Article from:

International Section News

September 2000 – Issue No. 23

INTERNATIONAL SECTION NEWS

NUMBER 23 SEPTEMBER 2000

Chairperson's Corner

by Angelica Michail

"If you want one year of prosperity, grow a seed,
If you want ten years of prosperity, grow a tree.
If you want 100 years of prosperity, grow people."

— Chinese Proverb

The purpose of the International Section is to encourage and facilitate the professional development of its members in international areas of practice. The Section Council pursues projects and activities consistent with that purpose. However, some areas of the world have not been included in the realm of international practice. Perhaps this is because the actuarial profession and/or insurance, pensions, and social security programs are either non-existent or just starting to develop there.

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Japanese Life Industry in Transition

by Stephen Conwill

The Japanese life insurance industry is in the midst of a dramatic transformation. Although one wave of restructuring is nearly complete, we anticipate an ongoing and important shift in the competitive dynamics of the industry. Restructuring and refocusing activities will place significant demands on financial and human capital for years to come.

To convey a sense of the changes that have already occurred, this article describes the Japanese life insurance industry in 1990 and at present.

A Look Back To 1990

Ten years ago, a strong consensus among industry observers would have characterized the Japanese life industry in the following terms:

Financially solid – Conservative asset valuation and net level reserving were viewed as providing a strong backbone of capital.

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Highly stable – The industry had grown steadily for 30 years, but there had been remarkably little change in the relative positions of market players. The famous "convoy" system was designed to assure that even the smallest operations survived.

Resistant to change – Industry evolution was slow, with only gradual acceptance of new product, marketing, and risk management ideas.

A difficult market to enter – Capital requirements were viewed as high in relation to perceived chance of success and potential return. Each new entrant struggled to find a viable niche in which to operate.

While there were elements of truth to this characterization, even ten years ago, there were signs of change to come. Let's reconsider this historical view in the present day.

A View from 2000

Financially Solid

Three of the 30 insurance companies operating in Japan in 1990 have been declared insolvent — with companies being seized by regulators in 1997, 1999, and 2000.

These insolvencies may not contradict the view that the industry was financially sound in 1990. While the present Japanese life insurance industry is clearly under-capitalized, the pressures now faced by the industry are the result of a multitude of events and corporate practices conspiring collectively to weaken the industry.

Some of the factors leading to the dramatic decline in industry strength include the following:

- *The dramatic decline in equity values between 1990-1992.* Unrealized gains on equities were a key component of "capital."
- *A steady drop in interest rates during most of the 1990s.* Reinvestment rates well below those needed to support long-term liability guarantees have resulted in the much discussed "interest gap."
- *The effect of Japan's prolonged recession on asset values.* Balance sheets have been pummeled by declining real estate values and increases in delinquent loans.
- *The effect of Japan's prolonged recession on the industry's core business* — increasing lapse rates creating investment and liquidity strains; declining sales exacerbating high overhead costs.
- *A material increase in competitive forces.* Competition is both external to the insurance industry (e.g., competition with banks and brokerage firms for savings) and within the industry, as many new foreign and domestic players are licensed.

"While the present Japanese life insurance industry is clearly undercapitalized, the pressures now faced by the industry are the result of a multitude of events and corporate practices conspiring collectively to weaken the industry."

Looking back with the extreme benefit of hindsight, industry problems could have been substantially avoided if restructuring and risk management were implemented in the early 1990s. In practice, given the 30 years of stability leading up to 1990 and Japan's cultural tendency towards incremental change, it is easy to understand why management was slow to act.

Highly Stable

Stability would hardly characterize the current industry, although we may be moving from a period of instability to a period of healthy but rapid change.

The competitive landscape has changed dramatically, with the entry of major new players through acquisition and the rise to prominence of many new entrants once viewed as niche players.

Among the earlier market entrants, AFLAC and Alico Japan are both important competitive forces to reckon with. Their new product and broader management strategies are carefully watched within the industry.

