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Don't Cry for Me, Argentina (and Hot Topics in Asia and Latin America)

Track: International

Moderator: William R. Horbatt

Panelists: Jose Luis Berrios-Martin
Ronald A. Colligan†
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Summary: Panelists discuss current issues in emerging markets, such as China Life's initial public offering and the impact of new international accounting standards.

MR. WILLIAM R. HORBATT: First, I'd like to give an apology from Lori Weyuker. She was going to speak about the Pinochet regime's attempt at risk assessment and health insurance in Chile. Unfortunately, she has got paid work, and that takes precedence over our session. But we do have three great speakers today. We've got Masaaki Yoshimura. He's with the Sumitomo Life Co. He's their chief representative here in New York. He has more than 20 years of experience at Sumitomo, where he has served as the appointed actuary. He has also been active in the Institute of Actuaries in Japan, where he has held the position of general secretary, which I know is important. Next to him is Ronald Colligan. He's with Guy Carpenter. I'm not sure what he does, but he travels a lot. Finally, we have Jose Berrios, who's with Milliman in their Denver office. He's heavily involved in recent developments in Mexico, where they're attempting to implement a regulatory system.

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So without any further ado, I'd like to ask Jose to start his presentation.

MR. JOSE LUIS BERRIOS-MARTIN: I'm going to give you a little background and try to give you a high-level view of what's happening in Mexico. There's a document that came out in one of the newsletters of the International Section on dynamic solvency. The title is "Dynamic Solvency Testing has Arrived in Mexico." If you have a chance to take a look at this document, it describes in a lot of detail what I'm going to give you in summary. If you're more interested in finding out all the details and specifics, I encourage you to look at this. This is also, I think, posted on the SOA Web site. If you're interested, I have a write-up of my own comments and take on that regulation, so give me your business card and I'll be glad to send it to you.

I'm going to try to go fairly quickly on the concept, so if you have any questions you can leave those for the end. I'm going to give you some of the issues that I see with regard to some of these regulations and some of my own conclusions. Obviously, this is my own perception of how things will develop in Mexico in the next four or five years. I hope it's going to be helpful.

Let me give you some of the background about the recent regulations. One of the things to keep in mind is that the commissioner of Mexico just finished serving his appointment as the head of the International Insurance Commissioners. So he has been getting a lot of feedback from colleagues from the United States and Canada and from other parts of the world, on what the new regulations regarding the solvency requirements should be. A lot of his work reflects his interaction in this committee.

In terms of some of the significant regulations that have passed in the last couple of years, starting in 2003, at the beginning of the year, there was a circular related to minimum reserve calculations (the circular number is 10.1.7). I'm going to go into a little more detail later. Around the same time there was another circular that came out regarding reserve adequacy and what kinds of things you should do to test your reserve adequacy (the circular number is 10.1.7.1). I have a copy of the documents so I'd be glad to send them to you.

In early 2004, two regulations (19.1 and 19.2) came out regarding the role of the auditors and the actuaries. Finally, the big whammy, as I call it, is the dynamic solvency regulation (20.12) that came out around the middle of 2004. Also, the Institute of Actuaries, with the insurance commissioner, came up with the idea of having certification requirements, so that the actuaries are certified to sign off on the reserves and those kinds of things. It's somewhat like the Society of Actuaries' examination system except that there's one exam, depending on the line of business or the actuary's concentration. It could be life, pensions or something else.

The minimum reserve regulation and reserve adequacy is basically a mechanical approach. They say, "This is the formula that you're supposed to use to calculate

minimum reserves." The reason for that was that there were a lot of companies in Mexico that were engaged in price wars selling endowments. Some of the modified reserve methods were a little aggressive. What they tried to do was eliminate some of the abuse that was inherent in that method and move it from a Commissioners Reserve Valuation Method (CRVM) type of reserve toward a net level premium type of reserve, depending on the structure of the acquisition expenses. It introduced a little conservatism. In some of the work we've done for some of the companies, it increased the reserves between 10 and 30 percent, which for some companies represented a significant amount of money that they had to set up.

Let's talk about the regulation for the actuarial auditors. Because of the Sarbanes-Oxley framework, the Mexican insurance commissioner was also concerned that there was a lot of conflict of interest between consultants and auditors. A lot of consulting firms in Mexico have an audit arm and they also have an IT arm. So, basically, the idea was that they would do the consulting for companies coming into Mexico, and then once they got established, they would do the audit for them. Then once the consulting firms got that type of work, they would implement administrative systems to do policy administration and calculation of the reserves.

It was very clear from the regulation that if a company had IT services related to calculation of the reserves, those created a huge conflict of interest because those products were developed by the consultants and were audited by the consultants. They were basically auditing their own type of work. So they said if you have IT services, you have to spin it off. Also, they wanted to define more stringent roles of the actuaries. For example, a lot of the consulting work was related to product development, so if a company did product development work, they are not allowed to audit the reserves because, again, they're auditing their own reserves.

The next regulation is dynamic solvency testing. This came out around the middle of 2004 and it's due by the middle of 2005. The essence of the framework is cash flow testing, but with the inclusion of projected new business. The idea is that the regulator will come up with its own set of scenarios for the companies to test. However, each company is supposed to develop its own set of scenarios. Some of them can be better or worse than the regulator's prescribed scenarios. Also, they could use correlations. It's very fuzzy at this point, but the idea is to have two sets of scenarios: the company's and the regulator's. Furthermore, it applies to companies as a total, so a company that sells life and non-life has to apply it to the whole block of business.

