A Proposal to Standardize the Use of Net Operating Profit Among Life Insurance Companies

by Akira Komatsubara and Kunio Ogihara
Insurance Research Group

1. Introduction

For commercial companies, the accepted measures of profit are operating profit or recurring (ordinary) profit. But due to the peculiarities of financial services, banks and insurance companies do not have something corresponding to operating profit, while recurring profit fails as an appropriate measure of profit for the business.

For example, since both banks and insurance companies hold substantial assets in securities, recurring profit (in the short term) can be overstated by including realized gains from the sale of securities because valuations are based either on cost or the lower of cost or market.

Furthermore, valuation methods used by insurance companies can greatly affect income because many expenses such as increases in liability reserves are based on valuation. Thus an accurate grasp of valuation methods is critical.

To take another example, in recent years, mutual companies have expanded their equity capital by relying in part on Fund financing. While the economic effect of such financing is identical to ordinary borrowing, the legal requirement to treat interest from Funds separately as a surplus distribution tends to obscure actual conditions.

Such accounting methods of life insurers only invite confusion among concerned parties. Thus in addition to recurring profit and unappropriated retained earnings, income statements need to devise a profit indicator that accurately expresses net profit.

Banks already have a profit indicator called "net operating profit," which is separate from profit reported on income statements and has been disclosed since the fiscal 1989 interim period. In addition, the property & casualty insurance industry has been reporting an "insurance underwriting profit" since fiscal 1996 (see below).

Life insurers do not presently report information that corresponds to net operating profit and directly expresses net income for the core business. There have been isolated attempts to use

net operating profit; one company has voluntarily reported net operating profit since fiscal 1997, while publications such as *Nikkei Kinyu Shimbun* (June 10, 1999) have tried to calculate the net operating profit of life insurers. However, these attempts are not necessarily based on a standardized format.

This paper briefly examines how banks and p/c insurers report net operating profit and insurance underwriting profit respectively, and then proposes a definition of net operating profit suitable for life insurers.

2. Net Operating Profit of Banks

The following equation shows how banks calculate net operating profit as an indicator of net income. On disclosure statements, net operating profit has become a focal point for analyzing the performance of banks. (Net operating profit cannot be calculated from publicly released income statements.)

Net operating profit = Net interest income + Fees and commissions + Trading account profit + Other operating profit — Recurring expenses — Provision for possible credit losses

More specifically, the sources of profit are as follows (Figure 1).

1. Net interest income: Interest income from loans, securities, deposit accounts, etc.
2. Fees and commissions: Income from foreign exchange operations, securities operations, etc.
3. Trading account profit: Income from short-term trading of derivatives, etc.
4. Other operating profit: Gains from transactions of bonds, foreign exchange, etc.

Another way to look at net operating profit is as recurring profit adjusted for extraordinary profit (separate allowance for credits of borrowers, loan amortization, capital gains from stock sales, gains from money held in trust, etc.).

Net operating income was originally introduced at banks in fiscal 1989 at the same time accounting standards were revised for the banking industry (Administrative Order No. 61, "Partial Revision of Enforcement Regulations of the Banking Law," July 11, 1989).

Table 1 Net Operating Profit of Banks

	(Income)			(Expense)		
Recurring profit	Money management income	Interest on loans		Interest expenses	Deposit interest	Recurring expense
					Interest on borrowings	
		Interest on securities	Net interest income	Fees & commissions	Foreign exchange fees Others	
		Interest on call loans		Trading account	Trading expense	
	Fees & commissions	Commissions				
		Trust fees		Other operating expenses	Bond sale loss	
		Other			Redemption loss	
	Income from trading account	Securities			Valuation loss	
		Financial derivatives		Operating expenses		
		Other		Other recurring expenses	Prov. for general res. *	
	Other operating income	Bond sales	Net operating profit		Prov. for specific res.**	
					Written-off claims	
		Bond payments			Stock sale loss	
		Other			Stock devaluation loss	
	Other recurring income	Stock sales			Money held in trust	
		Money held in trust	Current profit	Extraordinary loss	Property sales	
		Other			Other	
Extraordinary income		Sale of property	Pre-tax profit	Taxes		
		Recovered loans	Net profit	Dividends, directors' compensation		
		Other		Retained earnings		

