OLIS 2010 Spring

Impact of Regulatory Changes on the Insurance Industry

～ Impact on Marketing

Shohei Ueda

Nippon Life Insurance Company

Profile

- 1983 Joined Nippon Life
  - 1996 Manager, Finance Planning & Management Dept
  - 1997 Manager, Finance & Investment Planning Dept
  - 2000 GM, Tokyo Office of Public & Investors Relations Dept
  - 2003 GM, Public & Investors Relations Dept
  - 2005 GM, Kumagaya Branch
  - 2008 GM, Financial Institution Relations Operations Office
  - 2009 Executive Officer, GM, Risk Management Dept
- Activity outside company
  - 1999 Member of Insurance Issue WG, Financial Council

Contents

Diversification of Japan’s insurance market

1. Rise in consumer protection

2. Strict supervisory regulations

Diversification of Japan’s Insurance Market

Deregulation of Insurance Industry

Turning point :
Revision of Insurance Business Law in 1995

Japan's Financial Big Bang

【Backgrounds】

- Revitalization after collapse of bubble economy
  ※ Life industry : Negative interest spreads!
- Trends to deregulation with three pillars
  - Free (Market where market principle functions.)
  - Fair (Transparent and fair market)
  - Global (International and advanced market)

Deregulation of Insurance Industry

New Insurance Business Law Enforced in 1996

Deregulation	◆ Product design and pricing ◆ Deregulation between financial institutions (Banks ⇔ Securities companies ⇔ Insurers)
Policyholder protection	◆ Standard policy reserves (= minimum requirement) ◆ Solvency margin standard ◆ Safety net to policyholder from insolvent insurer

Development of Deregulation

- Medical/cancer insurance (2001-)
- Products for bancassurance (2001-07)

Deregulation promoted product development, customer service, and reorganization of the industry.

Diversification of Life Insurance (1)

(1) Channel diversification to meet customers' needs.

【Formerly】

Agents

Agents

Insurance shop

Internet

Bancassurance

Increasing needs for comparison between different products before entry.

Sales of savings-type products harmonized with bank products.

Diversification of Life Insurance (2)

(2) Diversification of products

- Variable annuities with principal guarantee (Bancassurance product)

Various medical products	Sickness	Cancer, geriatric, 3 or 7 designated dread diseases
	Hospitalization	Hospitalization of over 5, 2 days or 1 day
	Outpatient	Consultation with doctor
	Others	Surgical operations (88), advanced treatment, intensive treatment, radiotherapy Products with/without cash surrender value

Environmental Changes Insurance Industry Undergoes

1. Rise in Consumer Protection

2. Strict Supervisory Regulations

1. Rise in Consumer Protection

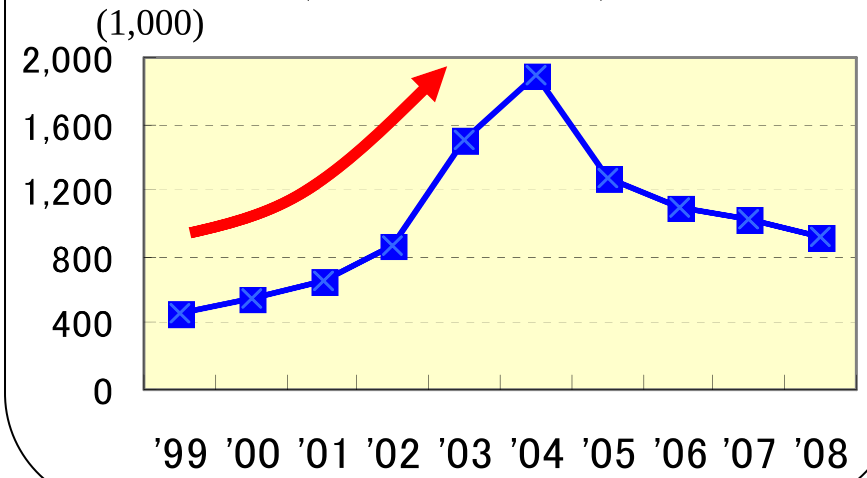
2. Strict Supervisory Regulations

Rise in Troubles with Consumers

While consumer service improved, various troubles became public concern.

- Complaints to consumer center

(All industries)



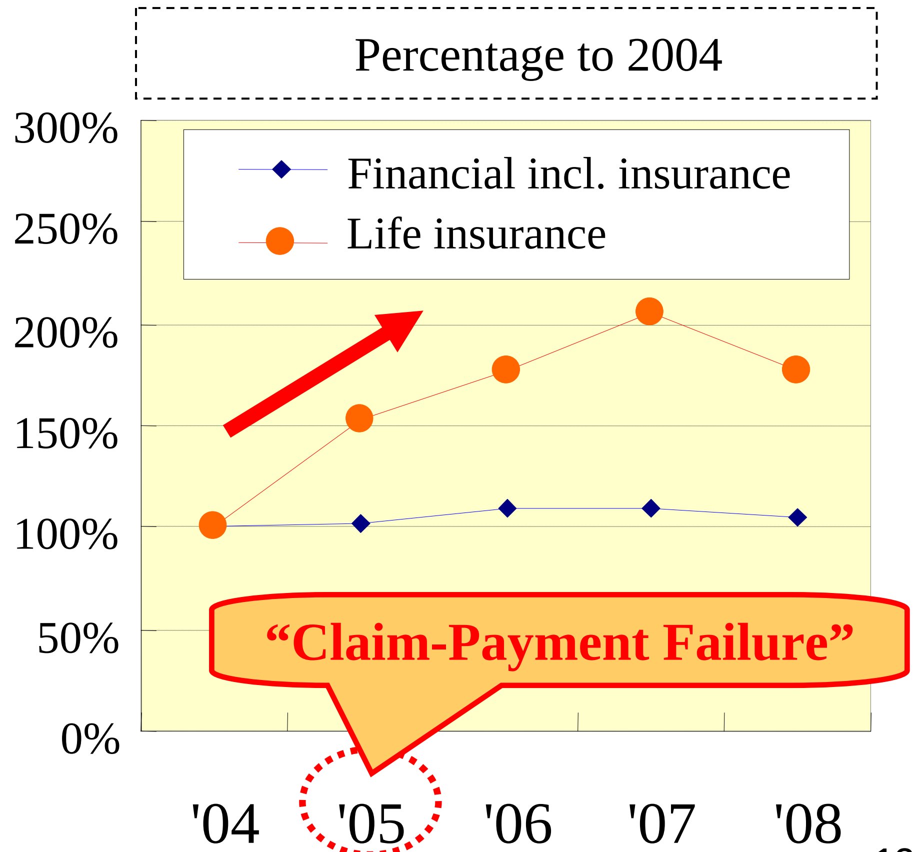
- Disgraceful affairs
  - ✓ Food poisoning
  - ✓ Fraudulent food products
  - ✓ Defective building
  - ✓ Recall concealment
  - ✓ Nuke-trouble concealment
  - ✓ Window-dressing account

Complaints about Life Insurance

Complaints in 2008

	Category	(000)
1	Telephone service	125
2	Loan	119
3	Products in general	60
4	Online service	41
5	Apartment, condominium	33
6	Consultation	16
7	Health food	16
8	Esthetic service	15
9	**Life insurance**	**13**
10	Automobile	13

Complaints about life insurance



Source: National Consumer Affairs Center of Japan

Rise in Consumer Protection

Legislation for consumer protection

2000 Law on Sales of Financial Products enacted

2000 Consumer Contract Law enacted (contracts in general)

(2005 Claim-Payment Failure)

2006 Financial Instruments and Exchange Act enacted

2008 Insurance Law revised (※Revisions after 100 years)

2009 Consumer Affairs Agency (Competent authorities) established etc.

Debacle of Life Insurance - "Claim-Payment Failure"

Claim-Payment Failure

- A large number of nonpayment cases were revealed in both life and nonlife industries mainly for medical products.

