Financial Overview of Life Insurance Companies in Fiscal 2007

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Due in part to the inappropriate handling of claims payments, new business at the nine leading life insurers plummeted in fiscal 2007. Another troubling trend is the persistent downtrend of business in force, which has impacted mortality and expense margins. As a result, core profit declined despite improvement of the negative spread from higher interest and dividend income. We review the industry's performance and developments in fiscal 2007 including the emergence of Japan Post Insurance.

1. Introduction

Due in part to the erosion of public confidence from the inappropriate handling of claims, new business declined significantly in fiscal 2007. Although the negative spread narrowed, core profit was squeezed by the downtrend of business in force. These developments suggest an urgent need to reinforce the life insurance business model. Below we review the developments and performance of the life insurance industry in fiscal 2007.

2. Industry Review

The launch of Japan Post Insurance Co. in October 2007 brought the number of private life insurers to 41 in fiscal 2007. In Exhibit 1, results are aggregated by the following categories: traditional life insurers (13 companies), foreign-owned life insurers (16 companies), entrants from the non-life insurance industry (9 companies), and entrants from other industries (2 companies).

The setback to new business partly stems from a blow to consumer confidence following revelations of insufficient payment of claims and benefits by life insurers. Among the nine leading insurers, new business fell -21.4% from a year ago, surpassing the -20.0% plunge of fiscal 2006. As a result,

Exhibit 1 Life Insurance Business Performance in Fiscal 2007

	New business Indiv. life & annuity			Business in force Indiv. life & annuity			Premium income			Assets under management			Core profit		
	¥ tril.	% chg	% shr	¥ tril.	% chg	% shr	¥ tril.	% chg	% shr	¥ tril.	% chg	% shr	¥ bil.	% chg	% shr
Major & 2nd-tier (9)	37.5	−21.4	56.2	844.4	−5.7	79.1	16.76	−3.4	60.0	160.3	−5.0	75.0	2,123.5	−11.0	83.1
Traditional (13)	37.9	−21.2	56.8	848.5	−5.6	79.5	17.04	−3.4	60.9	161.9	−4.9	75.7	2,099.5	−11.9	82.2
Foreign-owned (16)	16.4	0.9	24.6	134.7	1.3	12.6	7.89	10.0	28.2	37.8	2.8	17.7	426.8	−5.8	16.7
Non-life insur. entrant (9)	8.0	−4.3	12.0	48.3	4.8	4.5	2.26	−24.0	8.1	10.1	7.9	4.7	7.4	−71.1	0.3
Non-insurance entrant (2)	4.4	4.2	6.6	35.8	3.6	3.3	0.77	5.7	2.8	4.2	5.1	2.0	20.9	−31.5	0.8
Subtotal (40 cos.)	66.7	−13.3	100.0	1,067.4	−4.0	100.0	27.95	−1.9	100.0	213.9	−2.9	100.0	2,554.6	−11.7	100.0
Japan Post Insurance	5.5	−	[8.2]	148.3	−	[13.9]	8.46	−	[30.3]	112.5	−3.5%	[52.6]	575.6	−	−
TOTAL (41 cos.)	72.2	−	−	1,215.7	−	−	36.41	−	−	326.4	−3.1%	−	3,130.2	−	−
(For reference) Zenkyoren (JA Kyosai)	17.9	72.6	[26.9]	187.2	−4.9	[17.5]	4.76	2.2	[17.0]	43.5	−1.3	[20.3]	418.7	−0.7	−

