Life Insurers’ Bankruptcy Risks and Liquidation Procedures

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Nobuyasu Uemura

- Managing Director, Capitas Consulting Corporation
  - Based on experience analyzing and assessing insurers' management as a credit analyst and regulator for about 20 years
- As an analyst at Rating and Investment Information Inc. (R&I), covering mainly insurance industry (1997-2010)
- In FSA Japan, mainly in charge of monitoring and encouraging enterprise risk management (ERM) of insurers (2010-12)
  - Also in charge of upgrading of solvency regulations
- Received Ph.D. in 2008, study of midsize insurers' bankruptcy in Japan
  - *"The Failure without Management: Truths behind the Seiho Crisis in the Heisei Era"*

Today's Agenda

1. Bankruptcy of Midsize Life Insurers

2. Insurer Liquidation Procedures

3. Trend in Solvency Regulations for Insurance Industry in Japan

4. Q & A

1. Bankruptcy of Midsize Life Insurers

- Insurers' main business is risk-taking
  - Mortality & longevity risk, property & liability risk, health & accident risk, etc.
  - Because life insurance policies are long-term contracts in many cases, the top management priority is to fulfill the long-term coverage requirements.
    - Vulnerability to change in the financial market (interest rates, in particular)
  - Most non-life insurance policies are renewed annually, but more types of risk must be taken due to diverse coverage options
    - Including risks associated with transfer of risks taken (counterparty risk of reinsurance company, etc.)
  - Around 2000, midsize insurers failed one after another in Japan.

