Financial Overview of Life Insurers in Fiscal 2008

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Life insurers were staggered by the unexpected speed and scope of the financial crisis triggered by the U.S. subprime mortgage problem. Amid plummeting asset values, companies managed to post a net profit by resorting to a reversal of internal reserves. Meanwhile, solvency concerns have not arisen as yet. Our annual financial overview examines these and other developments in fiscal 2008.

1. Introduction

Japan's life insurance industry was rocked in fiscal 2008 by the unexpected magnitude of the U.S. subprime loan crisis and ensuing global financial crisis. In addition to the impact of the global stock market downturn, concerns exist that the economic slump may continue to dampen demand for life insurance in the future. To cope with losses from falling asset prices, companies undertook a reversal of internal reserves, enabling them to post a positive net income. Meanwhile, due to the strengthening of internal reserves in recent years, solvency has not emerged as a problem.

2. Life Insurance Industry Review

In fiscal 2008, one life insurer failed while five new entrants emerged, bringing the total number to 45 companies. In Exhibit 1, companies are grouped into the following categories: traditional (12 companies, including the 9 leading insurers), foreign-owned (17 companies), entrants from non-life

Exhibit 1 Life Insurance Industry Performance in Fiscal 2008

	New business Indiv. life & annuity			Business in force Indiv. life & annuity			Premium income			Total assets			Core profit		
	Trillion yen	Change yoy	Market share	Trillion yen	Change yoy	Market share	Trillion yen	Change yoy	Market share	Trillion yen	Change yoy	Market share	Billion yen	Change yoy	Market share
Major & 2nd-tier (9)	33.3	-11.1%	54.8%	795.4	-5.8%	78.1%	16.49	-1.6%	60.3%	152.1	-5.1%	74.2%	1,392.1	-34.4%	80.4%
Traditional (12)	34.1	-10.0%	56.1%	798.8	-5.9%	78.4%	17.25	1.3%	63.1%	154.1	-4.8%	75.1%	1,308.6	-37.7%	75.6%
Foreign-owned (17)	13.7	-16.9%	22.5%	132.0	-2.0%	13.0%	7.07	-10.3%	25.9%	36.0	-4.7%	17.5%	385.9	-9.6%	22.3%
Non-life affiliate (9)	8.7	8.1%	14.3%	51.3	6.2%	5.0%	2.20	-2.5%	8.1%	10.7	6.5%	5.2%	7.8	5.4%	0.5%
Non-insur. affiliate (6)	4.4	0.0%	7.2%	36.6	2.4%	3.6%	0.80	3.6%	2.9%	4.4	3.5%	2.1%	28.3	35.4%	1.6%
Subtotal (44 cos.)	60.8	-8.9%	100.0%	1,018.8	-4.5%	100.0%	27.33	-2.2%	100.0%	205.1	-4.1%	100.0%	1,730.6	-32.3%	100.0%
Japan Post Insurance	6.1	10.9%	(10.0%)	137.4	-7.4%	(13.5%)	7.88	-6.8%	(23.8%)	106.6	-5.3%	(52.0%)	432.4	-24.9%	–
TOTAL (45 cos.)	66.9	–	–	1,156.2	-4.9%		35.2	–	–	311.7	-4.5%		2,163.0	–	–
(For reference) Zenkyoren (JA Kyosai)	15.4	14.2%	(25.3%)	179.1	-4.3%	(17.6%)	55.2	-16.0%	(20.2%)	43.2	-0.7%	(21.1%)	422.6	0.9%	–