Notes: * Provision for general reserve for possible loan losses is based on actual average percentage of bad debt loss on actual defaults during a certain past period.
** Provision for specific reserve for possible loan losses is for borrowers who are legally or substantially bankrupt.
Source: NLI Research Institute

(1) To accommodate the diversification of banking activities, a key feature of the new accounting standards is the introduction of four distinctions based on the type of income or expense (net interest income, fees and commissions, other operating income, and other recurring income). Thus net interest income and fees and commissions can be distinguished in net operating income before expenses are deducted (in gross operating income).

(2) Gains from securities transactions are now differentiated for stocks and bonds, the five balance reckoners of bonds (gain or loss from sales and redemption, and valuation loss) have been included in net operating income under other operating income, and gain from stock sales has been removed from net operating profit.

(3)Gains from money held in trust have been removed from net operating profit.

When banks introduced net operating income as a profit indicator for the core banking business, it replaced the previously released operating income (*chuki* profit).[1] Previously, when operating income was in use, the five balance reckoners related to securities (stocks and bonds) were deducted from recurring income, but gains from trading securities (gains from trading public bonds) were included in operating income. This made it possible to mask trad-

ing losses from operating income by transferring the bonds into the investment securities account.

Moreover, designated money held in trust was not differentiated but instead treated as deposited money, and its profit was included in operating income. This practice had been cited as a non-transparent obstacle to competition.

In addition to these circumstances, the revisions described above were also triggered by a growing interest in Japan and abroad regarding bank disclosures amid an environment of diversification and globalization of banking and the growing prominence of equity financing.

As a result, disclosure advanced further as: (1) the clarity of reported financial data was improved to accommodate the diversification of banking activities (clarification of income corresponding to transactions such as investment management profit), and (2) gains from stock transactions and money held in trust were excluded from net operating income (however, gains from bond transactions are reflected in net operating profit).

Then from fiscal 1998, following the approval of market valuation accounting for derivatives transactions and other trading operations, profit reporting was further enhanced by adding the new distinction of trading account profits to show trading transactions in gross operating profit.

The basic approach to net operating profit has remained unchanged, while enhancements in the way it is reported have led to its acceptance as the main profit indicator for banks.

3. Insurance Underwriting Profit of Property & Casualty Insurers

The p/c insurance industry also has a standardized profit indicator called insurance underwriting profit, which was adopted in fiscal 1996. Basically, the activities of the p/c insurance industry are divided into insurance underwriting and investment management, and the underwriting profit is reported under recurring profit as follows.

"Insurance underwriting profit" = Underwriting profit — (Underwriting expense + Operating, general and administrative expenses) ± Other balances

where:

(1) Insurance underwriting profit includes net premium income, deposits of savings premiums by policyholders, investment income on savings premiums (explained below), and other underwriting profit.
(2) Underwriting expense includes net benefits paid, claims expenses, maturity refunds, and increase in liability reserve.
(3) Other balances include the amount equivalent to corporate tax for automobile liability insurance, etc.

On the other hand, with regard to investment management, the following items are reported: investment management gains (interest and dividend income, gain from sale of securities, other investment gains, transferred investment income on savings premiums, (a negative item explained below), and investment management expense (loss from sale of securities and other investment expenses).

Two additional points should be mentioned:

(1) In calculating underwriting profit, interest paid on liability reserves for savings products is entered as an expense (provision for liability reserves), but backed out under an income adjustment item (income on savings premiums). An amount equivalent to income on savings premiums is then deducted from investment income.
(2) Within investment income, gains from securities sales are not treated separately as extraordinary income. This stems from the predominance of short-term policies in p/c insurance, which reduces the size of assets under management compared with life insurers.

Thus in the p/c insurance business, profit is reported with an emphasis on underwriting performance (net profit). Underwriting profit results for fiscal 1998 are shown in Table 2.

