

From Recovery to Reform:

The Future Direction for Regional Banks and Life Insurance Companies

Summary

As bank loan margins continue to shrink and sales by life insurance companies remain sluggish, a pressing issue for the Japanese financial sector is the rebuilding of its revenue base. Small- and medium-size regional financial institutions competing with Japan Post Bank need to become more efficient by consolidating their operations. Life insurance companies can only do so much by pouring massive human resources into marketing. Instead, they need to rethink their sales channels.

Reforms at Banks and Life insurance companies Fall Short

— Regional Banks Must Hasten Efficiency to Prepare for Intensifying Competition

Business conditions for Japanese banks and life insurance companies have been recovering since 2002. In terms of profitability and financial strength, both sectors are gradually moving from recovery to a new stage at which institutions will be better positioned to seek out new business opportunities. In Japan Financial Report No. 17, we take a closer look at the issues remaining to be addressed by regional banks and life insurance companies, as well as the future course of their business reforms.

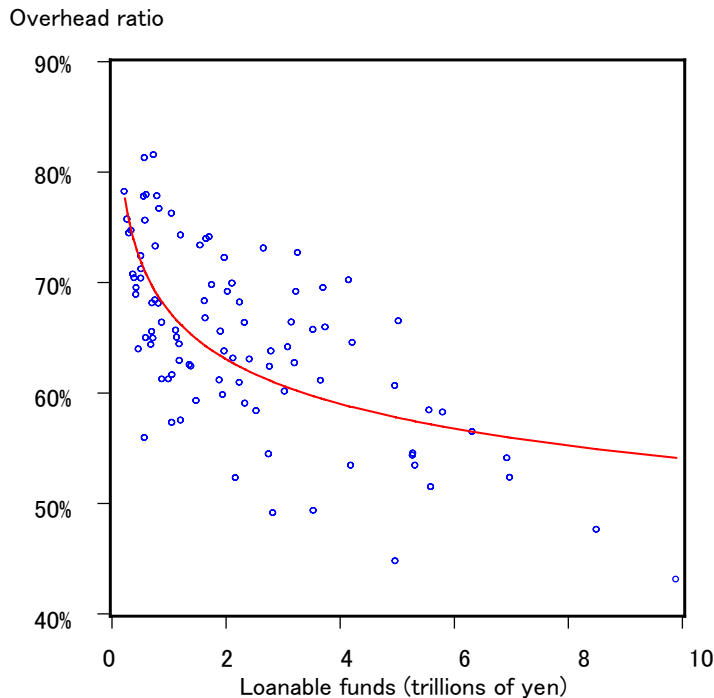
Two indicators of financial health for banks are the ratio of impaired to sound loan assets and the real capital adequacy ratio. Compared with major banks, regional Japanese banks have been slower to see improvement in these measures, which have even deteriorated for some regional banks. Two SME lending banks, ShinGinko Tokyo and Incubator Bank of Japan opened only recently, and they have been forced to charge off considerable amounts of impaired loans. ShinGinko Tokyo is in fact operating in the red, while Incubator Bank of Japan would also be if deferred income tax assets are ignored.

High Expense Ratios and Low Commission Income

One issue facing regional banks is the fact that their expense ratios, including personnel expenses, exceed those of large banks. These high expense ratios pressure the earnings of regional banks and are a factor in slowing their recovery.

Figure 1 plots regional banks' overhead ratios (operating expense to gross business profit). The greater their loanable funds (savings deposits plus time deposits

Figure 1. Loanable Funds and Overhead Ratios of Regional Banks



Note 1. Regional banks and members of Second Association of Regional Banks (excluding regional banks in Tokyo, Osaka and Nagoya, and Ashikaga Bank, being under temporary state control).
Data for the year ended March, 2007.

Note 2. Overhead ratio(OHR): operating expense / gross business profit.

Note 3. Loanable funds: deposits + CDs + bonds.

