Financial Overview of Life Insurance Companies in Fiscal 2000

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1. Introduction

The investment climate in fiscal 2000 was a severe one due to sustained ultra-low interest rates and the depressed stock market. It was a particularly bad year for life insurers, as five life insurance companies succumbed to the burden of negative spreads, threatening the credibility of the industry.

In this paper, rather than looking at individual companies, we focus primarily on the financial condition of the ten major and second-tier companies as a whole.

2. Business Results

In aggregate, new business for the ten companies grew by 1.4 percent for the year. Nonetheless, business in force continued to decline for the fourth straight year.

We separated the 44 life insurers into four categories — traditional, foreign affiliate, non-life affiliate, and other — and measured growth and market shares in new business and other key indicators (Figure 1).

Figure 1 Business Results of Life Insurers

	New business Individual policies & annuities			Business in force Individual policies & annuities			Income from premiums			Assets under mgt.			Core operating profit	
	¥ tril.	Growth	Share	¥ tril.	Growth	Share	¥ tril.	Growth	Share	¥ tril.	Growth	Share	¥ bil.	Share
10 major & 2nd tier companies	*109.0*	*1.4%*	*81.9%*	*1,192.5*	*–2.9%*	*90.7%*	*21.99*	*–2.0%*	*84.9%*	*165.99*	*2.0%*	*90.6%*	*2,090.7*	*94.4%*
12 traditional companies	109.2	1.4%	82.1%	1,194.1	–2.9%	90.8%	22.03	–2.0%	85.0%	166.43	2.0%	90.8%	2,089.5	94.4%
15 foreign companies	12.5	10.2%	9.4%	71.1	0.4%	5.4%	2.61	11.1%	10.1%	12.69	–0.7%	6.9%	93.9	4.2%
13 from non-life	6.0	4.5%	4.5%	23.0	19.0%	1.7%	0.63	21.4%	2.4%	1.56	41.2%	0.9%	14.6	0.7%
3 from non-insurance	5.3	12.6%	4.0%	27.3	11.0%	2.1%	0.65	0.3%	2.5%	2.58	19.7%	1.4%	16.6	0.7%
Total of 43 companies	133.0	2.7%	100.0%	1,315.4	–2.1%	100.0%	25.92	–0.3%	100.0%	183.26	2.4%	100.0%	2,214.6	100.0%
(For reference)														
Postal Life Insurance	15.3	–4.2%	(11.5%)	208.1	–1.0%	(15.8%)	13.53	(–7.3%)	(52.2%)	117.27	(3.6%)	(64.0%)	—	
Zenkyoren	14.9	–9.2%	(11.2%)	241.7	–1.8%	(18.4%)	(5.03)	(–1.5%)	(19.4%)	(35.60)	(5.1%)	(19.4%)	—	
Daihyku, Chiyoda, Kyoei	9.9			96.5		—	(1.55)		—	(10.58)			—	
Tokyo	(0.7)			(6.5)			(0.17)		—	(1.10)		—	—	

Notes: *1.* The categories are defined as follows (by order of assets under management).
10 major and 2nd tier companies: Nippon, Dai-ichi, Sumitomo, Meiji, Asahi, Yasuda, Mitsui, Taiyo, Daido, Fukoku.
12 traditional companies: The 10 companies above, plus Yamato and Azami.
15 foreign affiliates: AXA Group, American Family, GE Edison, ALICO Japan, Aoba (Artemis), Prudential, Aetna Heiwa, ING, ManuLife, AXA, Orico, Credit Suisse, Skandia, Zurich, Cardif.
13 non-life affiliates: Tokyo Marine, Yasuda Kasai Himawari, Sumitomo Marine Yu-Yu, Mitsui Mirai, Nichido, Dowa, Chiyodakasai Ebisu, Dai-Tokyo Happy, Fuji, Koa, Nippon Fire Partner, Kyoei Kasai Shinrai, DIY.
3 non-insurance affiliates: Sony, ORIX, Saison.
2. Postal Life Insurance and Zenkyoren (*JA Kyosai*): For new business and business in force, individual annuities are calculated using annual amount of pensions, share is expressed as a proportion of the 43-company total, and income from premiums and assets under management are for fiscal 1999.
3. Zenkyoren: Data on policies in force is not released and has been estimated. Income from premiums and assets under management include non-life portion.
4. Fiscal 1998 data is shown for Daihyaku. Fiscal 1999 data is shown for Chiyoda, Kyoei, and Tokyo. Data for Hartford was unavailable.
Source: Compiled by NLI Research Institute based on company data.

Both foreign and non-life affiliated life insurers have increased their market share. Since foreign life insurers rely heavily on third-sector products such as cancer insurance, income from premiums is a more appropriate measure than insurance coverage. Although currently 10 percent, the share of income from premiums should come close to 20 percent when Daihyaku, Chiyoda and Kyoei are added to the foreign camp in the future.

3. The Negative Spread Situation

The successive failures of five life insurers has focused attention on the primary cause of failure, loss from negative spreads. Although life insurers have informally disclosed the amount of loss from negative spreads, many have altered their calculation method to improve transparency.

