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The Impact of Regulation in Japan and Other Asian Insurance Markets

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Summary: This session looks at the impact of regulation on the management of insurance operations in Asia, with a particular focus on Japan, which this year introduced its first major insurance law revision in 50 years. The session addresses:

- *Japan's New Insurance Business Law*
- *Likely course of deregulation in Japan*
- *Implications for existing companies and prospective new entrants*
- *Emerging regulatory issues in other Asian markets.*

Mr. Stephen H. Conwill: This session will take us from Hong Kong to Korea and then to Japan. I think you'll find a remarkable contrast in doing business in Asia.

Our first panelist will be Tom Jaros of Principal International in Hong Kong. Principal, of course, is known as one of the premier companies operating in the U.S. market. They've been working very hard for several years to bring some of that expertise to Asia, and Tom will share some of the experiences that he has had in Hong Kong over the last year-and-a-half. Principal has a fairly small operation in Hong Kong, and, as a result, Tom has really been responsible for most activities that an actuary will engage in and many nontraditional activities as well.

Last will be Stephan Rajotte, who is with ING in Korea, Netherlands Life in Korea. He has been there for about a year-and-a-half. His background is actually in marketing. He had been with ING in Toronto before being called to Korea to take on some of the real challenges that ING and the other companies in Korea are facing. Korea is known as one of the most difficult markets in Asia, if not the world, to operate in, and Stephan will bring us up to date on why that is, what's happening in the regulatory environment, and what companies can do to try to improve the situation there.

Mr. Thomas A. Jaros: Hong Kong is on the southern coast of China. It's an extremely small country of 400 square miles, which is 20 x 20 miles. Seventy percent to eighty percent of it is too mountainous to build on, so, you have a very high concentration of people. It's known for pure capitalism. That's not quite correct. There are rules and regulations, but, in general, the government tries to stay out of the way of business, and they state this very publicly all the time. It was a real shock to me when I first heard this, that they want to stay out of your way. We want business to go about doing business, and that's it and the government very strongly supports this position. There are very low taxes, and a service industry orientation. Hong Kong has become a very expensive place to live. Labor has become very expensive. So, almost all the manufacturing has moved out of Hong Kong. They've gone to places like China, Vietnam, or Indonesia, where you can find labor at a much lower cost.

The population is 6.3 million. It is a very popular place to start your headquarters for a foreign company. Life expectancy is a little bit higher than the U.S. One of the reasons I’ve been told that this happens is that it is because Hong Kong's such an expensive place and if you get sick, you can't afford to live there. The rents are very high. Most of the population is on government-assisted housing. If you're not well enough to work, then you're in trouble because there aren't very many social benefits. You have to depend on your family there. There are very few government programs in Hong Kong, so people have a need to save money. There are about 200 actuaries there, based on the number of members of the Actuarial Society of Hong Kong. You're not considered a qualified actuary unless you're a fellow of one of the institutes or societies, so there are about 100 qualified actuaries. About 50 of them are local; and 50 of them are ex-patriots. If you’re an Associate of the Society of Actuaries (ASA) in Hong Kong, you’re not necessarily a qualified actuary there.

Insurance has been in place in Hong Kong for some time. Forty percent are covered by some type of group policy which is very often a medical policy. Twenty-five percent of the population have an individual policy. There are an amazing number of companies in Hong Kong, over 200. Sixty-two are able to sell life insurance, but the number that are really active in the market drops down to about 10 or 15. A lot of those companies are just barely active, if active at all.

Many of the companies are incorporated outside of Hong Kong. There are various reasons why you might not want to be incorporated in Hong Kong. Some of this has to do with the fear of what might happen after 1997. Others might be doing it for tax purposes. The insurance industry has been growing very rapidly in Hong Kong. Individual life expectancy has been going up. The pension industry is likely to really take off after next year. They've just passed a law that will be requiring every company in Hong Kong to set up a defined-contribution pension plan, and the group business, while it's very small, in some years in the recent past the entire sector has been growing at 50% a year. There is rapid growth in the insurance industry.

There are a number of regulatory bodies to work with in Hong Kong. The Insurance Authority is the main one—a rather recent development. They've only been around since 1990. Inland Revenue is the tax department. They have the securities and future commission, which is very similar to the Securities and Exchange Commission (SEC) in the U.S. Occupational Retirement Schemes Ordinance (ORSO) regulates retirement schemes and mandatory provident fund (MPF). That's a new law that's coming into effect probably sometime in 1997. It could be a little later depending on how long it takes to put the regulations together. They're going to wait until they have the regulations approved before the law is actually an act. The law has been passed, but they're going through this process with getting the regulations down before putting it into place.

The insurance ordinance was written in 1983. Prior to 1983 they just had a collection of laws that were scattered throughout various documents. It was consolidated in 1983. It's one of the things you could pick up and read in a few hours if you wanted to. You see that in a lot of the southeast Asian countries. You could pick up the China insurance law or the Vietnam insurance law and skim over it in a couple hours. In 1990, the Office of the Insurance Commissioner was created to oversee the insurance industry. In 1993, we had an office created to look at retirement schemes. Very recently, in 1995, they introduced the first minimum reserve and solvency margin laws. The solvency margin would be very similar to risk-based capital, but it's minimum capital requirements. In 1996, they created the MPF law, which requires companies to set up pension plans.

Taxation of insurance companies is amazingly simple. I don't know how many people are involved in financial reporting. Rather than try to work through all the problems using your profit, there are two methods available for figuring out what your tax bill's going to be, and the first one's called the 5% method. What happens here is that the tax authorities just assume that your profit is equal to 5% of premium, and then the tax rate for corporations in Hong Kong is 16.5%. You take 5% of your premium times 16.5%, and that's the taxes you pay. It's very simple and very easy to apply. It doesn't matter how much money you make. That's what it works out to be.

Mr. Daniel J. McCarthy: That's, in effect, a premium tax. Is there also a regular premium tax?

