

The Japanese "Big Bang" and its impact on life insurance companies

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The following essay is based on Mr. Saito's speech in FALIA Top Management Seminar on October 15, 1997.

Introduction

Probably the most serious issue for Japan today is how to deal with the rapid aging of the country's population. For the financial sector, meanwhile, the key issue at present is the Japanese "Big Bang" that the government is planning, which will sweep away the regulatory framework that has until now divided the sector into separate industries and maintained barriers between the Japanese and international financial worlds.

The sections of my essay will be (1) changes in the external environment for the life insurance market, (2) the current state of the life insurance industry and directions in insurance regulation, (3) the Japanese "Big Bang" and its impact on life insurance companies.

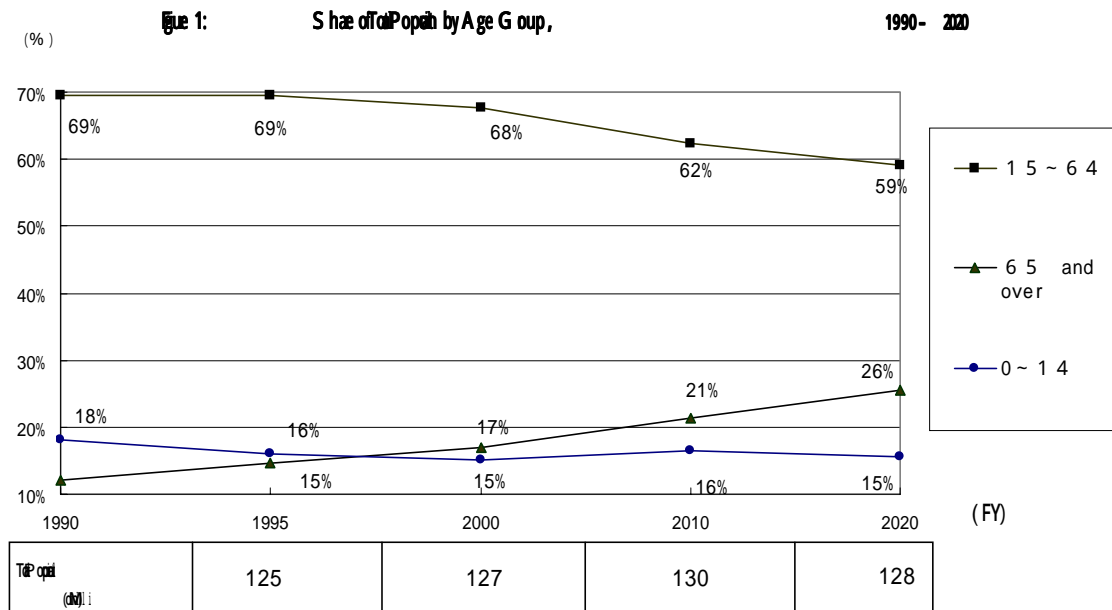
1. Changes in the external environment of the life insurance market

The Japanese life insurance industry is now facing a set of challenges quite unlike anything it has experienced in the five decades since the end of World War II. The source of these challenges is, in large part, qualitative and quantitative shifts in the external environment of the market. The changes have been of such an extent that we have seen what may be termed a discontinuity in this environment, which has turned into something quite unlike what it was before.

(1) Changes in the population structure (figure 1)

The first area of change I would like to discuss is our nation's population structure. You may refer to figure 1 of "Share of Total Population by Age Group(1990-2020)".

Japan's total population is now about 125 million. It's expected to peak at 130 million or so in the year 2010, and then start to shrink. The "working-age



Source: The National Institute of Population and Social Security "Population Projection for Japan(96)"

population," defined as those from age 15 through 64, has already started to decline, having peaked in 1995. This decline is now turning into something of a drag on economic growth. According to the baseline scenario calculated by our affiliate, the Dai-ichi Life Research Institute, the aging of the population and decline in the working-age group will result in a real economic growth rate of under one and a half percent (1.4%) a year in the period from 2006 to 2010. This will be only half of the average rate over the past 15 years, which has been about 3%.

What is of special note is the composition of the population. Over the years from 1990 to 2010, the share of the 65-and-over age group is expected to rise rapidly, while the shares of the younger age groups record a long-term decline. In 1995, for example, there were 87.1 million people aged 15 to 64 and 18.2 million aged 65 or over. This means there were about five working-age people for every senior citizen. But in 2010, there will be 81.3 million people aged 15 to 64 and 27.8 million aged 65 or over. This will mean a ratio of only three working-age people for every senior citizen.

One major factor behind this demographic shift is the decline of the birthrate. Japan's total fertility rate, which is the average number of children born to a woman during the course of her life, fell below 2.0 in the mid-1970s, and it has continued to decline since then. As of 1995 the figure was 1.42, and by the year 2000 it is expected to be 1.38. Given that birthrates are low and falling and lifespans are long and rising, the population is bound to age rapidly. In 1990 the elderly were 12% of the total, but in 2010 they will account for more than 20%.