＜Particulars in the life industry＞

Feb. 2005 Nonpayment cases were found at particular company. Suspension of a part of their business.

July 2005 The FSA ordered researches to all the companies.

～ Mass media still reported researches to be insufficient. ～

Feb. 2007 The FSA again ordered researches and nonpayment was found for all the companies except a company.

July 2008 The FSA ordered improvement to worst 10 companies.

Debacle of Life Insurance - "Claim-Payment Failure"

Causes of nonpayment

(1) Complexity of product	Consumers' options expanded ･･･ ◆ Various benefits and many riders are too complex for policyholders to understand and keep in mind ◆ Difficult policy provisions (like dictionaries!)
(2) Improper sales	◆ Insufficient explanation ・ About product ⇒ Suit consumer's needs? Optimal? ・ About consumer's disadvantage ⇒ Beneficial to life company though ･･･ ◆ Insufficient aftercare ・ Explanation only at entry ⇒ To hand policy provisions is enough?

Lessons from Failure

Consumers watch the insurance industry more severely.

It requires a lot of effort and time to win consumers’ trust once lost!

The industry should straighten itself to prevent recurrence of such events, paying attention to consumers’ criticism!

Effect of Revised Insurance Law

Law pertaining to general rules of insurance contract

- Revised Apr. 2008 ⇒ Enforced Apr. 2010 **<Revision after 100 years>**
- Structure: materialization, effect, benefits, expiry

- **Provisions on sickness medical insurance were added.**
  (The law provided “Life Insurance” and “Nonlife Insurance” before 2008.)
- **Provisions for protection of policyholder, insured, and beneficiary.**

What effect on the industry?

Each company had taken countermeasures after the lesson of unpaid claims and was not affected much!

Concrete Measures for Improvement

Measure 1
Breakaway from policy-provision-oriented principle

Measure 2
Breakaway from “pay on demand” principle

Measure 3
Others

Concrete Measures for Improvement (1)

Measure 1
Breakaway from policy-provision-oriented principle

NG	**All necessary information is specified in the policy provisions! So, life companies do not confirm whether customers understood the contents of their contract.**

Policyholder's correct understanding is important!

Policyholders' signatures are required after sales representatives read out important items.

Concrete Measures for Improvement (1)

【Notes】Detailed measures

◆ **Measures on sales** (Reflected on FSA guideline)	● **Explicit statement in handouts of policy specification, material items (plus oral explanation)** ・Product design, coverage, insurance period, condition, policyholder dividends, cash surrender value, etc. ・Cooling off, representation, commencement of insurer's liabilities, exclusions, etc. ● **Confirmation of applicant's intention** ・Applicant's needs, suitability, etc.
◆ **Policy provision in plain manner** **Delivery method**	● **Clear wording instead of ". . . provided by the company" in policy provisions** ● **Use of tables or large fonts** ● **Terms in plain manner** ● **Large size of paper (A4 size)** ● **Distribution of CD-ROM (or paper if requested)**

Concrete Measures for Improvement (2)

Measure 2
Beyond "pay on demand" principle

NG	**Life companies do not pay benefits until requested.**

Any possibility of other claimable benefits should be suggested to customers.

【Example】
If hospitalization/cancer is stated in claim paper for surgical operation benefit, such possibility of other claimable benefits should be suggested.

Concrete Measures for Improvement (2)

【Notes】 Products to avoid nonpayment

【Notes】 Products to avoid nonpayment

- **Suspension of sales of products (riders) not selling well nor currently much needed**

- **Simplification of complicated medical products (Conversion without medical examination)**

Review of products liable to lead to nonpayment	**● Abolition of outpatient rider and development of alternative product (lump-sum payment at hospitalization)** **● Abolition of family-protection rider** **● Change in operation coverage to fit public medical insurance system**

Concrete Measures for Improvement (3)

Measure 3 Others

To render services truly needed by customers

- **Agents should visit policyholders once a year to explain the product again and to see if an insurance event has occurred.**
- **Agents should show proper manner and clothing to customers.**

1. Rise in Consumer Protection

2. Strict Supervisory Regulations

Impact of Strict Supervisory Regulations - Overview

Change in product

Change in regulations

(1)

Better consumer service by product diversification

Consumer protection

(2)

Measures taken

Supervisory regulations on risk diversification

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Trends to global standard of accounting and supervision

IFRS and ISRs

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Measures taken

Supervisory regulations on risk diversification

Valuation of risk is internationally studied.

(3)

Medium-term direction

Economic-value-based supervisory regulations
(Rise in risk in calculation)

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Evasion of risk

(4)
Restriction on product?
Restriction on investment?
Self-responsibility more required?

NG
Deterioration of consumer service

Current Supervisory Regulations

【Supervision = policyholders protection】

Insurance responsible for the public offers long-term coverage.
Sound operation is important for policyholder protection.

NG Aftercare is not taken

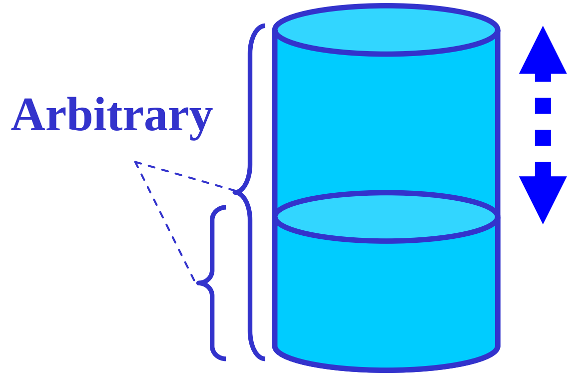
After 1996 when deregulation started, various standards for the soundness (minimum standard) were set up.

1. **Standard Policy Reserves**
2. **Solvency margin standard (Early warning measures)**

(1) Standard Policy Reserves

【Premium】

Arbitrary level!



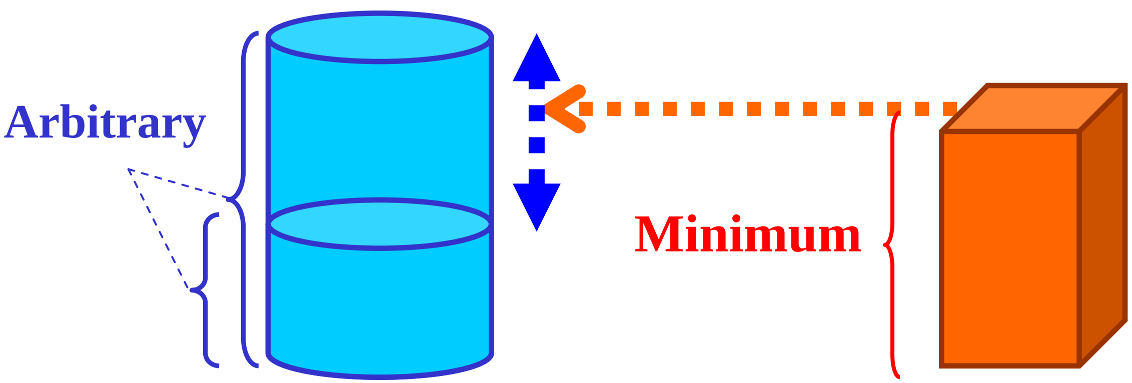
Due to deregulation life companies arbitrarily determine the level of premiums.