Mr. Jaros: There's no regular premium tax, and you're right, it is, in effect, a premium tax of less than 1%. A company can choose, if they like, to use the surplus method. If they choose to use the surplus method under which you're taxed on the change in the surplus, then you can't go back to the 5% method. Therefore, many people use the 5% method, but there might be situations in which the surplus method is advantageous, for instance, like in pension plans.

From the Floor: What's the tax rate on the surplus method?

Mr. Jaros: Sixteen and a half percent.

From the Floor: The same rate?

Mr. Jaros: The same rate. If you choose to use the surplus method, then you're going to stay positive with the surplus method, but if you stay with the 5% method, which a lot of companies do, you can do that.

The maximum rate for individual taxation is 15%. Investment income is not taxable to individuals. Capital gains are not taxable to individuals. You're just taxed on the income that you get from your job. That's it. You might call up your congressman and say, Hong Kong is able to make the country run with low taxes, but he might point out, if you look at Hong Kong, they don't need any tax benefits in order to sell their whole life and endowment products. Why don't we just get rid of the tax benefits for whole life and endowment policies? It's amazing because they do sell a lot of policies in Hong Kong that are either whole life or endowment with no tax advantages whatsoever.

In Hong Kong, it's very hard to determine if your company, or a company that you're buying a policy from, is financially strong or not. The statutory financial statements are not made available to the general public. There's only one publicly listed company in Hong Kong. So, you can find their statements, but that's the only company that's like that. The rating agencies really haven't come in yet. They're starting to come in, but that's a voluntary thing. One measure of strength that is often quoted is the number of agents on staff. I always thought that was an interesting thing. It might stem back from a long time ago. If you're working on a cash basis, or if you have a lot of agents bringing in new business, you're always going to be able to pay off claims from old policies. I don't think that's the case now in Hong Kong, but that might be, and it's just my own personal speculation of how it started several years ago. Standard & Poor’s (S&P) has come in and looked at a few of the companies in Hong Kong. They generally think that the life insurance industry is OK. Their view of the general insurance or the nonlife insurance is a little bit pessimistic. This created a little bit of uproar when S&P made these statements because the Insurance Authority at the time stated that they should be the body looking after whether a company is strong. It didn't take too kindly to having an outside body come in and tell them how strong the industry is.

Minimum reserves and solvency margin regulations are very recent introductions into Hong Kong. Both are based on British standards. The idea was to come up with very simple rules that would still offer the consumer some protection. However, they're very short documents. There was a walkout from the Actuarial Society of Hong Kong when they first tried to introduce these regulations. The Actuarial Society of Hong Kong doesn't have as much influence as, say, the Society of Actuaries (SOA) or the American Academy of Actuaries (AAA) has in the U.S. There were many people who felt that there wasn't enough input from the actuaries when they were coming up with rules and the regulations. So, there's a little bit of concern. Things happen very fast in Hong Kong. With things happening so fast, there isn't always enough time for input from all bodies.

The solvency margin regulations, like I said, are a very recent development. This is most of the formula. The actual document is four or five pages long, but look at the net amount of risk, 0.3%. Then you take 4% of your reserves, and you have it for your basic whole life policy. That typically works out to be a solvency margin of maybe 40–50% of premium. Health insurance would be 20% of premium. Once again, they're just trying to come up with something here that will offer the consumer some protection, but they want something relatively simple to implement. They're not working with a very large staff at the Insurance Authority. They want something that's workable to start off with.

There is no need to file rates or materials with the Insurance Authority. If it's an investment-lined product, you do have to file with the Securities and Futures Commission. They want to look at your illustrations to make sure that you're following the regulations. They do look at things very closely for an investment-linked product, but if it's not a investment-linked product, there's no need to file with the Insurance Authority.

The new law that's coming into effect, which has been passed but we're still waiting for the regulations to go through, requires all employers to set up a defined-contribution plan or an equivalent plan of 5% of employee contributions, 5%

employer contributions, and a preservation of benefits, meaning that you can't get your money out until you're age 60 or when you retire, and the benefits are portable. You can take them from company to company, similar to what you would find in the U.S. with a 401(k) plan. The regulations are still being worked on. One of the reasons that it might take a little longer to get the regulations through is there is a changeover in government which is taking place next year. The insurance issues and the pension issues are not a high-priority item compared to the other items that have to take place before 1997. It is far down the list of things that people are looking at.

The Hong Kong dollar has been pegged to the U.S. dollar since 1984. One U.S. dollar has been equal to 7.8 Hong Kong dollars since 1984. It fluctuates a little bit, from 7.73 to 7.83. What this had led to is a lot of U.S. dollar policies in Hong Kong. You also have a lot of companies using U.S. dollar assets to back up their Hong Kong dollar liabilities.

Mr. Conwill: Is there a guess as to what would happen if the peg were removed?

Mr. Jaros: I've heard that it could go up or down. People generally believe that if the peg was removed and you invested in U.S. dollars, you would come out ahead, but that's only a guess. The inflation rate in Hong Kong is maybe 10–12% compared with the 2–3% you see in U.S., but you still have interest rates that are comparable to the U.S. because of the peg.

There are no foreign currency restrictions for life insurance companies at this time. The statement there is not quite correct about general insurers. General insurers are property/casualty companies. They're required to hold 80% of their assets in Hong Kong, but not necessarily in Hong Kong currency. You might want to make note of that. Just that the assets have to be held in Hong Kong; they don't have to be in Hong Kong currency. They're considering a 30% requirement in Hong Kong-denominated assets for pension plans in the future. It's just something they're considering. It has been a real controversial issue in Hong Kong. They don't like to have restrictions on which way their cash can go.

Of course, in 1997 Hong Kong's going to move from British rule to China rule. There are not big changes expected in the insurance industry. There'll be changes, and you heard James Baker talk about these earlier, but insurance is fairly far down the list as far as important items are concerned in Hong Kong. You might see something that's going to affect the insurance industry from the outside. China has its own insurance law. It specifically excludes Hong Kong, Taiwan, and Macau. These are all countries which China believes are part of its territory. Hong Kong reverts to China next year, Macau in 1999. Macau is a very small Portuguese colony, like Hong Kong, and, of course, if you read Chinese law, you'll find Taiwan mentioned as a territory of China all the time.