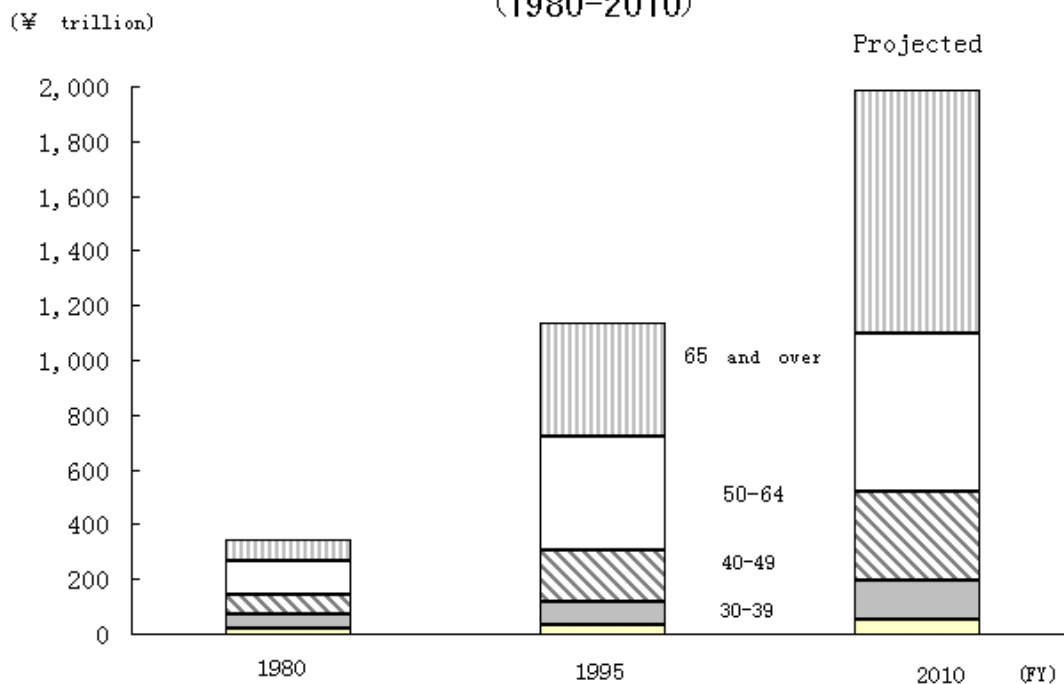
Furthermore, the pace of this aging process is much faster in Japan than in the other industrial nations.

(Just for reference, the doubling of the share of the elderly from 10% to 20% of the population is expected to take 61 years in the United States, from 1972 to 2033, and to take 78 years in Britain, from 1950 to 2028; in Japan's case the same doubling is projected to take only 22 years, from 1985 to 2007.)

(2) Change in the structure of personal financial assets (figure 2 , 3 , 4)

Next I want to discuss change in another aspect of the external environment of the life insurance market, namely, personal financial assets. You may refer to figure 2 of “Household Financial Assets (1980-2010)”.

**Figure 2: Household Financial Assets
(1980-2010)**



Source: Projection by Dai-ichi Life Research Institute, Inc.

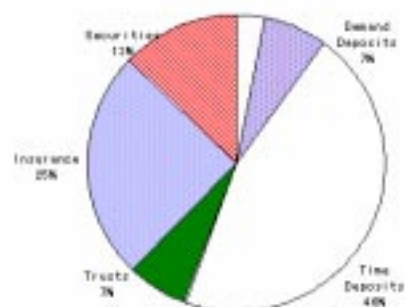
As of 1995, personal financial assets in Japan totaled 1,200 trillion yen. Of this total, some 418 trillion, or 37%, is said to be held by households headed by people aged 65 or over. By 2010, it's estimated that the total will rise to 2,100trillion yen and that the share held by the elderly will rise to about 45%. To put it another way, out of the 900-trillion-yen increase in the total, some 523 trillion, or well over half, will be in the assets held by the 65-and-over group. It's obvious that older people are going to be extremely important customers for financial institutions.

Next please refer to figure 3 of “Breakdown of Financial Assets by Type” Life insurance now accounts for 300 trillion yen in personal financial assets. This figure which includes the asset of the Postal Life Insurance Bureau, is about 25% of the total.

Figure 3 : Breakdown of Financial Assets by Type

Breakdown by Type	Unit: ¥ trillion	
	Amount	Share
Cash	36	3.6%
Demand Deposits	84	7.0%
Time Deposits	644	45.7%
Negotiable Deposits (CDs)	0	0.0%
Foreign-Currency Deposits	0	0.0%
Trusts	77	6.5%
Insurance	300	25.2%
Securities (Sub-total)	151	12.6%
National Government Bonds	4	0.3%
Local Government Bonds	1	0.1%
Public Corporation Bonds	2	0.2%
Bank Debentures	22	1.9%
Corporate Bonds	7	0.5%
Stocks	83	6.9%
Investment Trusts	32	2.3%
Total	1,192	####

Figure 3 : Breakdown of Financial Assets by Type



Remarks: Figures are as of September 30, 1996.