Table 2 Underwriting Profit of P/C Insurers

(¥ billion; %)

Co.	Insurance underwriting profit		Net premiums income	
A	77.0	(11.4)	1285.4	(–3.8)
B	53.5	(–14.2)	901.5	(–3.9)
C	16.4	(6.3)	614.5	(–3.5)
D	21.4	(– 7.4)	540.0	(–4.3)
E	17.6	(–17.4)	422.4	(–4.3)
F	12.6	(–16.1)	413.3	(–5.6)
G	16.6	(10.8)	392.0	(–4.1)
H	3.5	(–64.8)	382.1	(–4.7)
I	12.4	(–23.4)	340.7	(–6.2)
J	12.7	(17.8)	277.5	(–6.1)
K	9.1	(90.3)	268.8	(–5.8)
L	3.4	(–21.7)	223.1	(–5.4)
M	1.9	(–64.2)	151.3	(–5.4)
N	2.0	(23.2)	93.8	(–5.8)
Total	260.9	(– 5.2)	6307.2	(–4.5)

Note: Parentheses show % yoy change.
Source: *Nihon Keizai Shimbun*, May 21, 1999.

4. Proposal for Net Operating Profit for Life Insurers

As we already mentioned, compared to commercial companies, the financial settlements of life insurers are difficult to understand. To alleviate this problem, it is crucial to clearly report performance in the core business (net profit). Financial disclosure must consist of: (1) standardized methods that enable comparisons across companies, and (2) the company's analysis and evaluation of its own data.

For life insurers, we thus propose the following definition for net operating profit:

Net operating profit = [Recurring profit — Gains related to securities (including foreign exchange gains) + Writeoff of non-performing debt + Provision for contingency reserves] — Fund interest — Other adjustments

This method starts with recurring profit and makes the following adjustments.

(1) Gains related to securities = Gains from sale of securities — Loss from sale of securities — Loss from valuation of securities

This consists of gains related to securities such as stocks and bonds, and is reflected in recur-

ring profit. Since it is possible to post a profit from realized gains, from the viewpoint of measuring core business results, it needs to be excluded (that is, backed out of recurring profit). Since bond investments of life insurers are in principle held for the long term, these capital gains should also be excluded from net operating income. However, adjustments should be limited to gains of assets in the general account, and not the extraordinary account.

In the banking industry, owing to a persistent view that treats gains from the sale of bonds as extraordinary income, banks sometimes also report a revised net operating profit that excludes gains related to bonds.

(2) Foreign exchange gains

This primarily consists of gains from hedging, and is also backed out of recurring profit.

(3) Writeoff of non-performing debt = Provision for bad debts (excluding that posted as extraordinary loss) + Writeoff of loans

Bad loan writeoffs can arguably be called an extraordinary charge and should thus be excluded from net operating profit. Some people regard the provision for bad debts as an expense associated with lending, and thus believe that it should be reflected in net operating income (if so, the definition of net operating profit proposed here overstates actual results). In fiscal 1998, however, considering that 15 to 20 percent of risk monitored loans had to be charged to the general provisions for bad debts, the strong extraordinary element here led us to exclude it from net operating profit.

Due to similar circumstances in the banking industry, some banks put more emphasis on net operating profit excluding the allowance than on the usual net operating profit.

(4) Provision for contingency reserves

A contingency reserve is a liability peculiar to insurance companies, and is a contingency measure against earthquakes or other extraordinary risk. On the income statement, it is included under provision for liability reserves (and reflected in recurring profit). This provision is arguably an extraordinary charge depending on accounting practices, fluctuates substantially each year (possibly becoming negative), and shows wide discrepancies among companies. Thus it should be excluded when measuring core business results.

(5) Fund interest

Although Fund interest is treated as a surplus distribution, it is economically identical with the interest on borrowing, and thus should be reflected as an expense of net operating profit.

(6) Other adjustments

When a method called "financial reinsurance" is used, recurring profit increases momentarily.[2] However, since this is not a result of the core business, and thus needs to be excluded. Refer to the endnote for further details.[3]

Based on the definition above, we calculated the fiscal 1998 net operating profit for 13 major life insurers (Table 3).