The regulation are very few in Hong Kong. There is a noninterference policy from the government. They don't like to get in the way of business. It's a rapidly evolving market, and very rapidly growing. The China switch-over is not expected to make major changes in the insurance industry, and while regulation has been low, it is growing, and it is growing from where it has been in the past.

Mr. Conwill: Just to make one comment on something Tom said that I really appreciate, he said things happen fast in Hong Kong. In contrast, things happen very slowly in Japan.

Mr. Stephan Rajotte: I work for Netherlands Life Insurance Company in Seoul, South Korea. I'd like to first tell you a little bit about the market environment in South Korea, three major forces influencing regulations, and then I'd like to make some recommendations for the future of regulations. I will keep my comments basically on the life insurance industry, but also I will address some issues about the financial industry.

South Korea is, I think, one of the economic miracles of the 1980s and 1990s. Currently, South Korea is the 11th-largest economy in the world. They came from 1960 where the GDP per capita was around $500 U.S., and today it's over $10,000 U.S. They have done that in 30 years. It's the sixth-largest producer of cars in the world. It's just amazing what they have achieved in such a short period of time. Just to put it in perspective, in the 1960s, North Korea was also at about $500 U.S. per capita, and today North Korea is still around $600 U.S. per capita. So, basically no change in 35 years in North Korea but tremendous growth in South Korea. South Korea's the sixth-largest insurance market in the world, and I will tell you later why that happened. Until 1987, there were only six life insurance companies in Korea. Today there are 33. The 1995 premium income growth was 27%. The annual growth projected for the next ten years is 15%

Mr. McCarthy: What is the inflation rate?

Mr. Rajotte: The official inflation rate is about 5%, but the real inflation rate is 8–9%.

Mr. McCarthy: Is the growth rate in real dollars or nominal dollars?

Mr. Conwill: I think it's nominal.

Mr. Rajotte: Yes, that's right. If you can have, let's say, a Korean heaven, you would have God as the Ministry of Finance and Economy (MOFE), where basically it decides everything, and, as opposed to Hong Kong where the government is very involved in the regulation as you will see. The Insurance Standards Board (ISB) would be St. Peter where he's basically directing the order from God, and the Korean Insurance and Development Institute (KIDI), is basically the angels doing all the work and all the rates and all the checking. That's the Korean environment of regulation.

The insurance industry has grown very fast because of the tax advantages of life insurance. Those tax advantages, though, are disappearing very quickly, and right now it's expected that within the next year or two everybody, and I mean banks and other financial institutions, will have all the same tax advantages as the insurance companies. In the past that has not been the case, and that's one of the reasons why the Korean life insurance industry has grown so fast.

If you look at current market share, the original six life insurance companies have 72% of the market, and new foreign companies of which there are five, have 0.3%. I'm proud to say we're the largest one. However, you could look at it from the point of view that the big six have lost 28% of the market in the last nine years. So they had 100% of the market, and they've lost 28% to the new companies. In terms of product mix, about 68% of products are savings, and it's still very much a savings-oriented industry. When you see premium growth and projected growth, it's very heavily based on savings product. Insurance as such, whole life and term, is not a big portion of the premium income.

There are 360,000 career agents or tied agents, 95% are female, mostly housewives. Retention of agents is about 35% after one year.

Mr. Conwill: That's 360,000 in a country of 45 million!

Mr. Rajotte: Yes, the population is 45 million. The 13-month persistency is around 55%. The company with the best 13-month persistency would be around 70%. So, it's a problem in Korea.

I just told you a little bit about the market environment in Korea. Now I'd like to talk about three major forces influencing regulations in Korea. Social values are changing, and I will explain how that influences the regulations. The government's ambition has a very big impact on regulation and the life insurance industry itself.

Family values are changing very much in Korea. Traditionally, the family lived together, even newlyweds. After they married, they lived with their parents. So, you still find most of the people there living with the parents. Parents, children, and grandparents are all in the same house. They are much smaller houses or apartments, than what you have in the States, but that's changing. The younger generation, wants to move; they want to live on their own, and there's a lot of pressure in the family units to be broken. There was also some market research done in Korea recently with some focus groups made up of the younger generation, and they found out that the #1 priority of the people in those focus groups was to make money.

Now that's not very different than a lot of other countries in the world, but when you look at the family traditions, this is a very big change in Korea. Family was not even in the top five priorities of those focus groups. It's changing very much.

They want money to buy things. They want a house. They want a car. They want to move away from living with the rest of the family. What this has done is created a society of heavy spenders. You will not believe how much money the young generation is spending in Korea, and there's a lot of rich people as well. What this has done—because of the purchase of foreign goods and the interest to buy something American or European—has caused the trade deficit to increase tremendously in Korea in the last couple of years. Now, you might say how does the change in the social values, impact the regulations? The Korean government recently allowed a new tax incentive product to be sold by insurance companies and banks. Everybody's on the same playing field. There is no advantage for insurance companies compared to banks. That product is solely designed to try to help reduce the trade deficit that Korea has. They told us on October 21, 1996 that they would allow us to start selling this product. Everybody has the same product, even all the insurance companies and the banks. That product takes people back to the days when they were saving a lot more of their income.

As in many Asian countries, the population is aging, and there's a need to do more long-term planning. The government is starting to realize that, and they're starting to make some changes to help the aging population. There's also, I believe, because of that, tremendous opportunity for financial planners because there's a great deal of money, but a lot of people really don't know what to do about saving for the long term.

