chile	South Korea	Russia
Columbia	Malaysia	South Africa
Czech Republic	Mexico	Taiwan
Egypt	Morocco	Thailand
Hungary	Peru	Turkey
India	Philippines	

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