Number of Japan's Financial Institutions

Number		No. of Branch, (1996)	
Domestically Licensed Banks	173	Insurance Companies	65
City Banks	11	Life Insurance Companies	29
Regional Banks	64	Non-Life Insurance Companies	26
Members of 2nd Assoc. Regional Banks	85	Securities Companies	224
Long-Term Credit Banks	3	Postal Savings	1
Trust Banks	30	Finance Companies	32,802
Foreign Banks	94		
Cooperative Financial Institutions	835		
Shoko Chokin Bank	1		
Financial Institutions for Agr., Forestry & Fishery	3,884		
Total	4,967		

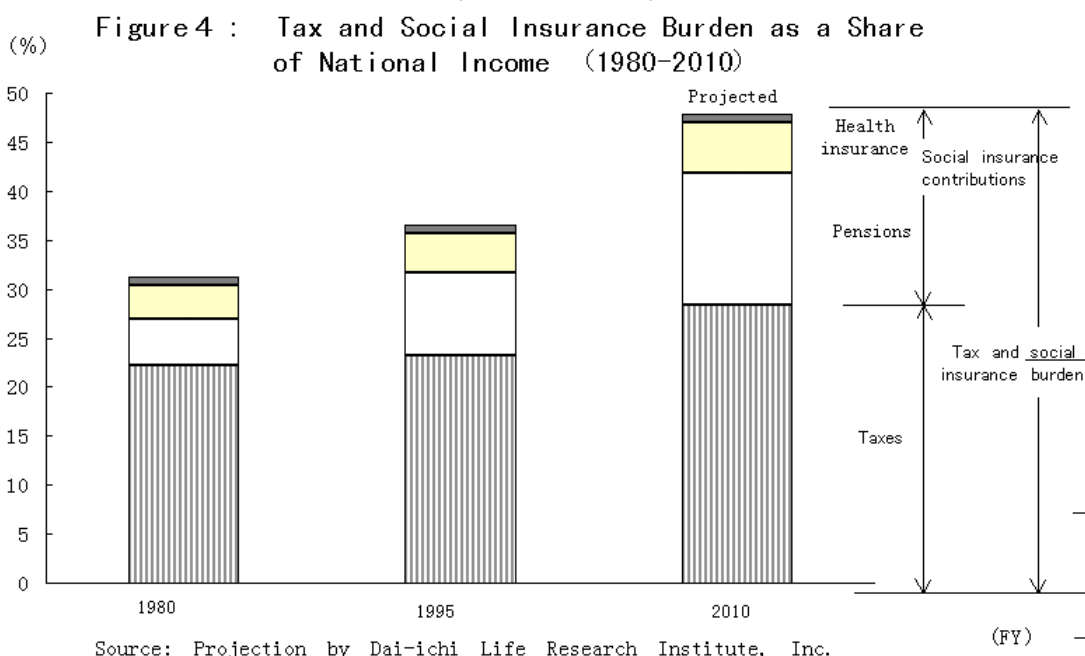
Sources: BOJ Economic statistics ; others

In the United States, the “baby boomer” generation is getting older, and to meet the shifting needs of its customers, the life insurance industry has introduced products like universal insurance and variable insurance. Not only that, but life insurance companies have also set up subsidiaries that handle mutual funds and provide investment advisory services. In other words, they have been working to increase their ability to attract funds not as single companies but as corporate groups. It's essential for Japan's life insurance companies to make similar efforts to provide attractive products and services for the personal savings market, where growth prospects are good. This will probably mean offering not just life insurance but also related financial services.

The effects of these changes in external circumstances on the life insurance market may be summed up in two points: (1) lower growth for death coverage, which has been the mainstay of the market's growth until now, and (2) expansion of the market for pensions, medical care, and nursing care for the elderly and infirm.

Next please refer to figure 4 of “Tax and Social Insurance Burden as a Share of National Income (1980-2010)”. Now I will briefly discuss a directions

of reform of the public pension system in highly aged countries. One major result of the population aging process will be an increase in the burden of taxes and social insurance premiums as a percentage of national income. If the existing social security system is kept in force, the total burden will rise from the present level of just under 35% to about 50% in 2010. And if we include the effective burden imposed by fiscal deficits, along with the additional public nursing care insurance scheme currently under consideration, the figure is bound to be considerably greater than 50%. As we can see from the examples of Britain and the former West Germany, where the 65-and-over age group has already topped the 15% mark, the ordinary response to this sort of situation in highly aged countries is to revamp the public pension system, switching from the rising benefit levels that were based on assumptions of rapid economic growth to a regime of more restricted benefits.



