Japan's Life Insurance Industry Gains Strength by Overcoming Financial Crisis

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I. Insurance companies rocked by gale-force winds

After several years of relatively smooth sailing, the life insurance companies, an important segment within the asset management industry, have been hit hard by the worsening of the investment environment, specifically the global economic slowdown, decline in yields, and decline in share prices, all of which were sparked by the subprime loan mess. There are already some major insurance companies in Europe and the US that have received injections of government capital, and we expect the impacts from the crisis to spread to those companies without a business base strong enough to weather this "perfect storm."

The collapse of Japan's bubble economy in the early 1990s was the equivalent of a major typhoon reaching landfall at the life insurance companies' doorstep, and seven small to medium-size life insurance companies with weak businesses wound up failing. The companies that survived took measures to strengthen their capital base and reshuffle their asset portfolios, but this latest subprime-induced financial crisis has quickly put the smaller life insurance companies into difficult straits. Even some of the majors are being directly affected, including by having to record net unrealized losses on stocks in their portfolios.

The subprime loan problem has gradually gained momentum, and now appears to be developing into a monster typhoon threatening a global recession. Just when Japan's life insurers were in the midst of making changes in response to the previous typhoon, they are being hit by a new, even more powerful storm. With a decade having passed since the 1990s crisis, Japan's life insurance sector was finally starting to forge a new direction. The market is now watching closely, and with trepidation, to gauge how the management reforms implemented thus far have held up during the current crisis.

II. Major Changes in the environment over the past decade

Although nobody would deny that the collapse of Japan’s bubble economy in the 1990s had a major impact on the life insurers, it may also be true that the bubble’s collapse sparked some long-term, fundamental changes that Japan’s life insurance industry needed anyway.

With 90% of households owning a life insurance policy, Japan has one of the world’s highest rates of market penetration for life insurance. The life insurance market had already reached saturation in the 1980s, however, as a result of declines in the Japanese economy’s potential growth rate and the graying of Japan’s population. The time has already come for life insurance companies to revise their business models, which are built on assumptions for economic and population growth that are no longer valid.

In the 1980s, the massive funds available to Japan’s life insurance companies enabled them to invest all over the world and put them in the global spotlight, but the bubble economy also made it possible for them to delay reforms, and consequently do nothing but store up energy for future change. In fact, since 1995 Japan’s life insurers have experienced three changes drastic enough to shake the foundation of their business.

The first of these was a contraction of the market for individual life insurance, which had been a core product. In Europe and the US, the life insurance market is centered on savings-oriented products, such as endowment and universal life policies, as well as on products to help business owners minimize inheritance taxes, but the majority of policies sold in Japan have been individual term-life policies that pay death benefits but do not build any cash value. Although maybe unthinkable in Europe and the US, in Japan it was not unusual for a recently hired college graduate to purchase a term life insurance policy valued at over ¥40 million, which equates to five times their annual compensation.

Nevertheless, the sustained slump in Japan’s economy that began in the early 1990s caused household incomes to stagnate, and made individuals think twice about buying such a large amount of surplus life insurance protection. The faith of households in life insurance has also been badly damaged by the successive failures of life insurance companies and, more recently, by scandals throughout the sector in which a portion of insurance benefits were never paid as promised. This led to rapid shrinkage of the life insurance market, on a scale unprecedented in Japan. Total individual life insurance policies outstanding at end-2007 had dropped to about two thirds of its level of 10 years prior.

As their home market shrank, Japanese life insurance companies’ international presence started to decline. Ten years ago, Japan had the largest life insurance market in the world based on both total premium income and per capita premiums, but now, in part owing to exchange rate impacts, Japan ranks only third in premium income, which is less than 60% of that of the US, and tenth in per capita premiums. Once an insurance superpower, Japan now trails the leading Western economies as well as the quickly developing countries in Asia.

The second drastic change was in the competitive landscape as a result of a breakdown in the majors' dominance of the market. The five largest life insurers'[1] share of premiums was 60% 10 years ago, but less than 50% in 2007. It is instead the new market entrants and foreign capitalized insurance companies that are increasing their market share, and they are steadily taking market share away from the majors using one of the three following methods.