In terms of government's ambitions, the priority of the government is very clear. You see it almost every day in the newspaper. They want to be part of the Organization for Economic Cooperation and Development (OECD) and the World Trade Organization. That's their goal. They make some changes on a weekly basis to the regulations because they feel that if they make those changes, they will gain easier approval to join OECD. From a Canadian perspective, being part of OECD is maybe not so important, but they want the status recognition. The government is also very interested in globalization; so much so that they're encouraging companies to expand overseas. For example, individual mortgages didn't exist in Korea two years ago because the government wanted the banks to focus on lending money to the companies that wanted to expand overseas, and the government controls the loans. They still do. Everybody was focused on expanding overseas, and now you see more and more products from Korea, Samsung, and Hyundai. They're coming to North America and Europe, but I think we haven't seen the tip of the iceberg yet. They're heavily involved in expanding overseas, and you will see more of that.

First, I want to explain one difference between Japan and Korea, and that relates to concentration of wealth. In Japan, you have many companies doing business with each other. For example, Toyota may get many other companies to make some parts for the cars. They all work together, but they're owned by different people; there are different shareholders. In Korea we have conglomerate companies which basically own 300 companies. Samsung, for example, is the largest life insurance company, but they also build buildings and they build chairs. They also build televisions. They have stockbroker firms. They're involved in just about everything. Sometimes I look at something in Korea, and I say I'm sure Samsung makes this. There's only about 30 of those chaebols or conglomerates—that's what I mean by concentration of wealth. Most of those conglomerates are owned by families, and there is a large number of very rich people there. There are a lot of people in the lower or middle class but no upper middle class. There are the very rich, and then there are the others. The government realized that, and is starting to try to change just by allowing loans to new entrepreneurs. What would happen in Korea is, when a person would start a business, as soon as the business is successful, this entrepreneur would go to the bank and say I need money to expand. The bank would reply that they only lend to companies that go overseas. If you are not going overseas, then no money. Samsung or Hyundai would then buy that business. That's the way it worked, but the government is slightly changing that approach.

Sometimes I wonder if there is a long-term strategy and if the government has some long-term objectives because things do change very quickly in Korea. I would say almost every week there's some kind of announcement of changes which takes everybody by surprise. Thinking about the long term is something that I believe the government needs to do a little bit more work on.

Deregulation of the financial industry is very much needed in Korea. They're making changes, but the changes are driven by joining OECD, and they are slow to make some other changes. You have to understand that 35 years ago this country was basically broke. I mean people were poor and nobody had any money, and now they've achieved so much in such a short period of time, that they're afraid to give it up. They're afraid somebody from the States or Canada or Europe will come in and destroy what they have built over those 30 years. That's one of the reasons why they're very cautious about changing regulations. They make some very small change from our perspective. The Korea economy needs deregulation, and you see this kind of recommendation regularly.

The life insurance industry is the third force. First, I'm going to divide this force in three areas. I want to talk about the solvency issues, product development, and distribution issues. Regarding solvency, in the late 1990s, the government wanted to give some incentive to the new insurance companies. The government allowed everybody to defer 50% of their cost, including commission—to help them develop market share because, remember, there were only six companies up to 1987. What happened is many of those companies went after market share in a very aggressive way, so much so that they spent a lot of money. What's happening now is that that money is basically gone, and now they have to amortize those deferred assets. They need more capital, but there's no money. That is a serious problem in Korea. In 1985, the industry total losses were $760 million U.S. The accumulated losses of the industry were $2.9 billion U.S. It was the net capital of the industry, minus $1.5 billion U.S. It's expected to go to $2 billion, minus $2 billion net capital for all of the insurance companies together. I don't know too many industries in the world that are working with a –$2 billion net capital. This is a very serious problem. From the insurance company's point of view; they're getting 27% premium income growth.

They're looking at it from a cash-flow point of view, or at least that's my perception of it. They're saying we're getting premium income. As for solvency and reserves, they're not as concerned as they should be, and the government is really struggling to try to make the companies a little bit more attentive to this without breaking the relationship, which is also very important in Asia. There are nine companies which are bankrupt. They really have serious problems, but the government has just recently announced that they will allow mergers. They will also allow companies to merge and to fire employees. This is brand new. Traditionally in Korea, if two companies wanted to merge, the government did not allow the companies to let go any employees. Nobody saw a need to merge because what would be the purpose? Even now when you see those kinds of deficits in capital, I think it will even be difficult to have companies merge, but we will see. It will be interesting. By the way, in February 1996, the government reduced the solvency requirements to a level that is much lower than risk-based capital or what you have in Europe. There's still a lot of pressure on the government to reduce those solvency requirements even further. The pressures are coming from the insurance companies which do not have capital to put in. It will be interesting to see what happens.

Product development includes very strictly regulated interest rates, mortality tables, dividends that we pay, and products that we're allowed to have. Contrary to Hong Kong, we have big books telling us how to price products and so it's very detailed from that point of view.

The product approval process is very complex. If you want to have a new product which doesn't exist, it will take six months to be approved. It's quite likely that it will be sent to all your competitors to ask for their opinion, and by the time it is approved, it's most likely that the competitors will introduce it as well. If you want to copy an existing product, then you will get approval in two weeks. However, in the brochure that you give to the client you have to say that you have copied the rates and everything for this product from XYZ Company. That's a bit different.

Universal life is not allowed. Unit-linked products are not allowed. This is something I'm working on, trying to help the government introduce universal life. They are interested, but I feel they will take a little bit of time. Product guarantees are usually 7.5% interest rate for the life of the product. Most life insurance products, savings, or protection products guarantee 7.5% on the investment. The longest term investment vehicle is three years. You don't have ten-year and 20-year bonds. A three-year government bond is the longest that you'll find. There is quite a bit of a potential asset and liability matching problem. By the way, interest rates currently are about 12% in Korea. A year ago they were about 16%, and everybody's expecting the rates to go down further. One of the reasons some people say that there's not so much concern about matching of assets and liabilities is because the persistency is so bad!