As far as the new certification requirements, as I indicated, it's an examination. It's a single examination by area of practice. It started in the middle of 2004. Some people concentrate on pensions and payout annuities, so they have to take a specific exam for that. People who work on life have to take an exam for life. People who work on different disciplines have to take all the lines of business. There's an exam for auditors as well.

Because this is new in Mexico and a lot of the company actuaries are fairly seasoned, it's going to create some problems. There are some actuaries who feel that they don't need to take some of these exams, so these actuaries are going to be phasing out of the market. They feel that it's too strenuous for them because these are long exams. I think the experience the first time was that people who started to take the exams at 9 a.m. and got done by 9 p.m., so it was a 12-hour exam. I think the structure of the exam will be changing because people were allowed to bring in anything they wanted: textbooks, notebooks, formulas, anything so they could spend a whole day. It was thesis-type stuff. A lot of people said, "Oh, this is nonsense. This doesn't prove anything. I know my stuff."

It's going to tighten the circle of actuaries because now certified actuaries are more valuable. As far as foreign actuaries, like U.S. actuaries, I asked, "How do I take the exam? What do I need to do to take the exam?" They said the rules are not defined yet; they're not clear how the rules will work out for people coming from overseas. So it's going to be a little bit of a tight circle in Mexico. I hope that will open up.

There are some issues I see with dynamic solvency testing (DST) after reading this document. It strikes me that there's a readiness issue with regard to the insurers. There are not a lot of people who have done this type of work, and there needs to be an appointed actuary leading that role. Unfortunately, at a lot of the local companies, the talent is not great. The international companies, where they're bringing people in, are probably used to doing some of the cash-flow testing work, but for the majority, I think there's a problem with having systems and models in place by the first quarter of 2005.

Also what's interesting is that the insurance commissioner's staff is not required to take the accreditation exams. So there's a credibility issue on the part of the company, saying, "I'm going to provide a report. I'm going to invest a lot of time and provide a report that we don't know if the regulators can read it and understand it." So that's another issue that I see. How is the commissioner's office going to review all this stuff?

The other issue is consistency of results. Because you have a situation where you have companies that are life and non-life, some of the companies' portfolio for life might not be material and some other companies' life portfolio may be the most material. There are going to be some issues with consistency when people start comparing results and assumptions. It's very fuzzy.

Also, regarding the clear rules and roles of the auditors, there's a working group trying to define some of these issues. Obviously, members of the working group are members of the big companies, so it could be a situation where there are some influences from certain people to shortcut some of the process.

Finally, my take is that because the insurance commissioner has been involved in a committee that is fairly active on solvency and regulations, maybe the Mexican market is becoming over-regulated, which could be a good thing for companies that want to be there in the long term. However, companies that want to start an operation in Mexico might want to think twice because of the cost involved.

Here's some food for thought on some of the issues related to credibility. The historical data could be a problem, especially for lines of business such as auto, where there are a lot of companies that don't really know how many policies they have on the books because they sell to groups. They don't really underwrite the cars. If somebody comes with 100 people and says that he or she wants to insure 100 cars, that's fine. But they don't know if they have a 100 or 150. It could be 200. If their loss ratios are going up, they'll probably start asking questions. But there's a lot of faith, and the data is not there. It's not accessible.

Another issue is the projection period. The regulation says that for life, you're supposed to project at least five years and for property and casualty (P&C), at least two years. Again, it might or might not be material, depending on the size of the business.

Also, what about renewals? What do you do about renewals? It's supposed to be a test for inforce plus new business. In the case of P&C, if anybody can predict renewal of certain contracts that are fairly large, they're pretty good actuaries, because my feeling is that a lot of these P&C contracts move from company to company every two or three years.

The regulation has a statement that basically says if you're an actuary, you are allowed to blow the whistle if you see there are certain things that don't make sense. It could be management is trying to fudge the numbers or is telling you to use a new business scenario that's very optimistic when, in fact, things are not going all that well. That's very new for Mexico.

There are not clear guidelines on ethics. There could be a lot of interpretation of the regulation and it could lead to professional misconduct, so that has to be worked out by the Mexican Institute of Insurance and the commissioner's office. Also, the company actuary should abide by ethical principles. Like I said, the new regulations are becoming such that they're putting a lot of pressure on actuaries, who could become actuaries at risk because of internal politics.

Finally, the deadline has been shifting a little bit, so it's to be seen what happens in 2005 to actually have a fairly good evaluation of how the new regulations are developing.

This is a new discussion with regard to minimum capital requirements. The current regulation is based on the average face amount, and the factor is .03 percent. Now

Mexico is trying to get into a risk-based capital (RBC) type of model. If you look at the new proposed factors, which apply to the net amount at risk (obviously adjusted for reinsurance), it's fairly shocking for group life, because it goes from .03 percent to .0689 percent of net amount at risk.

What the regulator is trying to do, in my opinion, is fix what's essentially a pricing problem. The group contracts in Mexico typically have experience refunds. Usually those experience refunds are paid up front. They come up with a dividend formula up front. They say, "OK, you give me $100 and I have a dividend of $98, so I pay you back $98. Then, at the end of next year, when the experience develops, we'll tell you if we need to charge you $105." If you charge them $105, the client is going to switch to another company, right?

The regulator is saying that if you're going to issue this type of business, you're going to have to set up more reserves. The transition rules apply for eight quarters, and that's the way it is.