Given Japan's prospects for lower growth and aging population, our country will also need to slim down its public pension system and move toward greater reliance on private-sector financial security. This switch toward greater demands for individuals to look after their own financial security can be expected to mean greater demands on life insurance companies to meet these needs.

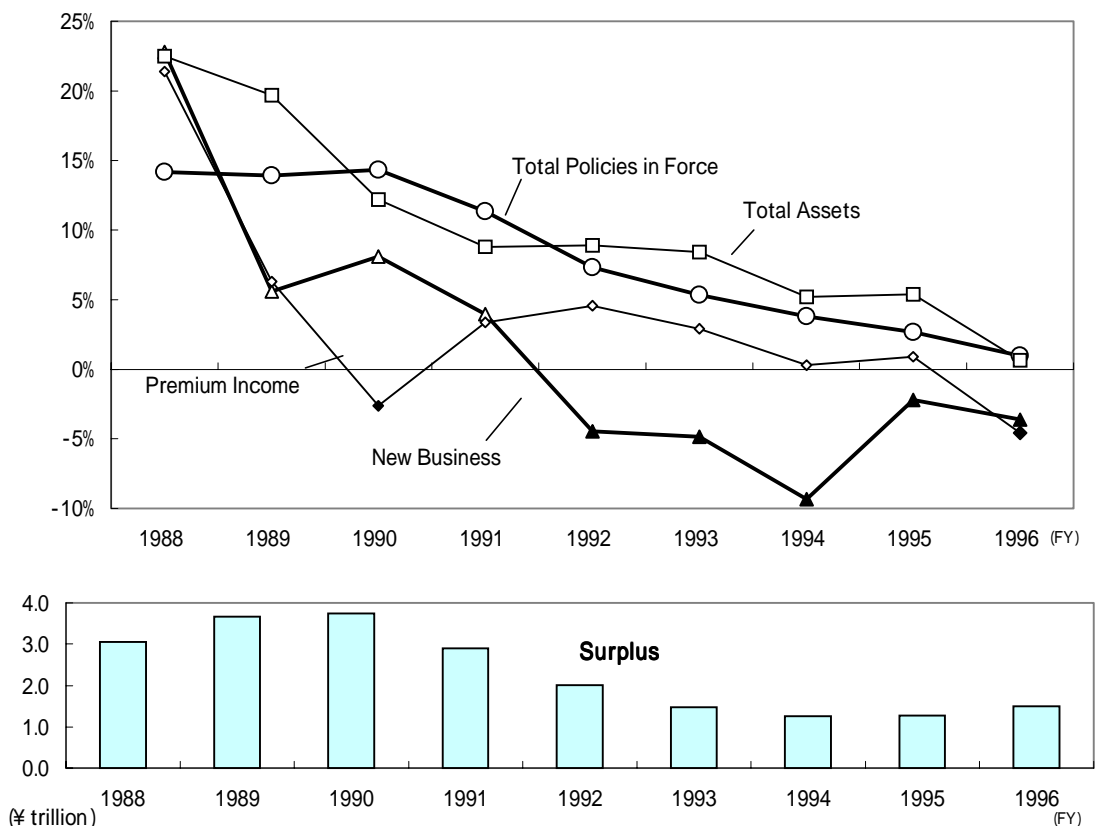
2. The Current State of the Life Insurance Industry and Directions in Insurance Regulation

(1) The current state of the life insurance industry (figure 5)

Now I will briefly discuss the current state of the life insurance industry. Please refer to figure 5 of “Current State of Life Insurance Industry(Growth Rate)”. The growth in the volume of life insurance in force has plunged in the 1990s. It has declined for eight years in a row since 1989. This reflects both the maturation of the market for death coverage and the stagnation in personal income levels since the bursting of the “bubble economy” of the late 1980s. Since the start of the current fiscal year, with the failure of Nissan Life, policy surrenders have been increasing, especially at the smaller companies, and it appears possible that the total amount of insurance in force may actually decline over the course of the year.

Meanwhile, the persistence of low interest rates has forced companies to adjust their expected rates of interest downward three times, in 1993, 1994, and most

Figure 5 Current State of Life Insurance Industry (Growth



Source: Life Insurance Association of Japan

recently in April 1996; this has meant higher premium rates. As a result of these developments, the volume of new business sold has declined for five years in a row. Premium income has also been stagnating during the 1990s. The total for 1996 was

29 trillion yen, which was 4.6% less than the previous year. This was only the second decline in the postwar period, the previous drop having been the 4.3% figure recorded in 1990. Asset growth has fallen off, too. In 1996 total assets for the industry reached 189 trillion yen, which represented a growth rate of only 0.7%. In this context, the surpluses that are used mainly to pay policyholder dividends have dropped sharply from the peak level of 3.74 trillion yen recorded in 1990. The figure for 1996 was about 1.5 trillion yen, which was up a bit from the previous year.