In terms of distribution, commission levels are regulated, and they're relatively low. Recruiting quality agents is quite difficult because of the image of housewives, and pressure sales is still very much part of the Korean public. That's how they perceive life insurance agents. Training is minimal. Very few agents are what I would call financial advisors or financial planners. They're basically just selling based on a relationship. Very little needs analysis is being done, if any. The regulation requires improvement in persistency. Every year the government sends us a document we have to fill out on what we are doing to improve our persistency, but it's not followed very well by the companies because persistency is barely moving up. Independent agents are not allowed yet; however, they have announced that starting in 1997 they will allow independent agents. There will be quite a few interesting changes. They've also allowed cross-border selling, which when you ask them they're not entirely sure what it means. They will basically allow companies or agents from other countries to sell products in Korea in 1997. This is something that was announced in the newspapers which was very big news. If you call the government and ask “What did you mean by that?” they say, “We're working on defining how that's going to work." In fact, they do have a bit of time, but it will be interesting to see what happens.

The three forces, social values, the government's ambition, and the industry. In terms of some recommendations, this is my personal opinion, I would really like to help the government. I'm trying to do that, and actually the American Chamber of Commerce in Korea is now working with the government to try to develop an overall long-term plan for the financial industry, not only the life insurance industry but also nonlife, the banks, and brokerages. I think this is very much needed. Then, once we have this plan, we have to enforce regulations to achieve that long-term plan. Sometimes the government has not been strict in enforcing regulations. For example, on solvency issues many companies are underfunded, and they should not be allowed to continue to do business, but there's no change being done on that issue. I would like the government to liberalize the product development process, which would open the door for true competition. As I said earlier, they're very cautious about that, and I think they have to be, but I would like that to be open a little bit faster. We also need to do much more training, particularly of the distribution system, but of the general public as well.

In conclusion, in the short term we will see many changes. In the medium to long term, I think there are a lot of good opportunities, and the last thing I'd like to mention is that I'd like to tell you a bit of an analogy, for the east-versus-west way of thinking. It's very easy to look at what I've just explained to you and say, "This is terrible. How can they allow those kinds of things?" Sometimes things happen in different ways. In Asia, things don't work in the same way that we're used to. They get there, but they get there not by doing one, two, three, four, five, but by doing five, two, three, one, four. Sometimes when you're there you say, "That will never work," but it does work. For example, I do my own driving in Korea, and a lot of ex-patriots tell me I'm crazy, because, if you have an accident as a foreigner, you go to jail. They first have to find out if you have enough insurance to cover the accident and what happened. So, a lot of expatriates say no driving for me. I'm not interested in going to a Korean jail. The signs are not always in English, so that's another problem. The traffic is also quite incredible in Korea. There are three million cars. There are 14 million people living in Seoul. You have to be aggressive to drive in Korea, otherwise you get stuck in a corner. If I would drive the way I drive in Korea here, I would probably go to jail, too, but my point is that they get there. People go home at night. They make it to their home and to their work every day, and things work. If we would drive the way people drive in Korea in the States, with the same kind of density of cars, it would never work. By the way, Korea has the second-highest traffic accident death rate in the world. They have a different way of doing things, but in the end it works.

I think the life insurance industry is in big trouble. There are many very important issues to deal with, but I really feel that, as desperate as it may look, they will get there with time and hard work.

Mr. Conwill: I have to say you're very courageous having been to Korea many times. I would definitely not get behind a wheel. Stephan said that every two weeks there is an announcement of a change in Korea, and the same thing is true of Japan. Every two weeks there is an announcement of a change. There's continual talk of change in Japan, but things change very slowly in that country.

I work for Milliman & Robertson Japan. I would like to turn the subject to regulatory trends in Japan, subtitled, "Understanding the Ministry of Finance and the Japanese View of Regulation." In order for an insurance company to do business in Japan, it's critical to have a good understanding of the Ministry of Finance (MOF). It is critical to understand how the MOF interacts with other semiregulatory bodies and with private industry because if you want to get anything done in Japan, you will need MOF approval. The best way to get approval is to know how they operate.

First, a very brief outline of a few key points in the history of life insurance in Japan. The industry itself got under way about a hundred years ago. As you may know, Japan closed itself off to trade with foreign countries almost entirely for about 250 years, between 1600 and 1850. It opened its markets up rather rapidly thereafter to trade, and around that time the insurance industry was established. Meiji Life was the first company in 1881. Japan then began to send students and diplomats all over the world to pick up technology. Actuarial science and insurance law were actually imported from Germany in the late 1800s. The very strict regulatory foundation that exists in Japan was brought from Germany about 100 years ago. The industry did quite well in the pre-war period of the early 1900s. Like the rest of the economy, it was in shambles in 1945 but was quickly reestablished after the war. It's interesting that when it was reestablished, most of the companies, which in the pre-war period had been stock companies, were restructured as mutuals, in part, because the U.S. occupation forces felt the mutual company format was a better way to run an insurance company.

In the 1950s and 1960s the industry played a very key role in capital formation in Japan. Around 1950, the industry accounted for only about 3% of total assets in Japan. Now that's more like 20–25%. They've been a real force for capital formation. The period of the 1950–1960s was really the industry getting back on its feet. Around 1973, the first foreign company entered Japan, and that was the beginning of a gradual period of product innovation and product change. In the 1950s and 1960s, the endowment plan had been the main policy sold in Japan. By the 1970s, you started seeing whole life, term life, and then a lot of health and accident riders in various combinations. Industry growth occurred in the 1970s and 1980s. By the mid-1980s, people were beginning to realize that the insurance law which had been brought from Germany 100 years ago—the foundation of the way we were doing business—was not adequate. Looking for ways to deregulate, bring greater product innovation, and really consumerism led to initial discussions of an insurance law which was passed after about ten years of deliberation, in 1996.

Until 1996, there were only 31 life insurance companies operating in Japan, which is really quite remarkable when you consider that this is the largest life insurance market in the entire world. In 1996 there were 13 new entrants, and we'll talk about why there are so many. Essentially as a result of deregulation, we have quite a few new companies. There is a very high concentration of business in the largest companies. Most of the products sold even today would be considered traditional by North American standards. Variable life is permitted for sale in Japan but is not a major part of the market. There's a very high degree of regulation on product design and price by the MOF. Distribution is mainly through salesladies. About 80% of the business sold in Japan is through sales ladies who work with friends, relatives, and neighborhood organizations. The market is definitely open, contrary to what you might hear in the press, but it is very hard to enter. The MOF will scrutinize your business plan and your home office operations in great detail before they will grant you a license. Although the official capital requirement is only about $10 million U.S., in practice you'll probably need about ten times that much to establish an operation in Japan.