Notes: 1. Life insurers are classified as follows, and listed in order of assets under management; company names are as of fiscal yearend.
9 major & 2nd-tier: Nippon, Dai-ichi Mutual, Meiji Yasuda, Sumitomo, Mitsui, Asahi Mutual, Taiyo, Daido, Fukoku Mutual.
13 traditional: 9 major & 2nd-tier companies, plus T&D Financial, Yamato, Dai-ichi Frontier, and Fukokushinrai.
16 foreign-owned: ALICO Japan, Aflac Japan, AXA, Hartford, ING, AIG Edison, Prudential, Manulife, AIG Star, MassMutual, AXA Financial, PCA, Cardif, Zurich, and Credit Agricole.
9 entrants from non-life insurance industry: Mitsui Sumitomo MetLife, Tokio Marine & Nichido, Tokio Marine & Nichido Financial, Sompo Japan Himawari, Mitsui Sumitomo Kirameki, Aioi, Nipponkoa, Fuji, and Sompo Japan DIY.
2 entrants from non-insurance industries: Sony, ORIX.
2. Although Japan Post Insurance began operation on October 1, 2007, flow indicators such as new business reflect the full fiscal year for convenience; business in force includes reinsurance of policies ceded by the Management Organization for Postal Savings and Postal Life Insurance.
3. For business in force of Japan Post Insurance, reinsurance of individual annuities ceded by the Management Organization for Postal Savings and Postal Life Insurance are valued by income benefit. The rest of business in force is valued by maturity benefit, similar to the 40 life insurers. Market share is expressed as a ratio to the 40-company total.
Source: Compiled by NLI Research Institute based on financial disclosures.

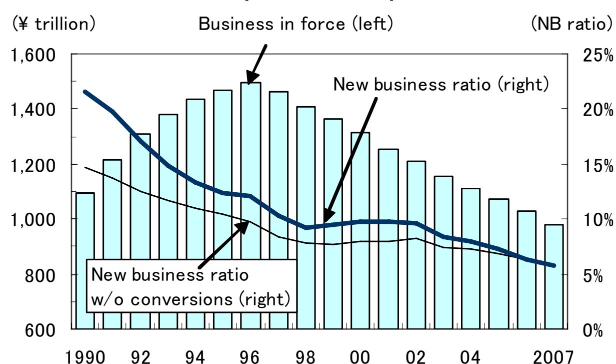
business in force also declined by -5.7%.

However, the 16 foreign-owned life insurers posted growth in both new business and business in force. As a result, their market share in terms of premium income rose to 28.2%, surpassing the previous high of 27.9% in fiscal 2005.

In contrast, the nine entrants from the non-life insurance industry suffered a -24% plunge in premium income, mainly from slumping sales of variable annuities distributed through banks.

Japan Post Insurance is shown separately from the 40 insurers, in part because results cover only the six-month period since October 2007. At that time, the new company reinsured in-force policies ceded by the Management Organization for Postal Savings and Postal Life Insurance.

Exhibit 2 Business in Force and New Business Ratio (1990 – 2007)



Note: New business ratio = new business (including net increase due to conversions) ÷ business in force in preceding period.
Source: Japan Institute of Life Insurance.

Exhibit 3 New Annualized Premiums (NAP)

(¥ billion unless noted)

	Individual insurance	Individual annuity	Total	of which 3rd-sector
Major & 2nd-tier (9)	624.3	191.4	815.7	214.9
Traditional (13)	629.1	212.8	841.9	215.6
Foreign-owned (16)	418.8	400.1	818.9	205.2
Non-life insurance (9)	97.9	382.5	480.4	21.1
Non-insurance (2)	79.5	2.2	81.7	25.1
Total (40 cos.)	1,225.3	997.6	2,222.9	467.0
Japan Post Insurance	1,100	683	1,783	114
Indexed to individual insurance = 100				
Major & 2nd-tier	100.0%	30.7%	130.7%	34.4%
Traditional (13)	100.0%	33.8%	133.8%	34.3%
Foreign-owned (16)	100.0%	95.5%	195.5%	49.0%
Non-life insurance (9)	100.0%	390.7%	490.7%	21.6%
Non-insurance (2)	100.0%	2.8%	102.8%	31.6%
Total (40 cos.)	100.0%	81.4%	181.4%	38.1%
Market share				
Major & 2nd-tier	51.0%	19.2%	36.7%	46.0%
Traditional (13)	51.3%	21.3%	37.9%	46.2%
Foreign-owned (16)	34.2%	40.1%	36.8%	43.9%
Non-life insurance (9)	8.0%	38.3%	21.6%	4.5%
Non-insurance (2)	6.5%	0.2%	3.7%	5.4%
Total (40 cos.)	100.0%	100.0%	100.0%	100.0%
Year-on-year change				
Major & 2nd-tier	-15.2%	-20.8%	-16.6%	-13.4%
Traditional (13)	-15.1%	-19.7%	-16.3%	-13.2%
Foreign-owned (16)	-6.4%	17.6%	3.9%	5.3%
Non-life insurance (9)	-39.4%	-12.5%	-19.7%	7.1%
Non-insurance (2)	-4.4%	69.2%	-3.3%	19.5%
Total (40 cos.)	-14.5%	-4.4%	-10.2%	-3.5%

Reflecting industry-wide trends, both new and in-force business (including the reinsured portion) declined at Japan Post Insurance in fiscal 2007. Still, we note that assets under management remain 52% as large as the combined assets of the 40 insurers.