1. Bankruptcy of Midsize Life Insurers

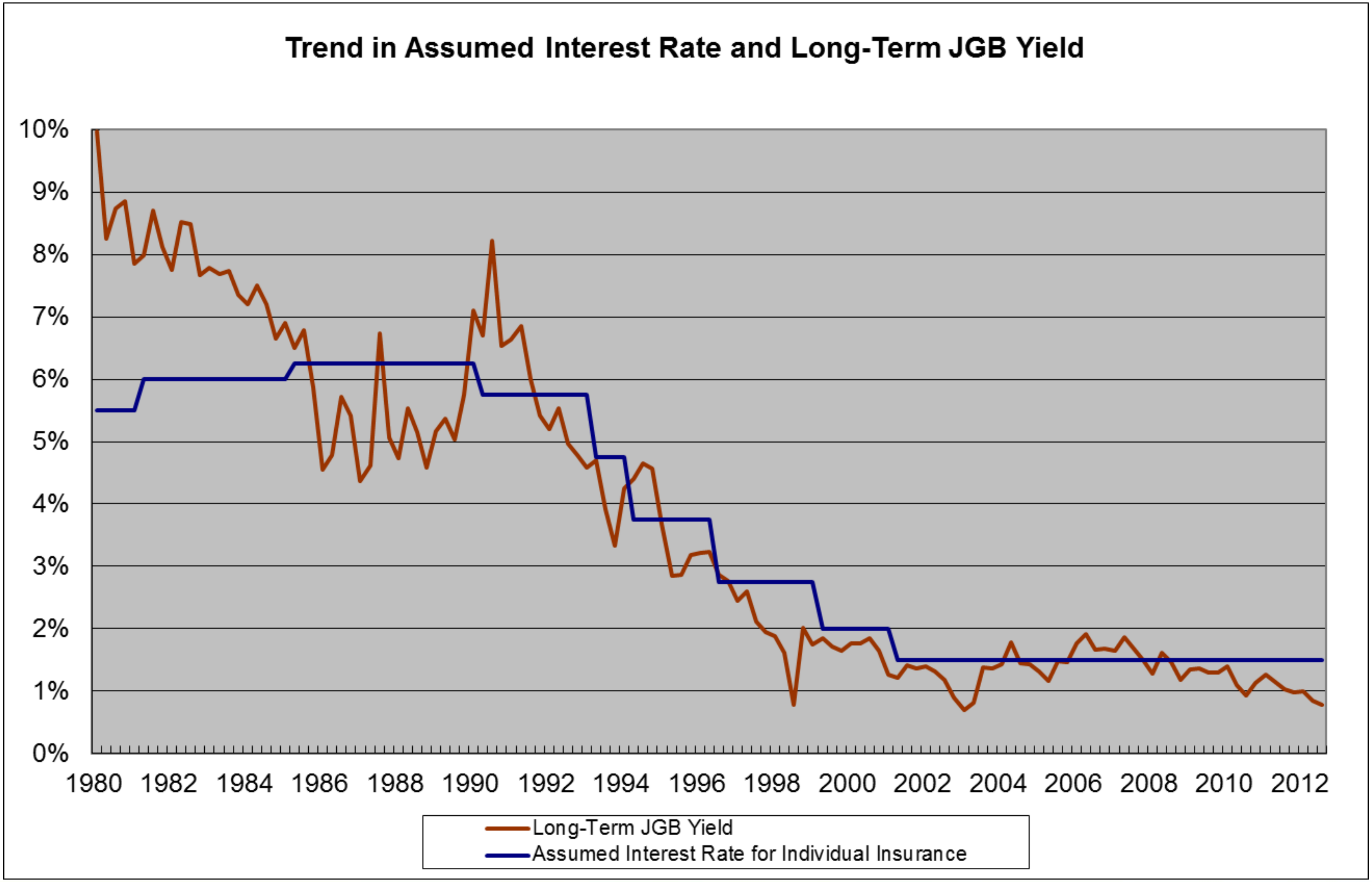
Life insurer's bankruptcy

	Nissan	Toho	Daihyaku	Taisho	Chiyoda	Kyoei	Tokyo	Yamato
period of bankruptcy	Apr-97	Jun-99	May-00	Aug-00	Oct-00	Oct-00	Mar-01	Oct-08
procedure	insurance business law				rehabilitation procedure			
negative net worth	302.9bn.	650.0bn.	317.7bn.	36.5bn.	595.0bn.	689.5bn.	731.0bn.	64.3bn.
financial help	200.0bn.	366.3bn	145.0bn.	26.7bn.	no	no	no	27.8bn.
cut of reserve	0%	10%	10%	10%	10%	8%	0%	10%+
goodwill	123.2bn.	240.0bn.	147.0bn.	7.0bn.	約320.0bn.	364.0bn.	32.5bn.	3.2bn.
guaranteed rate								
- before bankruptcy	unknown	4.79%	4.46%	4.05%	3.70%	4.00%	4.20%	3.35%
- after bankruptcy	2.75%	1.50%	1.00%	1.00%	1.50%	1.75%	2.60%	1.00%
early surrender charge	7 years	8 years	10 years	9 years	10 years	8 years	10.5 years	10 years
rehabilitation sponsor	no	GE	Manulife	Yamato life	AIG	Prudential	Taiyo & Daido	Prudential

What Caused the Failure?

- View that “failure was inevitable”
  - Impact of the burst bubble economy
    - Decline in interest rates
    - Drop in stock and land prices, etc.
  - Business environment in 1980s
    - Assumed interest rate (guaranteed rate) raised
    - Burden from dividends to policyholders
    - Supervisory attitude of authorities, etc.
  - Competition for scale expansion among midsize life insurers
- Were these the only external factors accounting for the bankruptcies?

Decline in Interest Rate



Life Insurers' Bankruptcy and Internal Factors

- Analysis of factors leading to the failure of midsize life insurance companies during the Heisei life insurance crisis, based on public information and interviews
  - Interviews with relevant individuals
    (Managers and actuaries at that time)

  => Internal factor revelations related to bankruptcy

    (1) Related to business models
    (2) Related to management team
    (3) Related to management structure

  - The chain of internal and external factors ultimately drove insurers to bankruptcy

