

Financial Overview of Life Insurance Companies in Fiscal 2003

by Kunio Ogihara
Insurance Research Group
ogihara@nli-research.co.jp

1. Introduction

In fiscal 2003, life insurers managed to avert a solvency crisis thanks to the stock market's recovery (the Nikkei stock average rose from 7,972 at yearend fiscal 2002 to 11,715 at yearend fiscal 2003). However, they continued to struggle with two other issues: the decline in business in force, and negative spread. Below we analyze the financial condition of life insurers overall (all 40 companies), and then focus on the nine major and second-tier companies and postal life insurance (Kampo).

2. Overall Performance of Life Insurers

The performance of the 40 life insurers is shown in Figure 1, according to our classification into traditional companies, foreign-affiliated companies, affiliates of non-life insurance companies, and affiliates of non-insurance companies.

Traditional life insurers saw a sharp plunge in new business growth (-20.3%), which contributed to an unprecedented 5.6% decrease in business in force. By comparison, the strong growth among foreign life insurers has been conspicuous. Since foreign life insurers have focused their attention on third-sector products, performance is best evaluated using premium income rather than a sum insured basis. We find that foreign life insurers have grown their market share from 17.7% last fiscal year to almost 20% (19.9%). In addition to third-sector products, robust sales of variable annuities through banks have contributed to their strong performance.

Conventionally, the primary performance indicator of life insurers has been the sum insured amount. However, in view of the growing importance of business areas other than death-benefit life insurance, another indicator—annualized premium income—also needs to be tracked.

Figure 1 Major Performance Indicators

	New business			Business in force			Income from premiums			Assets under management			Basic profit		
	Indiv. policies & annuities ¥ tril.	Growth	Share	Indiv. policies & annuities ¥ tril.	Growth	Share	¥ tril.	Growth	Share	¥ tril.	Growth	Share	¥ bil.	Growth	Share
Major & 2nd-tier (9)	79.0	-20.4%	74.2%	1,036.0	-5.6%	84.8%	18.61	-4.6%	71.7%	152.8	0.7%	82.9%	2,059.0	3.0%	89.2%
Traditional (11)	79.7	-20.3%	74.7%	1,040.4	-5.6%	85.1%	18.80	-4.5%	72.5%	153.8	0.7%	83.4%	2,051.7	2.9%	88.8%
Foreign (17)	15.5	10.2%	14.5%	120.3	-0.1%	9.8%	5.17	22.3%	19.9%	23.7	9.1%	12.9%	223.8	99.1%	9.7%
Non-life insur. affil. (10)	7.0	16.8%	6.5%	31.8	15.3%	2.6%	1.33	37.7%	5.1%	3.9	39.7%	2.1%	10.6	-50.7%	0.5%
Non-insurance affil. (2)	4.5	7.6%	4.2%	29.7	5.9%	2.4%	0.63	3.8%	2.4%	3.0	14.6%	1.6%	23.3	-4.5%	1.0%
Total (40 companies)	106.6	-14.1%	100.0%	1,222.2	-4.4%	100.0%	25.94	1.8%	100.0%	184.3	2.5%	100.0%	2,309.4	7.3%	100.0%
(For reference)															
Postal Life Insur. (Kampo)	11.2	-19.3%	(10.5%)	187.8	-4.5%	(15.4%)	12.29	-14.2%	(47.4%)	121.9	-3.1%	(66.1%)	-449.8	-	-
Zenkyoren (JA Kyosai)	15.6	-5.1%	(14.6%)	223.4	-3.6%	(18.3%)	3.86	12.9%	(14.9%)	42.1	2.9%	(22.9%)	414.3	-10.7%	(18.9%)

Notes: 1. Life insurers are grouped into the following categories.

9 major & 2nd-tier: Nippon, Daiichi, Meiji Yasuda, Sumitomo, Mitsui, Asahi, Taiyo, Daido, Fukoku.