Let’s take a look at just how big this market is. In a ranking of the largest insurance markets on a premium basis, Japan significantly exceeds the individual premium income of the U.S. Even if you ignore the premiums from the Postal Life Insurance Bureau, the largest insurance operation in the world, Japan still exceeds the U.S.

From the Floor: You said the market was open, but hard to enter. Could you elaborate on that?

Mr. Conwill: When I say the market is open, any company which is clearly solvent in its home market and submits a ten-year business plan of operations with the MOF describing planned marketing methods, the products you plan to offer, and the staffing of your operation, you receive a license from the MOF. In terms of the ability to operate fully in this environment and bring new ideas, you're quite limited. If you plan to come to Japan with a very new product or marketing method, you may be in negotiations for a very long time to get that plan of operations approved, but if you want to open an operation following relatively traditional patterns in Japan, as long as you're capitalized well enough, you won't have a problem.

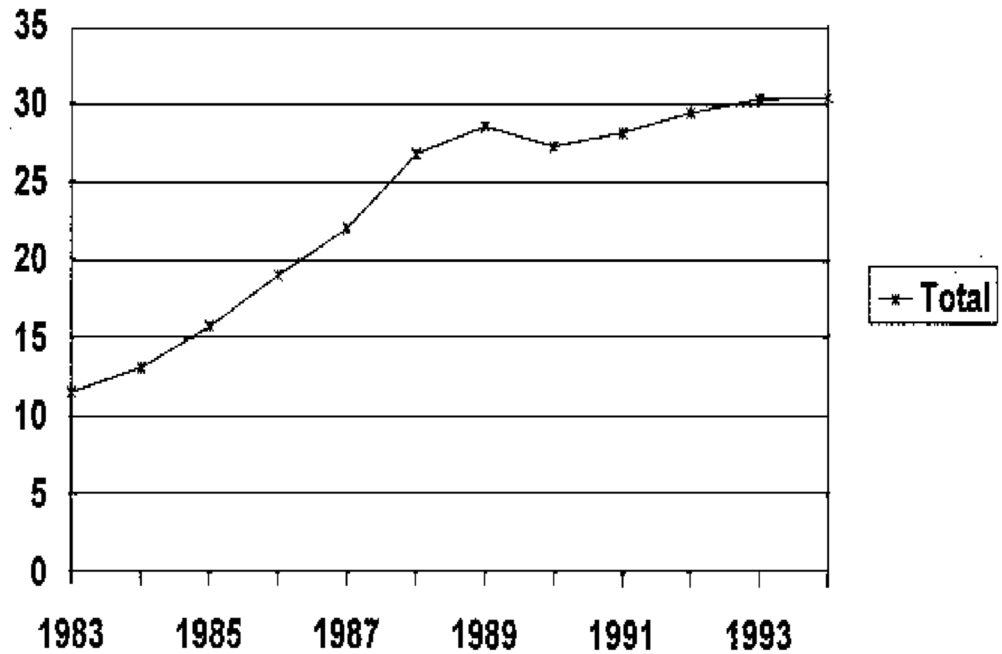
From the Floor: I've been following articles in the press about the life and nonlife sectors—Japanese companies can open subsidiaries in the opposite sector—and also opening up the third sector—can you comment on that?

Mr. Conwill: Until the new insurance law was made effective in 1996, life insurance companies were prohibited from owning and operating a nonlife company, a property/casualty company, and a property/casualty company could not set up a life insurance subsidiary. That restriction was removed in the new insurance law and is actually the reason for the large growth in companies, because 11 nonlife insurance companies have set up life insurance subsidiaries. This is probably the most important short-term effect of the new business law because many of these 11 companies are very well-capitalized, and have very strong marketing forces in the nonlife sector, and will at least have some success in selling insurance business.

Life insurance or annuities are contingent on life, either living or dying. Nonlife insurance is contingent essentially on property, and the third area is everything else, which usually means hospitalization, cancer, dread disease, and personal accident type coverages. Although it's not written into the regulations, the MOF has not permitted the largest life insurance companies to operate in the third area, or they have limited their ability to operate in the third area. The current dispute really centers around whether or not the access of the large companies to the third area should be liberalized and how rapidly. Many of the people on the U.S. side are saying if you're going to deregulate, you should deregulate the first and second areas, the primary areas first because they are the core of the market. After you deregulate the primary areas, it's fine to deregulate the third areas, but it's prejudicial to U.S. and foreign interests to deregulate in the third area, where the U.S. has historically been strong, without giving us a chance to operate in a freely deregulated first and second area.

Chart 1 shows the very rapid growth of the life industry premium which occurred in the 1980s and the leveling off which occurred in 1989 and 1990. The 1980s were a very good era for the life insurance industry in general. Beginning about 1990, there was the crash of the so-called bubble economy in Japan. Life insurance premiums leveled off, and it's generally believed that we're in a saturated or no-growth era in life insurance. The bubble represents the equity spike in 1989 which is really quite significant both from an industry management perspective and a regulatory perspective. Keep in mind that Japanese companies historically invest 20–25% of their cash flow in equities. In the late 1980s, they were taking in large amounts of money from single-premium endowment and other policies and investing in equities. It's not hard to imagine that there are companies in financial difficulty now as a result of this spike and the rapid decline in equity values which occurred over the following years.

CHART 1
HISTORY OF LIFE COMPANY PREMIUM



From the Floor: Have you seen any shift by Japanese companies to invest overseas?

Mr. Conwill: In the 1980s, there was a fairly big move to invest in U.S. Treasury securities. During that time, the yen decreased in value from about 260 yen to the dollar to around 100 yen to the dollar, and many companies have taken some serious capital losses. As a result of that experience, they really have been reluctant to diversify significantly abroad.