Due to criticism that investment performance was not adequately reflected in the use of the basis rate for calculating dividends, many life insurers have decided to announce the loss from interest spread. Including the companies who have not changed, there are now five negative spread calculation methods in use.

For a more accurate comparison, we calculated the negative spread for ten companies using the same standard used by company B (Figure 2).

- When looking at the average scheduled interest rate, it is necessary to consider the composition of group pension insurance in policy reserves. Since the guaranteed interest rate of 1.5 percent for group pension insurance is lower than for individual insurance, a large group pension composition reduces the average scheduled rate.
- The spread is the difference between the average scheduled rate and the basic yield (the ratio of income gains from investment to policy reserves), which is the investment performance. The spread distribution shows a maximum difference of approximately 1 percent.

The loss from the interest rate spread is obtained by multiplying the spread with the policy reserve, and then subtracting the cost of interest for the policy reserve. However, we must note that group pension insurance produces an interest spread gain, and that the overall interest spread loss includes this gain. Since the challenge for life insurers lies with the negative spread associated with individual insurance and annuity policies, it would be effective to separately disclose these values as well.

Figure 2 Negative Spreads Estimated with a Common Standard

(¥ billion)

	Company										
	A	B	C	D	E	F	G	H	I	J	Total
① Average policy reserve	33,188	22,567	17,958	13,408	8,961	7,913	7,708	6,298	4,877	4,058	126,936
② Average scheduled interest rate	3.80%	3.70%	3.70%	3.30%	3.80%	3.30%	3.64%	3.84%	3.41%	3.20%	3.64%
(Group pension as % of reserve)	*21%*	*22%*	*19%*	*29%*	*20%*	*41%*	*27%*	*10%*	*47%*	*41%*	*24%*
③ Basic yield (of reserve)	2.92%	2.63%	2.32%	2.79%	2.57%	2.75%	2.43%	2.60%	2.99%	2.39%	2.67%
④ Spread (③ − ②)	–0.88%	–1.07%	–1.38%	–0.51%	–1.23%	–0.55%	–1.21%	–1.24%	–0.42%	–0.81%	–0.97%
⑤ ① × ④	–292.1	–241.5	–247.8	–68.4	–110.2	–43.5	–93.3	–78.1	–20.5	–32.9	–1,228.2
⑥ Prov. for policyholder dividend reserve	55.0	16.8	9.2	2.2	1.8	3.7	1.8	1.1	1.5	0.8	93.9
⑦ Negative spread (⑤ − ⑥)	–347.1	–258.3	–257.0	–70.6	–112.0	–47.2	–95.1	–79.2	–22.0	–33.7	–1,322.1

Notes: 1. The basic yield refers to investment gains (general account) in core operating profit, divided by policy reserve amount.
2. Special account portion and contingency reserve are deducted from policy reserve.
Source: Compiled by NLI Research Institute from company reports.

4. Core Operating Profit

Core operating profit, an indicator of income adopted by life insurers beginning this fiscal year, consists of operating income minus one-time items such as capital gains from the sale of securities and additions to the contingency reserve. It thus measures earnings in the core life insurance business. The core operating profit and operating profit of the ten life insurers are shown in Figure 3.

Although one company posted core operating profit growth of over 40 percent, the overall trend is downward. This is in sharp contrast to the diverse results for operating income, and illustrates the effectiveness of core operating profit as an indicator.

Core operating profit is essentially equivalent to the aggregate of the three income streams (expense gain, mortality gain, and interest gain). From the estimated negative spread gain or loss and core operating profit, we can obtain the gain or loss of the core insurance business (expense gain and mortality gain). The aggregated results for the ten companies are as follows: the interest gain is -1.32 billion yen and insurance related profit is 3.410 billion yen, for a total of 2,090 billion yen in core operating profit.

Figure 3 Core Operating Profit and Operating Profit

(¥ billion)

Company	Core operating profit		Operating income	
		% change yoy		% change yoy
A	618.7	–9.1%	471	59.5%
B	359.9	–10.1%	324	–29.2%
C	277.9	–10.4%	352	17.4%
D	275.9	2.1%	180	–6.0%
E	104.9	43.7%	96	–31.6%
F	175.0	–7.2%	126	–30.2%
G	92.6	–14.0%	72	–51.6%
H	13.9	–6.7%	21	1.0%
I	114.2	17.9%	82	138.2%
J	57.7	4.5%	58	–15.6%
Total	2,090.7	–4.8%	1,782	–3.0%

Source: Compiled from company reports.

5. How the Core Operating Profit is Used

Despite the negative spread, companies are thus still earning enough to cover the loss and post a core operating profit. But while this explanation suggests that companies are not in trouble, the truth is otherwise. Core operating profit is not the disposable final profit; real estate related disposal losses, non-performing loan write-downs, and corporate taxes are then subtracted to arrive at the surplus.

Moreover, part of the surplus (before addition to internal reserves) is paid out as policyholder dividends, and the rest is allocated to internal reserves.