I did a quick calculation on the endowment-type products versus the term-type products. It seems that for the endowment-type products, which is quite significant in Mexico, some companies will get a benefit after about 11 years. If they have a block of business in force after 11 years, their cost of capital (their minimum capital requirements) will go down. But if it's term products, sorry, you're going to have to talk to your reinsurer to get some deal so that you can adjust your capital requirements according to how much reinsurance you got. This is going to be interesting.

My own conclusion is that the effectiveness of these new guidelines will take time. There's no question about that. Things don't happen overnight. They never do. But eventually, time will tell what's going to be a good, solid company. I think the role of the actuary could be enhanced or could be viewed as a number-crunching position. They're going to need solid actuaries to deflect the perception that actuaries are number crunchers. Because there are a lot of significant issues in Mexico, the insight of having an appointed actuary is critical. You need to have the right people in place. Finally, I think those regulations are trying to create a level playing field. There are some companies that have typically taken advantage of the market, and it's not good for the policyholders or the shareholders. I think it's going to have a positive impact because it's going to require more accountability for some of the problems regarding product development, pricing, etc.

MR. HORBATT: I'd like to introduce Ron Colligan from Guy Carpenter, who's going to talk to us about the emerging markets in China and in India.

MR. RONALD A. COLLIGAN: After the introduction Bill gave me, I probably need to tell you what I do. I head up the global life and annuity practice at Guy Carpenter, which is the world's largest reinsurance intermediary. As part of that

responsibility, I've had the opportunity to do a lot of global travel to gain what I think is a fairly good overall perspective on what's going on as Western countries and Japan start expanding into the rest of the Asian marketplace.

What I decided to do was concentrate on the two that I consider the highest growth opportunity markets in Asia: India and China. Naturally, Japan is a very mature and developed market, and other parts of Asia, primarily Thailand and Singapore, have a very robust insurance marketplace right now, as does Korea. Interestingly enough, I was speaking with a CEO last week who had just gotten back from a trip to Vietnam, where they're looking for significant life business to be produced.

I want to first chat about where we were globally as a life industry going back probably 20 or 25 years. The great majority of the world's life insurance premium came from three areas. The three areas were the United States, Japan and Europe (including the United Kingdom). Statistics show that probably 20 years ago, 85 to 90 percent of the premium came out of those three areas. Those markets right now are mature, although they're probably not concentrating enough on innovation because of that maturity.

Distribution sources are thought to be decreasing or not as effective as they can be. Regulation, taxation and competition in those areas have become onerous. We see decreases in the number of players in those three areas due to mergers and acquisitions, companies going into run-off, etc. The critical mass for them to survive — critical mass is naturally the volume of life insurance inforce to get your administrative costs on a unit basis down as low as possible — is going up all the time. Margins are being reduced in the United States, in Europe, in the United Kingdom and in Japan, because of higher labor costs, IT and other infrastructure improvements and the like.

What has this led to? We'll relate this to China and India in a little while. It has led to a keen interest on the part of North American, European and some Japanese companies in expanding their horizons elsewhere in Asia. It has led to global reinsurers, who have been hit by significantly lower margins in North America, looking for new sources of reinsurance premium income. It has led to an awareness by the indigenous companies in developing markets that they have significantly more growth opportunity than do companies in the developed markets that we just chatted about. Naturally, that has led to an expansion of capital going into those markets, as a result of the two things just mentioned. It has also led to a recognition that the world's two most populous countries, India and China, are relatively underdeveloped, relative to insurance penetration and premium expenditures as a percentage of gross domestic product. In India, though, that's coming along very nicely. Then there's a recognition that Asia, and more specifically China and India, are very fertile sources of life premium growth as their market moves from infancy into maturity. Remember that when I talk about Asia and the industry being in its infancy here, I'm excluding Japan because we know how the

market is developed in Japan.

Let's talk a little about China. You'll see in this presentation that I concentrate more on China than India because I know the Chinese market better. I've had the pleasure of being in China three times in the last year and I've been working with some marketing groups and other entities that are looking to bring new sources of distribution into China.

Let's look a little at China. It has a population of 1.3 billion and a rapidly developing middle class, some say 350 million or more in the near future. About three years ago, I was fortunate enough to have an intern from Beijing, who did a study for me on the emerging Chinese market and really impressed me with some of the knowledge that was coming out of there relative to the emerging middle class and the insured marketplace in China. The culture is traditionally family- and savings-oriented. There has been a recent accession into the World Trade Organization (WTO). There's a very strong governmental desire in China to develop a highly educated, diverse and very productive workforce. Anybody in the room who is working in China knows that.

There was something that impressed me very much on one of my last visits there. It was a Saturday morning and a colleague of mine and I were working in Tiananmen Square. Two young people came up, started talking and continued to talk for an hour. At the beginning of the conversation, they found out that we were insurance executives. They were master's students in finance and wanted to practice their English. I think we see these things going on all over the country. The government wants a very highly educated, highly developed workforce, and this is the seed of a life insurance industry in China that's going to be very productive.

There's also another phenomenon going on now. A number of state industries that were formerly state-owned are privatizing. This provides more opportunity for companies that are thinking that employee benefits might be a good source of entry into the Chinese market. We'll chat more about that later.

State-owned companies dominated the insurance infrastructure in the past in China. China is the third-largest insurance market in Asia, but not for long. That's just not going to happen for long.