However, ･･･

(1) Standard Policy Reserves

【Premium】 **【Standard policy reserve】**

Arbitrary level! **Minimum reserve required by the authorities**



Fulfillment of liabilities!
and
Evasion of excessive pricing wars!

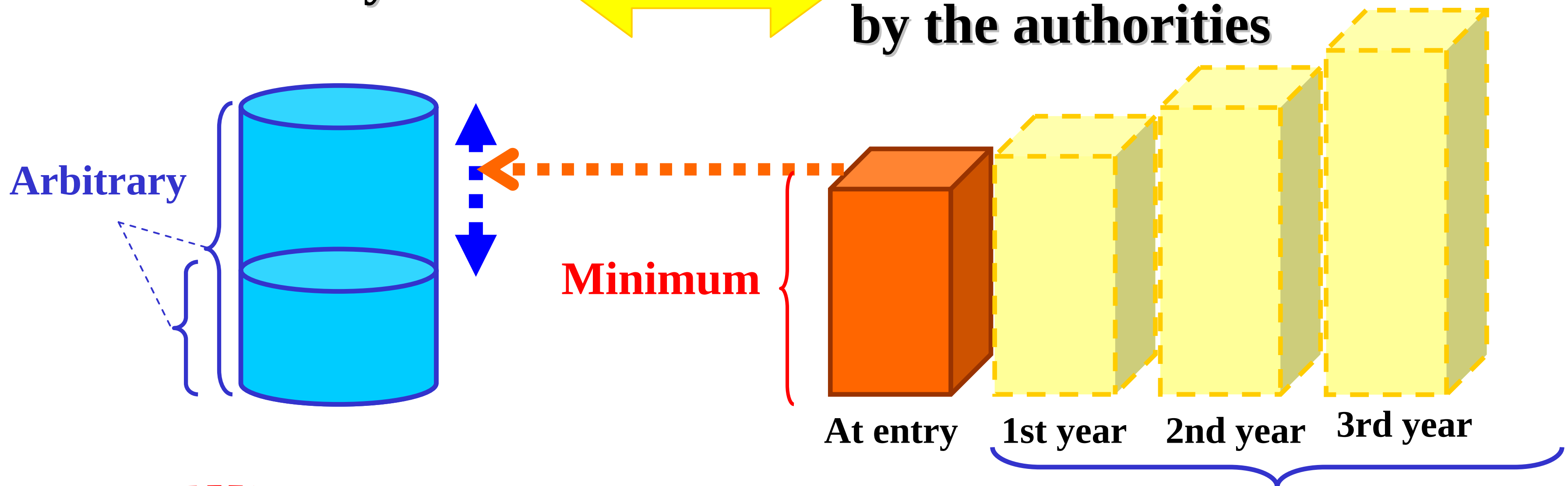
(1) Standard Policy Reserves

【Premium】

Arbitrary level!

【Standard policy reserve】

Minimum reserve required by the authorities



Amortized cost method

Actuarial assumption rates are fixed at entry (Lock in)
+
Additional reserves if deficit is highly probable