The Case of Nissan Life

Total assets				100 million yen, %
	Nissan life		Industry	
		yoy		yoy
FY 1985	3,680	19.1%	538,706	17.8%
FY 1986	4,441	20.7%	653,172	21.2%
FY 1987	6,964	56.8%	792,684	21.4%
FY 1988	13,230	90.0%	970,828	22.5%
FY 1989	16,270	23.0%	1,173,439	20.9%
FY 1990	18,555	14.0%	1,316,188	12.2%
FY 1991	19,443	4.8%	1,432,341	8.8%
FY 1992	20,285	4.3%	1,560,111	8.9%
FY 1993	21,029	3.7%	1,691,221	8.4%
FY 1994	21,461	2.1%	1,779,655	5.2%

percentage of the individual annuity in total reserve

＜FY 1986＞		＜FY 1989＞	
Nissan	Industry	Nissan	Industry
12.3%	2.9%	55.9%	6.8%

- Rapidly expanded by sales of high-interest-rate savings-type products through “Bank Ag”, which later became a burden on the management

<Testimony>

“Actuaries warned management, but couldn’t restrain the sales division and warnings fell on deaf ears.”

“The only information reaching the president was that ‘things were all right because …”

“The nominal data was apparently good, but did not reflect the actual state of business.”

“Financial institutions took the initiative in sales and the insurer lost control.”

The Case of Chiyoda Life

- Suffered from a large number of bad loans following the burst bubble
  - Execution of large investments and loans that became nonperforming later concentrated in the 2.5 years between1988-90
    - High yields had to be secured because high-interest-rate savings-type products were being sold in great quantities

<Testimony>

"The president assigned Mr. A, who was his right-hand man with no experience in asset management, to try to earn profits in the same way as selling insurance."

"Those objecting to Mr. A were excluded from the asset management division. Because he was backed by the president, and following the unusual removal of several objectors, no one dared to speak up."

"Mr. A took charge of examination and execution of investments and loans. To reduce criticism, the number of participants in asset management meetings was gradually reduced, and later, leading to a system in which plans were directly brought only to Mr. A."

The Case of Kyoei Life

- Had been a good company with a unique business base including teachers unions, but shifted to active sales of long-term savings-type products following other insurers in mid 1980s
- Suffered from a serious negative spread problem because it continued sales after its rivals had already stopped

Total assets				100 million yen, %
	kyoei life		Industry	
		yoy		yoy
FY 1985	12,124	20.5%	538,706	17.8%
FY 1986	15,037	24.0%	653,172	21.2%
FY 1987	18,996	26.3%	792,684	21.4%
FY 1988	24,601	29.5%	970,828	22.5%
FY 1989	30,009	22.0%	1,173,439	20.9%
FY 1990	35,034	16.7%	1,316,188	12.2%
FY 1991	39,343	12.3%	1,432,341	8.8%
FY 1992	44,803	13.9%	1,560,111	8.9%
FY 1993	50,641	13.0%	1,691,221	8.4%
FY 1994	54,357	7.3%	1,779,655	5.2%

<Testimony>

"No drastic action was taken based on the judgment that the external environment would change in policy term 10 years."

"Mr. B, who is the founder of the company, had thought himself that he had already retired in 1992. But his successors depended on his judgment, despite he merely expressed his feelings."

"Only to certain members of the management knew the real business status of Kyoei."

Lessons of the Failure

- Learning from the failure of midsize life insurers

  < Governance >

  - For failed insurers, both “self-discipline”, “solvency regulation” or “market discipline” did not work properly
  - The most important internal factors are “related to managers”
    - Top executive competencies / inappropriate behavior of those around them / dysfunctional management team
  - It is important to create an organization where governance works more easily

  < Risk management system >

  - Even if perfect structures are put in place, risk control will not work as long as it is not used for top management
    - It is not true that midsize life insurers were not aware of “risk” or “risk management” at that time

2. Insurer Liquidation Procedures

- Insurer liquidation systems

  <Procedures in law>

  - Based on Insurance Business Law
  - Based on rehabilitation procedures

  <Procedures in resolution plan>

  - Decrease in the assumed interest rate of existing policies
    - Established in 2003
    - No actual application cases so far
  - "Orderly resolution" by Deposit Insurance Corporation of Japan
    - Currently under preparation
    - Applied when necessary to avoid extreme turbulence in the market