11 traditional: 9 major & 2nd-tier companies, plus T&D Financial, Yamato.

17 foreign: AFLAC, Gibraltar, AXA Group Life, Alico Japan, AIG Edison, AIG Star, Prudential, ManuLife, Hartford, ING, Aoba, AXA, Mass Mutual, Credit Suisse, PCA, Zurich, and Cardiff.

10 affiliates of non-life insurers: Tokio Marine & Nichido, Sompo Japan Himawari, Mitsui Sumitomo Kirameki, Mitsui Sumitomo Citilinsurance, IOI, Nipponkoa, Tokio Marine & Nichido Financial, Fuji, Kyoei Kasai Shinrai, Sompo Japan DIY.

2 affiliates of non-insurance companies: Sony, ORIX.

2. For Postal Life Insurance (Kampo) and Zenkyoren (National Mutual Insurance Federation of Agricultural Cooperatives, or JA Kyosai), individual annuities portion of new business and business in force is calculated using annual amounts; shares are expressed as a ratio to the total of 40 insurers.

3. For Zenkyoren, assets under management and basic profit include non-life insurance portion.

Source: Compiled from company financial statements.

3. Condition of the Nine Major & 2nd-Tier Insurers

1. Solvency Improves Due to Stock Market Recovery

The primary feature in this year's statements was an improvement in solvency indicators due to the recovering stock market, which has enabled insurers to temporarily avert a solvency crisis.

The solvency margin ratio of the nine major and second-tier insurers rose 233 percentage points, from 572% to 804%. The factors contributing to the rise are broken down in Figure 2.

The rise in SM ratio can be attributed almost entirely to rising share prices. While higher interest rates (the 10-year government bond yield rose from 0.70% to 1.44%) reduced unrealized gains on government bonds, and declining land prices reduced unrealized gains in land, these effects were minor.

On the other hand, the denominator (which measures the amount of risk) rose slightly, decreasing the SM ratio 34 percentage points. This is attributed to a halt in the recent contraction in equity investment, and to an increase in stock market risk (fair value x 10%) due to rising share prices.

Figure 2 Composition of the Increase in Solvency Margin Ratio

(Unit: Percentage points)	
Numerator (change in solvency margin)	266
Capital on balance sheet	39
Other unrealized gains from securities	233
Domestic stocks	260
Bonds and foreign stocks	-27
Unrealized gains from land x 85%	-6
Other	1
Denominator (risk reduction effect)	-34
Increase in solvency margin ratio	233
(571.7% ⇒ 804.3%)	

Source: Compiled by NLI Research Institute

Moreover, the real net asset indicator (fair value of assets minus real liabilities), which complements the SM ratio as a solvency measure, rose to ¥15.7 trillion for the nine insurers (up 37% from the previous year), exceeding the ¥13.7 trillion level of two years ago.

Thus while solvency indicators have recovered, the cause cannot be attributed to a growth in basic profitability, which remains an important issue.

2. Negative Spread Remains at ¥1 Trillion Level

The negative spread, or difference between the guaranteed yield to policyholders and basic yield (ratio of net investment income in basic profit to the policy reserve), continues to plague insurers.

The guaranteed yield (including group pensions), which had declined approximately 0.1% each year, was expected to decline at an accelerating pace from the middle of fiscal 2002 due to a cut in the guaranteed yield for group pensions (mainly from 1.5% to 0.75%). However, the decline in fiscal 2003 amounted to only -0.11%, indicating that the average guaranteed yield for individual insurance contracts has been declining more moderately than expected.

On the other hand, while redemptions of high-yield coupon bonds and other bonds have caused the basic yield to trend downward, the decline was limited to 0.04 percentage point from the previous year due to the preference for fully-hedged foreign bonds and to higher stock dividends, which will be explained below. As a result, the negative spread decreased by 0.06 percentage point, from 0.92% in fiscal 2002 to 0.86% in fiscal 2003.