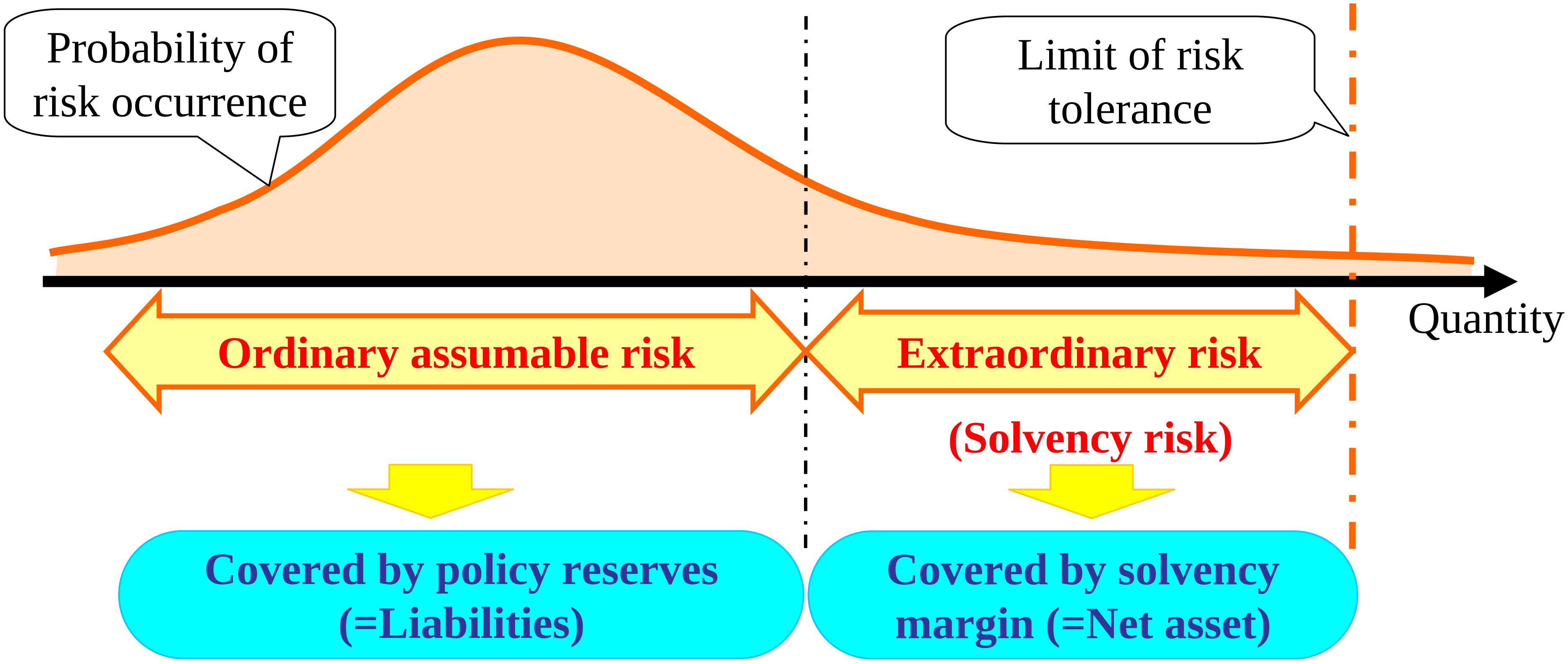
【Notes】
Balance Sheet of Life Companies

As of March 31, 2009 All the life companies

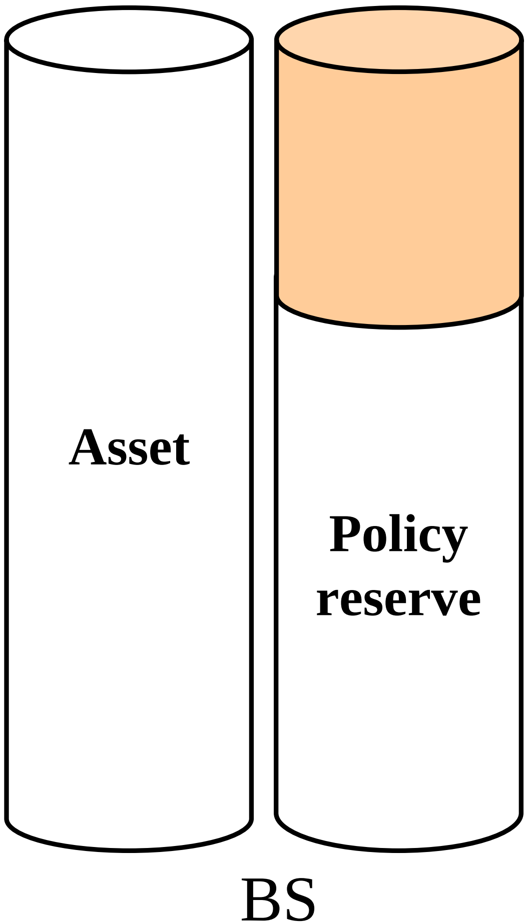
Asset		Liability	
		Policy reserves	**88.3%**
Cash and deposits	1.3%	Contingency reserves	1.5%
Call loans	1.1%	Outstanding claims	0.6%
Securities (Bonds, stock)	71.6%	Dividend reserves	1.4%
Loans	16.0%	Price fluctuation reserves	0.5%
		Net asset	
Real estate (Land, building)	3.2%	Funds/Redeemed funds	1.9%
		Surplus/Capital surplus	0.8%

(2) Solvency Margin Standard – Difference from Policy Reserves

Risks and financial resources



(2) Solvency Margin Standard



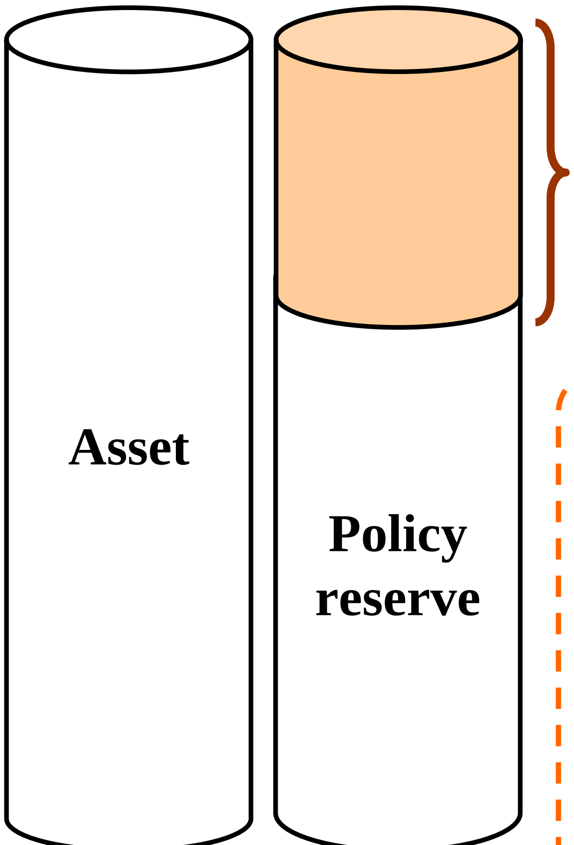
Solvency margin

- **Funds/Capital**
- **Other reserves**
- **Unrealized profit/loss**

Solvency risk
Calculated by method stipulated by the authorities

- **Funds/Capital**
  Funds, redeemed funds, capital, etc.
- **Other reserves**
  Price fluctuation reserve, contingency reserve, etc.
- **Unrealized profit/loss**
  On stock and real estate (market value fluctuates!)
  Unrealized P/L on fixed-income securities (bonds) is not included in SM!!

(2) Solvency Margin Standard



BS

Solvency margin

- **Funds/Capital**
- **Other reserves**
- **Unrealized profit/loss**

Solvency risk
Calculated by method stipulated by the authorities

Aggregation of the individual risk-based capital charges

＜Example＞
Ordinary death risk, sickness hospitalization risk, price fluctuation risk, credit risk, etc.

Calculation by factor-based method (simple!)

＜Example＞
Ordinary death risk : Sum at risk x 0.06%
Domestic stock risk : BS x 20% (2010～)

(2) Solvency Margin Standard

Early Warning Measures for financial soundness

$$\text{SM Ratio} = \frac{\text{Solvency margin}}{\text{Solvency risk}} \times 2$$

If margin = risk
200%

Ratio ≧ 200%	Non category	No action shall be taken
Ratio < 200%	Category 1	Submission and implementation of improvement plans
Ratio < 100%	Category 2	Dividend restriction Change in premiums Reduction of business
Ratio < 0%	Category 3	Suspension of part or all of business

Changes in Risk and Strict Supervisory Regulations

Successive failures of life companies with solvency margin ratio of over 200% ⇒ Review of solvency margin calculation

1999 Failure of Toho Life

⇒ **Review of solvency margin calculation**

- Exclusion of mutual stock holding between life and non-life
- Limit on inclusion of subordinated loans in SM calculation

2000 Failures of Daihyaku, Taisho, Chiyoda, Kyoei, Tokyo

⇒ **Review of solvency margin calculation**

- Change from acquisition cost to market value in risk calculation
- Inclusion of risk of government bond
- Restrictions on assets to be included in solvency margin

2008 Failure of Yamato Life

⇒ **Review of solvency margin calculation**

- Updated risk coefficients to calculate SM ratio in 2010

Changes in Risk and Strict Supervisory Regulations

New risks on variable annuities, medical products, etc.
⇒ **Inclusion in policy reserve and solvency margin calculation**

2001 Liberalization about cancer/medical insurance
～ Expansion of medical insurance market

⇨ **Revised standard policy reserve on medical product** (2007)

- Revision of mortality rates of medical insurance (survival risk)
- Stress test on morbidity/accident rates

2002 Bancassurance annuity sales started.
～ Market of VA with minimum guarantee expanded

⇨ **Stipulated standard policy reserve and solvency margin risk on minimum guarantee risk of VA** (2005)

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Deterioration of consumer service

(4)

Restriction on product?
Restriction on investment?
Self-responsibility more required?

Evasion of risk

(3)

Medium-term direction

Economic-value-based supervisory regulations
(Rise in risk in calculation)

International Trends of Accounting and Supervision

IFRS

IASB

- International Accounting Standard (Fair value)
- Insurance liabilities based on economic value

Standardized in 2011?

consist

ISRs

IAIS

- International SM (Insurance-version BIS)
- SM based on economic risk

Phased standardization

consist

consist

EU Solvency Requirements

EC

Solvency II

- Across all EU Member States
- Economic risk based (More concrete than IAIS)

Applied to EU in 2012?