Previous Liquidation Cases (Same as previous)

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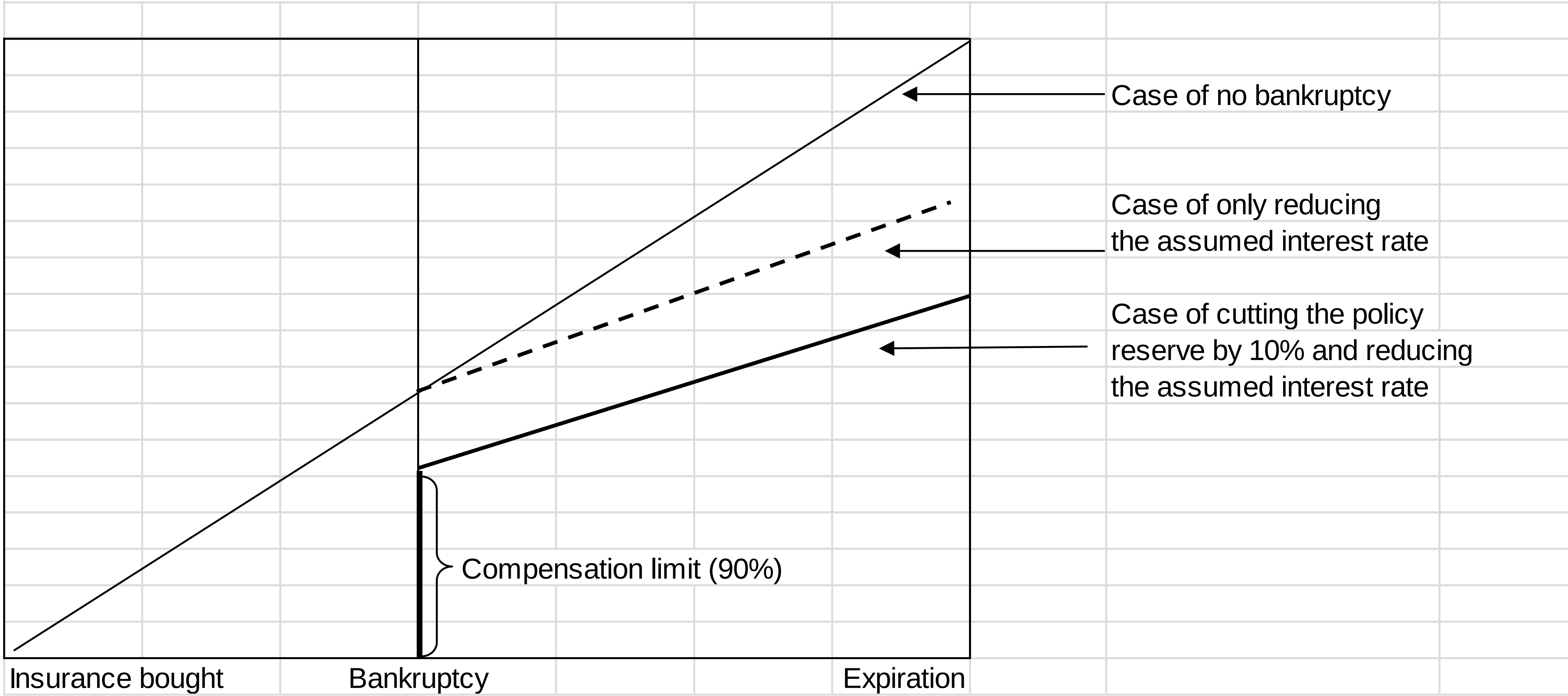
Life Insurance Policyholders Protection Corporation of Japan (PPC Japan)

- Provides prescribed compensation for insurance policies
  - Covers all insurance policies (excluding reinsurance)
  - Compensates up to 90% of the policy reserve
    - Not compensation for the insurance amount
    - Compensation may be cut for policies with a high assumed interest rate
    - In previous cases, the assumed interest rate was also reduced at the same time
  - Source of compensation is contributions from insurers
    - The government can provide support when the industry's contribution limit has been exceeded (No cases so far)
  - The PPC Japan also acts on behalf of policyholders during rehabilitation procedures
    - Resolving proposed rehabilitation plans, etc.

