

# Risk Alert

## Understanding China's Business Risk Environment

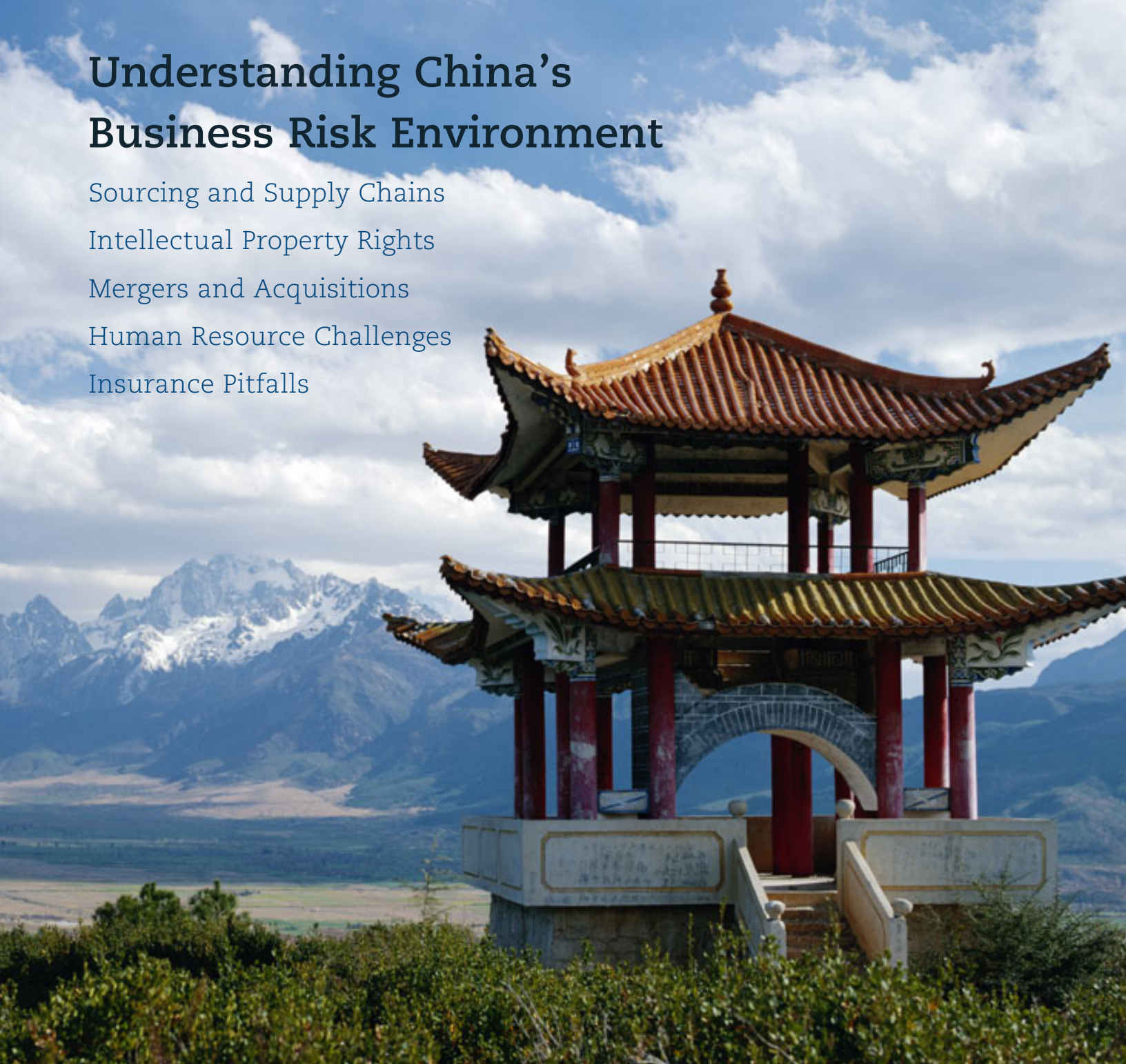
Sourcing and Supply Chains

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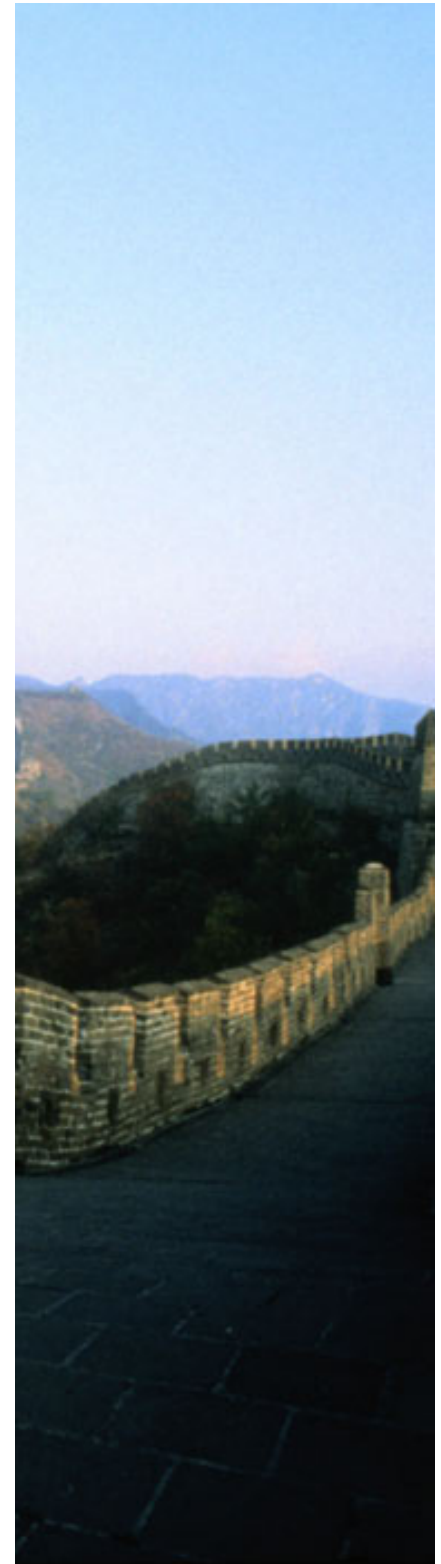
Insurance Pitfalls





# Introduction

With its booming economy, huge manufacturing base, enormous supply of natural resources, and expanding consumer spending, it's no surprise that China is high on the agenda for businesses around the world. More than 90 percent of multinational companies say that China is important to their global strategies, with 52 percent calling it critical, according to Mercer Management Consulting, a Marsh sister company.



One indicator of China's economic expansion is its gross domestic product (GDP), which is growing at a staggering rate and has averaged around 9 percent annual growth for more than a decade.

**GDP Growth Forecast**

Country/Region	2006	2007
China	10.3%	9.4%
United States	3.5%	2.3%
European Union	2.3%	1.8%

Source: Institute for International Economics (Note: China numbers are an average from two forecasters.)

But along with the opportunities from doing business in China come risks. This issue of *Risk Alert* looks at a number of key areas of risk that companies already operating in China—or thinking about operating there—need to consider. Among the critical issues are:

- sourcing risks, including supply-chain and business interruption issues;
- protection of intellectual property;
- recruitment, development, and retention of talented employees;
- trends and concerns in mergers and acquisitions; and
- the potential pitfalls of the Chinese insurance market.

## China and the World Trade Organization

China reached a milestone this fall, completing its fifth year as a member of the World Trade Organization (WTO). The WTO was established in 1995 as the successor to the General Agreement on Tariffs and Trade (GATT) and is the only international organization currently dealing with the global rules of trade.

When China joined the WTO in the fall of 2001, the move was hailed as a major milestone in global economics. "With China's membership, the WTO will take a major step towards becoming a truly world organization. The near-universal acceptance of [the WTO's] rules-based system will serve a pivotal role in underpinning global economic cooperation," Mike Moore, then-WTO Director-General, said at the time.

The move capped nearly 15 years of international talks with China, dating back to GATT. In joining the WTO, China committed to a number of actions to open and liberalize its economy, including:

- to treat all WTO member nations in a nondiscriminatory manner with respect to trade issues;
- to eliminate dual pricing and other practices, both for goods produced for sale in China and those produced for export;
- to not use price controls to protect domestic industries;
- to revise its own laws to ensure compliance with the WTO agreement; and
- to not maintain or introduce subsidies on agricultural products.

With China's five-year WTO anniversary in 2006, a number of organizations issued assessments of its progress.

In a recent survey, the European Union Chamber of Commerce in China asked its members how they viewed China's WTO efforts. Eighty-five percent of respondents said they have seen "great" or "considerable" improvement in China's business environment since it entered the WTO. However, nearly half said they believe China is behind schedule on implementing WTO agreements, and 19 percent said China was actively looking for ways to avoid or delay implementation of the agreement.

Many—21 percent—said that China was willing to follow only "the letter of the WTO accession requirements" and no more, a view also expressed by others. For example, the European Commission recently said the European Union will "urge China to move beyond its WTO commitments in further opening its markets to create opportunities for EU companies."