Net operating profit fell at all but one company, due mainly to a drop from the previous year in net policies in force as new policies fell and cancellations rose, and to the persistence of very low interest rates. This is in sharp contrast to the change in recurring profit, which varies by company, and indicates the effectiveness of net operating profit.

Table 3 Net Operating Profit of Life Insurers

(¥billion)

		Net operating profit		Recurring profit		Gains from securities	
			yoy change		yoy change	sales	yoy change
A	**98**	599.1	(−88.3)	199.1	(−25.5)	−257.6	(139.3)
	97	687.4		224.6		−396.9	
B	**98**	353.8	(−57.4)	113.3	(80.5)	−176.2	(190.0)
	97	411.2		32.8		−366.2	
C	**98**	338.6	(−55.3)	423.6	(188.1)	123.5	(218.2)
	97	393.9		235.5		−94.7	
D	**98**	196.6	(−57.5)	124.0	(92.8)	−30.6	(171.0)
	97	254.1		31.2		−201.6	
E	**98**	122.3	(−28.0)	103.2	(84.9)	47.4	(189.3)
	97	150.3		18.3		−141.9	
F	**98**	125.9	(−50.3)	43.3	(30.5)	3.2	(125.6)
	97	176.2		12.7		−122.4	
G	**98**	203.1	(−41.9)	79.9	(11.9)	−87.2	(81.7)
	97	245.0		67.9		−168.9	
H	**98**	10.2	(−19.1)	9.5	(−26.3)	64.8	(44.1)
	97	29.2		35.8		20.7	
I	**98**	123.9	(−18.6)	71.1	(−13.7)	−14.9	(14.6)
	97	142.6		84.8		−29.5	
J	**98**	20.6	(−14.8)	21.0	(−6.0)	−14.2	(−38.3)
	97	35.4		27.1		24.1	
K	**98**	36.0	(−38.5)	25.4	(−1.2)	7.5	(49.2)
	97	74.4		26.6		−41.7	
L	**98**	60.2	(−20.0)	42.2	(−3.5)	21.3	(−37.6)
	97	80.2		45.6		58.9	
M	**98**	38.1	(17.0)	61.3	(37.1)	45.8	(17.7)
	97	21.2		24.2		28.1	

Source: Compiled by NLI Research Institute from company announcements and *Nikkei Bond Bulletin*, June 14, 1999.

5. Conclusion

The definition of net operating profit proposed above is not entirely without problems. For example, if there is a major shift to foreign bonds, the spread between domestic and foreign interest rates will cause interest income to increase, and inflate net operating profit. Indeed, company M in Table 3, the only company to post an increase in fiscal 1998 net operating profit, increased its holdings of foreign assets from 12.5 percent to 22.9 percent.

Despite such limitations, it would be a significant step forward for life insurers to report net operating profit as a direct expression of core business results (net profit).

In an environment of very low interest rates, the life insurance industry is in danger of losing its ability to pay out benefits in the future. The need for accountability has thus never been greater than it is today. Life insurers need to report their financial condition in a more comprehensible format.

We do not presume to claim that the proposal in this paper represents the best definition. We only hope that it stimulates further debate on this critical issue of standardizing the reporting of net operating profit.

Notes

1. Derivation of *chuki* ("footnote") profit: Starting in the fiscal 1980 interim period, companies could choose between two valuation methods – cost or the lower of cost or market. To eliminate the effect of differences in valuation method on reported profit, companies reported profit excluding gains related to securities (gains from sale of securities, gains from redemption of securities, and write-downs of loss from securities) in a footnote to the income statement. (*Ministry of Finance Annual Report for Fiscal 1989*)

2. In "financial reinsurance," an insurance company transfers some of its policies to another insurance company, and in return receives in advance the expected future income from those policies.

3. Two adjustments are made. (1) When a company that does not rely on the net premium reserve method (for example, by adopting the Zillerized method) changes its valuation method and increases liability reserves, the increase, which is reflected as an expense in net operating profit, is backed out.

(2) The (one-time) fee received when financial reinsurance is implemented is entered as reinsurance income (which is a recurring profit item). This causes net operating profit to appear to increase, which thus needs to be revised downward. In principle, income from financial reinsurance must be added to liability reserves.