Among the other companies to enter the market before the wave of new entries that started in 1996, five (Sony, Prudential, ORIX, INA, and ING) have achieved premium incomes at or above $1 billion.

An additional two companies that entered or expanded operations recently through acquisitions (GE and AXA) have achieved premium incomes in excess of one billion dollars.

Finally, Tokio Anshin, the life subsidiary of Japan's largest property and casualty company, reached the billion dollar premium level after only three years of operation.

In a market with aggregate premium of approximately $300 billion, these companies still represent a relatively small portion of the total market. Nonetheless, most are sophisticated and aggressive players who will drive the ongoing realignment of the insurance sector.

Resistant to Change

The pace of change has picked up dramatically since 1996, due in part to explicit deregulatory measures, and in part to an acceleration of market driven

Market Penetration by the Newer Entrants

Company or Classs of Companies	Entry Years	Fiscal 1999 Premium Income (U.S.$ billions)
Alico	1973	3.2
AFLAC	1974	6.6
Other Earlier Greenfields	1976 - 1995	10.6
Recent Greenfield Wave	1996 - 2000	3.9
Entry through acquisition	1998 - 2000	7.4
Total Newer Companies		31.7

change resulting from the weakness of the mainstream firms.

On the product side, for example, we have seen the introduction of variable annuities, the development of new generations of variable life, and a growing divergence in price and product design from company to company.

Similar to past or present trends in other markets, we are seeing a steady move away from traditional tied agents and tentative but interesting moves toward direct distribution.

Driven by necessity, companies have begun a long process of operational restructuring aimed primarily at bringing expenses in line with market realities but in some cases, aimed at increasing operational flexibility.

Finally, the role of the actuary — long underutilized in Japan — is slowly being enhanced as management reflects on the effect of historically inadequate risk management practices.

A Difficult Market to Enter

The difficulty of market entry to Japan, relative to other countries, has often been exaggerated. It is a simple fact that market entry is difficult in any jurisdiction, and a successful acquisition or greenfield operation requires a long-term commitment of capital and quality human resources.

Japan has required a larger capital commitment than is typically needed in an emerging market. But the long history of successful new entrants, including Alico (1973), AFLAC (1974), Sony (1981), INA (1982), ING (1986), Prudential (1988), and ORIX (1991 — the year it acquired a small branch from United of Omaha), suggests that the potential for success may have been overlooked by companies considering the Japanese market a decade ago.

Since 1996, we have seen the establishment of 12 new companies by domestic firms, three new foreign greenfields, and five acquisitions of Japanese companies by foreign firms. We expect additional acquisitions and greenfield operations over the next few years. If the market was unusually hard to enter in the past, there is empirical evidence that the situation has changed.

Recent Restructuring Activities

While restructuring has occurred broadly across the industry, much of the publicity has focused on the weakest segment.

By 1995, there were hints of restructuring to come. Several companies were rumored to be facing severe capital pressures and began looking outside of Japan for capital infusions. At the same time, expected deregulation and a recognition of increasing success among new entrants were creating increasing interest in Japan among the foreign players.

In the spring of 1997, the pace of change moved up a notch with the failure of Nissan Life. Nissan's somewhat unexpected and highly publicized failure helped to promote a flight to quality — away from the weaker mainstream insurers towards either more stable mainstream players or well-capitalized new entrants.

Increased lapse rates and continued asset pressures forced two mid-sized mutuals — Toho and Daihyaku — to seek foreign capital and partners through “oldco/newco” transactions in 1998 and 1999, respectively. While both transactions brought some stability to the insurance market and continuity for employees, both companies subsequently failed in the face of ongoing asset side pressures. Both transactions brought aggressive, well-capitalized foreign players (GE and Manulife) to high profile positions in the Japanese life industry.

The Daihyaku transaction was followed by AXA's acquisition of Nichidan, a sizeable stock company, in a more straightforward transaction. Two smaller but still notable acquisitions occurred when Aetna acquired Heiwa Life, and Winterthur acquired Nicos.