Let's talk a little about regulation in China. One thing you'll see is that this is not a very actuarially oriented talk. I'm not an actuary. I'm trying to bring you a broad-based perspective on the industry, not a technical presentation to pique your interest in learning more about how actuarial science works over here. In China, regulation, life and non-life is regulated by the China Insurance Regulatory Commission (CIRC) that was created in 1998. CIRC has been very active in defining minimum solvency requirements, developing new statutory reserving and relaxing some very conservative investment rules to allow for more diverse investments

inside and outside of the People's Republic of China (PRC). They've also allowed major stock offerings, and we know that PICC and Ping An on the Hong Kong and other exchanges, these initial public offerings (IPOs), have been pretty successful.

There has been a compulsory cession, the China Re, which is the state-owned company that now has some private capital in it. Both non-life and life have a mandatory cession, but there's a thought that this is going to be gradually phased out. That has been a barrier to some foreign reinsurers in the marketplace, but you find that most foreign reinsurers in China have a very good relationship with China Re, and it hasn't been a hindrance to them.

There are very strict geographical restrictions right now on joint ventures. In China, a joint venture is an outside company coming in, and, with a partner in China, forming a company to write business in competition with the companies that are now 100-percent Chinese-owned. There has been a prohibition against the joint ventures in China selling group life insurance. Group life insurance is one of the most productive areas in China. That prohibition ends, I believe, either in December 2004 or January 2005. Some of the joint venture companies, quite frankly, such as MetLife, Sun Life, Manulife, ING and AXA, are going to be able to compete in the group life market. That's going to enable them, we think, to attain significant penetration there.

CIRC seems to be working very hard to comply with all the WTO accession agreements. Everything in the marketplace in China now, at least that I've observed, is very fair. Companies and the government are following the agreements that were made in the WTO, and are very good for the insurance industry in China, both the indigenous companies and the joint ventures. Most companies, particularly joint ventures, are operating in a very conservative way relative to regulation. They want to comply with the rules because the business in China is very important to them. I've heard of some schemes where some joint ventures were going to try to do some modified group underwriting on plans before the regulation changed. As soon as it got up to their legal department, the legal department said, "Absolutely not. We are complying with the spirit and the letter of the law until we're allowed to do group insurance."

As far as the industry structure, during 2003, many state-owned companies became joint stock companies, enabling them to sell shares and/or to take on strategic partners. China has 37 licensed insurance companies: 19 non-life and 17 life. Most new entrants in joint ventures are foreign companies with local partners. It's very interesting to see the local partners that some of the joint ventures in China have selected. For example, Manulife's partner is Sinochem, which is a big chemical company. MetLife's partner in China is the company that develops and runs the airports in China. They're not necessarily insurance-oriented partners, and they bring diversity into the marketplace. When I first heard that MetLife's partner was the company that ran the airports, I was scratching my head, and then I saw a big

travel accident insurance sign at the Beijing Airport.

As I said before, JVs expect large premium increases when they're allowed to start to write group insurance later this year. However, local companies still dominate the market share by a huge margin. That margin is probably 90 to 95 percent, or maybe even more. What we see happening, I think, is that as the industry in China internationalizes, and more companies from outside China come in with some product innovations that spur the local companies on, it enables competition to go on in a more beneficial way.

We're going to talk a little about product mix. There have been some legacy problems with some old products because of artificially high guaranteed returns prior to 1999. CIRC reduced the guaranteed returns from 6.5 to 2.5 percent. Certainly, 6.5 percent on a guaranteed basis is very difficult to sustain. That has changed, but there are still some policies in force that have that guarantee. These problems naturally require additional capital and product diversity. As I said before, the entrance of the joint ventures has caused local companies to work harder, but their sales are still brisk. The sales are predicated upon the savings and family orientation of the society.

The products are primarily whole life, but unit-linked life (unit-linked life in the European context is their form of variable) types of structures are being developed. There is very little term insurance being sold, but those products are being developed, and, as I've said, group life is sold. We think privatizing industries is going to accelerate group sales, and expect group sales to increase when joint ventures are allowed to sell them this year. There are some combination mortality and morbidity products emerging (critical illness and those types of things), and they're also sold as stand-alones. Personal accident and hospital indemnity policies are sold, in effect.

In a visit to China right after the first severe acute respiratory syndrome (SARS) scare, I asked some folks what impact they thought SARS had on the Chinese insurance industry. They said it was probably beneficial because they sell a lot of hospital indemnity policies and people wouldn't go into the hospital. It was interesting to hear that. I don't know if it's true or not, but that came from a reinsurer based in Hong Kong, as a matter of fact.

Mortality tables are relatively old, but they're being updated. One of the things that we heard over and over was the significant difference between urban and rural mortality and the unavailability of health care in rural areas. Insurers have to look at that. As I said before, the SARS impact was minimal and many think it was helpful. There's starting to be some interest in developing work-site and employee bonus contracts as a result of privatization. That's one of the things I was working on over there, and it was an absolutely fascinating project.

What do we see happening in China in the future? Look for increasing competition and resultant product innovation as the geographic and product restrictions are eliminated from the joint ventures. Look for increasing sales of term products and some migration of North American underwriting techniques to China.

I want to comment now on something I see happening worldwide. In North America we have had significantly good mortality in some circumstances. We keep hearing that it's creeping up in certain preferred classes, but that's primarily due to underwriting exemptions and the way we underwrite. We've gotten blood for many years because of HIV, and the benefit of blood testing is that it brought mortality down to very low levels. In most of the world, that's not done. I think as global reinsurers start to recognize that exporting some of these underwriting techniques overseas can bring those premiums down, we're going to see more term-like products sold because we're going to be able to sell them at a lower premium.