Reflecting this difficult situation, in April this year Nissan Life failed. It was a mid-level life insurance company, ranking 16th among the 31 companies in the industry as of the end of 1995, with total assets at that point of about 2.2 trillion yen, and annual premium income of about 250 billion yen. One special feature was that individual annuities accounted for about 50% of its total policy reserves. The reasons for this failure may be summed up as follows:

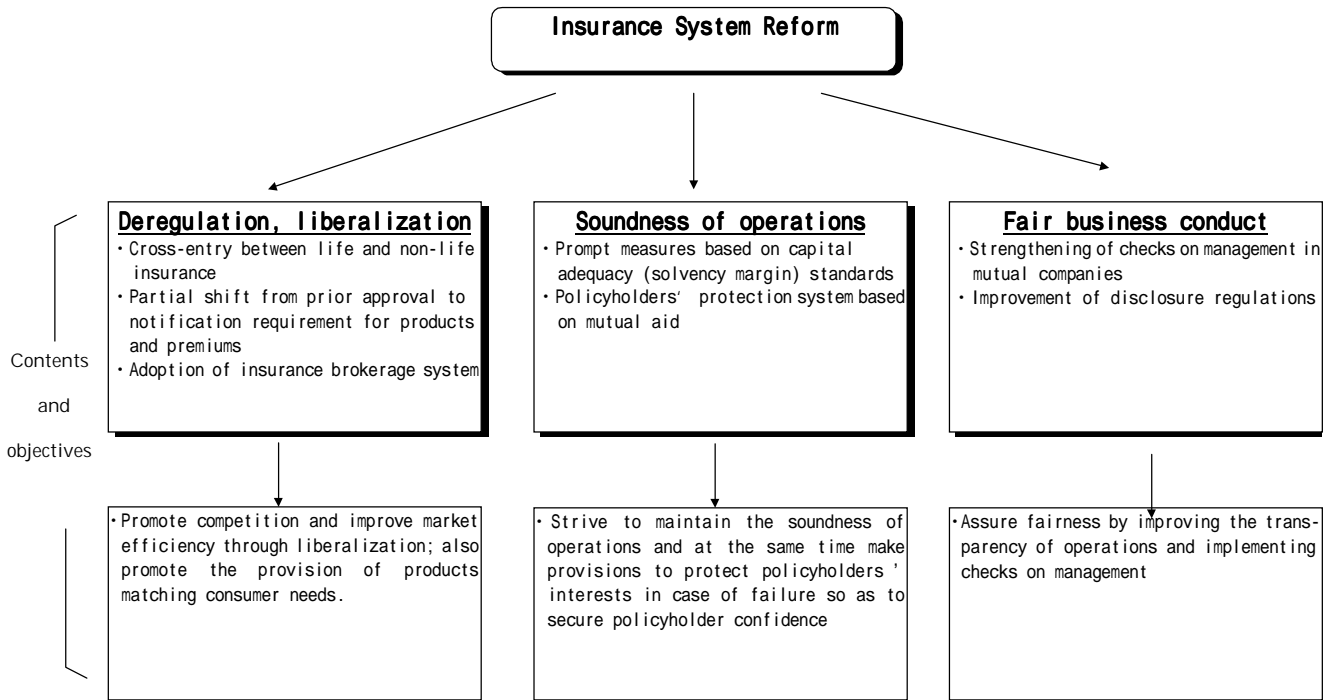
- (a) It had teamed up with many banks and sold large amounts of individual annuities based on high expected interest rates of 5.5% to 6.0%; this meant that it had to achieve very high earnings.
- (b) Interest rates were low even during the bubble years and turned even lower during the 1990s, meaning that its stream of income was much less than required to meet these commitments.
- (c) The company attempted to make up the difference through capital gains, putting large amounts of funds into domestic stocks and foreign investment trusts, but these investments were not successful.

Though there are differences of scale and circumstances, all of Japan's life insurance companies actually face the same problems as Nissan Life, namely, a structural shortage of income to meet the high interest rates on business in force and a need to take investment risks.

(2) Directions in insurance regulation (figure 6)

Next I will explain how the course of insurance regulation has shifted in the midst of these major changes. In April 1996 a new Insurance Business Law went into effect. It was the first time in over 50 years that the basic law governing the insurance industry had been revised. Please refer to figure 6 of "Reform of the insurance System". The three major elements required for reform of the insurance system are (a) deregulation and liberalization, (b) soundness of operations, and (c) fair business conduct. The regulatory system is being modified to address these

Figure 6: Reform of the Insurance System



Source: Hoken Kenkyukai, Chikujō Kaisetsu Shin-Hoken Gyōhō
(The new Insurance Business Law, explained in detail)

three points.

First of all, in the area of deregulation and liberalization, last year it became possible for life and non-life insurance companies to cross over into each other's fields of business by setting up subsidiaries. Six life insurers have set up non-life subsidiaries, and 11 non-life companies have set up life insurance subsidiaries. And as I will touch on later, the Japanese "Big Bang" will produce considerably more liberalization in the years ahead.