In a 2006 survey done by the US-China Business Council (USCBC), members were asked to name the most important WTO commitments China had implemented. Trading and distribution rights, market access, and tariff reductions were cited as the top three areas.

When asked to name China's WTO shortfalls, USCBC members named inadequate enforcement of intellectual property rights, restrictions in the financial services area, and transparency issues.

The U.S. government, meanwhile, has noted what it calls "delays in full implementation" of China's WTO commitments, blaming China's "complex legal and governmental structures" (*The President's Trade Policy Agenda*, March 1, 2006, <http://www.ustr.gov>.)

# China Sourcing and Supply Chains

Firms competing in the global economy face greatly enhanced supply-chain risks. As companies boost their dependence on sourcing from China and elsewhere, they should spend more time anticipating and modeling the potential impact that problems in the supply chain can have on their organizations.



## China Sourcing Strategy

The promise of low-cost manufacturing remains one of the primary reasons companies look to China as a sourcing base. Although other countries have lower labor costs than China, they cannot match it for overall manufacturing costs because they generally lack the infrastructure, have higher cost and fewer available raw materials, impose regulatory tariffs, have poor speed in shipping, and so on. Over the past 20 years, China's rapid manufacturing development has earned it the moniker "the factory of the world." And as China tries to move in an equally grand fashion toward becoming a base of the global knowledge industry, it is developing a work force with more technical skills. (The battle for that talent is extremely competitive, as will be discussed later in this report.)

Another change that has developed in companies' China strategies over time is an increased focus on serving not only export markets, but also the country's domestic market. Many upstream suppliers to industry have moved operations to China to be closer to their downstream customers, such as in the electronics and textile sectors. The No. 1 reason cited by European Union (EU) firms for doing business in China was to produce goods for Chinese markets, according to a recent survey by the European Union Chamber of Commerce in China. In a similar survey conducted of U.S. companies by the US-China Business Council (USCBC), 57 percent of respondents said their main objective in China was to access or serve the China market.

Whatever a firm's objectives in China, logistics operations within the supply chain can make or break its business. And yet, a recent survey of Marsh's European clients with operations in China and elsewhere in Asia found that 56 percent of respondents said their plans to maintain business continuity needed development; 8 percent said such plans were *nonexistent*. Only 21 percent said they had full business continuity management plans in place.

Companies looking to source in China should consider doing so in light of broader strategic and operational issues. Among the questions business leaders need to address when considering China as a sourcing base are the following:

- How should China figure in our global sourcing strategy?
- How should we integrate China sourcing into our broader China strategy?

“Whatever a firm's objectives in China, logistics operations within the supply chain can make or break its business.”

- What are the benefits and risks of China sourcing?
- How do we establish an effective sourcing operation in China?
- How do we increase our resilience to supply-chain interruptions?

Once a firm decides to source in China, it needs to manage the supply-chain risks. It becomes vitally important for businesses to take a systematic approach, which can be viewed as comprising four main steps:

1. Identify critical dependencies.
  - Critically evaluate and map the risks associated with the supply chain.
  - Identify and prioritize key suppliers.
2. Diagnose key suppliers' risk exposures and resilience to supply-chain disruptions.
  - Identify and prioritize suppliers' main risk issues.
  - Design a risk management program.
3. Conduct an in-depth analysis of critical supplier risks, and implement management and mitigation procedures.
  - Implement risk management/transfer programs.
  - Provide project management support.
4. Monitor and control the process.
  - Implement reporting and measurement processes and standards.
  - Continually test and update the program.

## Logistics Bottlenecks

Although the situation is getting better, enormous inefficiency still exists in China's logistics, evidenced by the fact that logistics in China account for about 10 percent or more of a product's retail value, compared to only about 3 percent in the United States.

The development of logistics in China has been held back by a number of factors. At one level, the poor national logistics situation reflects a history of fragmented markets with much local self-sufficiency. Added to that, the government's authority and policy on transportation development and oversight have been split between various ministries, creating a patchwork infrastructure. Chinese firms have relied on their own transportation assets and have, thus, been slow to accept

### China Infrastructure

China's economic boom has highlighted the need for massive improvements to its infrastructure. The highway system, in particular, was long seen as an impediment to opening up the country's interior to development.

The recently completed national superhighway system should help pave the way for continued expansion away from the coasts, while also improving transportation within the coastal regions.

Development of infrastructure has attracted a large amount of foreign investment. The current plans for continued infrastructure improvements include the following:

- The government plans to lay 17,000 kilometers of new track for passenger and freight lines by 2010, at an estimated cost of at least 1.25 trillion renminbi (the national currency).
- With domestic air travel forecast to grow at an annual rate of 14 percent, the government plans to build 44 new airports in the next five years at a cost of about US\$17.4 billion ("China to Boost Spending on Airports as Air Travel Grows," Dow Jones Newswires, February 28, 2006). China's Civil Aviation Administration said some of the investment will be used to expand existing airports.
- Provincial authorities are pushing ahead with projects to expand China's port capacity. Northeast China's Liaoning Province, for example, plans to inject more than US\$80 billion into creating additional berths and capacity by 2010.

There are, of course, caution flags to be heeded for any company investing in these areas. For example, some experts are concerned that capacity in the ports may become overdeveloped, potentially leading to declining profitability in selected facilities in the future.

third-party logistics providers. Finally, until quite recently, foreign third-party logistics firms have been excluded from domestic logistics.

Third-party logistics providers, whether domestic or international, currently cite two major obstacles to their growth:

- excessive regulation, such as the need for cross-province operating licenses, which hinders the provision of nationwide logistics solutions; and
- a shortage of managerial talent.

The Chinese government is pushing to create positive change in the logistics arena. For example, foreign logistics companies are now allowed to establish wholly owned subsidiaries in China. Such companies are able to serve multinational manufacturers striving to build integrated national sales networks across China. The completion of China's superhighway system is one indication of the government's drive to develop key infrastructure that will, among other things, assist in opening up the country's interior, which has lagged the coastal provinces in terms of development (see sidebar on page 6).

Despite much progress, however, domestic logistics remain far more challenging than export-oriented, cross-border logistics. Among the problems that remain to be tackled are a lack of industry specialization and technological know-how among Chinese logistics providers, the need to streamline customs systems, and illegal road tolls and other charges at the local level that can increase costs.

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## Product Safety

Product safety is now one of the most prominent sourcing risks resulting from manufacturing in China, and it poses a significant risk to any company's brand and reputation. According to the U.S. Consumer Product Safety Commission, 63 percent of all product recalls of imported goods resulted from products made in China. Likewise, the European Commission reported that of all product-recall notifications submitted in 2005, more than 50 percent originated in Asia, with most of those from China. And for companies serving China's domestic market, new laws have come into effect aimed at protecting consumers.

Some companies have responded to product-safety concerns by insisting their Chinese facilities and suppliers manufacture according to the same standards in place in North America or the European Union. Even in those cases, it is important for companies to understand how to plan for and resolve potential product-safety crises that may arise from their Chinese operations. Among the steps companies can take to reduce the likelihood and severity of major product-safety events from their China operations are to:

- establish a management system for product safety and products liability;
- analyze product-risk exposures and design and implement product-recall plans;
- investigate availability and pricing of products liability insurance;
- develop the capability to track and trace products from manufacture all the way through to delivery to the end consumer;
- enhance contractual protections with suppliers, vendors, and customers;
- audit supply-chain production quality; and
- understand how to comply with the variety of local, national, and international regulations, treaties, and laws.

## Managing China Sourcing Risks

It's important to note that the cost savings China sourcing will deliver are rarely as large as first imagined. A critical early step in China sourcing, then, is to go beyond the initial request for a quote from a Chinese supplier and determine the true costs and risks. For example, while a sample product provided by a potential supplier might meet a firm's specifications, subsequent shipments may not. Thus, there is a cost—not always apparent at first—in monitoring production and shipments on the ground in China.

Difficult challenges arise with shipments made within China, particularly to the interior regions. Foreign third-party logistics providers find it hard to establish a domestic network, while the Chinese logistics firms tend to be subscale and unsophisticated in terms of their ability to provide time-definite delivery or transparent

tracking. When working with China-based suppliers—or suppliers anywhere in Asia—a company should ask itself certain questions up-front:

- Do your China-based suppliers perceive supply-chain risks the same way you do?
- How might the risks your suppliers face affect your business?
- How prepared are your suppliers to control the risks in order to ensure your supply-chain integrity?

## Disaster Preparedness

There's also a greatly heightened risk of supply-chain interruption from natural disasters in China. Asia as a region suffers significantly in terms of the frequency and severity of natural disasters such as floods, tsunamis, typhoons, and earthquakes.

A recent Marsh survey of Asian suppliers of European companies indicates that many of them are not fully prepared to manage the risks from natural disasters. Only 28 percent of the survey respondents said they were fully prepared for—and could maintain business as usual in the event of—a natural disaster affecting one of their key facilities or suppliers. More than half said that they have some contingency arrangements in place, but that operations and suppliers would suffer significant delays if a natural catastrophe hit. And 20 percent of those surveyed said they had no contingency plans at all.