The loss from the negative spread shrank by approximately ¥100 billion, but remains at over ¥1 trillion. With many insurers predicting the negative spread to increase in fiscal 2004, no solution appears in sight yet.

Figure 3 Negative Spread

	FY 2003	FY 2002	Change
① Average guaranteed yield	3.25%	3.37%	- 0.11%
② Basic yield	2.40%	2.44%	- 0.04%
③ Negative spread (②-①)	- 0.86%	- 0.92%	0.06%
④ Policy reserve	¥124.7 tril.	¥125.2 tril.	-
⑤ Negative spread amount (③×④)	¥1,057.8 bil.	¥1,166.9 bil.	- ¥109.1 bil.

Note: Basic yield is the ratio of net investment income in basic profit to the policy reserve.

3. Basic Profit Excluding Interest Gain Continues to Shrink

Basic profit, a flow indicator that life insurers have been required to disclose since fiscal 2000, measures the profitability of the core business.

Basic profit for the nine life insurers increased ¥59.9 billion (3.0% from the previous year) to ¥2,059.3 billion. This is mainly attributed to a decrease of ¥109.1 billion in the negative spread. The basic profit consists of three components—expense profit, mortality gain, and interest gain. After deducting the interest gain from the basic profit, we find that the remaining expense and mortality gain decreased -1.6%.

Figure 4 Basic Profit

	FY 2003	FY 2002	Change
A. Basic profit	¥ 2,059.3 bil.	¥ 1,999.4 bil.	- 3.0%
B. Negative spread (interest loss)	- ¥ 1,057.8 bil.	- ¥ 1,166.9 bil.	-
C. Expense profit & mortality gain	¥ 3,117.7 bil.	¥ 3,166.3 bil.	- 1.6%
= B / C (%)	33.9%	36.9%	- 2.9%

In addition, since the decrease in new business has caused new-business related expenses to decrease proportionally and thereby increase profit, profitability appears to have deteriorated in the core profit components of expense gain and mortality gain. According to profit data for all life insurers released by the Financial Services Agency, the ratio of expense gain to mortality gain has shifted from 3:7 in fiscal 2000, to 2:8 in fiscal 2002, indicating a downtrend in the expense gain.

4. Basic Profit Tends to be Overstated

We must note here that the basic profit data tends to be overstated because it includes items that are earmarked for specific uses. For example, almost all of the mortality gain of group insurances

is returned to policyholders, and thus cannot be used for other purposes such as provision to the retained surplus. The same applies to the interest gain for group pensions.

Moreover, hedging costs associated with foreign bond investment should be deducted from the basic profit. In the past few years, life insurers have increased their investment in foreign bonds to take advantage of the spread between foreign and domestic interest rates. Foreign bond investment, which amounted to ¥6.2 trillion (equivalent to 4.0% of assets in the general account) at the end of fiscal 2000, the year the basic profit indicator was introduced, grew to ¥15.3 trillion (10.4% of assets) at the end of fiscal 2003.

While the return on foreign bonds should obviously contribute to basic profit, hedging costs are treated as a capital loss and not reflected in basic profit. Currency hedging costs basically depend on the spread between foreign and domestic short-term interest rates, and have the character of an income loss. If we assume hedging costs to be 1.5% of the ¥15.3 trillion in foreign bond investment, then ¥230 billion should be deducted from basic profit. (In the future, since the risk of lower prices accompanying higher interest rates in the U.S., and rising hedging costs will work to constrain foreign bond investment, foreign bond investment is not predicted to continue growing as it has in the past.)

5. Composition and Uses of Net Profit

In addition to basic profit, two other important components of net profit are capital gains and extraordinary gains.

Figure 5 shows the composition of net profit and its allocation to the retained surplus and reserve for policyholder dividends.

Compared to the large valuation and capital losses caused by the depressed stock market in fiscal 2002, capital losses narrowed significantly in fiscal 2003 on the strength of the stock market recovery.