Second, soundness of operations has become an extremely important concern in the wake of the failure of Nissan Life. In the neighboring field of banking, a system of "Prompt corrective action" is to be implemented by the Ministry of Finance on the basis of the results for the current fiscal year, ending in March 1998. Under the so-called domestic standard, capital adequacy is to be measured as the ratio of equity capital to risk-weighted assets, and prompt corrective action of various sorts is to be applied when this ratio falls below certain defined levels. If the figure is less than 4%, the banks will be required to submit and implement a rational plan for improvement of its operations. If it is under 2%, several actions will be required, for example:

- (a) the bank will have to submit and implement a rational plan for improvement of its capital adequacy,
- (b) it will be expected to eliminate or reduce shareholders' dividends and executive bonuses,

(c) it will have to reduce its total assets or at least restrain their growth,
and

(d) it will be expected to cut back on the operations of overseas subsidiaries.

And if the capital adequacy ratio is less than zero, meaning that liabilities are in excess of assets, the bank will be ordered to cease operations. Banks are now working desperately to improve their ratios, both by increasing the numerator and by decreasing the denominator. Increasing the numerator means adding to equity capital by issuing additional shares or taking on subordinated debt; decreasing the denominator means reining in total assets.

It appears likely that life insurance regulation will move in a similar direction. Under the new Insurance Business Law, the Ministry of Finance has defined the solvency margin ratio as the measure of capital adequacy, and it plans to adopt standards for prompt corrective action using this ratio. There's one big difference between banks and life insurance companies, however. A system of deposit insurance already exists for banks, meaning that peoples' money is covered even if a bank is ordered to stop operations. But life insurance policyholders are only covered by a voluntary fund set up by companies in the industry; there is no ultimate guarantee like that provided by the mandatory deposit insurance scheme. So MOF is thinking of pairing the introduction of prompt corrective action with the establishment of a payment guarantee system to serve as a safety net for policyholders. If the preparations proceed smoothly, it's possible that this pair of measures will be implemented at the start of fiscal 1999, just a year after prompt corrective action for banks is introduced.

Finally, the third element of reform is fair business conduct. One point that has been raised in this connection is the need for better disclosure of information. People have complained that the information disclosed by Nissan Life gave no indication to policyholders or others that the institution was in trouble. The prime focus of attention in the area of management information disclosure is solvency margins. MOF is encouraging banks to disclose their capital adequacy ratios, and I expect that it will similarly encourage life insurance companies to reveal their solvency margins. The regulators' current idea is to introduce three new elements at the same time, namely, (1) disclosure of solvency margins, (2) prompt corrective action, including the halting of operations, in line with solvency margin ratios, and (3) a mandatory payment guarantee system.

As MOF sees it, these measures, particularly the disclosure of solvency margins,

will make it possible to have policyholders exercise self-responsibility. More specifically, the ministry thinks that the reimbursement from the payment guarantee system when a company's operations are halted can be limited to a fixed amount or fixed percentage of each policyholder's claims on the company. Some people suggest there is a certain danger in this approach. Under today's severe conditions, solvency margins are at historically low levels. And at those companies that are having especially difficult times, the disclosure of their low margins might cause a wave of policy surrenders, thereby causing the companies in question to fail. Despite this potential problem, we think that solvency margin disclosure is bound to come in the near future. The big question is whether it will be applied to the results for the current fiscal year.

The Dai-ichi Life has a relatively strong position within the life insurance industry, but even for a company like ours, improving the solvency margin is an important issue for management, because we need to ensure that we have adequate funds to cope with the developments that the Big Bang will bring. Last year we increased our incorporation fund to 70 billion yen, and next year we plan an additional increase of 150 billion, for a total of 220 billion yen.

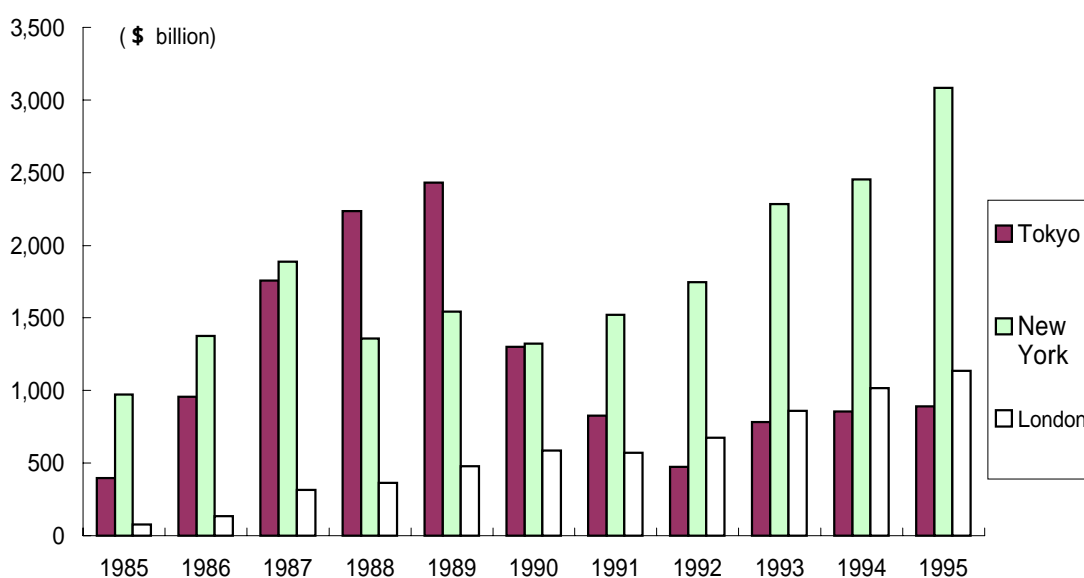
At the same time, we are working to strengthen our on-balance solvency, including reserves for price fluctuations, and by our centennial year of 2002 we aim to have net worth of 1 trillion yen. In terms of capital adequacy, the target will be a ratio of about 3.5% to total assets, comparable to the current ratio of the top city banks.