I think group market is going to make significant gains. As I said before, state companies privatize, and they look for employee benefit schemes to attract and retain workers. Significant growth is a given. There's a high learning interest. I heard a figure at a meeting in Singapore last year that LOMA, the Life Office Management Organization, conducted 35,000 exams in China last year, so there's significant interest in that. As I said before, some companies seem to be adopting Western-style distribution methods. Expect this to continue. We can look for significant improvement in operational standards. That's a worldwide phenomenon, because as IT improves, operational standards move to the fore.

Let's talk a little about India now. The population is 1 billion. There are 28 states and seven territories. The demographics are interesting. Age 65-plus is only 5 percent of the population. You see 63 percent in the 15-64 years age group, which is the insurance-buying population. Age 0-14 years is 32 percent of the population. So we see demographics in India that are going to allow us to go ahead, I think, and bring our products into that marketplace. There are a number of official languages. The population is primarily Hindu and Muslim. The life expectancy of males is 63 years and the life expectancy of females is 64.5 years. As a former British colony, India follows the common law system, and English is the language of contracts and courts, making things easier for companies from the United States, Canada and the United Kingdom to do business in India. There's a growing middle class as well, as I've said.

What's the history of the industry in India? There was a nationalization of all of the then-private companies that took place in the early 1950s. Private carriers were only allowed to be formed again in 2000. Life Insurance Company of India (LIC) was formed in 1954, and that is the behemoth of the Indian life insurance industry. We'll talk a little about some of the figures there later. Some of the companies now operating are Max New York Life, MetLife, Birla Sun Life, ING, AMP, HDFC, Aviva and Prudential. We can see the same companies that are investing in China are

investing in India. One company that had been particularly active in India is Standard Life of Edinburgh in the United Kingdom. We've had the pleasure of working with them very recently on a large placement in the United Kingdom, and China and India are the next steps with them.

Foreign companies in India are now able to own up to 26 percent of a company. I forgot to mention that it's now 49 percent in China. The government in India, though, is expected to increase the percentage of foreign ownership to 49 percent. There's a minimum capital requirement in India of about $20 million to set up a private company. Foreign reinsurers, though, need to put up about $45 million. There are foreign reinsurers operating in India now. The regulatory environment seems to be loosening.

Let's talk a little about current sales in India. In individual life, Private Life Companies is 11 percent and the Life Insurance Corporation of India is still 89 percent. In group life, private companies are 5 percent and the Life Insurance Company of India is 95 percent. You can see that there's a monopoly. There is a monopoly that did exist that has just recently been de-monopolized, but you can see that they still control most of the business. Premium-written figures show private companies only at 11.79 percent of the market. Next is a very interesting statistic. Life insurance premium has increased since private companies have entered, from 1.77 percent of gross domestic product to 2.59 percent. That's an astounding growth in a relatively short period of time.

I have a good friend who's chief worldwide underwriting officer of a very large North American company operating in both China and in India. He probably spends seven or eight months of the year there. I saw him two weeks ago before he left again for India. His company underwrote 350,000 policies last year in India. India is on the move.

Most companies are paying attention to the quickly emerging middle- and higher-income markets. That's no change from the United States. The pricing uses an ultimate mortality table.

What's going on in sales? Liberalization has benefited the consumer significantly. They've got a wider range of product choice. They sell unit linked, and unit linked is probably taking off pretty quickly in India. They do sell pure term and whole life. There's flexibility in terms of the contract length, the term period and the premium payment options. Private companies recently introduced the concept of riders in India, and it allows the consumer to customize the policy.

There's a huge sales force that exists in India, but a lot of them are relatively unproductive; they just write a few policies. Life Insurance Corporation of India alone has 600,000 agents.

Regarding regulation, the Insurance Regulatory Development Act (IRDA) was approved by Parliament in 1999. It was a politically contentious thing in India because naturally Life Insurance Corporation of India had a vested interest. It set the maximum, as I said before, of 26 percent of foreign ownership to protect the Indian financial sector, and this was only set after very hard bargaining. If you read the history of that, there was a lot of lobbying and politics that went into finally getting this law passed.

There's one interesting thing that they do that's very consumer-oriented. Any company that has a Web site has got to provide a link to other companies' premiums and a calculator, so that any consumer looking at insurance on the Web has the opportunity to click right on a competitor's site and see if they're getting a good deal.

It specifies time for the documentation and settlement of claims. It's felt by many people that the reform in India is real, though, and that private companies are here to stay. The Insurance Regulatory and Development Commission of India is going to put consumer satisfaction first, in our opinion.

What's going on in the future? We see continuing progress of private companies in gaining market share from the Life Insurance Corporation of India. As a result of this, we see continuing product innovation and price competition. We see a strong push toward operational strengthening, using India's vast IT resource. I don't think we need to tell anybody how much the North American and European industry is outsourcing IT to India. Indian companies are starting to take advantage of that, too. I also see in India some adopting of North American underwriting techniques. One of the reasons I see that is in India, if you look at it from a mortality standpoint, there are relatively few cancers. But there's a very high rate of diabetes, and some blood testing in India to pick up these diabetics could be a very beneficial thing on mortality. We see continuing liberalization of foreign ownership restrictions.

I hope this has been a primer for you on India and China.