Notes: 1. Companies are grouped as follows, and listed in descending order by total assets; company names are current as of fiscal yearend.
9 major & 2nd-tier: Nippon, Dai-ichi Mutual, Meiji Yasuda, Sumitomo, Mitsui, Taiyo, Asahi Mutual, Fukoku Mutual, Daido.
12 traditional: 9 major & 2nd-tier insurers, plus T&D Financial, Dai-ichi Frontier, and Fukokushinrai.
17 foreign-owned: Alico Japan, Aflac Japan, AXA, Gibraltar, Hartford, ING, AIG Edison, Prudential, Manulife, AIG Star, MassMutual, AXA Financial, PCA, Cardif, Allianz, Zurich, and Credit Agricole.
9 affiliates of non-life insurers: Tokio Marine & Nichido, Mitsui Sumitomo MetLife, Tokio Marine & Nichido Financial, Mitsui Sumitomo Kirameki, Sompo Japan Himawari, Nipponkoa, Aioi, Fuji, and Sompo Japan DIY.
6 affiliates of non-insurance companies: Sony, ORIX, Airio, Lifenet, Midori, and SBI AXA.
2. For Japan Post Insurance, business in force includes pre-privatization policies received from the Management Organization for Postal Savings and Postal Life Insurance in the form of reinsurance. Of this, individual annuities are valued by annual income benefit. The rest of in-force business is valued by maturity benefit, similar to the other 44 life insurers. Market share is expressed as a ratio to the 44-company total.
3. For JA Kyosai, new business and business in force include comprehensive life insurance and annuity products (valued by annual income benefit). Premium income and total assets include amounts corresponding to non-life insurance.
Source: Compiled from financial disclosures by NLI Research Institute.

insurance (9 companies), entrants from non-insurance (6 companies), and Japan Post Insurance.

Among traditional life insurers, new business at the nine leading insurers continued to slide (-11.1%), although the pace of decline eased up from the previous year (-21.4%). Business in force also continued to decrease -5.8%.

At most foreign-owned life insurers, the growth trajectory of previous years took a downturn. In addition to plummeting variable annuity sales caused by the stock market decline, new business fell from the previous year due to the financial crisis (whose impact was transmitted through parent companies). As a result, business in force ended the growth streak of the past few years and dropped -2%.

Meanwhile, non-life insurance entrants managed to grow in new business.

Two new entrants have begun selling life insurance exclusively on the Internet. As full-fledged initiatives in a new sales channel, their performance is being closely watched.

Exhibit 2 shows sales performance in terms of new annualized premiums (NAP). This performance indicator replaced the mortality insurance performance indicator in 2005 because it reflects the growing demand in health and annuity insurance.

Exhibit 2 New Annualized Premiums

(¥ billion unless noted)

	Individual insurance	Individual annuity	Total	of which 3rd-sector
Major & 2nd-tier (9)	612.0	249.5	861.5	205.9
Traditional (12)	613.1	338.0	951.1	206.0
Foreign-owned (17)	396.3	332.4	728.7	205.1
Non-life insurance (9)	111.0	348.7	459.7	28.9
Non-insurance (6)	78.2	1.6	79.8	25.9
TOTAL (44 cos.)	1198.6	1020.7	2219.3	465.9
Year-on-year change				
Major & 2nd-tier	-2.0%	30.4%	5.6%	-4.2%
Traditional	-2.5%	58.8%	13.0%	-4.5%
Foreign-owned	-5.4%	-16.9%	-11.0%	0.0%
Non-life insurance	13.4%	-8.8%	-4.3%	37.0%
Non-insurance	-1.6%	-27.3%	-2.3%	3.2%
TOTAL (40 cos.)	-2.2%	2.3%	-0.2%	-0.2%
Market share				
Major & 2nd-tier	51.1%	24.4%	38.8%	44.2%
Traditional	51.2%	33.1%	42.9%	44.2%
Foreign-owned	33.1%	32.6%	32.8%	44.0%
Non-life insurance	9.3%	34.2%	20.7%	6.2%
Non-insurance	6.5%	0.2%	3.6%	5.6%
TOTAL (40 cos.)	100.0%	100.0%	100.0%	100.0%
Indexed to individual insurance = 100				
Major & 2nd-tier	100.0	40.8	140.8	33.6
Traditional	100.0	55.1	155.1	33.6
Foreign-owned	100.0	83.9	183.9	51.8
Non-life insurance	100.0	314.1	414.1	26.0
Non-insurance	100.0	2.0	102.0	33.1
TOTAL (40 cos.)	100.0	85.2	185.2	38.9
Japan Post Insurance	362.1	205.8	567.9	39.7
(Indexed)	100.0	56.8	156.8	11.0

On an aggregate basis for all 44 companies, NAP fell -2.2% from the previous year in individual insurance, but rose 2.3% in individual annuities. By company category, individual insurance NAP decreased across the board with the exception of non-life insurance entrants. Meanwhile, annuity NAP performance was mixed. At foreign-owned companies, the growth trend in mainstay variable annuity sales came to an abrupt halt. On the other hand, annuity sales grew at traditional life-insurers on the strength of fixed annuities.