Although there are many potential rewards to sourcing in China, a company that simply reacts to sourcing and supply-chain difficulties when they happen—without having a plan in place in advance—is likely to suffer unpleasant consequences.

### Avian Flu Preparations Slow to Take Wing

A recent Marsh survey of European Union companies with operations in Asia revealed a startling weakness: Only 21 percent of respondents said they were fully prepared for the supply-chain disruptions that could potentially be caused by avian flu or a similar pandemic.

Further, another 21 percent said they had no contingency plans whatsoever for an outbreak—this, despite the fact that avian flu (“bird flu”) has been one of the most talked about global risks of the past 18 months. Since surfacing in Southeast Asia in 2003, the H5N1 strain of avian flu has sparked international discussion and action aimed at preparing for a pandemic that could, under worst-case conditions, cause millions of deaths and more than US\$1 trillion in damages.

Although other countries have reported higher numbers of human avian flu cases, China has been at the center of the avian flu battle. China reported 12 confirmed cases of human avian flu in 2006, resulting in 8 deaths. Since the outbreaks began in 2003, China has reported 21 cases, of which 12 were fatal; worldwide, there have been 252 cases and 148 fatalities, the World Health Organization said in October 2006.

China has reported numerous outbreaks of H5N1 in domestic poultry, with the latest in October 2006. Officials have culled millions of domestic fowl and also have undertaken a massive campaign aimed at inoculating billions of chickens.

Companies doing business in China or elsewhere in Asia are well-advised to ensure their business continuity planning makes adequate preparation for the potentially devastating consequences of a pandemic.

For more information, visit <http://solutions.marsh.com/afpandemic>.

## Intellectual Property Rights

The theft of intellectual property (IP) continues to be a major problem for multinational companies operating in China, consistently ranking among their top five concerns. In annual member surveys conducted by the US-China Business Council (USCBC), IP issues ranked third in 2006, first in 2005, and second in 2004. In the European Union Chamber of Commerce in China's 2006 member survey, 66 percent of respondents said Chinese intellectual property rights (IPR) regulations and enforcement are ineffective.



In 2003, IPR infringement in China resulted in lost sales revenue of about US\$60 billion for companies based in the European Union, Japan, and the United States. The potential for even greater losses exists as companies move more of their mission-critical research and development functions to China, creating ever greater exposures. In addition to lost sales, a company's reputation and brand image—which are harder to put a dollar figure on—are damaged by IP theft. When pirates target a successful company, its products and brand may become closely associated in the media with poor quality and with counterfeiting issues in the media.

But it's not only overseas companies losing out to pirates. The Chinese economy loses billions of dollars in tax revenue each year, and Chinese companies may also become targets of counterfeiters. Some economists believe that the negative effects IP violations have on the Chinese economy will push the country to toughen its stance and strengthen its laws. "Chinese laws and regulations are converging with international standards. Patent, trademark, and copyright applications are being filed in growing numbers and damages and fines are increasing," according to economists at NERA Economic Consulting, a Marsh sister company.<sup>1</sup>

The NERA economists go on to say that the IPR situation in China is typical of a developing economy at a crossroads, moving from an "imitative" to an "innovative" stage of development. However, Chinese authorities are not bringing enough cases, and the fines remain too low to be a deterrent or to compensate IPR owners. Although IP infringers caused more than US\$60 billion in lost revenue to companies around the world in 2003, they were assessed fines by the Chinese government amounting to only about US\$30 million, a small fraction of the damage they caused.

The amount of counterfeit goods of Chinese origin seized at U.S. borders is more than 10 times greater than from any other trading partner, according to the Office of the U.S. Trade Representative (USTR). And all goods are at risk—if it *can* be copied, it *will* be copied. For example, in September 2006, U.S. customs agents seized 15 containers with 135,000 pairs of counterfeit sneakers coming from China. "Inadequate IPR enforcement is one of China's greatest shortcomings as a trading partner," the USTR said in its *2006 Special 301 Report*.

1. Alan Cox and Kristina Sepetys, "Intellectual Property Rights Protection in China: Litigation, Economic Damages, and Case Strategies," in *Corporate Counsel's Guide to Doing Business in China*, Thomson West (2006).

### Regional Markets Provide Pirates Range of Opportunities

Brand piracy is so pervasive in China that particular areas and markets are widely known for specializing in manufacturing, selling, or shipping particular items. The Office of the U.S. Trade Representative identified several "hot spots" that require increased attention and resources by Chinese authorities:

#### ■ Guangdong Province

This area is the center of the large-scale manufacturing of a wide range of counterfeit goods, from low-cost consumer goods to high-technology products.

#### ■ Beijing City

This highly visible center of retail piracy is the home of the infamous Silk Street Market, where numerous products, from university textbooks to CDs and DVDs to software and more, can be found.

#### ■ Zhejiang Province

Located in eastern China, this area is identified as a major center for distributing counterfeit goods overseas.

#### ■ Fujian Province

Long known as a home to the large-scale manufacturing of a wide variety of goods, such as footwear, this province is also the center of a number of long-running legal cases in which little government action has been taken.

Source: *2006 Special 301 Report*, Office of the U.S. Trade Representative, <http://www.ustr.gov>.

Governments around the world continue to pressure Chinese authorities to do a better job of enforcing IP laws, and there are signs of progress. In May 2006, President Hu made a speech in the Political Bureau of the Chinese Communist Party calling for strengthening the country's IP system.

Some progress has also been seen in enforcement. In February 2006, the U.S. Department of Justice obtained a conviction against a U.S. citizen for counterfeiting a popular pharmaceutical. With the cooperation of Chinese law enforcement, the operation resulted in the seizure in China of 600,000 labels, 440,000 tablets, and more than 500 pounds of raw pharmaceutical manufacturing materials. And in a case involving the first joint IP investigation with Chinese and U.S. authorities, four people were convicted recently in China of selling more than 133,000 illegal DVDs in more than 20 countries.

But what IPR holders continue to see on the ground is that most enforcement remains in the hands of administrative authorities—with no authority to make arrests—rather than police authorities. This means that counterfeiters pay small monetary fines and face little risk of jail sentences. China's State Administration of Industry and Commerce (SAIC) is the primary enforcer of IP regulations. It has the authority to seize counterfeits from markets, warehouses, and factories. Many companies find it helps to be proactive with the SAIC by using an independent investigative firm to track counterfeiters, locate the warehouse or the factory where the counterfeiters are producing the product, and then pass the information on to the SAIC along with a formal letter of complaint. In theory, the SAIC should then raid the offending site.

Brand owners are well-advised to keep up the pressure on pirates through investigations and raid actions. They should also practice thorough due diligence on employees and potential business partners to see if they have a track record of IP theft or are currently involved in counterfeit activities. Kroll recommends background checks be performed on all managers and technicians who have access to proprietary information. It's important to understand who these people know, who they are related to, and whether they have their own companies or connections to competitors. Companies that take appropriate precautions in the short run may be able to avoid IP theft with the potential to cause tremendous financial damage in the long run.

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Combating IP theft requires an understanding of the interaction between policies, procedures, information technology (IT) systems, and physical security in order to strike a balance between protection and the need for an open, collaborative business environment.

Among the steps a company can take are the following:

- **IP inventory** – A firm needs to have a good understanding of what its own IP is in order to develop a plan to protect it. An inventory should include a list of all patented and patentable technology, trademarks, copyrights, and business plans. It should include a list of which employees have access—and which should have access—to the types of information identified.
- **Policy and procedure review** – Companies should conduct periodic reviews of the documents that support existing IP protection policies and procedures—employment agreements, information classification procedures, information security processes, incident-management procedures, business continuity plans, and the like.
- **Information technology systems** – It's important to look for vulnerabilities in IT systems and networking. There are international standards that provide best practices for information security management.
- **Physical security** – Protecting key assets by means of an appropriate physical infrastructure is also a key consideration in preventing IP problems. Areas such as perimeter security; internal access controls; and monitoring, surveillance, and incident-response controls should all be continuously checked.
- **Communication and training** – Employees should be made aware of the steps the company takes and their role in IP protection.

## Pirates Become More Sophisticated

Counterfeiters—also called “pirates”—used to be happy simply copying another company's final product. Now, pirates have begun copying entire companies. They copy business cards, offer repair services, and may even have offices in several jurisdictions. In one case, investigators from Kroll identified a group of ex-managers of a foreign retail store using their knowledge of store layout and supply network to copy a retail store.

Infringers are becoming increasingly sophisticated and cautious. They will typically produce the product at one location and affix the label and packaging at another location. Many of the more advanced counterfeiters will practice counter-surveillance techniques to avoid being raided.

There are two types of factories involved in manufacturing counterfeit products in China. The first type is typically referred to as an “underground factory” that:

- does not have a business license;
- is likely to move from place to place to avoid detection;
- is established specifically to manufacture counterfeit products; and
- may be used to target a single brand or to produce several brands.

Pirates in the more well-established type of factory may:

- produce their own brands;
- compete with multinationals;
- be former licensees of a brand they now copy or be managed by former employees of the brand; and/or
- avoid detection by using midnight shifts or working on the weekends for their counterfeiting operations when there is little chance the regulatory authorities will be watching.