3. The Japanese “Big Bang” and Its Impact on Life Insurance Companies (figure 7,8,9)

My third main theme today is the Japanese Big Bang and its impact on life insurance companies. Please refer to figure 7 of “Trading Volume on Three Major Stock exchange”. “Big Bang” was the term applied to the sweeping deregulation of Britain's security industry by Margaret Thatcher. Japan's Prime Minister Hashimoto has borrowed this term to describe his own reform plan, which aims to deregulate the entire financial services sector. There are three major factors behind the Big Bang reform drive: globalization, advances in information and communications technology, and the appearance of new financial products in the major Western markets.

In the latter part of the 1980s, there was much talk of Tokyo as an international financial center ranking alongside New York and London. But since the start of the 1990s, financial transactions have been shifting overseas, and Tokyo's position has declined sharply. The figure 7 shows how poorly Tokyo has done by comparison with the other two markets. The purpose of financial system reform is to get a jump on the international trend toward liberalization and the advances in information technology and to reestablish Tokyo's position as an international financial market on the same level as New York and London.

Figure 7: Trading Volume on Three Major Stock Exchanges



Source: BOJ Compendium of Economic and Financial Statistics and OECD

(FY)

Please refer to figure 8 of “Financial System Reform Plan (June 13, 1997)”. One key feature of this reform plan is the setting of a clear timetable for the whole set of changes. It's quite a bold departure from previous practice, where partial reforms were carried out and then debate was reopened concerning further changes. A second key feature is the adoption of three basic principles to guide the far-reaching reform of the market. The principles are summed up in three English words: “free”, “fair”, and “global.” The market must be a free one in which market principles prevail. To be fair, it must be a transparent one in which people can place their confidence. And it must be international and progressive. The third key feature is the adoption of measures based on the perspective of users.

These fall into four categories:

- (1) Expansion of choices for investment and fund raising
- (2) Improvement of intermediary services and promotion of competition
- (3) Improvement of market utility
- (4) Establishment of rules and frameworks for fair and transparent transactions

The asterisks on figure 8 mark those items that have a particular bearing on the insurance industry. Japan's Big Bang has some points in common with the original Big Bang in Britain. For example, Britain lifted its controls on foreign exchange and cross-border capital transactions in 1979, several years before its Big Bang; Japan has also made foreign exchange liberalization the front runner of its financial reform program. A major revision of the Foreign Exchange and Foreign Trade Control Law has already been enacted and will go into effect next April. Another

Figure 8 Financial System Reform Plan (June 13, 1997)

	Schedule				
	1997	1998	1999	2000	2001
(1) Expansion of choices for investment and fund raising (5 items)					
* Complete lifting of the ban on securities derivatives	_____	_____			
Introduction of asset management accounts at securities companies	_____	_____			
* Sale of investment trusts by banks, etc.					_____
* Sale of insurance by banks, etc.					_____
* Promotion of liquidity with use of asset-backed securities					_____
* Liberalization of cross-border capital transactions		_____			
(2) Improvement of intermediary services and promotion of competition (10 items)					
* Use of holding company system		_____			
* Expansion of scope of operation for business by industry-specific subsidiaries		_____			
Banking, securities, and trust businesses		_____			
Insurance, banking and other financial businesses		_____			
Review of licensing system for securities companies		_____			
Diversification of securities company operations		_____			
* Liberalization of brokerage commissions for stock trading		_____			
Abolition of the regulations related to the segregation of long-term and short-term banking		_____			
Promotion of electronic money and electronic payment systems		_____		_____	
* Reform of the rating organization system for non-life insurance companies		_____			
Diversification of fund-raising sources for non-bank financial companies		_____			
Liberalization of foreign exchange operations		_____			
(3) Improvement of market utility (6 items)					
Lifting of the restriction of off-exchange trading of listed securities		_____			
Improvement of liquidity in the OTC (NASDAQ) market		_____			
Expansion of trading in financial futures		_____			
Improvement of the short-term money market		_____			
Abolition of the reporting requirement for cross-border capital transactions		_____			
Lifting of the ban on trading of unlisted and unregistered stocks		_____			
(4) Establishing rules and frameworks for fair and transparent transactions (14 items)					
* Review of system of consolidated financial statements		_____		_____	_____
* Improvement of auditing standards for financial products		_____		_____	_____
* Enhancement of auditing by accountants		_____		_____	_____
* Enhancement of inspection, surveillance, and punishment systems		_____		_____	_____
* Adoption of prompt corrective action		_____		_____	_____
* Protection of users of financial institutions, etc.		_____		_____	_____
Financial Services Law		_____		_____	_____
plus eight additional items		_____		_____	_____