As a result of the above, the market share of foreign-owned companies in individual insurance and individual annuities fell 4-percentage points to 32.8% in fiscal 2008 from 36.8% in fiscal 2007.

NAP of third-sector products amounted to 465.9 billion yen, or 38.9% of individual insurance NAP (1,198.6 billion yen). Foreign-owned insurers and traditional insurers both enjoy a 44% market share in the third sector.

3. Profit Condition of the Nine Leading Insurers

1. Shrinking Core Profit

Core profit (a flow indicator of profitability adopted in 2005, and defined as ordinary income minus net capital gains and net extraordinary gains) plummeted -34.4% at the nine leading insurers to 1,392.4 billion yen (Exhibit 3).

This largely stems from the expanding negative spread (investment margin), which ballooned to

-681.5 billion yen after shrinking in fiscal 2007 to -255.6 billion yen (from -445.6 billion yen in fiscal 2006). This deterioration stemmed from lower interest and dividend income amid the financial crisis and ensuing economic downturn, and recognition of income losses from private fund redemptions.

In addition, the other two components of core profit—expense margin and mortality margin—fell -12.9% due mainly to the decline of business in force.

A more detailed view of the three core profit components comes from the seven life insurers who disclose such data (Exhibit 4).

In fiscal 2007, the mortality margin plunged -11.2% because some companies made provisions for policy reserves of third-sector products. Because this factor disappeared in fiscal 2008, the decrease contracted to -4.2%, reflecting the decrease of business in force. Factors reducing the mortality margin include: (1) decrease of business in force; and (2) smaller selection effect due to the relative decrease of new business (mortality and hospitalization rates tend to be lower for newly written policies). On the other hand, the mortality margin was boosted by the decrease of medical benefit costs due to shorter hospitalizations.

Exhibit 3 Core Profit of 9 Leading Insurers

(Billion yen, unless noted)

	FY 2008	FY 2007	FY 2008 yoy change
A. Core profit	1,392	2,124	− 34.4%
B. Negative spread (investment margin)	−682	−256	166.6%
C. Expense margin and mortality margin	2,074	2,380	− 12.9%
B. / C.	32.9%	10.7%	22.1%

Note: C = A - B

Exhibit 4 Core Profit of 7 Leading Insurers

(Billion yen, unless noted)

	FY 2008	FY 2007	FY 2008 yoy change	FY 2007 yoy change
Core profit	1,379	1,946	− 29.2%	− 11.8%
Investment margin	−531	−260	104.6%	− 39.5%
Mortality margin	1,761	1,837	− 4.2%	− 11.2%
Expense margin	329	449	− 26.6%	− 21.1%

Meanwhile, the expense margin continued to decline as cost efficiency improvements were outweighed by lower premium loads (in addition to the decrease of business in force, a growing proportion of policies have a low premium load).

2. Resurgence of Negative Spread

The negative spread refers to a situation in which the investment yield (net investment income in core profit divided by policy reserves) falls below the yield promised to policyholders (guaranteed rate). As stated above, the negative spread amount rebounded in fiscal 2008 after contracting in fiscal 2007.

The average guaranteed rate has slowly trended downward due to the decreasing number of policies with a high guaranteed rate. The average guaranteed rate, which decreased 0.12-percentage point in fiscal 2008, is expected to continue decreasing 0.1-percentage point per year going forward.