In addition, pirates may:

- outsource the production of parts, packaging, labels, and other items to shops that specialize in copying parts and trademarks; and/or
- buy labels and other brand identifiers from a supplier that supplies the genuine factory.

# Talent: A Key Human-Resource Challenge

A common misperception about China is that there is a limitless pool of workers from which companies can draw. But the pool doesn't look quite so full when a company starts searching for key people with high levels of technical expertise in a given industry, management ability, education, language skills, or experience working in the global economy.



## Talent, Talent, Talent

The top human-resource (HR) issues cited by companies in their China operations were building leadership capabilities in employees, acquiring key talent, and retaining key talent, according to a recent survey conducted by Mercer Human Resource Consulting.



Source: Mercer Human Resource Consulting (2006).

Companies are seeing high rates of turnover, especially among 25- to 35-year-old professionals who have worked for a company for two to five years in production, engineering, and sales departments. In fact, the average tenure for people in that key age group fell from an average of three to five years in 2005 to just one to two years in early 2006. And companies pay a real price when key people leave: Each departing professional costs an employer an average of 25 percent to 50 percent of that employee's annual pay, with top professionals costing 200 percent or more, according to Mercer. Among the strategic and operational problems associated with such turnover are missed production schedules, growth delays, and increased unit costs.

Winning the talent challenge depends on taking the right steps along a continuum from recruitment to development to retention.

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# Recruiting Talent

Recruiting talent is challenging for many employers because there's a limited pool to choose from and an abundance of companies doing business in China. Year in and year out, China continues to be one of the largest recipients of foreign direct investment. Multinational companies are going to China to establish joint ventures, expand existing operations, set up research labs, and more. And they all scour the landscape for talented employees. Many of them focus on the people already working for existing multinationals, looking for ways to entice already-trained employees to jump ship. In other words, they want to "buy" experienced talent to ensure expansion goals can be met.

Some companies make the strategic decision to enter China through a joint venture (JV). There are many reasons for doing so, of course, but a key one is to gain quick access to an employee base with a particular set of skills in a given industry. A word of caution: Make sure you know who those employees are before taking them on as partners, just as you would elsewhere in the world. For example, do any of them have criminal backgrounds, particularly surrounding IP issues? Do they own or work for other companies, especially potential competitors? China labor law makes it difficult to terminate some types of employees, so you need to know your potential exposure in advance.

Another key to getting the right people is to have a capable HR team in place. The team needs to understand the motivators for Chinese employees and how they are changing. Such an understanding makes it much more likely that the initial contact with prospective employees will be favorable and that the "right" employees will be hired.

In many cases, companies reach out to expatriates to staff their China operations. Because there is still a gap between the overall needs of companies in the employee area and the availability of talented workers, this will remain a critical aspect for many companies for a long time.

Reaching out to expatriates involves its own set of difficulties. First and foremost are issues associated with language and cultural differences. To counter this, many employers are anxious to accelerate leadership skills of Chinese nationals. For this tactic to succeed, employers must be conscious not to create an artificial ceiling that limits the advancement of key Chinese employees.

### Counting on an Accountant Shortage

One indicator of the strains put on China's work force by its booming economy is the dearth of accountants. As companies in China move to comply with international reporting standards, they face a serious shortage of skilled accountants.

"Our view is that it will be a real challenge for China to train sufficient numbers [of accountants], not only in time for the shift to international accounting standards but to cater to the exponential growth of its economy in the coming years," a representative of the Institute of Chartered Accountants in England & Wales (ICAEW) told *The Wall Street Journal* ("Help Wanted: Number Crunchers," July 13, 2006).

As Chinese companies move to get in line with international financial-reporting standards by the end of 2006, they are facing a shortage of 300,000 qualified accountants and may need as many as 3 million in a few years, the ICAEW representative said.

There is also the practical matter that expatriates cannot participate in Chinese government-sponsored programs such as education (including for their children), health care, and retirement. This means employers must establish separate programs for this group of employees, adding to the already higher cost of expatriate talent. Recent trends show that employers are addressing some of these challenges by bringing expatriates in at lower technical/professional levels—and for shorter durations. The underlying goal then becomes knowledge transfer and skill building among local staff.

## Developing Talent

Not long ago, it was easy to convince Chinese employees—like employees anywhere—to switch firms simply by offering more money. And while cash is still a major motivator, fortunately for employers, many employees are now seeking something from their jobs in addition to a paycheck. And much of what they are looking for involves career development.

Of employees responding to a survey by Mercer Human Resource Consulting, higher salary was still the top motivator for attracting talent to an organization. But once employees were already working, other concerns bumped pay aside for the No. 1 slot, as shown in the following chart.

### Top Five Employee Motivators

1. Opportunities for career advancement and development
2. Attractive salary and compensation/benefit package
3. Work/life balance
4. Relationship with supervisor or direct manager
5. Meaningful/creative work

Source: Mercer's 2006 *China Employee Attraction and Retention Survey*.

Companies are finding that if they offer skills-development training, management training, and access to other career builders, employees will stick with them.

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# Retaining Talent

Retention involves a mix of strategies centered on meeting employees' needs and is in many ways closely tied to employee development. The pool of workers that five or ten years ago may have been attracted to a company based solely on pay is entering a different life phase involving marriage and families. Benefits will become a much bigger concern and motivator as the population continues to age. For example, companies are finding that flex benefits programs that involve a holistic approach to rewards can prove quite useful in enticing employees to stay.

Successful retention strategies now involve balancing the employee contract across pay, benefits, and careers. A company needs to understand what its differentiating factors are for its unique work force and focus on those areas that provide the greatest return on investment both now and in the future.

As already mentioned, employees are attracted to companies that emphasize training and career development with a clear path for future advancement. Thinking about retention in this way means companies need to have a clear strategy in other areas, such as matching individuals' career paths—including their training and exposure to various company locations and business units—with a clear succession plan for key positions.

Communication also takes on a larger role if employees are to be retained as key assets. Employees want to be engaged, and they seek regular feedback from managers about their progress. A transparent career progression program lets employees see where they stand on their career paths. And as brand names are important for the Chinese consumer, we also see that “employment brand” is fast becoming a driver of HR strategies.

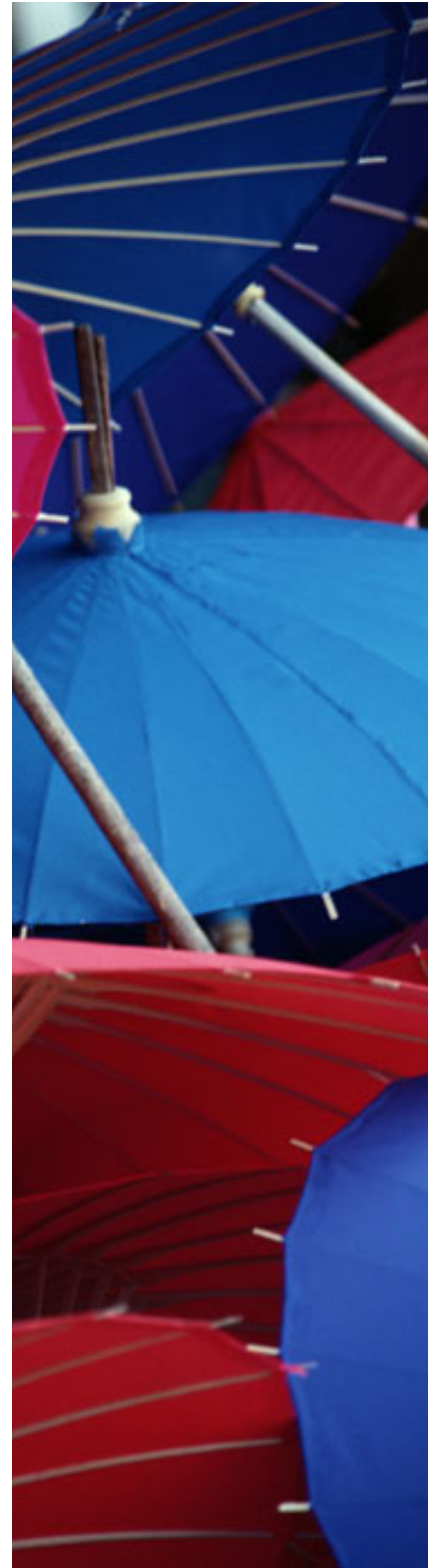
# Putting It All Together

Whether entering China with a joint venture or as a wholly owned company, it's important to have HR staff or consultants familiar with relevant Chinese laws, including tax concerns. For example, there may be critical issues to understand regarding the offering of equity and stock to Chinese nationals, there are benefits considerations for Chinese nationals surrounding residence issues, and Chinese nationals must be insured by China-based insurers for supplemental benefits.

## Mergers and Acquisitions

China offers a virtually unlimited merger and acquisition (M&A) growth potential based on its large population and market size.