MR. HORBATT: Thank you, Ronald. I definitely learned something. Our last speaker will give us an overview of the Japanese market.

MR. MASAAKI YOSHIMURA: I'm not quite sure whether Japan is as "hot" as Argentina and other countries presented here, but I'm going to talk about the issues relating to Japanese life insurance business and relevant regulations. I hope you enjoy my presentation.

My presentation can be broadly divided into three parts. The first one is the historical data of the Japanese life insurance industry, and the second and the third parts describe what we experienced before and after the famous burst of the bubble

economy in Japan in the early 1990s. Because the time of my presentation is limited, I'm going to skip most of the first part, which you can see in your handout or in the CD-ROM you might get after the annual meeting. However, I want to mention a couple of important facts or explanations that might be beneficial for you.

We have about 40 life insurance companies in Japan. The agents are the mainstays of distribution channels for traditional life insurance companies. In terms of asset distribution, although securities account for 60 percent and are the largest component of assets, we have about 10 percent of stocks in it. We also have loans and real estate basically in our general account. As explained before, the Japanese life insurance market is huge; it's the second largest in the world at present.

Now many of you might know about the negative spread problem in Japan, but the fact of life is a little different. The basic problem mentioned here is one of the measures for the operation of life insurance companies which was introduced in Japan a couple of years ago. You can define net income as before policyholder dividends and without capital gains and losses. Negative spread is just the difference between the interest rate assumption of the initial premium calculation and the current investment yield of the company. So it's just a matter of profit analysis, and major products like whole life with term are still very profitable. This is why many life insurance companies still maintain a high yearly level of basic profit. However, products like individual annuities that were sold in the old days when the interest rate assumption was optimistic are not profitable at all. However, as these are not the major products, the impact is limited.

Now I'm going to talk about the financial environments of the Japanese life insurance industry before 1990. The Nikkei 225 average, one of the representative stock indices of Japan, increased slowly until the middle 1980s. In 1985, the Japanese yen started rapid appreciation against the U.S. dollar. A dollar then was about 240 yen, but after, it depreciated to 140 yen. Then around this time, keeping step with the rise of the Nikkei average, land prices charged in commercial districts rose. It triggered seemingly endless creation of credit, supported by land prices, and accompanying rapid expansion of Japanese economy, which appeared to double afterward.

I recall at that time that the ever-higher land price in Japan was so prevalent that stockbrokers and real estate agents were leading dissipated lives — drinking, going on sprees and spending lots of money at exclusive clubs. Even ordinary people like us were keen on buying real estate and trying to make money in the future.

In 1989, nobody thought the Berlin Wall would be down until just before it happened. The Japanese government enacted Organic Law of Land in December 1989, so called the "Constitution of Land," which stipulated basic principles for the use of land in order to normalize supply and demand and to facilitate sound formation of land prices. After setting up the basic principles on land, the Japanese

government took further measures in 1992 to lower the land prices, while land prices had already started to fall at that time. My point here is that you don't know when you are in a bubble before it bursts and so Japanese life insurance businesses were enjoying smooth sailing in the 1980s.

If you look at a graph of the 10-year Japanese government bond (JGB), the long-term interest rate from January 1985 until March 1992 used to be high and normal. From 1965 to 1991, yields on the assets of life insurance companies were approximately in the range of 7 to 8 percent, but started to fall after 1985. However, on the contrary, most life insurance companies *raised* their assumed interest rates in 1981 and 1985. In 1985, under the circumstances that market interest rates started to fall, they were raised to compete with other insurance companies that raised their assumed interest rate a year ago. I think we did a competition that we shouldn't have done at that time.

If we could have had the strongest motivation for asset/liability management at that time, without too much depending on the rise of stock prices and without having too much of an optimistic view on the future interest rate, the impact on so-called "negative spread" might have been quite different.

Let's talk briefly about what kind of life insurance products were sold in Japan before the 1990s. The main product until the early 1960s was endowment. Endowment with term became popular afterward. That was the main product in the 1960s and 1970s. Cancer insurance was introduced and many other riders, like sickness and hospitalization, were developed in the 1970s.

In the 1980s, many products shifted to whole life with term, with various riders. I have to tell you that almost all the products I mentioned so far are with profits. Then in the middle of the 1980s, sales volume of single premium endowment (SPE) started to upsurge. I'll talk about this later. Finally, in 1989, the Insurance Council of the Minister of Finance (MOF) started its deliberations to make overall amendments to insurance business law. That was previously revised about a half century ago.

If you look at the amount of single premium of individual insurance through the 1980s, there was a huge influx of premium due to the rise of assumed interest rates, coupled with spreading knowledge about SPE's favorable tax treatment compared to other financial instruments among Japanese people at that time. The amount of premium was about 5,000 billion yen, or about $50 billion. You might be surprised that such a huge amount of money was flowing into the life insurance industry in Japan every year. Clearly there was an increasing trend in the amount of assets of the life insurance industry in Japan as well.

Before the 1990s, basic issues of the Insurance Council included the role of insurance business, the scope of business for insurance companies, the form of

insurance companies, solicitation of insurance polices, regulation of insurance business and, one of the more important topics, the revision of the insurance accounting. Issues of insurance accounting included risk management, valuation liability, revision of dividend policy and introduction of segmentation.