Exhibit 5 Negative Spread

	FY 2008	FY 2007	FY 2008 yoy change
① Average guaranteed rate	2.93%	3.05%	− 0.12 ppt
② Investment yield (*)	2.38%	2.84%	− 0.46 ppt
③ Negative spread rate (②−①)	− 0.54%	− 0.2%	− 0.34 ppt
④ Policy reserve	¥ 127.1 tril.	¥ 126.3 tril.	−
⑤ Negative spread amount (③×④)	¥ 681.5 bil.	¥ 255.6 bil.	+ ¥ 425.9 bil.

Note: Investment yield = Net investment income in core profit ÷ Policy reserves

Meanwhile, the investment yield plummeted to 2.38% from 2.84% in fiscal 2007, which largely explains the expansion of the negative spread. The declining investment yield can be attributed to several factors: (1) low long-term interest rates (the yield on the 10-year JGB almost reached 1.9% at one point due to inflationary concerns, but then dropped to 1.35% at fiscal yearend due to monetary easing to combat the deepening recession due to the financial crisis); (2) decrease of dividend income due to the ailing economy, a trend that will likely continue; (3) losses associated with private fund redemptions (the investment yield even turned negative at some life insurers).[1] The third factor is thought to be a temporary one (in hindsight, it helps explain the robust income gains of the past few years).

3. Net Income and Its Appropriation—Reversal of Internal Reserves Helps Boost Net Income

A prominent financial characteristic of fiscal 2008 is the large asset impairment caused by the financial crisis, resulting in a capital loss of 3.5 trillion yen. To offset this loss, companies made large reversals of their internal reserves. Below we examine the three components of net income—core profit, net capital gains, and net extraordinary gains—to see how each contributed to the bottom line, and then explain how net income was generated and appropriated.

The capital loss grew to 3.5 trillion yen, consisting of a realized loss of 1.3 trillion on the sale of stocks and foreign securities, and an impairment loss of 1.8 trillion yen.

Two points are notable in the net extraordinary gains section. First, corporate and inhabitant tax expenses plummeted from the previous year. In fact, taxable income was negative at many companies even though net income was positive. This is because internal reserves such as the contingency reserve from which large reversals were made are after-tax accounts and thus not taxable.

Exhibit 6 Net Income and Its Appropriation

(Billion yen, unless otherwise noted)

	FY 2008	FY 2007	FY 2008 yoy change
① Core profit	1,392	2,124	− 34.4%
② Capital gains	914	650	40.6%
③ Capital losses	− 3,534	− 971	264.0%
Core profit + Net capital gains	− 1,228	1,803	−
④ Gain/loss from disposal of real estate	92	− 6	−
⑤ Write-down of unrecoverable loans	− 9	6	−
⑥ Corporate & inhabitant tax	3	− 459	−
⑦ Tax effect adjustment	− 234	306	−
⑧ Retirement benefit cost (extraordinary)	− 3	3	−
⑨ Other expenses	− 502	− 774	− 35.1%
A. Net income (add lines ①〜⑨) *	− 1,881	880	−
(a) of which, provision for policy reserve	− 498	− 930	− 46.5%
A ' Net income before provision for policy reserve	− 1,383	1,810	−
Change in contingency reserve	− 1,601	− 64	2,409.1%
Change in price fluctuation reserve	− 470	94	−
Change in on-balance-sheet capital	− 202	240	−
B. Change in internal reserves	− 2,273	270	−
B ' Change in internal reserves, broadly defined: B − (a)	− 1,775	1,200	−
(B ' / A ')	−	66%	−
C. Provision for reserve for policyholder dividends	391	6,100	− 35.9%
(C / A ')	−	34%	−

Notes: 1. Line A net income is before provision for (or reversal of) the contingency reserve and price fluctuation reserve.
2. Numbers are rounded upward to the nearest billion yen.

Second, other expenses (Exhibit 6, line 9) are mainly associated with provisions for additional policy reserves (due to reserve strengthening based on a valuation interest rate below the guaranteed rate).

When changes to internal reserves such as the contingency reserve are backed out, net income decreases to -1.9 trillion yen (net income decreases further to -1.4 trillion after backing out the special provision for the policy reserve of 0.5 trillion yen).