Note 4. Approximation line is given by the OLS estimation of
 $\ln(\text{OHR}) = \alpha + \beta \ln(\text{Loanable funds}) + \text{error}$

Source: JCER

plus bonds), the lower are their overhead ratios, and this correlation is especially pronounced for banks with loanable funds of up to about ¥2 trillion. If small regional banks in particular rationalize their operations by increasing their size through business integration among themselves, their overhead ratios would drop sharply, enabling them to increase their financial efficiency.

Expectations are that the newly privatized (and very huge size) Japan Post Bank will enter the lending business in the future, meaning that enhancing financial efficiency is a pressing issue for regional banks. Mergers are not the only option to greater size. Banks may also integrate under a holding company, leaving their

individual brands intact. Institutions could also cut costs by integrating their IT systems. In this way, tie-ups could assume a diversity of forms. In any event, forms of business which envision regional linkages transcending the city or prefectural framework need to be considered.

The second issue for regional banks is the fact that they have not sufficiently pursued commission business as a source of income independent of lending income. As margins on loans continue to shrink, city banks have made commission income a major source of earnings through various means, including sales of investment trusts. In this way, they have raised the ratio of their net fee and commission income to gross profit to as high as 16%. The same ratio for regional banks is 8%, while the ratio for members of the Second Association of Regional Banks is at 4%, margins more appropriate for non-core operations.

Bank margins may narrow further owing to factors such as intensifying competition among lenders in recent years and rising interest rates on deposits in the wake of the Bank of Japan's abandonment of the zero-interest rate policy. One could therefore say that securing broader sources of income, including commission income, could also be one strategy for regional banks to raise their earnings in a stable manner.

Regional banks will quickly lose the trust of customers in their regions and thereby harm themselves severely unless they fully explain their financial products and provide consulting services which take customer needs into consideration. This spirit needs to be reflected in the management organization by making bank employees thoroughly aware of the importance of such matters as consumer protection, the obligation of full explanation and compliance.

Risk Tolerance Assessment also Falls Short

Rising stock prices, declining bond yields and other factors have led to an improvement in the unrealized securities positions of life insurance companies, which helped them further improve their financial standing in the year ended March, 2007. Solvency margins (their capacity to pay) for life insurance companies, which measure their financial viability, now stand at between the 800%—1,300% levels for the nine major firms, or between four- to just under seven-fold above the 200% level seen as the minimum for financial viability, meaning that their capital positions are sound.

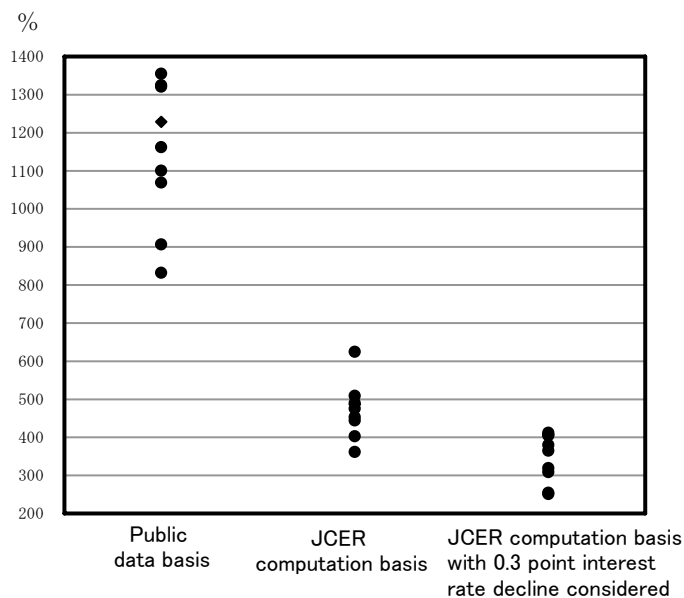
However, many questions surround the figures publicly released by these firms. As a result, our analysis in the past has been based on our own independently

computed “adjusted solvency margin,” which gauges these standards more stringently. In addition to considering capital quality, our standard has taken much greater account of potential volatility in equity prices. However, since our original criteria did not fully account for interest rate risk, it left a major issue unaccounted for.