But while China's M&A activity jumped more than 35 percent to US\$46 billion in 2005, from US\$34 billion in 2004, it still paled compared to about US\$181 billion in Japan and US\$1 trillion in the United States in 2005, according to analysis of deals by PricewaterhouseCoopers.



Results in China in 2005 were also boosted by major foreign investments and by China's "Big Four" state-owned banks. Some of the key drivers behind China's M&A activity over the past five years include the following:

- **World Trade Organization requirements** – By joining the World Trade Organization (WTO) in 2001, China agreed to reduce import tariffs, allow 100 percent foreign ownership in numerous industries, and permit significant market access to foreign investors in some previously restricted sectors such as retail and distribution.
- **Consolidation** – The Chinese government wants to consolidate highly fragmented industries and believes foreign capital and expertise will help to do so.
- **Capital influx** – The country's economic growth has attracted the interest of China-oriented private equity funds.
- **Rise of private companies** – The number and size of privately owned enterprises continue to grow, thus increasing the number of targets for potential acquirers. The M&A process involving private enterprises is generally simpler than that involving state-owned enterprises.

Source: Adapted from "Improving the Odds for M&A Success in China," Mercer Management Consulting (2006).

### Selling in China: Moving Beyond the "Sofa Factor"

The days when China was seen only as a source of low-cost workers are receding in the rearview mirror. Recent surveys of U.S. and EU companies doing business in China found the vast majority of companies listing their primary goal of being in China as tapping its enormous domestic market.

Over the past 20 years, some of the major problems of doing business in China have shifted from manufacturing issues to sales concerns. Chinese buyers still give inordinate credit to sellers based on the length of the relationship—the so-called "sofa factor" or how many times have you sipped tea together.

Other problems stemming from traditional Chinese ways of doing business include that Chinese customers may not have a clear grasp of their own cost structures or that they may backtrack on agreed terms and conditions, citing factors claimed to be beyond their control.

Beyond traditional aspects of selling in China, three strategic pitfalls can have a profound impact on the ability to sell in China:

- **Relying too heavily on Chinese partners** – The experiences of many joint ventures show that Chinese partners often bring much less value in sales and distribution than was hoped.
- **Being surprised by local competitors** – Foreign companies selling in China may seriously underestimate the pace and significance of the threat from local competition.
- **Trying to compete on price alone** – Chinese firms generally have a superior cost structure due to a lack of expatriate staff, less pressure to adhere to certain environmental and labor laws, and a greater ability to avoid paying taxes than their foreign competitors.

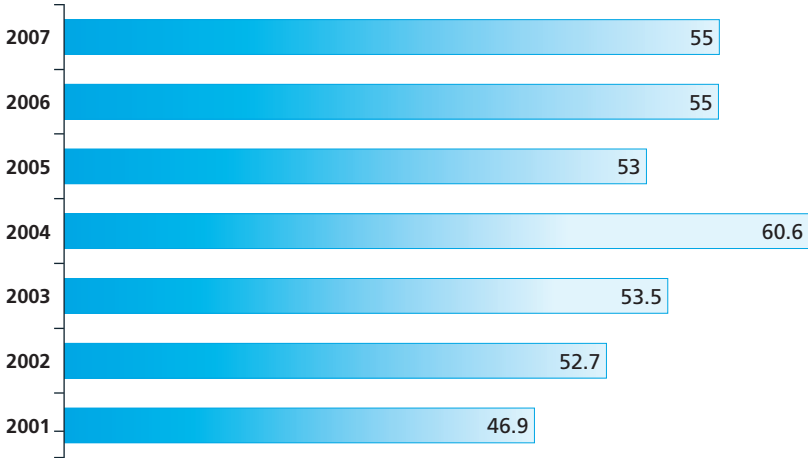
Source: The above was adapted from "Beyond the Sofa Factor," an article by Paul Clifford of Marsh and Mercer that appeared in *The Wall Street Journal* on August 24, 2005.

# Attitude Shift on Foreign Direct Investment

Since the early 1990s, the Chinese government has not only accepted a high level of foreign direct investment (FDI), but has even courted it, eager for capital to keep its economy booming. M&A activity is the largest source of FDI not only in China, but in countries around the world.

Lately, however, Chinese regulatory authorities have been reacting to criticism of the level of FDI. For example, in 2006, the Chinese government halted a US\$375 million bid by a U.S. private equity firm to purchase an 85 percent stake in a Chinese machinery manufacturer. Criticism inside China of that and other proposed deals focused on the “selloff” of critical national assets at what some saw as fire-sale prices. In the financial services sector, Chinese authorities recently announced a temporary moratorium on foreign acquisitions of Chinese brokerages.

Foreign Direct Investment (FDI) in China Since 2001\* (in US\$ billions)



Source: World Bank.  
\*2001 marked China's entry into the World Trade Organization. 2006 and 2007 numbers are projected.

Still, strong private-sector growth, ongoing privatization, and regulatory reform will continue to attract significant foreign investment. Recently, banking and high tech have been two of the most attractive areas to foreign investors. Going forward, information technology, electronics, retail-consumer products, general manufacturing, telecommunications, and transportation distribution are expected to see strong growth, utilizing joint ventures and newly approved holding-company structures.

FDI will continue to be important; but large Chinese companies are emerging themselves; and they are very capable of raising capital, developing technology, and competing in their own right. The Chinese government is seeking to nurture and protect these companies and shield them from intense foreign competition. China’s goal is to become the dominant force in the world economy, with favored status granted to domestic businesses. The M&A regulatory environment is expected to evolve favorably, but companies will need to stay keenly aware of the many adjustments along the way.

## Due Diligence— The Chinese Way

China is subject to a different mix of risks than are present in North America and Europe. And the attitudes that underlie M&A due diligence are also different. For example, China does not have a litigious bent, though that may slowly be changing. Some of the generalized differences in the way acquirers from outside China (and elsewhere in Asia) approach M&A activity are outlined in the table below.

**Global Standards Complement Local Traditions**

<b>North American/ European Characteristics</b>	<b>Asian Characteristics</b>
Global viewpoint	Local viewpoint/traditions
Rigorous, disciplined insurance/risk management process	Insurance/risk management due diligence a low priority
Insurance/risk management a recognized discipline	Multidisciplinary risk patchwork (insurance/human resources/reputational risk)
Stable regulatory environment	Highly reactive regulatory environment

### China’s Largest Bank Sets World Record for Initial Public Offerings

In October 2006, investors around the world showed just how hungry they are for a crack at the Chinese financial services market. The initial public offering (IPO) of shares in the Industrial and Commercial Bank of China (ICBC) attracted a world record US\$21.1 billion.

How hungry were investors? News reports said that more than US\$300 billion in orders had been placed for the IPO. Investors were eager to buy into China’s leading domestic bank, with more than 18,000 branches, 2.5 million corporate customers, and 150 million personal accounts.

ICBC was the third of China’s four largest banks to go public in the past year, placing a total of about US\$42 billion worth of shares into global portfolios.

Due-diligence projects in China should focus on an inventory of issues including:

- political risk;
- adequacy of coverage on physical assets, with a particular focus on catastrophe risk;
- business interruption and contingent business interruption, especially contingent business interruption relative to suppliers and major customers;
- international products liability;
- supplier products liability;
- emerging environmental exposures;
- HR exposures, such as labor-law compliance and strategies to attract and hold employees; and
- directors and officers liability protection.

## Deal Breakers

In China, as elsewhere, a major deal breaker is defined as a risk that has the potential to increase deal costs and reduce profitability. Deal breakers are highly dependent on the type of business, its location, its management, and its operation.

**Physical risks:** A business located in a flood plain, a coastal area subject to typhoons, or an earthquake zone is highly susceptible to loss. Much work is going on at the present time to map and model China's high-hazard zones. Hand in glove with physical risks are issues surrounding disaster planning and business interruption. These areas have been seriously neglected in China and in Asian risk management overall.

**Representations and warranties:** High on the radar screen in China is representations and warranties risk. For example, if an operation is spinning off from a government entity, the buyer may be concerned that it has no recourse in the event of a breach in the representations and warranties. This risk may be mitigated by using insurance capital to indemnify against a breach.

**Reputation:** Another major area of concern is reputational risk. In emerging markets, there are many ways that fraud can occur.

