

## *Life Insurance Company Failures and Policyholder Protection*

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On April 1 2005, after a number of postponements, Japan introduced full-fledged limits on deposit insurance coverage. In other words, in the event that financial institutions fail there is now a possibility that depositors could suffer partial losses on deposit holdings (other than those used for settling accounts) for which the principle exceeds 10 million yen.

Just why was there a need to lift the country's long-standing blanket protection of deposits? The Financial Service Agency offers the following explanation:

“Limiting deposit insurance protection will result in depositors taking a more disciplined approach to the selection of the financial institutions at which they entrust their precious money, while for their part, the financial institutions will truly get serious about strengthening their business foundations and improving earning power. Ending the blanket deposit protection is a critical step in streamlining the nation's financial system as a whole.”<sup>1</sup>

In other words, capping government deposit insurance coverage will demand that depositors subscribe to the principle of self-selection and self-responsibility in making the decisions of where they put their money. The prerequisites for this transition may be described as proper information disclosure and the move to a scrupulous system of supervision by the authorities.

However, as a case in which such steps were not carried out, and Japan's household finances suffered massive losses as a result, I cite the example of the failure of a number of major life insurance companies in the latter half of the 1990s. It was during these years that seven of Japanese life insurers, which in the 1980s had grown so influential that they were often referred to collectively by the nickname of “The Seiho” (“the life insurers”), defaulted upon their obligations and declared bankruptcy. In the cleanup that followed, policyholder benefits shrunk by as much as 70 percent, and as a result of early cancellation deductions made over the seven to ten years following changes in policy terms, surrender value was cut by as much as 20 percent.

Furthermore, under the revisions in the Insurance Business Law made in July 2003, it became mandatory to lower expected rates of interest prior to the legal failures of life insurers (business suspension orders under the said Insurance Business Law, or requests to begin rehabilitation procedures under the Special Financial Institution Rehabilitation

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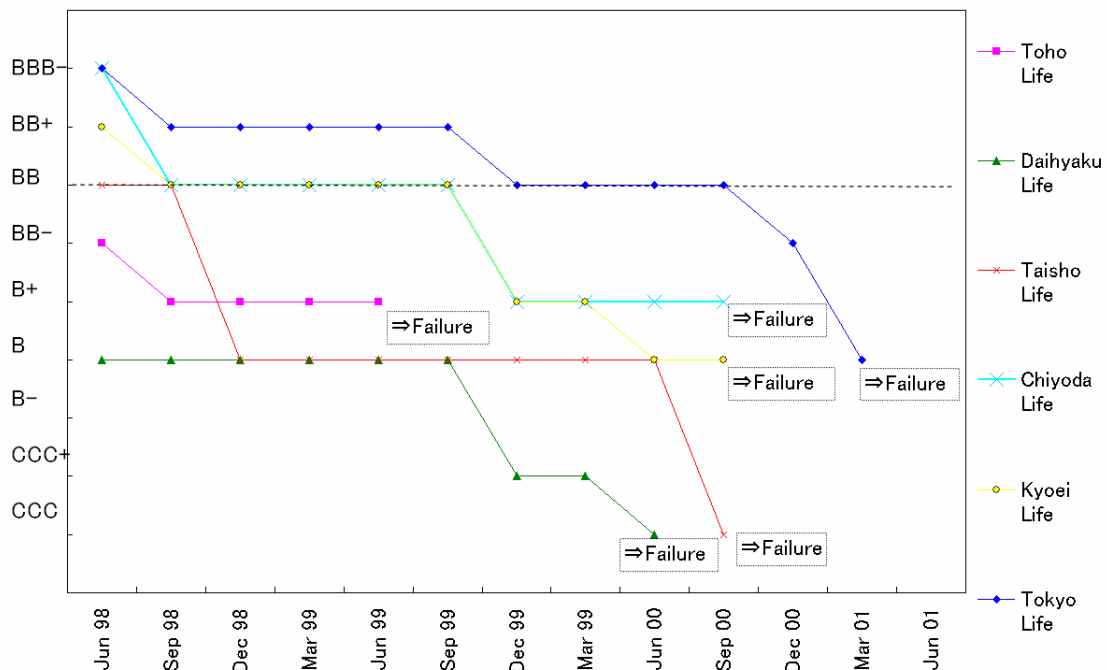
<sup>1</sup> [http://www.fsa.go.jp/qanda/ginkou/ginkou\\_c.html#06](http://www.fsa.go.jp/qanda/ginkou/ginkou_c.html#06) (in Japanese)

Law). Temporary suspension of cancellations undertaken at a time when reductions in expected interest rates are being carried out is economically tantamount to a deposit freeze. In short, as things stand now following these legal revisions, there is the possibility that both policyholder finances and companies will face default prior to the legal failure of the financial institutions in question.

In view of this, I examined the following three questions: (1) Are the policyholders (household budgets and companies) being supplied with adequate information to make proper asset selections? (2) What information should policyholders view with the greatest importance pertaining to the business soundness of life insurers? (3) In what ways do policyholders actually evaluate and select private life insurance companies?

First, the standard barometers used to judge life insurance company soundness and efficiency are mortality rates, business expense ratios and investment returns (the so-called three profit sources), with the key point here being whether or not these sources are being maintained at their original levels. However, in the latter half of the 1990s (when there was a steady stream of life insurer failures), there was no disclosure made of the individual breakdowns of these three profit sources, nor are these figures being clarified at the present time either. There is significantly large presence of asymmetric information between life insurance companies and policyholders, creating difficulties in readily comparing the merits and demerits of the insurance products or the benefit payment abilities of the life insurers on the basis of information disclosed by the individual companies. The upshot of this is that the life insurer failures of the late 1990s

*Chart: Credit Rating in Failed Life Insurance Companies*



*Note: Ratings are from by Rating and Investment Information. The “BB” rating is defined as, “Although no problems exist with fulfilling obligations at present, in the event of major shifts in the future environment there is a high probability that the impact of those changes would be felt.” (Produced from Chart 10-4 of “Asset Selection and the Japanese Economy,” Katsumi Matsuura and Sayuri Shiraiishi, Toyo Keizai, Inc., 2004.)*

came about in the absence of policyholders being supplied with information required as the basic prerequisite for self-accountability. That situation remains unchanged to this day.

Next, as an objective indicator, the quickest and most useful information for assessing the ability of life insurance companies to pay out benefits is their credit ratings. The following chart examines the ratings of the life insurers that failed. According to this data, these companies became insolvent one to two years after falling below the “BB” rating, thereby entering territory viewed as reflecting risks in the ability to make insurance payments. Other ratings examined in this study include S&P and Moody’s, which also sorted out life insurers along these same basic lines from early on (more than one year before failure).

Finally, I conducted econometric analysis into how policyholders actually evaluate and select private life insurance companies. Specifically, I used the panel analysis approach to track the impact of the life insurer prompt corrective measures and soundness indicators on policyholder judgments. Solvency margin ratios, net assets, basic profits and other indexes are generally considered to be barometers for prompt corrective measures and soundness. Under the results of my analysis, I found that the indicator causing the greatest reaction among policymakers to be the solvency margin ratio. Although it is frequently pointed out that the contents of this ratio render it inadequate as an indicator, the reason for these results would appear to lie in the fact that this ratio is disclosed by all of the companies, while there is also direct linkage between it and prompt corrective measures by the Financial Service Agency. While the state of asymmetrical information between policyholders and life insurers is extremely pronounced, policyholder selections function as a force that tends to bring discipline to the way in which life insurance companies are managed.