Source: Ministry of Finance, "Financial System Reform", (June 13, 1997)

point is that the liberalization carried out in Britain was accompanied by implementation of measures to protect consumers. At the same time that the Big Bang was being implemented, a Financial Services Act was passed. The British government

realized that liberalization without consumer protection would lead to confusion among ordinary users of financial services, making the purpose of the deregulation program unclear. In Japan as well, in order to accomplish the reforms, existing laws and regulations have to be revised and the tax system needs to be reviewed, particularly as it applies to financial transactions; not only that, but the shape of the overall framework for protection of depositors and investors has to be reconsidered with a view to the enactment of a Financial Services Law. MOF is now at the center of ongoing consideration of these issues for the future.

Next, please refer to figure 9 of “outline of the Financial System Reform Plan by industry type”. Here you see a graphical representation of how the various liberalization measures of the Big Bang relate to the various industries of the financial sector. The areas where the ovals intersect show those items that affect more than one industry. We, as a life insurance company, take a basically positive view of the Big Bang. As a result of the reforms, a number of new possibilities will open up for us:

- (1) We will be able to establish holding companies.
- (2) We will be able to carry out banking and securities business, either through directly owned subsidiaries or through subsidiaries owned by holding companies.
- (3) We may be able to own companies carrying out non-financial activities, such as health care and nursing, either as directly or indirectly owned subsidiaries.
- (4) We will be able to directly sell investment trusts. As a result, we can hope to use this product to attract funds from the personal savings market, which, as I have noted, has great potential for the period to come.
- (5) There will also be advantages for us as institutional investors:
 - (a) Complete lifting of the ban on securities derivatives
Until now over-the-counter derivatives have been restricted; the lifting of this restriction will be a favorable development, since it will mean greater diversity in our hedging options.
 - (b) Promotion of liquidity with use of asset-backed securities
The availability of asset-backed securities will of course mean more options for investors; it will also benefit life insurance companies by promoting the liquidity of their assets, such as bad debts, real estate provided as collateral, and owned real estate.

(c) Deregulation of brokerage commissions for stock trading

This will mean lower transaction costs for us as investors.

(d) Review of the system of consolidated financial statements, improvement of auditing standards, etc.

Measures like these will promote the establishment of a "fair and transparent" market, and as such they will be advantageous to investors.

In addition, the reforms will establish a new range of options for cross-entry between our industry and the banking and securities industries.

(1) Cross-entry between insurance and securities will be permitted as soon as the necessary legislation is enacted.

(2) Entry from the insurance industry into the banking industry will also be permitted as soon as the necessary legislation is enacted. However, entry from the banking industry into insurance will not be permitted until 2001.

(3) Sales of insurance products by securities companies will be permitted as soon as the necessary laws are in place. Sales of insurance products by banks are to be permitted starting around the target year of 2001, but they are to be limited to products issued by the banks' own subsidiaries or sister companies, and sales will be permitted only in connection with housing loans.

As entry from the banking industry into insurance will not be permitted until 2001, you may think the conditions for banks are severe. In addition, they won't be able to sell insurance until 2001 or later, and the products they are allowed to sell will be extremely limited. In other words, the various liberalization measures of the insurance industry will lag behind that of other financial sector, banking and securities industry. There are several reasons for this. For one thing, cross-entry between life and non-life insurance was not permitted until three years later than cross-entry between the banking and securities industry. Also, unlike the other financial industries, insurance still lacks an adequate safety net for consumers.

Except for entry from other industries into insurance, all the elements of the Big Bang reforms are scheduled to be completed by 1999, just two years from now. The rapid changes are bound to have a major impact on life insurance companies. For example, the deregulation of brokerage commissions in the securities industry and the revision of the rating organization system in the non-life insurance industry are bound to increase pressure on life insurers to compete rate-cutting. In fact, some companies have already cut their rates for mail-order business

starting this September. As we see it, the changes brought about by the Big Bang will be greater than any of the changes we have experienced over the past 50 years, and we will not be able to survive in the new age with the management systems and concepts that have guided us in the past.

Figure 9: Outline of the Financial System Reform Plan by Industry Type