This loss was offset by a reversal of internal reserves amounting to 2.3 trillion yen (including 1.6 trillion yen from the contingency reserve and 0.5 trillion from the price fluctuation reserve), which enabled a provision for the policyholder dividend reserve of 0.4 trillion yen. Due to tight financial conditions, many companies either reduced the dividend amount or left it unchanged.

4. Slumping Stock Market Depresses Solvency Margin Ratio

We next examine a key stock indicator of financial soundness—the solvency margin ratio (SM ratio). Due to the slumping stock market, the net valuation gain of "other marketable securities" including stocks plummeted to 0.1 trillion yen from 6.9 trillion yen in fiscal 2007. As a result, the SM ratio of the nine leading insurers dropped 215 percentage points from 1,088% to 873%.

The current situation can be compared to the stock market slump in late fiscal 2002. At that time, shareholders' equity on balance sheets (such as foundation funds, contingency reserve, and price fluctuation reserve) stood at 5.9 trillion yen, and the SM ratio was 570%, indicating that financial soundness was not as good as it is today. However, on-balance equity was subsequently enhanced while maintaining dividends, and reached 9.6 trillion yen in fiscal 2007. In fiscal 2008, on-balance equity of over 2 trillion yen was drawn down, and although marketable securities decreased in value, the stock market slump helped reduce the risk amount, causing the SM ratio to recover to the 800% level.

Exhibit 7 Solvency Margin Ratio

	FY 2008		FY 2007		FY 2002	
	Amount (¥ tril.)	SM ratio	Amount (¥ tril.)	SM ratio	Amount (¥ tril.)	SM ratio
(1) Solvency margin	14.6	873%	23.4	1,088%	10.9	570%
of which:						
Capital on balance sheet	7.5	449%	9.6	446%	5.9	309%
Unrealized gains from securities available for sale	0.1	7%	6.9	319%	1.0	52%
Unrealized gains from land	0.9	54%	1.2	54%	−0.5	−29%
Debt finance	1.2	73%	1.0	47%	1.1	56%
Excess amount of policy reserve based on Zillmer method	4.4	266%	4.1	189%	3.3	173%
(2) Total risk	3.3		4.3		3.8	

Notes: 1. SM ratio = Solvency margin ÷ (Total risk amount /2)
2. All SM ratios are calculated using the same denominator.

Despite the postponed implementation of the FSA's revised SM ratio, the current financial crisis has prompted the implementation of new supervisory guidelines for comprehensive risk management and upgrading of the stress test.

4. Japan Post Insurance

Although Japan Post Insurance was privatized in October of fiscal 2007, we continue to treat it separately from the rest of the life insurance industry due to its sheer size.

In individual insurance, new business grew 4.6% from the previous fiscal year, apparently because one-time factors attributed to the reorganization disappeared (Exhibit 8).

Exhibit 8 Business Results

(yoy change)

	Japan Post Insurance	9 leading life insurers
New business	4.6%	− 13.1%
Business in force	− 7.8%	− 6.3%

On the other hand, business in force (including pre-privatization policies ceded by the Management Organization for Postal Savings and Postal Life Insurance in the form of reinsurance) continued to decrease faster than at the nine leading insurers. However, this is likely due to the volume of maturing endowment policies, which are a mainstay product of Japan Post Insurance.

Exhibit 9 Core Profit Results

(Billion yen)

	FY 2008	FY 2007 (2H only)
Investment margin	− 350.0	− 200.0
Mortality margin	350.0	170.0
Expense margin	430.0	290.0
Core profit	432.4	267.2

The core profit results are shown in Exhibit 9. The negative spread improved slightly to 0.37% (= 2.03% average guaranteed rate－ 1.66% investment yield) from 0.38% in fiscal 2007 2H (= 2.06%－1.68%). The contingency margin edged up, while the expense margin decreased.