International Trends of Accounting and Supervision

IFRS

IASB

- International Accounting Standard (Fair value)
- Insurance liabilities based on economic value

Standardized in 2011?

consist

ISRs

IAIS

- International SM (Insurance-version BIS)
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Phased standardization

Japan's accounting supervision

consist

consist

EU Solvency Requirements

EC

Solvency II

- Across all EU Member States
- Economic risk based (More concrete than IAIS)

Applied to EU in 2012?

Medium-Term Direction of Supervisory Regulations (Economic Valuation)

Japan is also studying economic-value-based supervision.

- **Medium-term direction – BIS deferred economic valuation**
- **Under study taking cross border discussion into consideration – Many problematic points**

(1) Liabilities based on economic value (fair value)
(2) Solvency margin/risk based on economic value

◆ Liabilities based on economic value (IASB)

⇒ Extended discussion partly because of financial crisis

US postponed application to IFRS until 2015?

◆ Solvency margin/risk based on economic value (IAIS, EU Solvency II)

⇒ Procyclicality, CEA’s objection to Solvency II

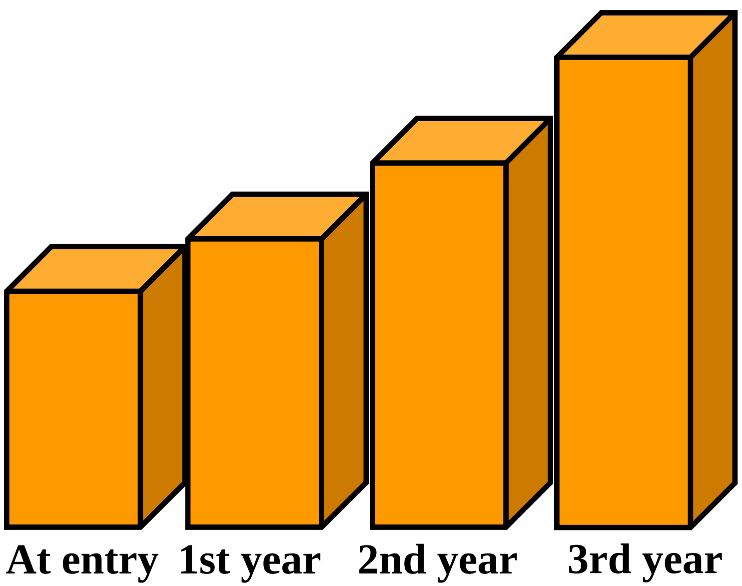
(1) Liability (Policy Reserve) Based on Economic Value

【Current : Amortized value】

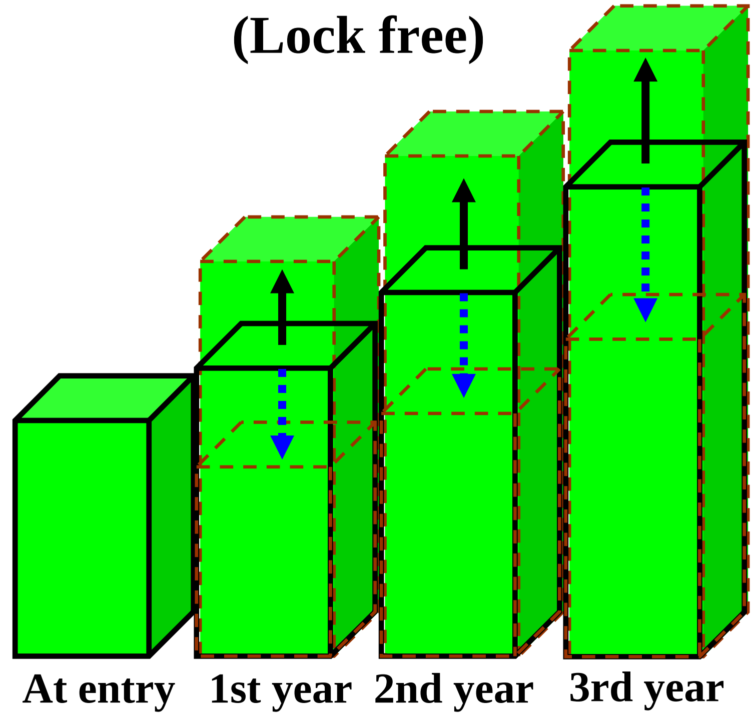
Actuarial assumption rates at entry are fixed until maturity
+ addition to deficiency
(Lock in)

【Future : Economic valuation】

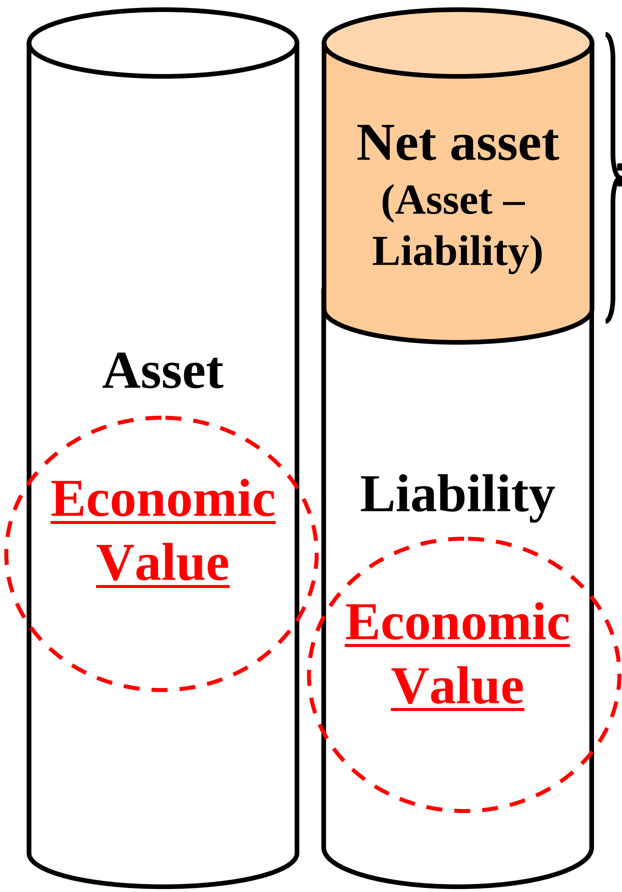
Valuation based on assumption rates consistent with market value at valuation date
(Lock free)