Life Insurers' Liquidation Concept

Image of Compensation by Life Insurance Policyholders Protection Corporation of Japan



3. Trend in Solvency Regulations

- Change from the “convoy system”
  - Until the revision of the Insurance Business Law in 1995
    - Strict regulations from authorities
    - But bankruptcy of midsize insurers could not be prevented

  - Current solvency regulations
    - Introduction and revision of solvency margin regime
    - Promotion of self-discipline
    - Enhancement of market discipline

  - Response to international prudential regulations

Solvency Margin Ratio (SMR)

$$\textbf{Solvency Margin Ratio} = \frac{\text{Margin (Capital)}}{1/2 * \text{Risk Amount}} > 200\%$$

Prompt corrective action

200% and more	No action → **Early warning system**
less than 200% and 100% or more	FSA issue a business improvement administrative order to the company.
less than 100% and 0% or more	FSA order … – Submission of plans to increase the capability of paying claims – Prohibitions of payment of dividends – Restraint on operating expenses – Prohibitions of new business etc.
Less than 0%	FSA order suspension of business

Revision of Solvency Regulations

1996 Solvency margin ratio (SMR) introduced

1999 Prompt corrective action system introduced

< 2000 Daihyaku, Taisho, Chiyoda and Kyoei Failure >

2007 Report by a “Review Team of SMR” released

< 2008 Lehman Shock, AIG’s crisis, etc.>

2010 SMR revised under the current scheme

2010 Field test conducted for introducing to introduce the economic value-based solvency regime

2012 IMF released an assessment report of FSAP Japan

- Requested Own Risk and Solvency Assessment (ORSA)

2014 Revision of Guideline for Supervision

- ORSA-related rules established

Promotion of Self-Discipline

- Development of ERM (Enterprise Risk Management) accelerated in the Japanese insurance industry
  - For sustainable and stable enhancement of corporate value while maintaining financial health under their risk appetite
    - Different from traditional “silo” risk management system
  - FSA pays attention to insurers’ ERM
    - FSA believes steady improvements in corporate value will help to protect policyholders
    - Response to international trend in supervision, such as ICP16, FSAP

  =>

    - Revised on Insurance Inspection Manual in 2011
    - Revised on Supervisory Guideline for Insurance Companies in early 2014, including the introduction of ORSA

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ERM and Traditional Risk Management

	ERM	Traditional Risk Management
Purpose of risk management	Achieving strategic goals while securing their capital	Avoiding and reducing losses
Covered risks	All types of risk (Incl. unquantifiable or potential risks)	Specified risks
Organization in charge	Not a specific division but the business as a whole (Company-wide activity involving the top executive)	Risk management division or other dedicated organization
Perception of risk	Integrated view of all risks	Recognized by risk type (silo approach)
Response to risk	Continuous activities	Response as needed

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ERM related Disclosure (T&D Holdings)

Aiming at	Integrated capital, risk and profit management based on economic value to grow corporate value stably and sustainably

Manage business by securing "capital efficiency " and increasing "capital adequacy"

Capital adequacy (financial soundness and stability)

- Keep comfortable capital level
- Appropriate risk management (control EV volatility)

+

Capital efficiency (profitability)