Deregulation has been a topic of discussion in Japan for about ten years, and the discussions really began around 1987, which was during the bubble economy. It's been really interesting to watch the evolution of discussion over the almost ten-year period. When the discussions began, there was a giddy sense of belief in the Japanese economy and that growth would go on forever. The initial focus of deregulation was really how can we provide more policyholder value? There was a concern that life insurance companies were building up gigantic amounts of hidden surplus as a result of conservative accounting methods. There was a lot of discussion of—how can we improve policyholder dividends, and enhance value? How can we distribute this enormous amount of value that we're apparently building in our organizations? The discussions shifted rather quickly towards solvency and actuarial issues, and the law that was passed and became effective in 1996 contains less of an emphasis on deregulation and market opening, and a greater emphasis on solvency and accounting than it would have if we hadn't had the bubble experience.

The last point, that much discretion is left to the MOF, is absolutely critical to understanding the situation in Japan. The new insurance law is fairly vague in many important areas and specifically leaves discretion up to the MOF. There are many things that can happen contingent on MOF approval.

Let's take a look at life insurance regulatory bodies in Japan. Insurance regulation occurs at the Insurance Department of the MOF, and it's fairly significant that the Insurance Department is within the Banking Bureau at the MOF. Banking has been viewed in Japan as more significant than life insurance, and deregulation and innovation have occurred more rapidly in banking than in insurance. We've often been told that if you want to know what's going to happen in regulation of insurance, look to what was happening on the banking side five years ago. How does the Insurance Department at the MOF conduct its regulatory activities? They are notoriously understaffed at the MOF, and they do call on advice from many organizations including the Life Insurance Association of Japan, unofficially Nippon Life, and some of the other large companies in Japan. I think Stephan mentioned that if you bring a new product to Korea, it will be given to Samsung Life or some of your other competitors. It's humorous, but it's not a joke. If you bring a new product to Japan, it's possible that the MOF will ask for advice on the product from Nippon Life or another competitor. They also do have teams of academic advisors who support the rather small regulatory staff.

With what I've just said about the staffing at the MOF, we'll have a quick quiz. How many actuaries are there at the MOF? Keep in mind that this is a $500-billion life insurance industry, the largest life insurance industry in the world, and it has very strict product regulation, price regulation, strict solvency requirements, and requirements for cash-flow testing. There are no actuaries at the MOF, and that brings another question, how do you regulate a $500 billion life insurance industry without actuaries? The answer is very conservatively.

From the Floor: Why is that? Do you have any explanation?

Mr. Conwill: The MOF has historically hired mainly from Tokyo University or a few other very prestigious universities. It's one of the most sought-after positions in Japan. The MOF does not hire any experienced professionals, so everyone is home-grown. Also, at the MOF, like at private companies, they tend to rotate professionals among a wide variety of departments within the MOF to get wide exposure. Given that practice, it's not beneficial to someone's career to spend seven or eight years studying actuarial exams and becoming an actuary. The history of why that arose is really a very important question. The U.S. trade negotiators have been criticizing the fact that the MOF doesn't have the staff to implement deregulation, but culturally it will be very difficult for them to go out and hire 10–20 actuaries or whatever they might need. It's a very interesting point.

Things move slowly, and regulation is conservative in Japan. Here are a few things which are prohibited in Japan. Nonsmoker discounts are prohibited. The official reason is that there is not enough data to support giving discounts to nonsmokers. That's actually not true. The suspected real reason is fear of price competition and tobacco lobby pressure. Variable annuities are prohibited in Japan. The official reason is that insurance companies may not engage in the securities business. They can issue variable life but not variable annuities. The suspected real reason is pressure from the securities firms and the MOF paternalism. Variable annuities expose policyholders to too great a degree of risk. The experience with variable life, which was introduced in Japan in 1986 during that bubble period, was not a good one. Universal life is prohibited in Japan. The official reason is that insurance companies may not engage in the banking business. Universal life just looks an awful lot like a bank account. The suspected real reason is pressure from banks, fear of price competition and fear of massive replacement activity. The Japanese are very aware of what happened in the U.S. when universal life was introduced.

It is possible to get new products approved in Japan. A few things are essential to getting it done. Enlist the support of your company colleagues. If you do establish an operation in Japan or acquire an operation, you'll find that if a new idea comes from a parent company from the west, you may have a lot of trouble building a consensus within your own company that this is a good idea. You'd better start and enlist your own staff. Prepare very obsessively. When you file the new product with the MOF, you will be asked questions in minute detail about the development, pricing, and marketing of the product, and the impact of the product on your financials. Pursue both high- and working-level contacts at the MOF and then be very polite in almost all the discussions. Apply trade pressure, but try to be subtle in your application of trade pressure, and find a respected industry partner. If you feel it may be to your advantage, don't be afraid to go talk to a potential partner. You may gain an advantage by talking directly to Nippon or the other people who are going to see your product in the end anyway.

Moving back to deregulation, among the stated goals of deregulation at the time the process started in the late 1980s was promotion of competition. There was a feeling that the companies were amassing great wealth, and there should be more competition, more product opportunities, and more price competition. Preserving the soundness of the business was a priority. They wanted to introduce competition but maintain a sound business at the same time. As we said earlier, the trend in the initial discussions focused on competition, and the end result was more related to soundness of the business, and ensuring fairness and equity. We could talk about this for a long time, but the concept of fairness is very culturally relative. You can discuss the concept of fairness and equity for years before you come to a real agreement.

We had a question earlier about life/nonlife entry, and I think I said that the impact of deregulation will really not be seen in Japan for five or more years, but there are a few immediate impacts. The first is that there were 13 new life insurance companies in 1996. Eleven of them were subsidiaries of nonlife companies. There are two, new foreign companies. This really will change the market. The new companies will not get a 28% market share as fast as occurred in Korea, but they will take market share in a market that, as we saw earlier, is already rather flat. Six new nonlife insurance companies were set up by the life companies, and that will have an effect of stretching the management of the life companies.