Under study



(2) Solvency Margin and Risk Based on Economic Value



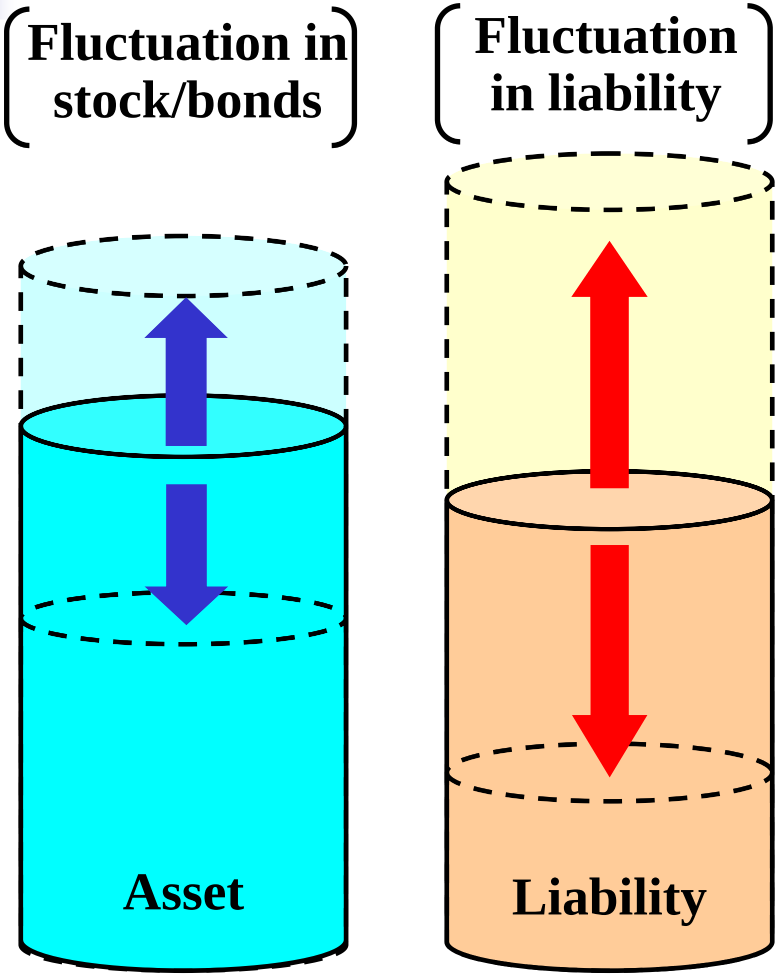
Solvency margin
(Economic Value)
Including unrealized P/L on fixed-income securities (bonds)

〉

Solvency risk
(Economic Value)
Decrease in net asset
<Ex. Once in 200 years>

$$\text{SM Ratio} = \frac{\text{Solvency margin}}{\text{Solvency risk}} \times 2$$

Features of Economic Valuation

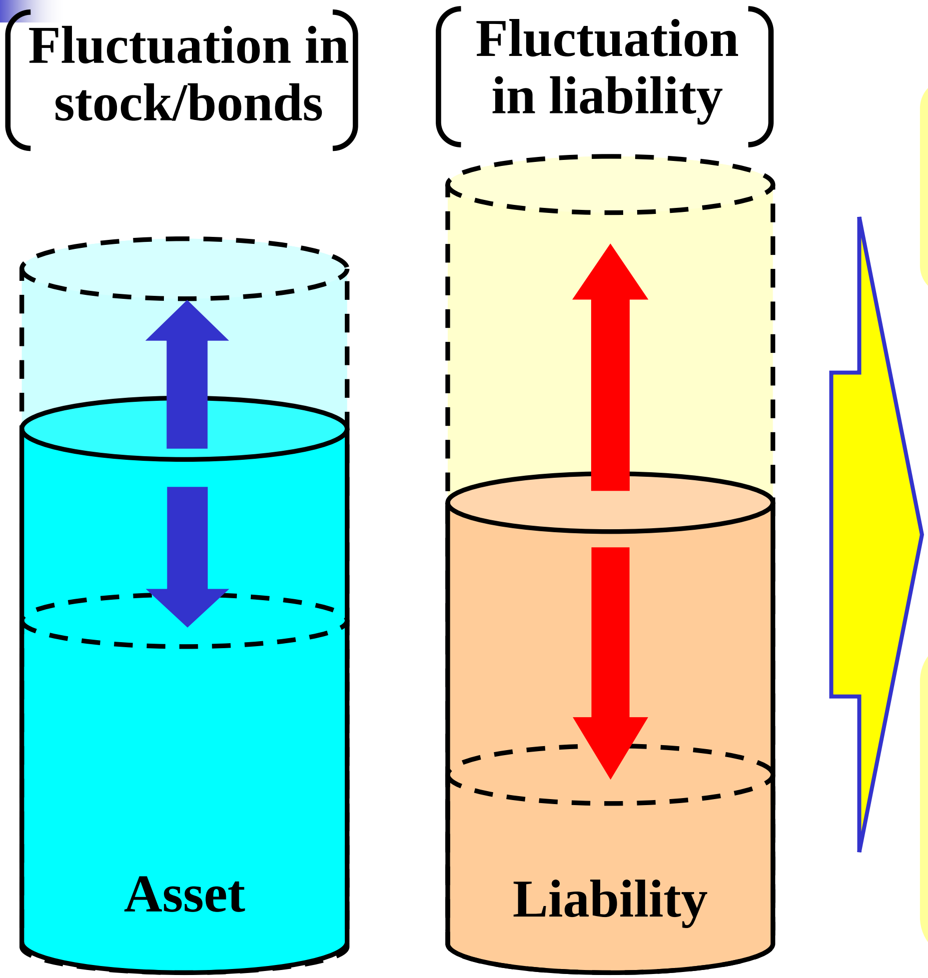


Valuation based on economic value . . .

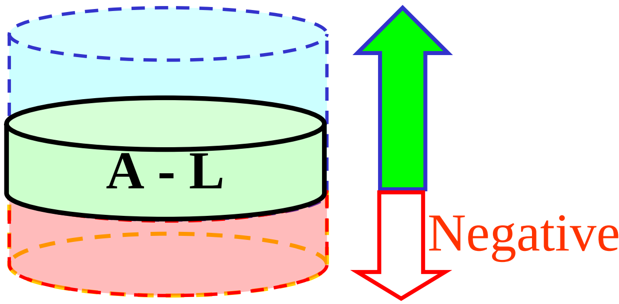
- Depends on fluctuation in market (Fair value)
- Liability on long-term insurance protection includes prospects for 20 or 30 years in the future.

Fluctuation in:
asset ＜ liability

Features of Economic Valuation



◆ Economic value-based net asset, i.e. economic value-based margin largely fluctuates!