One approach, used by Sony Life and Prudential Life, is to consult with consumers on the policies they have with other companies and try to motivate them reconsider those policies. Because this process almost always results in policyholders getting rid of unnecessary insurance coverage, it is causing the overall size of the market to contract.

A second approach is to offer simple policies with low premiums, such as the policies sold online by the AIG affiliate Alico Japan and the cancer insurance sold by Aflac Japan. This approach leads to consumers meeting their minimum insurance needs, and is also causing the overall market to shrink. The third approach is to introduce products not previously seen in Japan, such as variable annuities. Unlike the other two approaches, this creates growth in new market, and is thus a segment in which not only new market entrants but also the incumbent insurance companies are quite active.

The third drastic change has occurred in sales channels. For years, the typical sales channel for Japan's life insurers has consisted of female sales associates representing a single life insurer making sales visits to either the workplace or the home. This system has its roots in the postwar years, when the life insurance industry cooperated with government policies aimed at employing war widows. There has been a rapid decline in the number of these sales associates in recent years. After peaking at 450,000 in March 1991, their numbers are now down to about half of that. Growing to take their place have been retail sales by securities brokerage firms and banks, sales by agents, and online sales. Laws prohibiting the sale of life insurance by brokerage firms were abolished in 1999, and laws prohibiting sales by banks in 2002. Both of these have become important sales channels for annuity products, demand for which has been growing in step with the aging of Japan's population. This is because pension products, which have both savings and investment characteristics, also have simple enrollment procedures and generate commission income for the selling institution, and this makes them conducive to being sold by other financial institutions.

[1] To achieve more consistent comparisons, we calculated market shares using five companies in 1997, Nippon Life Insurance, Dai-Ichi Mutual Life Insurance, Sumitomo Life Insurance, Meiji Life Insurance, and Yasuda Mutual Life, and used four companies for our calculations in 2007, Nippon Life Insurance, Dai-Ichi Mutual Life Insurance, Sumitomo Life Insurance, and Meiji Yasuda Life Insurance.

III. Business is becoming more flexible

Although the business environment has changed considerably over the past decade, there has also been a huge increase in the options available to management to deal with those changes. These include flexibility in how a company is structured, and an increase in the number of ways to raise the equity capital that provides management with a buffer.

Most of Japan's leading insurance companies are still organized as mutuals, although a comprehensive revision of the long-standing Insurance Business Act in 1996 created a path for demutualization. There have also been a number of life insurance companies in Europe and the US that have demutualized since the 1990s, based on the growing need, created by the diversification and globalization of financial services, for greater flexibility in managing the business and raising capital. Three of Japan's second-tier life insurance companies have demutualized thus far: Daido Life Insurance in 2002, Taiyo Life Insurance in 2003, and Mitsui Life Insurance in 2004.

Japan also saw the first merger between mutuals, that of the majors Meiji Life Insurance and Yasuda Mutual Life in 2004. Although the mutual and joint stock company formats each have their pros and cons, management now at least has the flexibility to choose the format that it deems most appropriate.

The same is true of procuring capital. Demutualizing makes it possible to raise capital by issuing stock, while a mutual company also now has a more diverse range of ways to raise capital. Previously, mutual companies were required to distribute at least 80% of surplus funds to their policyholders, but this requirement was lowered to 20% in 2002, making it considerably easier to increase capital using retained earnings. In addition, they have been allowed since 2001 to issue kikin bonds (similar to subordinated debentures) as a way to temporarily increase capital. Although still a bond, these make it possible to raise capital from a broader class of investors.

Japan's life insurers have worked to increase their capital over the last several years by using these methods, and consequently are now considerably stronger financially than they were immediately following the economic bubble's collapse. Returning to the initial question of whether the life insurance industry can survive the current financial crisis, we think it is fairly well positioned to absorb the impacts from the crisis.