As a result, net profit excluding provisions for the contingency and price fluctuation reserves (though defined as liabilities, these reserves resemble capital) surged from the previous year to ¥1.4 trillion. The net profit was used to boost the solvency margin (e.g., the contingency reserve and price fluctuation reserve, which were partially depleted in the previous year).

While ¥4.7 trillion was allocated to dividends for the next fiscal year, an estimated ¥3.6 trillion of this is for group insurance. Many life insurers are keeping dividends unchanged for individual policyholders.

Figure 5 Composition and Uses of Net Profit

(Unit: ¥ billion)

	FY 2003	FY 2002	Change
① Basic profit	2,059.0	1,999.0	3.0%
② Capital gain	834.0	1,311.0	- 36.4%
③ Capital loss	- 1,081.0	- 3,007.0	- 64.0%
Basic profit + Net capital gain	1,811.0	303.0	497.2%
④ Loss from real estate disposal	- 262.0	- 156.0	68.3%
⑤ Write-down of loans	75.0	78.0	- 4.2%
⑥ Corporate & resident tax	- 236.0	- 98.0	140.6%
⑦ Tax adjustment	59.0	83.0	- 29.0%
⑧ Retirement benefit expense (extraordinary loss)	- 65.0	- 121.0	- 46.1%
⑨ Other	17.0	21.0	- 19.3%
A. Net profit (total of ①~⑨) *	1,400.0	111.0	1,160.1%
Change in contingency reserve	421.0	- 144.0	-
Change in price fluctuation reserve	287.0	- 137.0	-
Change in on-balance-sheet capital	225.0	- 3.0	-
B. Change in retained surplus	933.0	- 284.0	-
C. Provision for reserve for dividends to policyholders	466.0	395.0	17.9%

Notes: Shows net profit before provision for (or deduction from) contingency reserve and reserve for price fluctuation. Numbers are rounded to nearest billion.

4. The Medium-Term Perspective

Below we examine trends in the basic profit performance indicator since its introduction four years ago in fiscal 2000.

1. Business Performance

Looking at the sum insured performance indicators, both new business and business in force have declined. The productive-age population (15-64) peaked out in 1995 and has been declining since. While death-benefit life insurance remains an important segment for life insurers, the constraints imposed by changes in the population structure cannot be ignored. A rational strategy would be to put more emphasis on third-sector products such as medical and long-term care coverage. If excessive competition is averted and fair pricing is achieved in the market, policyholders will also benefit.

Figure 6 Business Performance of the Nine Major & 2nd-Tier Life Insurers

(Unit: ¥ trillion)

	FY 2000	FY 2001	FY 2002	FY 2003
New business	109.00 (100)	106.30 (98)	99.30 (91)	79.00 (72)
Business in force	1,192.5 (100)	1,145.7 (96)	1,097.7 (92)	1,036.0 (87)
Income from premiums	21.99 (100)	21.29 (97)	19.52 (89)	18.61 (85)
Expenses	2.71 (100)	2.67 (99)	2.50 (92)	2.36 (87)
Assets under management	165.99 (100)	158.35 (95)	151.77 (91)	152.77 (92)

2. Basic Profit and Net Profit Trends

Basic profit and net profit results since fiscal 2000 are shown in Figure 7. The following observations can be made:

1. The negative spread has decreased due partly to the reduced guaranteed yield for group pensions. For individual policies and annuities, however, the decrease has been more moderate.
2. Expense and mortality gains have decreased roughly in parallel with business in force.
3. In fiscal 2001 and 2002, capital losses ballooned to approximately ¥3 trillion due to declining share prices, compared to a loss of ¥1 trillion in an average year.
4. As a result, net profit plunged in fiscal 2001 and 2002, forcing life insurers to draw down contingency and price fluctuation reserves.
5. Net profit rose in fiscal 2003 from fiscal 2000, enabling life insurers to replenish internal reserves. However, whether solvency is sufficient to cover future risks remains to be seen.