For the 40 life insurers, Exhibit 2 plots trends since 1990 for individual insurance in force, and the ratio of new business to the previous year's business in force. While individual business in force peaked out in 1996, the new business ratio has trended downward over the entire period, reaching approximately 5% in fiscal 2007. Moreover, among converted policies, death protection has decreased while third-sector protection has grown, such that the net increase in new business due to policy conversions has shrunk to nearly zero.

In fiscal 2005, reflecting the growth of the third-sector and annuity markets, disclosure became necessary for new annualized premiums (NAP), in addition to the face amount of death protection (Exhibit 3).

In fiscal 2006, third-sector NAP plunged among all insurers. It continued to slide in fiscal 2007 at traditional life insurers, but recovered at foreign-owned insurers and entrants from the non-life insurance sector.

Third-sector NAP totaled 467.0 billion yen in fiscal 2007, or 38% as a ratio to individual insurance NAP (1,225.3 billion yen), up from 34% in fiscal 2006.

By market share, traditional life insurers hold the lead in individual insurance with a 51% share. However, in individual annuities, they trail behind foreign-owned and non-life insurance entrants, whose combined market share almost reaches 80%. In the third sector,

foreign-owned life insurers are almost even in market share with traditional life insurers.

3. Profit Condition of the 9 Leading Insurers

1. Decline of Core Profit

Core profit (operating profit minus net capital gains and extraordinary gains) dropped -11% from the previous year to 212.41 billion yen. Although the negative spread component of core profit continued to improve as investment income was boosted by strong corporate earnings, the other two components of expense margin and mortality margin (the latter was redefined to include third-sector products) suffered sharp declines.

In Exhibit 5, more detailed results for fiscal 2006 and 2007 are shown for the seven leading life insurers who disclosed such data. The expense margin decreased at a constant pace in both years. Notably, however, the mortality margin careened downward, from 0.3% in fiscal 2006 to -11.2% in fiscal 2007. This is attributed to the decline of business in force, especially in recently underwritten policies with low risk. In addition, some major life insurers increased their policy reserves after re-evaluating third-sector liabilities, and charged the mortality margin.[1]

Exhibit 4 Core Profit (9 life insurers)

(¥ billion unless noted)

	FY 2007	FY 2006	Change
A. Core profit	2,124.1	2,385.9	－11.0%
B. Negative spread (investment margin)	−255.6	−445.6	**－42.6%**
C. Expense margin & mortality margin	2,379.7	2,831.5	－16.0%
B / C	10.7%	15.7%	**－5.0%**

Note: C＝A － B

Exhibit 5 Core Profit (7 life insurers)

(¥ billion unless noted)

	FY 2007	FY 2006	Change (FY 2007)	Change (FY 2006)
Core profit	1,946.2	2,206.1	－11.8%	6.5%
Investment margin	−259.7	−429.3	**－39.5%**	**－38.8%**
Mortality margin	1,836.7	2,067.4	－11.2%	0.3%
Expense margin	448.6	568.3	－21.1%	－21.1%

Exhibit 6 Negative Spread

	FY 2007	FY 2006	Change
① Average guaranteed rate	3.05%	3.14%	－0.09 ppt
② Investment yield *	2.84%	2.78%	＋0.07 ppt
③ Negative spread rate (②−①)	−0.20%	−0.36%	＋0.16 ppt
④ Policy reserve	¥126.3 tril.	¥125.3 tril.	－
⑤ Negative spread amount (③×④)	¥255.6 bil.	¥445.6 bil.	－¥190.0 bil.

Note: Investment yield = net investment income in core profit ÷ policy reserve.