Let’s try to make a forecast of where things are going in the mid-term, maybe the next 5–10 years, in Japan. There are still a few foreign companies looking at the market. There's still some interest in Japan. We'd anticipate another five or so new companies entering the market in the mid-term. There may be some restructuring of existing companies. As a result of the bubble economy, there are four or five companies in Japan with extremely weak balance sheets. The new business law does allow demutualization, which, in the past, had not been a very viable possibility. It's possible that as a result of the solvency concerns there will be serious restructuring. It may not be a merger or demutualization, but it could be a dramatic change to a few of the existing companies. Currently, after the new business law, banks and brokerage firms still cannot own a life insurer. That's been discussed at the Diet and within the industry for quite a long period of time. We could see that happen. There will be some increase in product design, flexibility, and price competition. Somewhat ironically, in 1996, the MOF put a lot of pressure on companies to adopt a uniform pricing approach, significantly increasing margins over those that had existed in the past couple of years, mainly to try to rebuild industry capital. With 13 new companies and with U.S. trade pressure, it's inevitable that the price competition will creep up regardless of the MOF’s desire to keep a cap on it in the short term.

There is growth in the brokerage distribution of insurance. Independent agents may now sell life insurance policies from more than one company, which, in the past, had been prohibited. If that's coupled with meaningful price deregulation, it could have an impact on the industry. I mentioned earlier that about 80% of business in Japan is still sold through salesladies. A few companies, most notably Sony Life and Prudential Life, introduced professional male agency systems in Japan. Those two companies have been doing quite well, and there's an increase in professionalism even among the more traditional agency forces of the large companies

From the Floor: Can you comment on ceding companies' freedom to use reinsurers? The specific question is, do they have to use local reinsurers? What are deposit requirements in the case of offshore reinsurance?

Mr. Conwill: In Japan, almost all life reinsurance is done by insurers that are licensed or do have operations actually in Japan.

From the Floor: Operations or companies?

Mr. Conwill: Offices in Japan. So, Kyoei Life, the large local Japanese company, and Swiss Re and Munich Re have offices in Japan. I can't comment on the actual deposit requirements of offshore companies. There are a handful, six or seven companies, that do very small amounts of reinsurance that do not have an actual operation in Japan.

From the Floor: Does the MOF require a ceding company to reinsure with a company that has a license in Japan?

Mr. Conwill: The MOF does not require it.

Mr. Jaros: I can answer for Hong Kong. I don't believe there is any requirement that you have a company in Hong Kong. We've talked to a number of reinsurers outside of Hong Kong, and there are no restrictions on having a deposit there.

Mr. Rajotte: In Korea, the government used to have full ownership of the reinsurer, and everybody had to do their business with KRIC, a Korean reinsurer. That's changing. They don't own it, and officially, you don't have to do business with the Korean reinsurer, but if you reduce your reinsurance portion, it's suspected that it might have an impact on other dealings you might have with the government, indirectly. I've tried to reduce our percentage with the Korean reinsurer, and I was very gently told not to do that. In terms of foreign reinsurers, they are in Korea as well, but there are no requirements, and the government just doesn't worry about that. They're just thinking big reinsurers must be good and must be professional. We have a lot of other problems to deal with. They don't have time.

From the Floor: With the exclusion of Hong Kong and Macau from China insurance law, once China takes over, is there potential that the Hong Kong companies can get into the China market?

Mr. Jaros: I don't know. There are a lot of companies that seem to be speculating, but it's anybody's guess on whether or not that will actually happen.

From the Floor: I have a remark about the Korean market. You say that in 1997, the Korean government may allow cross-border selling of life insurance. Based on my experience in Taiwan, they won't allow U.S. companies to sell their products, simply because the premiums are significantly lower than those offered in the local market. I don't believe the government can tolerate such significant competition from American products.

Mr. Rajotte: Yes I agree, but I'm hoping that this will be a catalyst for changes.

Mr. William J. Bugg, Jr.: I'd like to make a comment, it doesn't sound like prices are high enough. You gave the exhibit showing how well the companies are doing. So, I can't figure out why you'd want to charge less.

Mr. Rajotte: I don't think it's a question of less. I think it's a question of offering a different kind of product.

For example, ING has universal life somewhere else in the world. When we are cross-border selling, perhaps we can sell universal life in Korea, but, when I questioned the government about what they mean by cross-border, there's no clear answer on that.

From the Floor: My understanding is that in some countries there are underground sales of universal-life-type products. Could you comment on whether that would motivate the government to approve the product from the current companies in Korea or from outside?

Mr. Conwill: By underground sales, do you mean sales in that country by a life insurer outside of the country?

From the Floor: Unauthorized sales.

Mr. Rajotte: I'm not aware of it, and my feeling is that the regulators are so strict. I'm not aware of that at all. So, I'm a little bit surprised.

From the Floor: It did happen in Hong Kong. As long as it is products not being offered in Hong Kong, and they're not actively advertising, but somebody from Hong Kong wants their product there, they are allowed to buy it legally in Hong Kong. If you are thinking of opening a shop in each country, are you allowed to have a subsidiary? Can you have a branch operation, or do you need to have a joint venture?

Mr. Jaros: You can do all three in Hong Kong. Just until recently the government wasn't offering any new subsidiary licenses in Hong Kong, but they've changed their position on that. On the branch side, you can open up a branch if you're well enough capitalized in your home country, in Hong Kong, and, of course, joint venture operations are always available there. So, all three routes are possible.

Mr. Rajotte: In Korea, when they first allowed foreign companies to come in, it was only through a joint venture. However, two years later they allowed fully-owned subsidiaries. Right now it's quite clear that the joint venture has not worked. Some companies—Aetna, for example—have replaced them. Now you can operate a joint venture, or a fully owned subsidiary, or a branch.

Mr. Conwill: In Japan you have the option of either a branch or a subsidiary. There's no requirement that if you form a subsidiary, there be a joint venture partner, and, in fact, of the subsidiaries there only one is a joint venture company.