These results leave the strong impression that life insurers have been greatly affected in recent years by ultra-low interest rates and stock market volatility. While all financial institutions with large shareholdings were increasingly exposed to market risk, life insurers as a whole responded by reducing their equity backed ratio (thereby reducing exposure). Fortunately, the stock market's recovery in fiscal 2003 boosted the solvency margin ratio of life insurers, temporarily alleviating a crisis. While some would argue that larger investment gains could have been realized by staying more fully invested, the results should be accepted as the consequence of risk management measures taken.

Figure 7 Profit Trends of the Nine Major & 2nd-Tier Life Insurers

(Unit: ¥ billion)

	FY 2000	FY 2001	FY 2002	FY 2003
Basic profit	2,091.0 (100)	2,074.0 (99)	1,999.0 (96)	2,059.0 (98)
Negative spread (interest loss)	-1,322.0 (100)	-1,250.0 (95)	-1,167.0 (88)	-1,058.0 (80)
Expense profit + mortality profit	3,413.0 (100)	3,324.0 (97)	3,166.0 (93)	3,117.0 (91)
Capital gain	1,271.0	1,346.0	1,311.0	834.0
Capital loss	1,214.0	2,719.0	3,007.0	1,081.0
Extraordinary loss	-918.0	-648.0	-192.0	-412.0
Net profit	1,230.0	54.0	111.0	1,400.0
Change in retained surplus	650.0	-361.0	-284.0	934.0
Provision for reserve for dividends	580.0	415.0	395.0	466.0

Note: Numbers in parentheses are indexed values with FY 2000 = 100.

The other issue for asset management is how to overcome the negative spread. With the long period of ultra-low interest rates appearing to draw to an end, some have pointed out that rising long-term interest rates will have unfavorable effects: (1) the interest burden of companies and households will increase, retarding the economic recovery and prolonging deflation, (2) the government's fiscal condition will worsen as the interest burden of government bonds increases, and (3) capital losses will increase at financial institutions as bond prices decline. However, for life insurers, an increase in interest rates is actually good news—in addition to income gain increases, they enjoy accounting conventions that keep declining bond prices from significantly impacting profit, unlike the general case.¹ Thus under the assumption that securities are held for the long term, the amortized cost method is applied and price fluctuation effects can be alleviated.

5. Status of Postal Life Insurance (Kampo)

1. Decline in New Business Resembles Private Life Insurers

As we mentioned in last year's financial overview, ultra-low interest rates have reduced the

¹ Rising interest rates and real net assets: Different valuation methods are used for marketable securities depending on the holding objective. For bonds that will be held to maturity (comprising 18% of portfolios among the nine major & 2nd-tier insurers) and debt securities earmarked for policy reserve (DSR, which are unique to the insurance business, and comprise 45% of portfolios), the amortized cost method is applied. For other marketable securities, fair valuation is applied. In contrast to these financial accounting rules, regulatory rules for real net assets require fair valuation for all securities regardless of the holding objective. Thus if interest rates rise and bond prices fall, the real net asset value could turn negative, prompting a declaration of bankruptcy.

To avert this situation, in December 2003 the FSA declared that a negative real net asset value caused by rising interest rates would not in principle prompt an order to suspend operations, provided that: the real asset value is positive after deducting unrealized losses from bonds held to maturity and DSR bonds, and liquid assets are adequate to maintain ALM.

attractiveness of savings-based products such as Kampo's mainstream endowment insurance products. As a result, Kampo's new business decreased -19.3%, comparable to the -20.4% decline for the nine private life insurers.