IV. Focus more on future business development than on crisis impacts

Although Japan's life insurance companies are clearly being affected by the current crisis, the more important question is how management responds, including by leveraging the flexibility of its management and capital, to the long-term changes taking place in Japan's business environment. In that sense, we would like to look here at those companies that are making aggressive use of the new rules. For example, because the majority of sector companies are mutuals, not a single life insurer in Japan was listed on the stock market, although T&D Holdings, a holding company that owns the demutualized Daido Life Insurance and Taiyo Life Insurance, is now listed, as is Sony Financial Holdings, the Sony Group's financial arm and owner of a bank, a life insurance company, and a nonlife insurer.

There are two pending listings that should cause a radical increase in communication between the market and the life insurance industry, that of Japan's second largest life insurer, Dai-Ichi Mutual Life Insurance, and that of the privatized Japan Post Insurance. Dai-Ichi Mutual plans to demutualize and list its shares in 2010. With 8.5 million policyholders, it would have over 3 million share holders after demutualization, more than NTT or any other Japanese company. Dai-Ichi Mutual has been attracting attention recently as it aggressively searches for its next-generation business strategy, including moving into Asian markets with high growth potential and establishing a subsidiary specifically for the bank sales channel. Dai-Ichi Mutual was Japan's first life insurance company to adopt the mutual company structure, but it is now attempting to abandon that structure in favor of turning into a joint stock company. That alone is probably quite significant, but there is also Japan Post Insurance, which has over 50 million policies outstanding, including segregated old policies. Its total assets are twice those of Nippon Life Insurance, Japan's largest private sector life insurer, and the largest of any life insurance company worldwide. In addition, it has sold its policies through the post office's 24,600 branch offices, which offer a menu of financial services, and is Japan's first and largest provider of bancassurance.

The listing of these companies may strengthen the industry's dialogue with the market, and wind up creating a new business model for life insurance companies in Japan.

Figure 1: Top 15 companies based on insurance premium income

	FY1997			FY2002			FY2007		
	Company	Premium income	Share	Company	Premium income	Share	Company	Premium income	Share
1	Nippon	6,275	21%	Nippon	5,420	21%	Nippon	4,889	18%
2	Dai-ichi	4,012	13%	Dai-ichi	3,561	14%	Dai-ichi	3,098	11%
3	Sumitomo	3,413	11%	Sumitomo	2,693	11%	Meiji Yasuda	2,652	10%
4	Meiji	2,746	9%	Meiji	2,184	9%	Sumitomo	2,544	9%
5	Mitsui	1,766	6%	Yasuda	1,294	5%	ALICO Japan	1,348	5%
6	Asahi	1,711	6%	Daido	988	4%	AFLAC	1,114	4%
7	Yasuda	1,700	6%	Mitsui	952	4%	Daido	842	3%
8	Taiyo	1,329	4%	Taiyo	888	3%	ING	805	3%
9	Daido	1,167	4%	AFLAC	833	3%	Mitsui	800	3%
10	Fukoku	797	3%	Asahi	768	3%	Fukoku	736	3%
11	Chiyoda	780	3%	Fukoku	762	3%	Hartford	673	2%
12	Kyoei	747	2%	AXA Group Life	607	2%	AXA	655	2%
13	Nipponn Dantai	660	2%	ALICO Japan	585	2%	Sony	647	2%
14	AFLAC	592	2%	Sony	490	2%	Mitui Sumitomo MetLife	645	2%
15	Toho	470	2%	TOKIO MARINE	403	2%	Taiyo	636	2%
	Top 5 companies	18,211	60%	Top 5 companies	15,153	59%	Top 5 companies	14,531	54%
	Top 10 companies	24,916	82%	Top 10 companies	19,582	77%	Top 10 companies	18,828	70%
	Top 15 companies	28,164	93%	Top 15 companies	22,429	88%	Top 15 companies	22,083	82%

Source: Nomura Institute of Capital Markets Research, based on data from *Statistics of Life Insurance Business in Japan*, Insurance Research Institute (in Japanese)