Let's take a look at the subsequent state of the Japanese life insurance industry, which enjoyed tremendous success and was even known as the major player in foreign securities markets in the world. The Nikkei 225 average hit its highest record of almost 40,000 in December 1989 and dropped sharply afterward. When I joined my company, the stock index was about 8,000, so I was almost put back where I started. Not only stock price, but also land prices in urban areas fell sharply, to the level of more than 20 years ago.

Let's talk about the trend of the 10-year JGB interest rate, including the current rate. After hitting 8 percent in 1990, the rate of 10-year JGB continued to decrease. In 1990, the official discount rate was 6 percent. The Bank of Japan started reducing it. This is what you call the heart of the problem. In 1995, when this rate was already 1 percent, they took the measure to induce short-term interest rates still lower and set the official discount rate at 0.5 percent. However, it didn't boost up the economy or the stock market, and we saw various bankruptcies of financial institutions in the late 1990s.

The Bank of Japan once tried to lift the controversial zero-interest-rate policy in 2000, but, again, reduced the official discount rate to 0.25 percent in 2001. In this process, the Japanese long-term interest rate established a world record, which was previously observed as 1.125 percent in a city-state called Genoa in 1619. The Japanese long-term interest rate went as low as 0.5 percent in 2003. The current rate now moves between 1 percent and 2 percent.

As far as the typical assumed interest rate used for pricing the products that I mentioned before, we started to lower the assumed interest rate since 1993, and after, but we couldn't catch up with the rapidly declining interest rate. The so-called "negative spread" increased as market interest rates fell.
Since the Insurance Council started its deliberations in 1989, it took seven years to accomplish a complete revision of the insurance business law. During this period, the financial environment in Japan on the life insurance industry changed drastically. Although the new insurance business law, with various mechanisms for modern regulation of the insurance business, was enacted in 1996, the first bankruptcy of a life insurance company since the end of the World War occurred in 1997. There were seven life insurance company failures in Japan.

I'm not going through the specifics of each failure, but the common causes can be simplified into two factors. These two combined drove companies into failure. One is asset devaluation, like falling stock prices, falling land prices, the increase in bad loans and so on. The other cause is decreasing profitability of a company. The main

reason is that long-term investment alternatives are limited in Japan, and interest rates continue to be very low, so the investment rate of return has lagged behind assumed interest rates regarding the contracts issued in the periods of highest interest rates, which you have seen previously.

Nissan Mutual was a typical example. They sold a lot of a saving-type product around 1990 and increased their assets very rapidly. They failed because of the above-mentioned reasons. Someone has to compensate for the loss caused by the failure. In the seven failed companies, the percentage of policy reserve cuts range from 0 percent to 10 percent, and the post-acquisition guaranteed interest rates, which are newly applied future guaranteed interest rates to recalculate policy benefits, range from1 percent to 2.75 percent. Those are the numbers that show the degree of sacrifice of policyholders of these companies.

Let's talk about the measures taken by existing companies that have survived such a terrible financial environment. Those measures can be broadly categorized. In terms of measures relating to assets, there was a reduction of risky assets like stocks, foreign securities and real estate. There was an investment policy change, which means we reduced holdings of stocks and started to increase fixed-income bonds, like JGB. On the liability side, as product design changed, we started setting account-type products, like universal life, with short-term interest rate guarantees. We also started setting variable products, variable annuities, to meet the need of the new market challenge, like banks, and to avoid interest rate guarantees. We also cut dividends drastically for participating policies and increased premiums for saving-type products. In terms of capital and business restructuring, various measures that are taken in the other part of the world (injection of solvency capital, demutualization, coalition, mergers and acquisitions) are considered and applied when necessary.

Finally, I'd like to talk about current issues. I talked a lot about issues relating to negative spread, but the low-interest-rate policy by the government, or The Bank of Japan, to save major banks for the sake of the financial system in Japan is now over. One of the issues is how we cope with the expected rising interest rate environment. I think all of you would agree that the International Accounting Standards Board's (IASB) insurance contracts project, phase II, is an important issue, without any doubt.

The other issue might be bank assurance. Japanese banks started setting individual annuities since October 2002. A very hard discussion is now going on among the members of the Financial Service Council about whether regulators should allow banks to sell a wider range of life insurance products.

The next issue is about the recent active product developments in the area of health and medical, among life and non-life insurance companies. As the Japanese population ages and fewer babies are born, many insurance companies think the

markets of traditional death benefits or non-life products do not have much room for expansion, and they are stepping up efforts to make attractive health- and medical-related products for consumers.

Finally, although I don't have time to explain, there's a heated debate on the level and the method of the standard valuation reserve for minimum guarantee of variable annuities in Japan currently.

MR. HORBATT: Thank you very much. Now we have time for some questions.
FROM THE FLOOR: I have a question for Ron about the Chinese insurance regulations. In your opinion, what's the biggest problem in Chinese insurance regulations?

MR. COLLIGAN: I think the biggest problem, from the perspective of the JVs, is with the restrictions on group and on geography, and I think they're being resolved. I would have to say maybe statutory reserving. My only answer really is that the biggest problem for JVs has now been resolved.

FROM THE FLOOR: How about for all the local insurance companies and the JVs, not for JVs only? What's the biggest problem?

MR. COLLIGAN: You mean the geography for all companies?

FROM THE FLOOR: Yes, all companies, and all the industry.
MR. COLLIGAN: Isn't that being resolved now as well?

FROM THE FLOOR: Well ...

MR. COLLIGAN: No?

FROM THE FLOOR: Yes, thanks.