Starting in fiscal 2007, life insurers are required to make a ten-year cash flow projection of third-sector protection, and increase the policy reserve if a shortfall is predicted. As explained below, some life insurers have already done so.

2. Narrowing Negative Spread

The negative spread refers to the shortfall that occurs between the investment income yield (net dividend and interest income contained in core profit, divided by policy reserve) and guaranteed rate (assumed interest rate used for pricing) of policies). In fiscal 2007, the loss due to the negative spread shrank by 40% from the previous year to -255.6 billion yen (Exhibit 6).

The negative spread rate (investment yield minus average guaranteed rate) decreased 0.16-percentage point to 0.20%, down from 0.36% in fiscal 2006. Of this 0.16-point improvement, 0.09-point derives from a lower average guaranteed rate, and 0.07-point from a higher investment yield. By comparison, when the negative spread improved 0.27-percentage point in fiscal 2006, the investment yield contributed most (0.23-point) of the improvement.

Looking ahead, the guaranteed rate is expected to continue declining slowly.

With regard to the higher investment yield, while detailed data on interest and dividend income is unavailable, likely factors include dividend increases propelled by strong corporate earnings, and higher interest income as low-yield bonds were replaced with higher-yield long-term bonds.

3. Allocation of Net Profit

Net profit consists of core profit, net capital gains, and extraordinary gains. Below we examine these components, and see how net profit was allocated between retained surplus and reserve for policyholder dividends. Three characteristics were seen in fiscal 2007:

- due to lower capital gains and higher capital losses, the sum of core profit and net capital gains decreased by -21.1% from a year ago;
- Extraordinary gains were largely unchanged, except for the other expenses category.
- The sharp rise in other expenses relates to the provision for policy reserve (see below).

The -49.9% decline of net profit is mainly due to a large provision for the policy reserve. As a result, the allocation ratio to the reserve for policyholder dividends appears to balloon from the previous year. However, if the provision for policy reserves is backed out of net profit, the decline of net profit shrinks to -12.3% (Exhibit 7, line A'). Of this revised amount, 66% was allocated to the retained surplus, and the other 34% to the reserve for policyholder dividends. This represents the same pattern of allocation as in fiscal 2006. Thus while some companies raised dividends, the industry as a whole retained the same allocation (we leave aside the issue of whether the provision for required policy reserve actually qualifies as a retained surplus).

Currently, losses related to the subprime mortgage crisis are estimated at 3 billion yen, and thus limited in impact.

Exhibit 7 Net Profit Composition and Uses

(¥ billion unless otherwise noted)

	FY 2007	FY 2006	Change
① Core profit	2,124	2,386	− 11.0%
② Capital gains	650	738	− 12.0%
③ Capital losses	− 971	− 838	15.8%
Core profit + Net capital gains	1,803	2,286	− 21.1%
④ Gain/loss from disposal of real estate	− 6	− 49	− 88.2%
⑤ Write-down of unrecoverable loans	6	− 6	−
⑥ Corporate & resident tax	− 459	− 481	− 4.7%
⑦ Tax effect adjustment	306	309	− 1.2%
⑧ Retirement benefit cost (extraordinary)	3	12	−
⑨ Other expenses	− 774	− 315	145.3%
A. Net profit (add lines ①～⑨) *	880	1,755	− 49.9%
(a) of which, provision for policy reserve	930	308	202.0%
A ' Net profit before provision for policy reserve	1,810	2,063	− 12.3%
Change in contingency reserve	− 64	588	−
Change in price fluctuation reserve	94	125	− 25.0%
Change in on-balance-sheet capital	240	345	− 30.4%
B. Change in retained surplus	270	1,058	− 74.5%
B ' Change in retained surplus, broadly defined: B + (a)	1,200	1,366	− 12.1%
(B ' / A ')	66%	66%	0%
C. Provision of reserve for policyholder dividends	6,100	6,970	− 12.5%
(C / A ')	34%	34%	− 0%

Notes: Net profit (line A) does not include changes to contingency and price fluctuation reserves; rounded to the nearest billion yen.

4. Solvency Margin

The solvency margin (SM) ratio of the nine leading life insurers in fiscal 2007 stood at 1,088%, down from 1,221% in fiscal 2006. The contribution of individual factors is detailed in Exhibit 8.