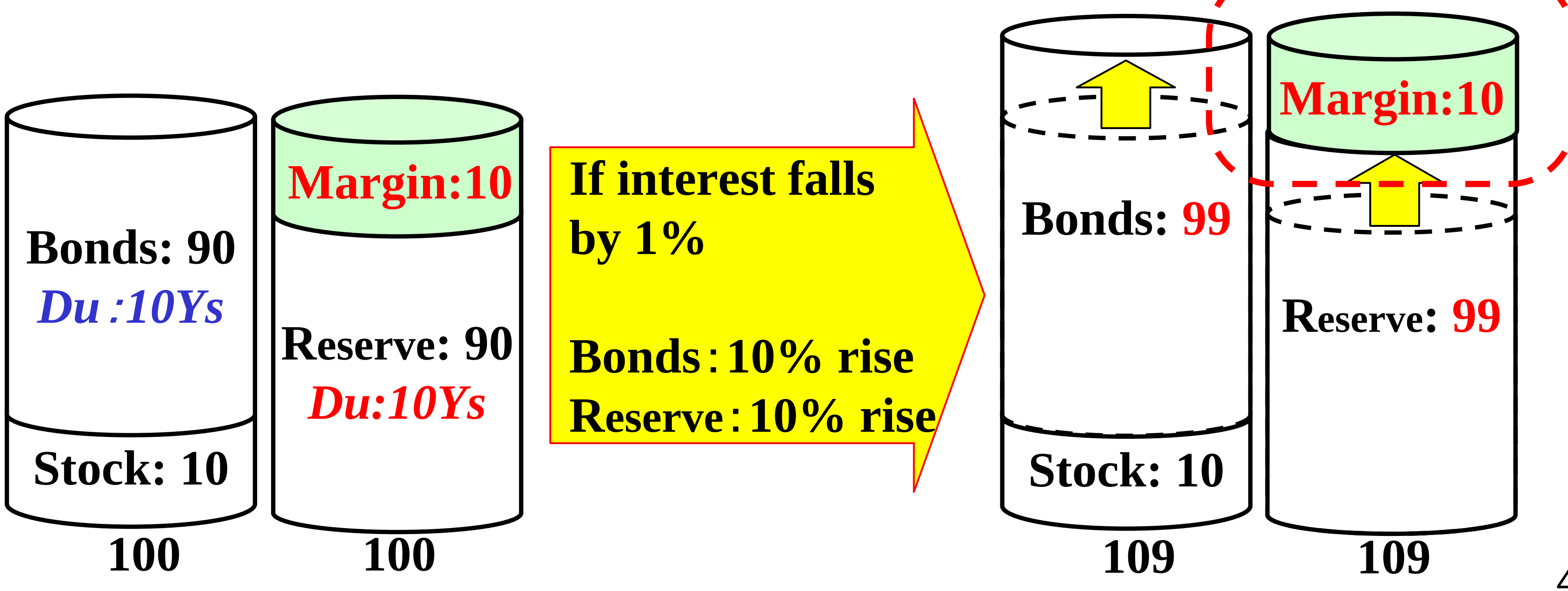


◆ If market environment at valuation date is severe, negative net asset can be calculated.

【Example】
Fluctuation in Solvency Margin by Interest

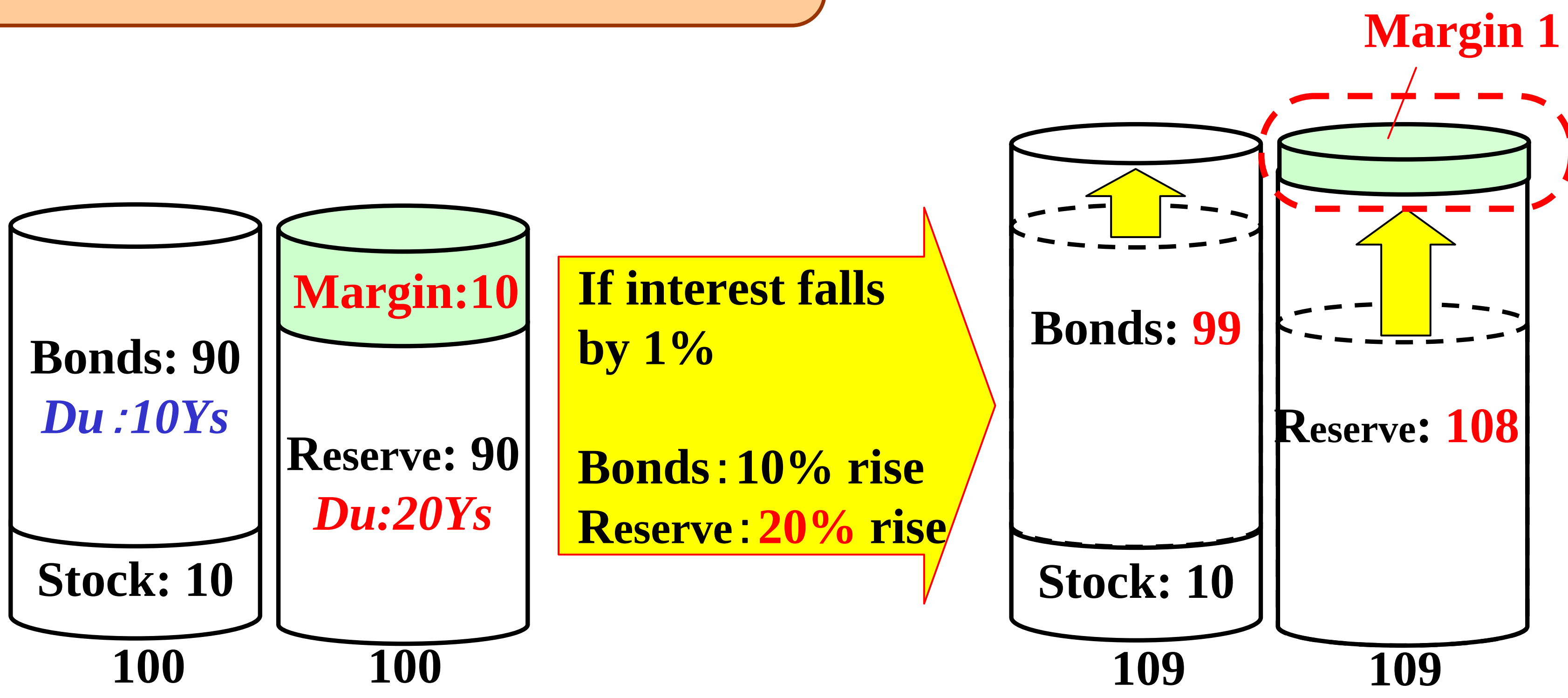
The duration of asset：10 years
= that of liability：10 years

<u>**Image of duration**</u>
- **Bonds: Period before redemption**
- **Liability: Insurance period**