The impact of the financial crisis on investment assets was limited due to the relatively small risk asset allocation. In fiscal 2008, the allocation to risk assets was further trimmed by posting a fixed amount of capital losses, such that equities comprised only 400 billion yen (0.4% of total assets) held in monetary trust. As a result, the reversal of internal reserves was limited to 190 billion yen from the contingency reserve, and 112.4 billion yen from the price fluctuation reserve. (Reversal of the price fluctuation reserve was necessary because the declining risk asset allocation reduced the legal reserve limit.)

Against this backdrop of stable performance, the dividend distribution for pre-privatization policies was increased again this year (to 280 billion yen, from 190 billion yen in fiscal 2007).

In addition, the SM ratio rose to 1,430% from 1,116% in fiscal 2007. This is largely attributed to the declining risk asset allocation, which reduced the risk amount. However, we should note that the numerator of the SM ratio omits a provision for additional policy reserves of 6.9 trillion yen.

5. Topics: The Treatment of Price Fluctuation Risk

A key financial feature of fiscal 2008 was the large reversal of internal reserves made to offset valuation losses of stocks and foreign securities. Below we introduce several pertinent accounting issues related to this matter.

The first issue relates to the respective characteristics and accounting treatment of the contingency reserve and price fluctuation reserve. Although the price fluctuation reserve usually plays a central role in offsetting asset valuation losses, companies relied more heavily on a reversal of the contingency reserve (1.6 trillion yen, compared to 470 billion yen for the price fluctuation reserve). One reason is that the contingency reserve directly impacts ordinary income, while the price fluctuation reserve is treated under extraordinary gain. This is because many companies regard the price fluctuation reserve not in the context of risk provision, but in the former context of capital gains and the reserves used to measure financial soundness under Article 86 of the Insurance Business Law Enforcement Regulations before the 1996 revision. However, considering its current role of coping with investment risk, the price fluctuation reserve's connection to extraordinary gain or loss need not be so strongly emphasized.

The second issue regards the need to increase the price fluctuation reserve limit. Under the Insurance Business Law, the price fluctuation reserve limit is equivalent to half the market risk amount used to calculate the SM ratio. Thus, for example, the risk coefficient of stocks is 10% of market valuation, while the reserve limit is 5%. By comparison, under JA Kyosai rules, both the risk valuation coefficient and reserve limit are 10%. We thus believe the current reserve limit should be raised to reflect the original intent of the price fluctuation reserve as well as to allow comparisons with JA Kyosai.

6. Conclusion

In fiscal 2008, the life insurance industry was rocked by a supposedly once-in-a-century financial crisis. In particular, several highly rated foreign-owned life insurers suffered heavy asset valuation losses due to the sharp stock price declines of their parent companies. Knowledge of this development also affected insurance sales, particularly in the variable annuity market. Many life insurers withdrew from variable annuity sales due to lower commissions resulting from plunging asset valuations, and due to profitability concerns arising from the minimum guarantee.

The impact of the financial crisis on life insurers is not limited to declining asset valuations. There is deep concern that the lingering recession will reduce disposable income and thus further dampen demand for life insurance. Despite reports that the economy has bottomed out, we must keep in mind that life insurance is a lagging industry, and will continue to be subjected to downside pressure going forward.

However, promising new developments have emerged. Some insurance companies have ventured into full-fledged Internet sales, while several others have announced plans. Internet sales will likely be given a boost by the recent trend toward simpler, inexpensive and easy-to-use insurance products. By complementing conventional sales through agents, efforts to support customer-initiated purchases will surely contribute to the provision of overall insurance services.

In the U.S. and Europe, the financial crisis experience has led to the revision of financial supervision. In addition to the conventional supervision of individual companies, they are studying the reinforcement of monitoring and supervision from the perspective of macro prudence. While this is important, the basic approach should be to further enhance the system for proper measurement and recognition of risk by each company. We believe this issue must continue to be addressed with our full attention.

Endnote

1. This view holds that if investment gains from private fund redemptions are treated as an income gain, then investment losses should similarly be treated as an income loss. However, another view holds that that losses arising when a position is closed should be treated as a capital loss. Clearly, standards should be unified to allow comparisons.