The 133-point decline is accounted for as follows: (1) components in the numerator contributed -279 points, while (2) the denominator (risk) contributed 145 points.

The lower SM ratio can be largely attributed to the stock market downturn. Although the stock market rallied in the first half due to the weak yen and briskness of stock markets abroad, it was pummeled in the second half by the subprime mortgage crisis, surging oil prices, and deteriorating

outlook for corporate earnings. For the fiscal year as a whole, the Nikkei average plunged 27.5% to 12,525 yen. Thus sagging domestic stock prices contributed -284 points to the SM ratio, while investments denominated in foreign currencies contributed a smaller negative amount.

Exhibit 8 Solvency Margin Ratio

(Percentage point)

	FY 2007	FY 2006
Decline of solvency margin ratio 1,221% ⇒ 1,088% (－133%)	133-ppt decline	100-ppt decline
Numerator (solvency margin)	－ 279	＋ 153
Capital on balance sheet	＋ 6	＋ 55
Unrealized gains from securities available for sale × 90%	－ 340	＋ 63
Domestic stocks	－ 284	＋ 39
Bonds, foreign stocks & bonds	－ 57	＋ 24
Unrealized gains from land × 85%	＋ 23	＋ 34
Other (e.g., provision for policy reserve)	＋ 32	＋ 1
Denominator (total risk)	＋ 145	－ 53

Capital on the balance sheet contributed an unusually low 6-percentage points to the SM ratio. This is partly because some companies transferred a portion of the contingency reserve (which is a component of the policy reserve, and included in capital) to the premium reserve (another part of the policy reserve, but not included in capital). The transfer, which reflects the recognition of liabilities due to the negative spread, appears under other expenses in Exhibit 7.

Meanwhile, total risk decreased in the denominator. This is because the price fluctuation risk, which is proportional to prevailing market prices, declined as stock prices fell, and also because the guaranteed rate risk declined at companies who reduced the valuation interest rate.

With the Financial Services Agency now reviewing all reserving and solvency requirements, new rules will likely apply to financial statements in the future.

4. Japan Post Insurance

Launched in October 2007 as a joint stock company, Japan Post Insurance warrants special attention due to the new company's sheer size. In addition, the shortened fiscal year makes it difficult to aggregate results with the other 40 companies.

We first compare year-on-year growth of individual insurance with the nine leading private life insurers (Exhibit 9). For convenience, new business reflects full fiscal-year results, including results prior to privatization. Similarly, business in force includes the reinsurance of business in force ceded from the Management Organization for Postal Savings and Postal Life Insurance.

Perhaps due in part to the privatization, new business plummeted in fiscal 2007, while business in force shrank by more than at the nine insurers. However, we should note that since Japan Post Insurance mainly underwrites policies with a relatively short maturity of ten years, a slump in new business can adversely impact business in force. Meanwhile, lapse and surrender rates are thought to remain below the nine insurers.

Core profit results are shown in Exhibit 10. The company also released results based on the previous pricing rate. In either case, similar to the nine insurers, the investment margin improved (negative spread decreased), while the mortality and expense margins deteriorated due to the reduction of business in force.

Since securities available for sale were booked at market value (including an unrealized gain of 1.7 trillion yen), an unrealized loss of 123.6 billion yen subsequently occurred due to the stock market decline and surging yen. However, when bonds held to maturity are included, the net result is an unrealized gain of 1.3

Exhibit 9 Performance of Japan Post Insurance

(yoy change)

	Japan Post Insurance	9 leading life insurers
New business	－24.9%	－22.2%
Business in force	－7.2%	－6.1%

Source: Compiled from company disclosures.

Exhibit 10 Core Profit (half-year)

Investment margin	－¥200.0 billion
Mortality margin	¥170.0 billion
Expense margin	¥290.0 billion
Core profit	¥267.2 billion

Source: Compiled from company disclosures.

trillion yen.

In addition, the company reported a solvency margin ratio of 1,116.3% (reinsurance of business in force is included as risk in the denominator, and the corresponding contingency and price fluctuation reserves are included in the numerator), exceeding the average ratio of 1,088% ratio for the nine insurers. However, the numerator does not include a provision to the policy reserve of 7.2 trillion yen.[2] If this amount is included, the SM ratio doubles, leaving the major private insurers far behind.

