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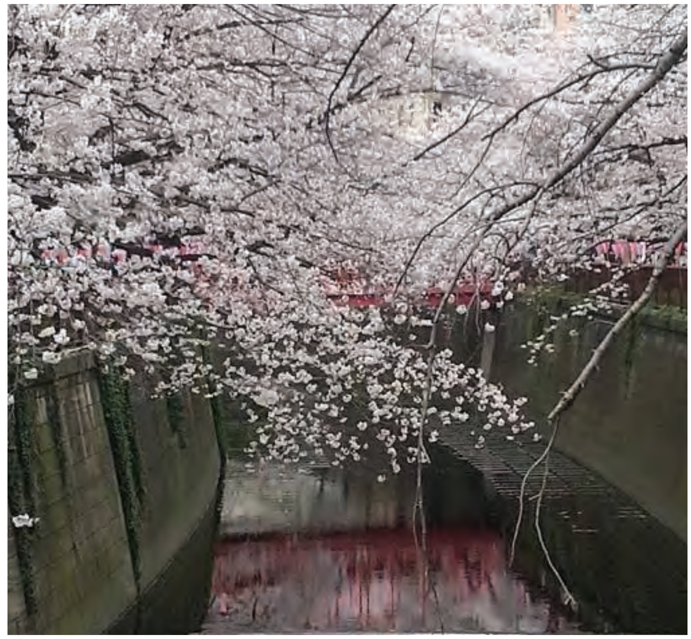
Why Japanese Life Insurers Are Still Surviving In a Zero Interest Rate Since 1995

By Kenichi Nogami



INTRODUCTION

Not only Japan, but also many Organisation for Economic Co-operation and Development (OECD) countries are struggling with a low/zero/negative interest rate economy these days. Many countries may expect the interest rate will recover when their central bank changes their monetary policy as the U.S. FRB did in late 2015. Upon hearing this FRB action, I recalled that Bank of Japan also tried to raise the interest rate in 2000 and 2006, but neither attempt was successful mainly due to the Global Financial Crisis in 2001 and 2007. This article does not intend to debate whether the U.S. FRB can successfully hike the interest rate back to a historical long term level or not, but rather to show how life insurance companies in Japan survived in a zero interest rate economy in the past twenty years.

VERY LONG NIGHTMARE

Bank of Japan started to lower the interest rate in mid 1990s. At very beginning, many Japanese Life Insurers expected the interest rate would recover soon. They chose not to change product pricing and maintained policy holder's dividends. In the meantime, other financial institutes were relatively more flexible in reducing the credit interest rate. As a result, some life insurers gathered massive money from the market by selling its traditional products, e.g., endowments, fixed annuities.

Unfortunately, this expectation soon proved to be incorrect. In 1997, Nissan Mutual Life filed for bankruptcy and was later taken over by a French company. It was the first time since the postwar period that a life insurer went bankrupt in Japan. Including Nissan Mutual, eight companies in total were bankrupted, and three companies stopped selling new business. These numbers are not small, considering that there are only around 40 companies in the Japan market.

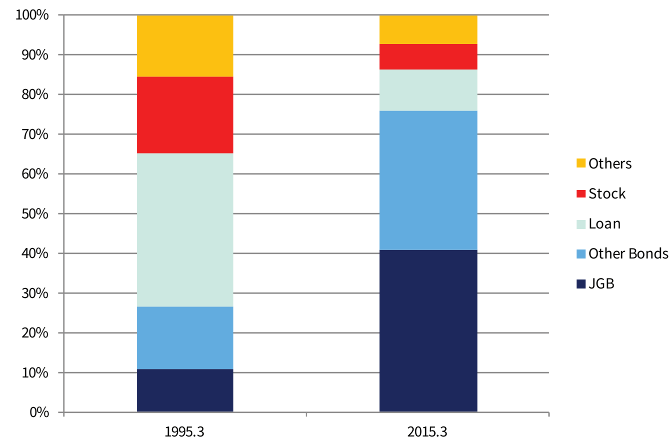
Thanks to those bankruptcies, local customers were quickly getting familiar with the solvency margin ratio—also known as RBC type minimum capital regulation—in order to check whether their insurance companies were solvent or not. Many consumer magazines ranked life insurers by this ratio. Life insurers had to improve their solvency margin ratio in order to have a higher ranking in the list and avoid being the next bankrupt company.