FROM THE FLOOR: I also have a quick question about China. You mentioned that the mortality table is relatively old, but it's being updated. I'm curious about what kind of table they're using now.

MR. COLLIGAN: I believe the table that's being used by the reinsurers is a 1988 table. The reinsurers tell me they're working on a new one.

FROM THE FLOOR: Is it reflecting the population in China?

MR. COLLIGAN: Yes.

FROM THE FLOOR: Oh, wow!

MR. COLLIGAN: Let me say this. It's probably a combination of Hong Kong and China experience that the Hong Kong reinsurers are using, so it's not up to date.

FROM THE FLOOR: When you say it's being updated, does that mean they're doing a survey?

MR. COLLIGAN: I believe they are, from what I understand.

FROM THE FLOOR: Oh, great! Thank you.

MR. HORBATT: I'd like to make a plug for the Society of Actuaries' International Experience Survey. We'd love to study Mainland China, just like we studied Taiwan, Korea, Mexico, Argentina and Chile. If there are companies that do have business in China, please contact the Society. We'd love to have you join our survey.

Any further questions?

MR. DAVID MERKEL: This is kind of a broad question for the first two panelists. When you look at the various markets that you're analyzing, who's competing more effectively, the foreign insurers or the locals?

My second question is for the last panelist. If Japan Post gets privatized, how will that affect the Japanese insurance industry?

MR. COLLIGAN: To answer the first question, from my perspective, the local companies are competing more effectively.

MR. BERRIOS: Absolutely, because of the low cost of capital requirements. Especially on pricing products, if you're an international company, you're biding by the parent company's guidelines. The cost of capital for the company I used to work for when I was in Mexico for two years was seven times the local. So in terms of pricing the products, obviously we're at a big disadvantage competing with the locals.

MR. HORBATT: The second question relates to the issue of Japan Post potentially privatizing.

MR. YOSHIMURA: It depends on how they are privatized. Currently, we are living very well because they only sell a very small amount of life insurance. The major life insurance companies, like us, sell a higher amount of protection-type products. So we are living together very well. But if they're in a privatized town, it might cause head-to-head competition, and then it's going to be a very big problem. The problem might be how the government handles this problem.

FROM THE FLOOR: I am working for a reinsurer in Japan. My first company went

bankrupt at the end of the 1990s. I have a quick question for Masaaki. Your company successfully survived under such a miserable circumstance and still expanded their business. There is still a miserable economic situation and hard pressure from the IASB issues. There is no comparison.

MR. YOSHIMURA: I'm not quite sure that I can answer your questions correctly. But as I explained in my presentation, lots of life insurance companies, life and non-life, are concentrating their resources into what we call "third area." It's not a life-death benefit area, and this is not a non-life product. It's the medical and health area. As I mentioned, it's a growing area. I think that's one of the ways for us to live and grow in the Japanese market. But as you know, many insurance companies in Japan also see Japan and China as a huge growing market, and many companies think they're an expansion to the market. I'm not quite sure whether my company is going to the China market or not.

MR. HORBATT: Do you have any thoughts, Ron?

MR. COLLIGAN: I agree completely with that. The expansion opportunities in that part of the world are huge. It's not only Japan and China. It's, as I said, Vietnam. It's Korea. It is Malaysia. It's Indonesia.

MR. MERKEL: I have a follow-up question. If the locals are generally the more effective competitors, then how do the foreigners stay in the business? What do they do to try to compensate so that they can stay in the business? I keep reading about various U.S. and European insurers going to various other countries to write insurance. If they have such a capital disadvantage and other disadvantages, why do they keep coming?

MR. COLLIGAN: My impression is that it's an investment in the future. They recognize that start-up costs are high, and they want to gain market share. It's an investment in the future. Is their capital cost going to come down in the future? Probably not, but they need to be and want to be in those particular markets. As their critical mass in that market develops, their capital costs might come down.

MR. MERKEL: Is there a difference in profit margins? For example, in a developing market you have a higher profit margin at a given price, so that's attractive in its own right even with the higher cost of capital?

MR. COLLIGAN: From my perspective, you have to look at the premiums being charged. If you look at the internal rates of return (IRRs) of U.S. life companies now, they're not particularly high. We've been in a price war in the United States for a number of years. If you look at the profit as a percentage of premium in other areas, it's significantly higher because the rates are much higher. It's a balancing act.

MR. BERRIOS: It also depends on the mix of the business. A lot of companies are in foreign markets because they have a better spread. There might be P&C products that are highly profitable that are compensating the life insurance products. Also, there are evolving regulations. As you can see in Mexico, they're trying to make it more difficult for the locals to compete, so it creates a level playing field. The international companies are betting that eventually everybody is going to have to compete on the same basis. If they have an expansion in a profitable organization where there are advantages of being there, it could develop profits in the long run because the growth is there.

MR. COLLIGAN: As a matter of fact, in Mexico the state-owned company was sold recently.

MS. MARY ANN BROWN: I have a question for Ron regarding India. When do you expect the 49 percent ownership to come through? Could you comment on opportunities for new entrants, as well as what you think the existing owners will do?

MR. COLLIGAN: I can send you a paper that we produced on the regulatory changes in India. Speculation is that that's probably going to come about within the next 18 months, but nobody knows. It's very volatile over there. Are there other companies that are going to be joining in? I heard it said by the CEO of a very large company that elected not to go into India about five years ago that it was one of the biggest mistakes that his company ever made. Yes, companies are going to look to get in and flourish there.