In January 2004, Kampo introduced a whole life insurance product with a term rider, apparently in a move to improve performance by emphasizing protection-based products. In the first three months, 84,000 new policies were sold, valued at ¥231.4 billion on a sum insured basis. The new product has not improved Kampo's performance significantly, since the average sum insured amount of ¥2.75 million is below the new policy average of ¥2.84 million. However, the hospitalization and medical benefit rider is very competitive with private sector products, prompting charges that Kampo is competing with rather than complementing the private sector. Specifically, when the death benefit is set at the maximum of ¥10 million, the daily hospitalization benefit stays high at ¥15,000 even after the term rider has expired. Opponents thus claim that the product overemphasizes medical benefits.

Business in force has also declined -4.6%, comparable to the -5.8% decline among the nine private insurers.

2. Negative Spread Expands Sharply

Kampo's profit situation is shown in Figure 8.

Figure 8 Profit Situation of Kampo

	(Unit: ¥ billion)		
	FY 2003	FY 2002	Change
Mortality profit	800.0	790.0	10.0
Expense profit	750.0	890.0	-140.0
Interest profit	-2,010.0	-1,410.0	-590.0
Total profit	-438.9	270.0	-718.9

Source: Compiled from Japan Post materials released June 30, 2004.

For fiscal 2003, the sum of the three profit components corresponding to the basic profit of private life insurers amounted to a loss of almost -¥440 billion. However, Kampo posted a surplus of ¥169.9 billion due to a reversal of policy reserves (¥179.9 billion) and capital gains (¥502.4 billion).

Notably, Kampo's negative spread grew sharply, in contrast to the nine private insurers, whose negative spread excluding group pensions decreased slightly.

The sharp growth of the negative spread can be attributed to: (1) the redemption of high-yield

coupon bonds, and (2) special factors related to fair valuation at the time Japan Post was launched. As for the fair valuation factors, when Japan Post was launched, unrealized bond gains were fair-valued at almost ¥3 trillion, and their book value was raised. However, most of these bonds were accounted for as debt securities earmarked for policy reserve (DSR). As a result, the amortization charge for over-par bonds swelled, reducing interest and dividend income. This amount has been estimated at around ¥500 billion.

While Kampo has announced that the negative spread peaked in fiscal 2003, the problem will linger on, similar to private insurers. But since Kampo does not pay corporate taxes, it can afford to hold an additional policy reserve of ¥8.8 trillion for the negative spread. In doing so, Kampo revalued the policy reserve using a valuation interest rate of 2.65% for all policies with a guaranteed yield exceeding 2.65%, and accumulated the difference as an additional policy reserve. In fiscal 2003, the interest rate used for valuation was reduced to 2.59%.

6. Conclusion

Looking ahead, new accounting changes are in store for life insurers: asset-impairment accounting for fixed assets² will be introduced fiscal 2005, while international accounting standards will be adopted in the near future. These are not changes that will significantly impact business, nor should they be.

Fluctuations in the life insurance business will arise from market factors such as interest rates, share prices, and currency rates. However, in a large sense, these factors must be accepted as exogenous factors. What life insurers must respond to are the contraction of the death-benefit life insurance market, and the growing needs in survivor-benefit life insurance, medical and long-term care insurance areas. They must enhance the efficiency of sales networks while devising new strategies to address the changing market. Moreover, two important institutional issues are also at hand: (1) the challenge from bank branch offices in selling insurance, and (2) privatization of Japan Post. A new business model for life insurance urgently needs to be constructed.

² Accounting for the impairment of fixed assets was adopted early by some non-life insurers in fiscal 2003, but most insurers have not done so. For the nine major and second-tier life insurers, we find that unrealized losses from land (including leaseholds) have been growing in the past few years due to falling land prices. These losses grew 23% to ¥661 billion in fiscal 2003, from ¥537 billion in the previous year.

As a result of asset-impairment accounting, companies that have already revalued land holdings are unlikely to be affected since book values approximate market values. However, if disparities emerge after revaluation due to further market price declines, asset-impairment accounting, which is retroactively applied, could have a significant effect..