REVISION OF ASSETS

Because capital market risk is calculated by risk factors by each asset class (e.g., stock is high, corporate bond is low and Japanese government bond (JGB) is zero), one way to improve the sol-

Graph 1: Historical Japanese Government Bond Yield

Graph 2: Asset Mix Change



vency ratio is to change the asset portfolio. In 1995 fixed income assets (bond and JGB) were less than 50 percent of the portfolio, but exceeded 75 percent in 2015. JGB's portion in particular increased from 11 percent to 42 percent in the same period, because its risk factor is zero and also the JGB market is very deep and liquid. Some companies did try to seek higher investment returns by having an aggressive asset portfolio, but it did not work out in the end. Currently some companies invest 30 to 40 years JGB to enjoy a slightly higher yield (0.97 percent for a 40 year rate as of March 1, 2016). Considering Bank of Japan's aggressive monetary policy targeting 2 percent inflation, I am a bit concerned that they are too optimistic to expect that this yield will continue for 40 years and that Japanese consumers will not lapse their whole life or fixed annuity policies.

REVISION OF PRODUCTS

On the other hand, revision of an insurance policy is not easy because it will influence consumers behavior—not only in regards to new business volume but also lapse experience. Many of the crises were triggered by a mass lapse event.

Lapse supporting products—including products with zero surrender value (e.g., whole life cancer protection, hospital cash)—are very popular in Japan. Regulators normally require more rational to approve a zero surrender value product (e.g., demonstrating lower price compared to a similar product with rational surrender value) to ensure customers are treated fairly. Because these lapse supporting products look profitable for the moment, many companies offer a higher sales commission, which give sales channel more incentives to sell.

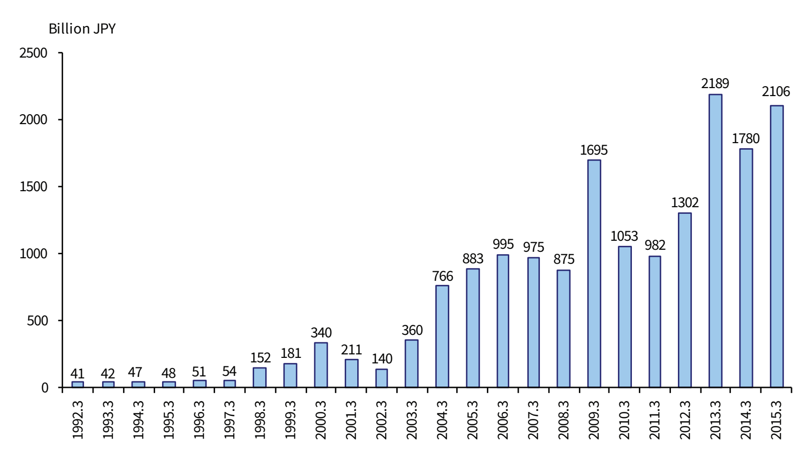
To reduce the credit interest rate, variable life and variable annuity could be a good option, but some insures have mispriced the minimum guarantee option cost. The option cost will increase when the interest rate becomes lower, so insurers must adjust option costs as interest rates change. Insurers experienced a loss during the global financial crisis, mainly because of earlier DAC depreciation by smaller account value and the fact that there was much lower lapse rate than expected in an in-the-money situation. Japanese consumers are very sophisticated and patient, who almost never lapse when account value is low.

Guaranteed interest rate products in foreign currency (Australian, USD, etc.) can also be profitable to insurers, because the credit interest rate can be changed every 10 years. However, some of them were sold without market value adjustment and foreign currency interest rate volatility is higher than Japanese yen. In 2016 a popular investment/saving type product in Japan is foreign currency variable annuity, whose minimum benefit is guaranteed in foreign currency. Variable annuity in Japanese yen has almost disappeared. This is not surprising as minimum guarantee option cost is too expensive to be offered in Japanese yen. In 1995, the credit interest rate in pricing was 5.5 percent to 6.5 percent in Japanese Yen, but currently is only about 0.5 percent to 1.5 percent. Even 0.5 percent could be considered high as Bank of Japan declared to introduce a negative interest rate in January 2016 and the current 10-yearJGB yield is negative.