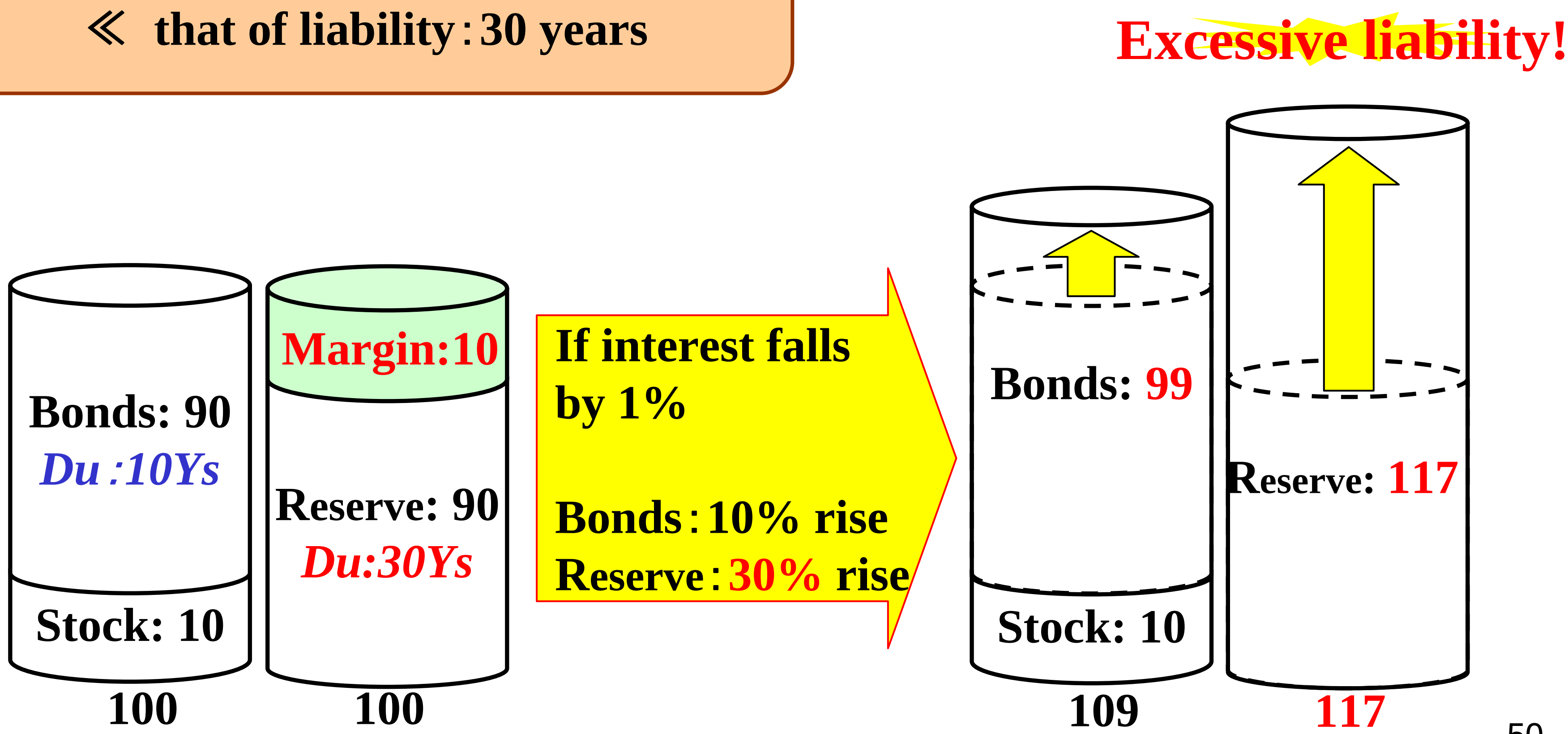
【Example】 Fluctuation in Solvency Margin by Interest

The duration of asset：10 years
＜ that of liability：20 years



【Example】
Fluctuation in Solvency Margin by Interest

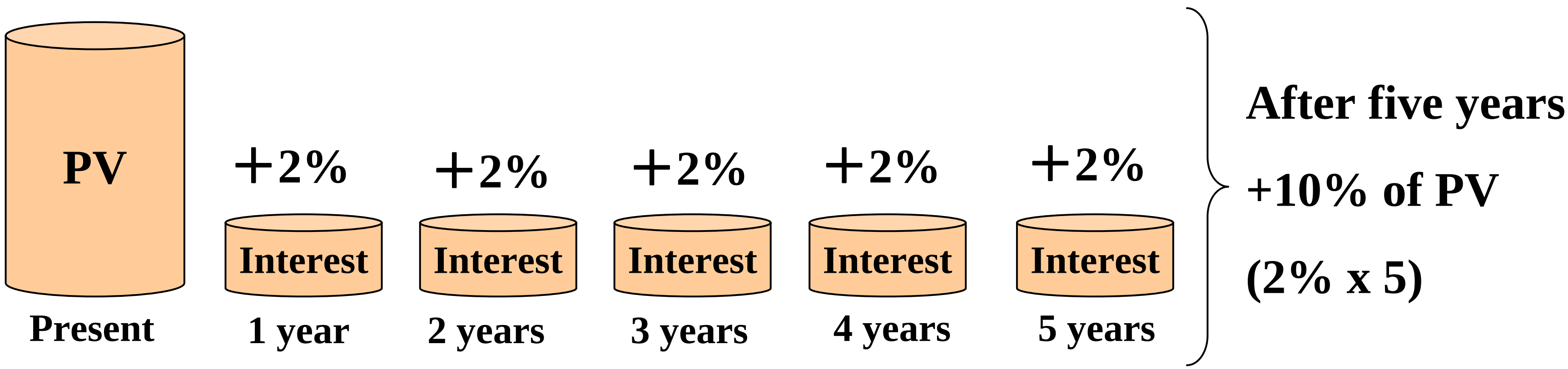
The duration of asset：10 years
≪ that of liability：30 years



#【Notes】 Why Present Value Rises If Interest Falls

Present value of debt to be repaid after five years

If interest rate (=discount rate) is 2% per year



PV will be -10% of future value after five years (2% x 5)

PV of debt to be repaid 100 after five years is 90 (-10%=2% x 5)

If interest falls to 1%, PV of the debt increases to 95 (- 5% = 1% x 5)

How to Secure Stable Margin – On Asset Side

- The duration on the asset side should be prolonged as long as possible ･･･

How to Secure Stable Margin – On Asset Side

- **The duration on the asset side should be prolonged as long as possible ･･･**

However,

- Quantity of ultra long-term bonds corresponding to ultra long-term liability is not sufficient

- If assets are fixed under the present low interest environment
  - Low profitability (⇒Negative interest spreads defer)
  - Liquidation risk of asset in unrealized loss position due to increase in surrender when interest rises (⇒Disintermediation risk)

How to Secure Stable Margin – On Liability Side

- Long duration on product with long-term guaranteed interest (ex. whole-life) on liability side – restriction on sales?
  - ✓ Shortened period of insurance?
  - ✓ Suspension of fixed insurance products?
    - ➢ Variable products
    - ➢ Fixed interest products with market value adjustment at surrender

- One of the important missions of insurance is to provide protection for uncertainty about the long-time future (ex. customer's old age)!

Customer services worsen ⇒ twisting of means and end!

Others: Issue on Excessive Risk Measure

- Solvency II in EU requires the capital charge for the risk to be occurred once in 200 years (a confidence level = 99.5%)

  <Ex. Risk on stock>

  "Stock price x 39%" empirically suggested

  ⇒ A half included in risk (※ 20% in Japan's SM)

- If authorities require higher level, as an insurer's behavior

  ・Reduction in risky assets (stock, etc.)

  ・Transfer of risk to policyholders

  Bad effect on pricing or product design!

  ✓ Trends to low-risk assets sacrificing high return

  ⇒ Lower assumed interest rate <u>raises premium</u>

  ✓ Investment on policyholder's responsibility (Variable)

Others: Issue on Procyclicality

- In a downturn, the increased likelihood of breaches of the capital requirement might lead insurers to sell stocks and bonds, exacerbating the market trend

Drop in SM due to stock price fall ⇒
⇒ SM ratio falls ⇒
⇒ (※) Reduction in risk to maintain SM ratio ⇒
⇒ Disposal of stock due to high risk ⇒
⇒ Further stock price fall ⇒
⇒ Further SM ratio falls ⇒
⇒ ※
Stock market drop-off continues ･･･

How to Cope with Economic Based Value

- **Be aware that economic valuation heavily fluctuates since prospects for far distant future are determined on environmental features at valuation date!**

  Proper explanation is required for the interested parties!

- **Use the statistical models/indices wisely depending on changing environment!**
  Don’t become a slave to your models!

Lastly

- **Cordial service from customers' standpoint is important more than ever before!**
- **Sound operations are required to secure long-term protection!**

Thank you very much.

<Note>

The opinion presented here is solely based on the authors' thoughts and would not represent the opinion by the company or the actuarial organization the authors belong to.