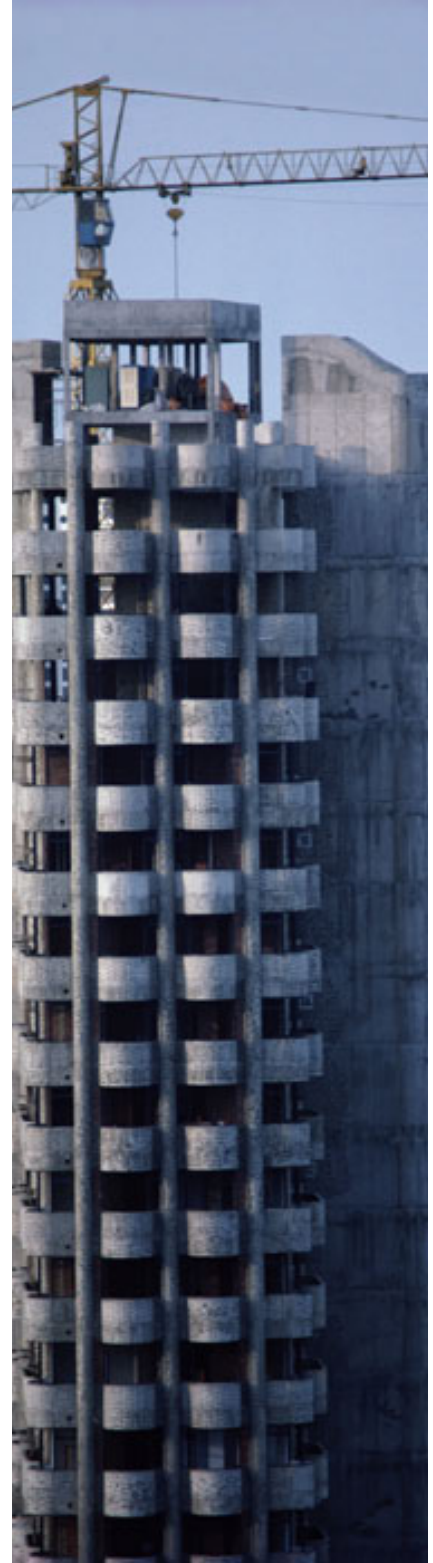
And a company may not really know all it would like to about who it is doing business with and who its partners are. Investigating a potential business partner's management team can avoid trouble after a deal is closed.

**Cost modeling:** Cost projection and modeling can pose significant difficulties in completing a deal in China. Rather than having a single major risk—such as workers compensation losses in the United States—there may be a host of issues that each alone may appear insignificant but in combination can create significant costs.

In many cases, costs may be incurred to meet a global standard. Examples include the cost of additional insurance such as products liability required by original-equipment manufacturers, property protection, business interruption, contingent business interruption, political risk, international coverage if the company is operating outside of China in addition to its China operations, and more. Compliance with Chinese work rules can be another area of significant unforeseen costs.

# Insurance Developments and Potential Pitfalls

The demand for more sophisticated risk management and insurance programs is likely to increase exponentially as global corporations continue both to move their supply chains to China and to increase their pursuit of China's domestic consumers.



And as China continues to meet the requirements of its WTO entry, the insurance market can be expected to continue its path to liberalization, with more entrants into the marketplace, expanded underwriting capacity, and a shift by regulators from a concentration on transactional/operational issues to more of a focus on insurer solvency.

It's critical to understand that the Chinese insurance market is undergoing significant and rapid change. Although it appears that China's insurance market is developing along Western lines, it would be a mistake to believe that there are not potential pitfalls. In fact, companies accessing the Chinese insurance markets need to exercise caution, stay informed on developments in a shifting environment, and pay attention to the details.

## Overview of China's Insurance Industry

Although the first insurance company in China was started in the early 1800s, the industry all but closed down between 1949 and 1980. Since 1980, when a government-controlled insurer was created, insurance premiums from all coverages—including life, auto, and business lines—have increased an average of 30 percent per year, according to the China Insurance Regulatory Commission (CIRC).

**Insurance regulation:** The first shareholder-owned insurer in China—PingAn Insurance Company—was established in 1988, while the first foreign-owned insurer entered the Chinese market in 1992. The China Insurance Law became effective on October 1, 1995; was revised on January 1, 2003, to comply with WTO requirements; and is undergoing further revisions at this time. In 1998, CIRC was established to administer, supervise, and regulate the Chinese insurance market, a role previously held by the People's Bank of China (see sidebar on this page).

**Admitted insurance:** Insurance for risks within China's territorial limits must be placed with an insurer licensed under the China Insurance Law to conduct business in China. The exceptions are for international marine insurance, international aviation insurance, international reinsurance, and insurance coverage not available in China.

### China's Insurance Regulator

Established in 1998, China Insurance Regulatory Commission (CIRC) works both to prepare local insurance markets to meet WTO requirements and to build the capability of the domestic insurance market for the intense competition WTO compliance is expected to generate.

As part of its functions and responsibilities, CIRC:

- formulates and enforces insurance laws and regulations;
- protects the interests of policyholders;
- develops insurance markets, maintains order in them, and ensures fair competition;
- promotes insurance industry reform and restructuring; and
- sets up a risk evaluation and advance warning system to minimize the risk of insurer insolvency.

The Commission recently described the need for a stronger insurance infrastructure in China: “[Insurance] is conducive to the risk management of natural catastrophes and traffic and workplace accidents while protecting lives and property and ensuring economic stability. Although such risks cost China dearly every year, only a limited proportion of businesses and households are covered by insurance. This has hindered the reconstruction process and increased the burden on the government. The campaign for faster development of the insurance industry will complement the disaster-mitigation-and-relief system and play an indispensable role in rapid and healthy economic development.”

Source: China Insurance Regulatory Commission, <http://www.circ.gov.cn>.

**Compulsory insurance:** Foreign insurers are not allowed to write compulsory insurance lines. With some local exceptions, there are four main lines of compulsory insurance:

- automobile third-party liability insurance;
- work-related injury insurance (workers compensation);
- personal accident for construction workers; and
- social security—pension and unemployment.

**Foreign exchange:** All nonlife insurance policies issued in China must be issued in Chinese currency, except if:

- the interest insured moves out of China;
- the interest insured exists or occurs outside China;
- the interest insured exists or occurs within China with an international lease, international syndicated loan, or other international financing; and/or
- both the insured and the beneficiary are foreign natural persons or foreign legal entities.

## Insurance Markets

Over the past decade, the Chinese insurance industry has experienced steady, rapid growth and attracted a large number of new entrants. Nonlife premiums have grown in the range of 10 percent to 12 percent for each of the past several years, while life insurance premiums have grown more than 20 percent in that same time. With US\$61 billion in premiums in 2005, China was Asia's third-largest insurance market, behind Japan and Korea.

In its recent special report, *China Insurance Outlook 2006-2007*, Standard & Poor's (S&P) changed its outlook on China's insurance industry from "developing" to "positive." S&P said China is likely to become the world's leading insurance market within a decade.

### China Reinsurance

China's reinsurance system is undergoing significant change. When established in 1996, China Reinsurance Company was an independent corporation funded by the central government and was the only specialized reinsurer in China. It maintains close to a 95 percent market share, although several international reinsurers have opened branches in Beijing and Shanghai.

The China Insurance Law of 1995 required that 20 percent of the transactions of local insurers (including foreign-funded insurers licensed in China) be ceded to the China Reinsurance Company. But after China's entry into the World Trade Organization (WTO), China Reinsurance Company was restructured into China Reinsurance (Group) Company—"China Re"—and diversified its business. The compulsory reinsurance cession to China Re ended in 2005.

The first comprehensive regulations of China's reinsurance market took effect on December 1, 2005. The regulations aim to promote domestic reinsurance markets. Insurers that issue policies in China must offer at least 50 percent of the insured amount to at least two domestic (Chinese) reinsurers—including licensed branches of international reinsurers.

Other requirements include that

- reinsured business to a single reinsurer should not exceed 80 percent of the total amount insured or the risk's limit of liability;
- temporary or facultative reinsurance to an affiliated company of the insured be no more than 20 percent of the amount insured or of the risk's limit of liability; and
- a foreign-invested insurer needs approval by regulators to enter into a reinsurance transaction with its affiliated companies.

Aviation, nuclear, petroleum, and credit insurance are excluded from the provisions. The regulations have direct implications on those insurance programs of multinational companies reinsured by captives or through fronting arrangements.

### Growth of Nonlife Premiums in China

2001	US\$8.3 billion
2002	US\$9.4 billion
2003	US\$10.5 billion
2004	US\$13.6 billion
2005	US\$15.9 billion

Source: *China Insurance Outlook 2006-2007*, Standard & Poor's (2006).

China's nonlife insurance markets are still highly concentrated among domestic insurers, with the top three firms holding over 70 percent of market share. Foreign insurers currently have very low market share; their branch operations are limited to a few major coastal cities, although they are now allowed to write large commercial risks nationwide.

Insurance-market capacity is rapidly expanding, particularly for property insurance, leading to fierce competition on premium rates, which can be up to 50 percent below international levels, a discount that most observers believe is not sustainable for the long run. CIRC has expressed its concern about the high level of competition and its impact on the insurance market's long-term sustainability, indicating recently that it may demand that insurers adopt more responsible underwriting and rating structures. It has stopped short of imposing tariffs; however, if the insurers are not seen to be taking the initiative, this could change.

Companies should pay strict attention to the security issues of China's domestic insurers, especially among the second and third tiers. Currently, none of the domestic insurers are rated by international rating agencies like A.M. Best, Standard & Poor's, or others, which raises questions about their potential inability to pay a claim.

“Currently, none of the domestic insurers are rated by international rating agencies like A.M. Best, Standard & Poor's, or others, which raises questions about their potential inability to pay a claim.”