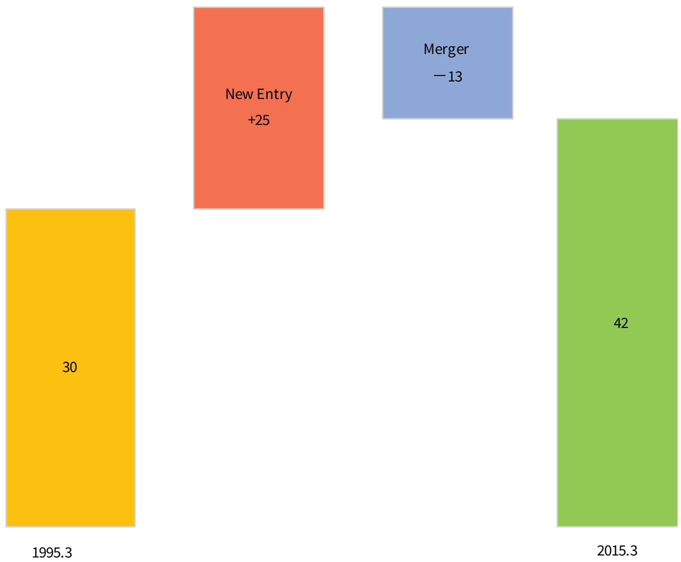
PAR TO NON PAR AND DEMUTUALIZATION

In 1995 there were 16 mutual companies that counted for more than half of total number of life insurers at that time. Market share of mutual companies in terms of premium was even bigger—around 80 percent—as all mutual companies were domestic big companies. Since then, many mutual companies were demutualized or purchased by stock companies. In 2015, only five mutual companies remain.

Graph 3: Reinsurance Premium by year



Graph 4: Number of life insurers in Japan market



Stock companies and mutual companies reduced policyholders' dividend and most of them gave no policyholders' dividend economically. In Japan many companies' policyholders' dividends are calculated by contribution from risk premium, expense loading and investment return. Investment spread became significantly negative, which quite often overshadowed risk premium and expense loading spread. Hence, most of the policies' total contribution became negative. Additionally, some companies hesitated or stopped paying policy holders' dividends to retain solvency capital. As a result, most of the in force policyholders' dividends became zero. Legally these policies are Par policies, but economically they become Non Par. Some insurers expect consumers would lapse these economic Non Par policies. But, unfortunately consumer magazines educated consumers that economic Non Par policies are very attractive and therefore, they retained these economic Non Par policies. In 1995, 3 percent to 5 percent of premium was refunded through policy holders' dividends. In 2015 it was almost zero. Legally, there were five mutual companies in 2015, but economically there are no mutual companies in Japan.

CAPITAL INJECTION

In Japan, only big, domestic mutual companies can get capital from the capital market through subordinate bonds/loans or additional fund raising. Small or middle size companies find it very difficult to get capital, even though they are companies with stock, because many investors recognize life insurers are in a difficult environment, demonstrated by the many bankruptcy cases in the past twenty years.

As of today, there are 16 foreign companies and 26 domestic companies in the Japan market. The number of foreign companies has tripled in the past two decades. These subsidiaries or branches got capital injection through either a capital increase or reinsurance. Reinsurance premiums paid by direct companies increased from 48 billion yen in 1995 to 2,106 billion yen in 2015—a majority through captive reinsurance, which results in a capital injection from home countries or risk transfer from Japan. The rest are through financial reinsurance provided by professional reinsurers or investment banks. Traditional reinsurance has very a small share.

GREAT OPPORTUNITIES

Based on what I described so far, one might conclude that Japan is not an attractive market for life insurers. It is true that a zero/negative interest rate is not an easy economical condition. But it is also true that in 2015 there were 42 companies in the Japan life insurance market—including 25 new entries—compared to 30 companies in 1995. What is the reason behind that? Interest rate is not the factor, because it is almost zero in Japan. The main reason is that consumers are buying long duration life insurance to protect them from longevity risk and after retirement risk. Japan has the world's longest life expectancy, which means Japan's after retirement risk is the greatest in the world. Normally speaking, health cost becomes expensive after age 70, and is very significant post age 80. Japanese consumers save money in zero interest rate bank accounts to prepare for post-retirement living. They have grown accustomed to the zero interest rate, and therefore accept low return of saving/investment products. Their individual financial asset size is now around 2 quadrillion JPY. It is possible that the current zero/negative interest rate will continue for some years, but this long duration risk can be a great opportunity for insurers. As long as consumers' concern exists, life insurers shall survive in a zero/negative interest rate. ■

Kenichi Nogami, FIAJ, CMA, JDr, MBA, is an entrepreneur, independent consultant, a member of actuarial committee Japanese Public Pension Fund and a member of investment committee Public Schools Mutual Aid Pension Fund. He held many senior positions in Japan insurance market including chief Representative of Zurich Life Japan, and EVP of Lifenet Insurance Company. He can be reached at *nogami2008@gmail.com.*