Earnings of the ten companies are shown in Figure 4. The details are explained below.

- The reduction in cost of capital is due mainly to the loss on valuation of securities, which occurred because of the shift from the lower of cost or market value method to cost value method.
- The decline in capital gains is due to the above shift, and to the decrease from last year in sale of securities to cover loss on valuation.
- Loss from real estate disposal exceeded the previous year's primarily because large insurers sought to increase the transparency of their real asset holdings.
- As for the disposal of bad loans, many life insurers were conservative and decreased the allowance for doubtful accounts. Compared to banks, since the proportion of non-performing loans has been low, the disposal burden has been small.
- Surplus (before addition to internal reserve) declined 17 percent from the previous year to 1,200 billion yen.
- Allocation out of surplus for provision to the dividend reserve declined by half from 1.1 trillion yen to 580 billion yen. This was mainly due to dividend cuts for group pension insurance.
- On the other hand, additions to internal reserves were larger at 630 billion yen, indicating their growing priority.

Figure 4 Profit Structure of Ten Major Life Insurers

(¥ billion)

		FY 2000	FY 1999	Change	Standardized to core op. profit =100
①	Basic profit	20,911	21,973	–5%	100
②	Capital gains	12,710	30,735	–59%	61
③	Cost of capital	–12,135	–27,585	–56%	–58
	Core operating profit including capital gains	21,486	25,123	–14%	103
④	Loss from real estate disposal	–6,116	–5,724	7%	–29
⑤	Bad loan write-down	239	–1,058	–	1
⑥	Corporate & resident tax	–3,160	–3,794	–17%	–15
⑦	Tax adjustment	1,335	2,908	–54%	6
⑧	Provision for retirement annuities benefits (extraordinary loss)	–1,918	–2,764	–31%	–9
⑨	Other	194	–99	–	1
A.	Surplus (total of ①~⑨)	12,059	14,592	–17%	58
B.	Provision for policyholder dividend reserve	5,802	10,744	–46%	28
C.	Change in internal reserve (= A–B)	6,257	3,848	63%	30
	Increase in contingency reserve	3,409	2,285	49%	16
	Increase in reserve for price fluctuations of investment in securities	1,095	783	40%	5
	Capital increase	1,753	780	125%	8

Note: Surplus is before additions to contingency reserve and reserve for price fluctuations.
Source: Compiled by NLI Research Institute from company materials.

6. Real Net Assets as an Indicator of Stock

Many life insurers experienced a decline in solvency margins due mainly to solvency margin revisions this fiscal year and the weak stock market (the Nikkei average fell from 20,337 to12,999 yen).

Meanwhile, another stock indicator was also disclosed in the form of real net assets. This assesses a company's value in the event that it is liquidated, and is defined as the value of assets at market prices minus real liabilities (policyholder liability is assumed to be as the surrender value). Standards are more rigorous than the numerator for calculating solvency margin, including the treatment of subordinated debt as a liability.

For the ten companies, net real assets declined 3.9 trillion yen from the previous fiscal year to 17.4 trillion yen (10.5 percent of total assets) due to stock price declines. The decrease in net assets was significantly larger than the increase in internal reserves taken from the surplus was 630 billion yen.

We revised real net assets by adding off-book debt and taking a more rigorous approach to land valuation (Figure 5). The aggregate for the ten companies, which reflects reality more closely, is 13.2 trillion yen (7.9 percent of total assets).

Figure 5 Real Net Assets

	(¥ billion)
Real net assets (reported)	17,390
Deferred tax assets	– 2,190
Shortfall in retirement annuity benefits reserve	– 620
Estimated future contributions to Policyholder Protection Organization	– 490
Decline in land valuation for taxation (at 80% of official land values)	– 930
Revised real net assets	**13,160**

Source: Compiled by NLI Research Institute from company materials.

7. Conclusion

Core operating profit, which measures profit in the core life insurance business, is determined by the negative spread amount, and expense gain and mortality gain of policies in force. Since today's ultra-low interest rates are expected to continue for the next several years, the negative spread situation will not be resolved soon. Moreover, considering that life insurance coverage will continue to be reviewed in light of the deflationary economy, policies in force are likely to decline along with the expense gain and mortality gain.

On the other hand, from the perspective of stock, the financial buffers of companies have diminished this fiscal year due to the decline in stock prices. Moreover, while the present situation does not resemble a crisis, in the future we must consider the possibility of further declines in stock and land prices.

Under these conditions, life insurers must do their utmost to limit the decline of policies in force, and strive to improve management efficiency in all areas. On top of this, they must follow proper procedures and establish a framework to adjust the scheduled interest rate to an appropriate level.

As the market for death benefit products shrinks with the aging of society, companies must shift their emphasis to health, long-term care, and pension insurance markets. Considering the characteristics and competitive conditions of both markets, the life insurance business model will need to be reconstructed. Thus while the negative spread poses an immediate challenge, at the same time life insurers must confront the key issue of renewing their business model. This is indeed a challenging time for the life insurance industry.