## China's Nonlife Insurance Premium by Business Class

Automobile: 69%
Property: 12%
Cargo: 4%
Liability: 4%
Other: 11%

Source: Standard & Poor's China Insurance Outlook 2006-2007.

## Property Insurance

The insurance industry in China is susceptible to natural catastrophe risks and massive risk retention, which can be as high as about 80 percent. Of the 35 property/casualty insurers operating in China at the end of 2005, the 22 domestic insurers held a market share of more than 98 percent.

**Geographic diversity and natural hazards:** China is geographically diverse, ranging from subarctic in the north to tropical in the south, with abundant coastline, deserts, mountains, and plains filling out the picture. With the diversity come abundant natural risks to property—such as earthquakes, typhoons, and floods. At present, the majority of multinational investments and assets at risk are in coastal regions prone to damaging floods, tsunamis, typhoons, earthquakes, and land subsidence. The high concentration of physical assets and employees in these areas increases the potential cost of any one catastrophe.

### Loss Estimates From a Major Event

Event	Total Property Loss	Insured Loss
Earthquake	US\$120 billion	US\$1.1 billion
Typhoon	US\$37.4 billion	US\$3.4 billion
Flood	US\$30.8 billion	US\$2.0 billion

Source: Swiss Re, *Natural Hazards in China*, 2006.

**Infrastructure:** As companies begin to expand operations throughout China, the assets at risk will be spread throughout the country. The infrastructure—firefighters and their equipment, emergency responders, utility crews, and so on—to mitigate utility outages, transportation disruptions, fires, flooding, and other emergencies varies substantially from city to city and from province to province. Even within buildings in the same city, there is great variance in such things as the presence of sprinkler systems and other safety measures often required in other countries.

Loss-control measures receive little, if any, recognition by domestic Chinese insurers, resulting in little tangible premium savings. Local insurers may survey their insureds about risks and protective measures, but the process is often restricted to a “checklist” and a tour of a site. Loss control is, of course, important from a risk management perspective; but the primary benefit in China at present will be to companies’ own assessment and management of risk, allowing them to make more informed decisions on loss limits, maximum projected losses, risk-retention levels, and so on.

**Valuation and underinsurance:** Many insurance managers in China assess asset values incorrectly, often basing decisions on book value or market value instead of replacement value. The lack of professional appraisal firms and indexing services adds to the difficulty.

**Builders risk coverage:** Construction “all-risk” policies are available. Exclusions typically include such perils as faulty design, riots, strikes, and terrorism, some of which may be bought back through negotiations with insurers. There is a large amount of capacity available in local insurance markets to insure builders risk; however, capacity is limited when companies need coverage for delay in start-up.

The main issues regarding builders risk come in the management of contractors and insurance policies. Many local Chinese contractors have acquired the skills and capabilities to meet the construction requirements of multinational companies that build new facilities or expand existing ones. However, these contractors tend to be much less sophisticated regarding risk control and insurance and often leave projects uninsured or inadequately insured.

This lack of insurance management often gives rise to substantial risks for project owners, especially when they award contracts to less capitalized contractors and/or delegate insurance purchase to contractors

### China at the Center of Climate Change Risks

As governments and corporations pay more attention to the risks associated with climate change—also called global warming—China’s role is a hot topic. China is expected soon to pass the United States as the world’s largest energy consumer. China annually burns more than 1.5 billion tons of coal—the leading industrial source of the greenhouse gas carbon dioxide (CO<sub>2</sub>).

The Kyoto Protocol is the primary international treaty aimed at reducing greenhouse gas emissions. The Protocol sets legally binding limits for the industrialized nations that have signed it for their emissions of CO<sub>2</sub> and other greenhouse gases. Developing countries—including China—are exempt. But when Kyoto’s first phase expires in 2012, China could face pressure to reduce emissions.

The combination of concerns about greenhouse gases and a rising demand for energy makes China a major target for companies offering renewable energy alternatives.

For example, the Kyoto Protocol has a mechanism—the Clean Development Mechanism (CDM)—that allows companies to earn credits for establishing or assisting climate-friendly projects in developing nations. The credits are tradable and can be used to offset emissions elsewhere. China is one of the leading host countries for CDM projects, representing nearly 30 percent of the total volume of the program’s carbon credits.

With its energy needs on the rise, China will also be looking for additional energy sources. Many experts believe China could become a key market for renewable energy products if it makes a concerted effort to reduce emissions. China and the European Union recently signed an agreement to develop cleaner coal-power technology.

China is also seeing a burst of activity around wind power and solar energy.

For more information, visit <http://solutions.marsh.com/climates>.

without adequate attention. Even if the contracts have specific clauses about indemnity and insurance requirements, it is advisable that project owners carefully review the coverage purchased and keep a close eye on policy maintenance.

**Transit/cargo coverage:** Insurance laws and regulations dictate that inland transit within mainland China must be placed with locally licensed insurers. Imports and exports to and from China are generally covered by a global marine program. Inland destinations can be far from the ports where cargo is discharged. Foreign insurers may be unfamiliar with conditions when cargo has to be hauled long distances inland; there is a tendency for coverage to cease at the point of discharge. Inland transit in connection with an overseas voyage can be insured; however, it is important to give detailed information to insurers so that coverage can be extended to the final warehouse. Integrated coverage forms for transit and storage are being introduced to local markets by international brokers, and domestic insurers are looking cautiously at stock-throughput wording.

## Liability Insurance

The litigious nature of the West is nascent in China, with attitudes, expectations, and laws changing quickly. New product and consumer-protection laws and regulations are creating new exposures for multinational companies.

Legal reforms on civil liability, as well as social awareness of the protection of rights and interests, are growing quickly in China—particularly in some relatively developed regions such as Beijing, Shanghai, and Guangdong. Although the laws and regulations often leave much room for interpretation and enforcement, the potential liabilities are a growing concern to companies. To what extent this will lead to a rise in litigation is unclear, but recent incidents and losses suggest that the tide is turning. Here are three examples:

- A Chinese company and its international auditor face a class-action lawsuit from shareholders over alleged accounting irregularities.
- An international computer firm is facing a class-action lawsuit from Chinese consumers alleging it falsely advertised one of its products.
- A Chinese company recently settled a class-action lawsuit filed in the United States related to its initial public offering in 2004.

The local insurance markets can provide basic policy forms for general liability and products liability, but coverage is limited. The interpretation of policy wording varies, and some policy exclusions—such as gross negligence—may cause claims disputes.

**General/public liability:** In general, very low limits are available in China because the court system does not hand out large awards. The decision to purchase general liability insurance is often driven by the demands of lenders. Products liability is written as a separate policy. Over the past 10 years, there have been numerous successful claims against business owners—primarily foreign retailers—made by individuals injured on a business’s premises. Previously, this type of claim had been virtually unknown.

Some local insurers provide basic policy forms for general liability, often in the form of public liability with limited scope of coverage. The interpretation of policy wording varies, and some policy exclusions—such as gross negligence—may cause claims disputes.

**Products liability coverage:** The local insurance market traditionally has been geared toward liability risks arising inside China. The limits of liability have been low, and the scope of coverage narrow. It is currently quite difficult in China to find adequate products liability or product-recall insurance—and it is expensive where it exists. Limits of US\$1 million to US\$10 million are generally available, but coverage is severely limited for exports to the United States and Canada.

Companies need to maintain a close eye on both the products liability insurance markets and on legal developments in this area not only within China, but also around the world. For example, the European Union’s 2004 General Product Safety Directive raised the bar for product safety in Europe by defining safety in more exacting terms.

### Changing China’s Risk Management Attitude

As is the case in other Asian countries, China’s attitude toward risk management is evolving to look more like that of Western companies.

In one recent indication of the move to more Western-style risk management, China’s State-Owned Assets Supervision and Administration Commission issued a guide to overall risk management of the largest enterprises run by the central government.

The guidelines permit such enterprises to establish a risk management committee under the board of directors. The goal is to improve risk management in state-owned enterprises, an area of governance now seen as weak in their overall management.

The commission said the guide is modeled on enterprise risk management of large foreign companies in developed nations and the common risk management practices of large multinational companies.

International experts expect to see the risk management consulting market grow rapidly in China in the coming years.

### Financial and Professional Lines

**Directors and officers liability (D&O) coverage:** There is a growing awareness of D&O liability as Chinese companies expand operations abroad and become global players. However, the insurance markets for domestic D&O liability in China are at an early stage of development, although they are rapidly evolving, making it critical for companies to work with a knowledgeable broker or otherwise stay in touch with new developments and products.

A typical D&O policy provides worldwide coverage and will respond to claims made in any country or involving any insured, subject to policy terms and conditions. In general, companies have not been purchasing local D&O policies. However, it should be noted that nonadmitted insurance is prohibited in China and that the payment of a claim or remittance of premium offshore might be considered a breach of the law. Multinational companies that purchase a local D&O policy—because the exposure is different from the parent/holding company—are often insured at limits of about US\$3 million to US\$5 million. Some industries with higher exposures may increase that to US\$10 million or more.