- Enhance ROEV
- Appropriate capital management

Stable and sustainable growth of corporate value

- Secure capital adequacy
- Enhance EV stability
- Enhance EV growth

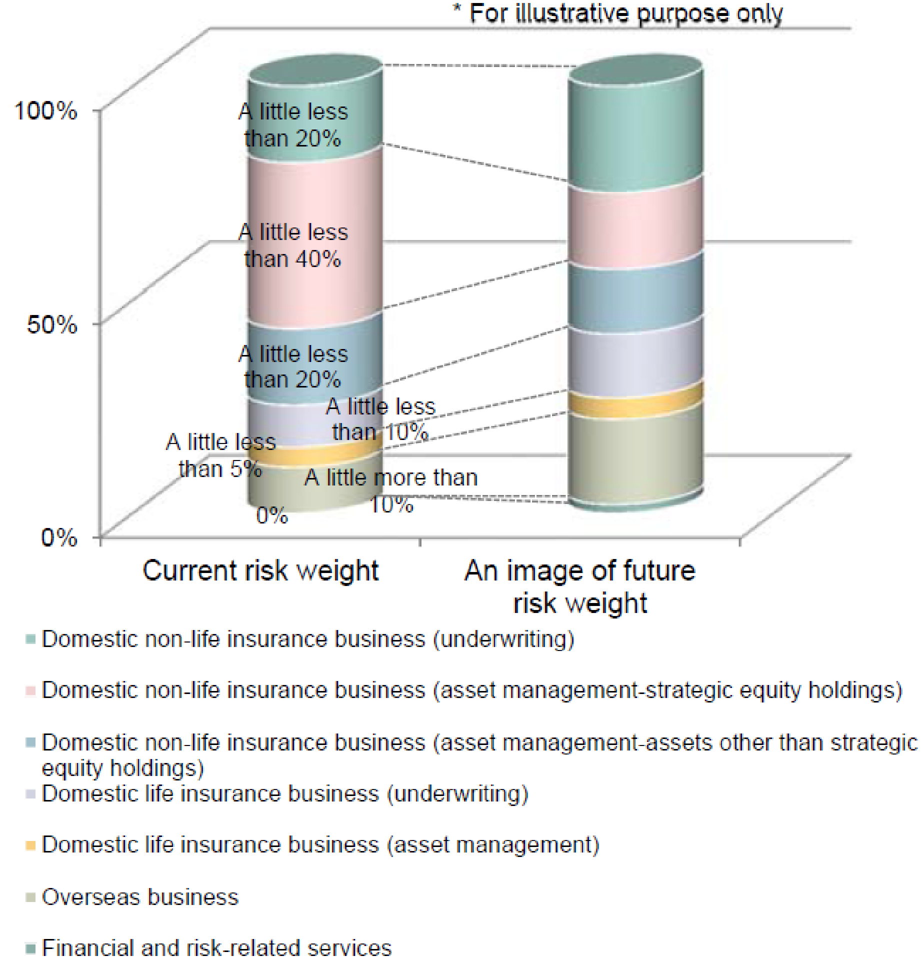
T&D Holdings, Inc. Corporate Strategy Meeting (May 24, 2013)

ERM related Disclosure (MS&AD)

Current risk weight and the direction of risk appetite

Business domain			Direction of risk appetite	
	Sub-domain		Current risk weight	Direction
Domestic non-life insurance business	Underwriting		A little less than 20%	↗
	Asset management	Strategic equity holdings	A little less than 40%	↘
		Assets other than strategic equity holdings	A little less than 20%	→
Domestic life insurance business	Underwriting		A little less than 10%	↗
	Asset management		A little less than 5%	→
Overseas business			A little more than 10%	↗
Financial and risk-related services			–	↗

Future risk portfolio



MS&AD Fiscal 2014 First Information Meeting (June 3, 2014)

Response to International Prudential Regulations

- Regulations related to G-SIFIs
  - G-SIIs also specified for insurance, following banks (G-SIBs)
    - Focuses on interconnectedness, non-traditional and non-insurance
  - Recovery and Resolution Plan (RRP) developed
  - Higher Loss Absorbency (HLA) set up

    ⇒ IAIS will develop Basic Capital Requirement (BCR) by 2014
- ComFrame
  - IAIS is developing a common framework for supervising Internationally Active Insurance Groups (IAIGs)
    - IAIGs are selected based on their size and international activities
  - IAIS will develop a global Insurance Capital Standard (ICS) by 2016
- Insurance Core Principles (ICP) update in 2011

*IAIS = International Association of Insurance Supervisors