These transactions are particularly dramatic when one considers that there are only forty-five life insurers in Japan, twelve of which are recently formed life subsidiaries of property and casualty companies.

A Few Numbers

For those who remember the Japanese life insurance market as dominated by a handful of large firms, the figures in the table above are interesting.

Although the aggregate premium of these newer companies is remarkable in

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and of itself, more interesting is the diversity of the various operations.

Included are companies with widely varying distribution, product niche, corporate culture and management philosophy.

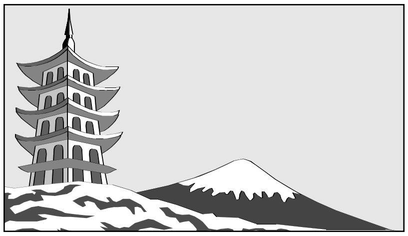
What Is Ahead?

In spite of the remarkable competitive restructuring that has occurred over the past five years, it is likely that we are still in the early stages of a longer-term trend.

Among the companies that are now viewed as Japan's mainstream players, it is unlikely that more than three or four will remain among the top ten firms a decade from now. Some will chart a course and remain — in substantially their present form — among the major players. Among others, we are likely to see mergers, failures, or simply slow and steady declines.

The diversity of competitive threats — and the multiple paths to success achieved by the more recent players — make it impossible to predict who will gain market share as the mainstream firms decline. However, in thinking about the competitive challenge faced by the mainstream companies — and for these mainstream players to develop a focused response — it is important to continually reflect on this diversity, illustrated by the list below:

- Foreign niche player moving to mainstream (e.g., AFLAC, Alico)
- Life subsidiaries of non-life companies (e.g., Tokio, Yasuda)
- Professional distribution (e.g., Sony, and Prudential)
- Direct distribution; internet sales (e.g., Zurich, ORIX, others)
- New product focus (e.g., Skandia, and others)
- New market segment (e.g., "401k" players, soon to come)
- Banks or brokerage firms (soon to come)
- New mantra (e.g., Softbank)
- Sophisticated multi-national (e.g., ING, AXA, and Zurich)
- Multi-Financial Service Provider (e.g., GE Capital)
- Strategic mergers among traditional players (e.g., Daido/Taiyo)



These competitors are coming at a time when the mainstream players are undercapitalized and are still exposed to large financial market risks.

Management risks trying to respond to these competitive threats on all fronts without adequate focus. Many mainstream players face very fundamental structural and risk management problems that need to be faced first before an effective response can be developed. For Japan's actuaries and the few foreign actuaries on the front lines, this is the fundamental task.

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Many of us pursued actuarial careers because we were employed by companies with actuarial student programs. We may not even have taken that first exam without the promise of financial help for the series of exams. Of course, the increasing salaries, status, and career challenges that follow successful completion of an exam kept us moving toward the ASA and FSA designations. As we developed, we also contributed to the expansion and enhancement of the actuarial profession and actuarial practice.

In many areas of the world, potential actuaries are not as fortunate because financial assistance is not available to encourage them to pursue the profession and help build the financial infrastructure of their countries. Below are two opportunities to help these individuals.

At the July Council meeting (see minutes in this newsletter) we decided to encourage and support a culture of taking actuarial exams in Mexico by approving $1,000 to help send a professor to Puebla, Mexico, to teach Course 1 techniques and strategies. The Latin American Committee developed the project which is expected to be implemented before the end of this year. The SOA provided the additional $4,000 needed for the project.

The Clearinghouse Scholarship Program is in need of funds for actuarial students in developing countries in Asia, Africa, and the Middle East. Scholarships are awarded to eligible candidates to help pay for examination fees and study notes. Donations may be contributed to the general scholarship fund or matched to candidates in specific countries. Maybe you can help.

Please contact Jim Toole (Latin America Committee), myself (Clearinghouse Scholarship Program), or Martha Sikaras, SOA staff (for both programs) if you want to learn more about these opportunities or if you (or your company) want to donate to the Clearinghouse Scholarship Program.

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