**Professional liability coverage:** Professional liability insurance is available, but on a very limited basis; and it's restricted to certain sectors and industries, such as lawyers, accountants, designers, engineers, and others. Insured limits are generally low. Like D&O coverage, professional liability insurance is at an early stage of development. Medical malpractice is beginning to be made compulsory in some regions of the country.

**Environmental liability coverage:** Environmental liability is developing rapidly, as cities such as Shanghai and Beijing are beginning to introduce new laws and tougher compliance standards. China has enormous environmental challenges, including large-scale water pollution problems and air pollution on a massive scale in some areas. As the country's local and national leaders put more teeth into laws aimed at stemming environmental damage, it can be expected that more insurance products will become available to assist companies in managing environmental issues.

**Employee dishonesty/fidelity coverage:** Fidelity guarantee insurance is one of the coverages companies need to consider because white-collar crime is a high-frequency loss issue. There is a high incidence of theft by employees and third parties—even of raw materials, which are often subsequently found in the commercial black market. Loss prevention tends to be reactive instead of proactive, with security measures often implemented after the fact. Due to generally high loss records, only a few insurance markets are willing to consider the risk. Those that do often quote high premiums.

### Trade Credit Insurance

There is widespread difficulty in managing credit risk in China due to the lack of a nationwide credit information database; the shortage, poor quality, and unreliability of buyers' financial statements; and other factors. Many companies thus try to mitigate credit risks, protect balance sheets, and obtain financing alternatives, all of which help drive demand for trade credit insurance for both domestic and export sales.

At present, domestic trade insurers are cautious about writing buyer risks and extending credit limits, which keeps their product offerings limited. Although many hurdles exist, the credit insurance market has witnessed significant positive change over the past two years as more insurers have entered the market. Leading international credit insurers generally have not applied for independent licenses in China, but have gained access through partnerships with domestic insurers. The export credit insurance market is generally expected to open up fairly soon.

### Political Risk and Terrorism Insurance

One of the key issues facing China is the social and economic integration of business into society. There is a widening gap between the “haves” and the “have-nots” that could lead to increasing social unrest. Some critics inside the country see economic growth as running rampant over social and environmental considerations. This could lead—some say it is already leading—the disenfranchised to resort to violence to achieve their goals or, at least, to be seen and heard.

Western businesses may increasingly find their facilities and, potentially, people being targeted as icons of wealth. Feeding the backlash are reports of instances of Chinese rural populations being stripped of land and housing to make way for new factories. Political risk insurance is, therefore, playing a greater role in investment-protection programs.

On the other hand, terrorism insurance is not a major consideration in China at this time.

### Claims Management

Claims management and services are often overlooked when arranging insurance in China. However, experience shows that claims negotiations in China can be long and technically complicated due to the complex risk environment and the interpretation of insurance policies. Many companies find relatively low premium rates up-front, but struggle to get claims settled promptly and equitably.

When possible, companies should use an international adjuster for claims management. Although such firms are beginning to appear in China, for local insurance programs, companies may find it difficult to appoint professional international firms. Compounding this problem is the lack of qualified, independent loss adjusters in China, although a number of loss-adjusting firms have been set up over the past few years. Their credibility, technical expertise, and experience—particularly for claims involving business interruption and liability—are slowly improving.

#### China’s Insurance Markets: Points to Remember

When deciding on an insurance program for China operations, there are a number of important points to keep in mind, including the following:

- Understand that China is very different from the United States and Europe.
- Consider whether in a joint venture you should seek to control the insurance placement.
- Ensure that you comply with the laws and regulations, and follow changes in them closely.
- Employ an international broker familiar with China’s risk and insurance environment.
- Be culturally sensitive in negotiations.
- Plan ahead, and allow plenty of time.
- Work closely with your broker and the insurer.
- Meet face-to-face with the primary insurers.
- Select reinsurers with experience in China.
- Agree on an international loss adjuster ahead of time.
- Pay premiums on time. Some policies will include an exclusion for indemnity if premiums have not been paid at the time of a loss.
- Three axioms of arranging insurance in China:
  1. Cheap is not always better. The devil is in the details.
  2. You get what you pay for.
  3. You do not get what you deserve, but what you negotiate.

## Master-Controlled Programs

Many companies have successfully expanded into China, and their operations have spread across the vast country. But insurance management often poses risks when it is decentralized and is delegated to finance or administrative managers. There can be a lack of consistency in coverage, including:

- gaps across entities;
- no centralized leverage with insurance markets;
- high administrative costs from a corporate perspective; and
- difficulty implementing global philosophies on risk retention and coverage.

A master-controlled insurance program (MCP) may provide a solution for some companies. The specifics of such a program will vary based on the needs of a particular company. The general objectives in establishing an MCP for China operations include:

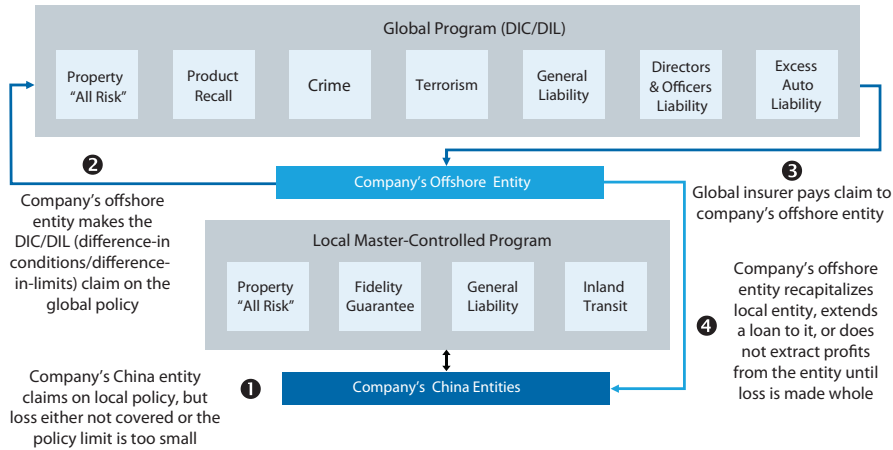
- gaining consistency in coverage and pricing;
- eliminating the need to purchase additional local policies, thereby gaining premium efficiencies;
- centralizing leverage with insurance markets;
- accessing insurers with acceptable security ratings;
- reducing the potential for gaps across entities;
- applying global philosophies to risk issues and management; and
- reducing administrative costs and logistics.

For an MCP to work optimally, the management of each entity involved must be willing to buy into the arrangement completely. There also needs to be an individual designated as the central focal point within a firm's China operations. And that person must be given the appropriate authority to manage and make decisions about the program and issues that may arise.

“ A master-controlled insurance program (MCP) may provide a solution for some companies. The specifics of such a program will vary based on the needs of a particular company. ”

The following diagram provides one example of how such a program would look and respond to a claim.

## Sample Master-Controlled Program



Remember, there are many other ways such a program could look. For example, a local fronting insurer could be the best solution for some companies.

## Conclusion

China has become such a dominant force in the global economy that businesses may be at risk if they *don't* engage it in some way, whether to access its domestic markets or to serve as an export base. But opening a China operation should not be viewed as an automatic win for businesses.



As with any opportunity, there are a wide range of risks in China's business environment, including sourcing issues; intellectual property protection; talent attraction, development, and retention; and merger and acquisition challenges.

Risk transfer through insurance can play a critical role in mitigating some of a company's risks in China. But companies must recognize that the Chinese insurance market is still in an early stage of development and, thus, holds many potential pitfalls, especially for those unfamiliar with the territory. It's important to work with trusted advisors when establishing risk-mitigation strategies for China operations.

## Web Sites of Interest

- China Insurance Regulatory Commission (page 26)  
<http://www.circ.gov.cn>
- European Union Chamber of Commerce in China  
<http://www.europeanchamber.com.cn>
- Marsh's climate change information  
<http://solutions.marsh.com/climates>
- Marsh's avian flu/pandemic information (page 9)  
<http://solutions.marsh.com/afpandemic>
- Marsh's China risks information  
<http://solutions.marsh.com/chinas>
- Office of the United States Trade Representative (pages 3 and 11)  
<http://www.ustr.gov>
- The US-China Business Council  
<http://www.uschina.org>

# Abbreviations and Acronyms in This Issue

- CDM: Clean Development Mechanism
- CIRC: China Insurance Regulatory Commission
- CO<sub>2</sub>: carbon dioxide
- D&O: directors and officers liability
- EU: European Union
- FDI: foreign direct investment
- GATT: General Agreement on Tariffs and Trade
- GDP: gross domestic product
- H5N1: a strain of avian flu
- HR: human resource
- ICAEW: Institute of Chartered Accountants in England & Wales
- ICBC: Industrial and Commercial Bank of China
- IP: intellectual property
- IPO: initial public offering
- IPR: intellectual property rights
- IT: information technology
- JV: joint venture
- LNG: liquefied natural gas
- M&A: merger and acquisition
- MCP: master-controlled program
- NERA: NERA Economic Consulting
- RMB: renminbi
- S&P: Standard & Poor's
- SAIC: State Administration of Industry and Commerce
- USCBC: US-China Business Council
- USTR: Office of the United States Trade Representative
- WTO: World Trade Organization


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