The numerator is characterized by a relatively high proportion of on-balance-sheet capital, including the contingency reserve. As for risk composition, the investment risk of 74% is comparable to that of the nine insurers (76%), while the third sector risk of 24% is much higher (9%). This reflects the higher proportion of protections such as hospitalization relative to death protection.

5. Topic: Market Valuation of Liabilities

As mentioned earlier, fiscal 2007 was characterized by the growing number of companies who moved aggressively to increase required reserves. Following on the two companies in fiscal 2006, two more leading insurers took action in fiscal 2007 to revalue liabilities associated with high guaranteed rates by reducing the valuation interest rate. This approach anticipates the likely outcome of the current international debate on market-based valuation of liabilities. Instead of continuing to use pricing rates for valuation. the aim is to reflect prevailing market conditions to achieve more realistic valuations of liabilities. We commend these first movers for their foresight.

Three trends were seen regarding additions to policy reserves in fiscal 2007.

(1) *Additions to required reserves*—Under Article 69-5 of the Enforcement Regulation of the Japanese Insurance Business Law, additional policy reserves must be set aside based on actuarial cash flow projections. Four leading insurers took such action. Beginning in fiscal 2007, the cash flow projection must include third-sector products.

(2) *Other increases to reserves*—Insurers can choose to set aside an additional policy reserve with the approval of regulators. In the current fiscal year, one leading insurer re-evaluated third-sector products by altering the mortality factor in accordance with rules.

(3) *Reserve calculation by month*—In the past, the reserving method recognized all policies to be underwritten in mid-fiscal year. However, some companies have switched to a reserving method that recognizes the month of underwriting. This move apparently anticipates the new requirement for quarterly disclosure slated to begin in fiscal 2008, and is a more appropriate way to recognize gains and losses.

Regarding solvency issues, attention has recently focused on variable annuities and their popular minimum guarantees. Until recently, variable annuities had steadily grown after banks started selling annuities in October 2002. The weakness may be due to a temporary market lull, or to factors such as the conservative stance of banks as they comply with the Financial Instruments and Exchange Act, and the slumping stock market.

At issue is the growing burden that minimum guarantees pose to life insurers amid the slumping stock market. The stipulated reserving method, which requires substantial provisions for policy reserves, has squeezed core profit at some companies. Although the minimum guarantees have yet to take effect, the re-evaluation and recognition of such liabilities based on recent conditions is in conformance with the trend toward market-based valuation.

Conclusion

Even after factoring in the problem of non-payment of claims and benefits, results for fiscal 2007 suggest a mottled outlook for life insurance demand. On the one hand, aging is expected to generate demand for retirement protection. However, the contraction of the core market segment for protection products, coupled with policy conversions by consumers amid the uncertain economic outlook, will work to reduce demand.

Although the scope of insurance products distributed by banks was expanded last December, the immediate impact on revenues in fiscal 2007 was not great. This could reflect difficulties that banks face in handling life insurance products, as well as their cautious stance due to regulatory compliance concerns. But while excessive optimism is unwarranted, considering the advantages banks offer in terms of convenience and credibility, they could become a major distribution channel once the proper environment is established.

With the business environment continuing to deteriorate for life insurers, the current business model offers poor prospects for renewed growth. To resolve the problem of non-payment of death benefits and further diversify the product lineup, companies need to develop a new business model and enhance management efficiency in all areas including distribution.

End notes

1. For fiscal 2007, the three margins do not add up to the core profit. The difference arises because of policy reserve provisions for variable annuity guarantees, which are reflected in core profit but not in the three margins.

2. With regard to the reinsurance of in-force policies ceded by the Management Organization for Postal Savings and Postal Life Insurance, an additional provision of 7.2 trillion yen was paid into the policy reserve. Contrary to conventional practice, the amount was omitted from the calculation of the numerator of the SM ratio. This unexplained omission has generated controversy.

3. If future redemption of liabilities is deemed at risk, documents mentioned in Article 4-2-4 of the Insurance Business Law, (statements of the methods of calculating insurance premiums and underwriting reserves) must be altered, and additions must be made to the premium reserve (Enforcement Regulation of the Insurance Business law, Article 69-5).