Life insurance companies hold very long-term liabilities at fixed interest rates. On the other side of their balance sheets, however, they do not hold corresponding long-term assets, exposing them to widening negative margins when market rates fall. Long-term interest rates are now still low, and there is little chance that rates will fall significantly in the future. However, there is a risk that long-term interest rates could once again fall if economies abroad deteriorate or if a stronger yen or other factors lead to renewed deflation.

Using data on the term structure of life insurance companies’ liabilities, we have sought to gauge their interest rate risk by constructing a newly revised solvency margin which takes account of interest rate volatility. Setting the downward interest rate risk for one year at 0.3 percentage point, and estimating life insurance companies’ interest rate risk from the structure of their total assets and liabilities under a set of fixed assumptions, and factoring this into the risk value of the solvency margin, we find that the margin for each company is between 20% and 40% lower compared to our original estimate, meaning that interest rate risk has a significant impact on their finances (Figure 2).

Figure 2. The Distribution of Solvency Margins



Note. Nine major life insurers (Nissay, Dai-Ichi, Meiji Yasuda, Sumitomo, Mitsui, Taiyo, Daido, Asahi and Fukoku).

Source: JCER

Even if we take interest rate risk into consideration, the solvency ratios for the nine major life insurance companies at 250%—420% exceed 200%, which shows them to be in sound condition. However, the ratios fall sharply when insurers' publicly released data are not used, so it is clear that computation methods for solvency ratios based on insurers' publicly released figures are severely inadequate for assessing the risk tolerance of life insurance companies.

Differences in Sales Channels

A look at the core, insurance-policy operations of life insurance companies shows the followings: While cancellation rates have fallen, death insurance policies have declined while non-life/casualty insurance policies have leveled off, meaning that insurance policy operations have been sluggish overall. Although sales of private pension plans through banks had been increasing over the years, such sales slowed in the year ended March 2007.

Life insurance companies are adopting a business strategy of developing attractive products and improving their sales channels in a bid to develop new business in an otherwise saturated market. Traditional life insurance companies are groping for ways to find their own development strategy in an effort to beat back competition from foreign insurers and life insurance subsidiaries of casualty insurers. In this way, they are breaking from the habit of imitating each other. However, as seen in the recent series incidents in which insurers have withheld payouts to policyholders, the life insurance industry overall has paid so much attention to expanding earnings that it has neglected the protection of policyholders. Companies are taking measures to prevent recurrences, but as the general picture emerges, both regulatory authorities and the industry will need to take thoroughgoing improvement measures after the facts are made clear.

Sales channels are the source of new policies, and insurance companies are shifting their sales channels from sole reliance on sales-staff channels in the direction of using agents and banks as sales outlets (Table 1). Given the problems involved in frequent hirings and retirements as well, sales-staff channels involve high costs, and traditional life insurance companies have been offsetting these costs partly through their security-related insurance product operations.

Table 1. Changes in Private-sector Insurance Subscription Channels

	1994	2006	
			Change
Life insurer salespersons	88.0%	66.3%	-21.7pt
Home visit	53.9%	51.0%	-2.9pt
Workplace visit	30.2%	15.3%	-14.9pt
Direct marketing	0.7%	9.1%	8.4pt
Via Internet	-	1.8%	-
Via TV, newspapers, magazines etc.	-	7.3%	-
Over the counter of life insurance companies	1.5%	2.1%	0.6pt
Via banks and securities firms	1.9%	3.3%	1.4pt
Via insurance agencies	2.9%	7.0%	4.1pt
Other/unknown	4.8%	12.2%	7.4pt

Note: Sample number: 4,088.

Source: Japan Institute of Life Insurance, "National survey on life insurance for FY2006" (*Seimei hoken ni kan suru zenkoku jittai chosa*).

Differences in the cost of sales channels affect the types and price ranges of the mainstay products handled by insurance companies, as well as their efficiency and profitability. After obtaining policy descriptions from a number of life insurance companies, we have made a comparison of premiums on simple term insurance policies having approximately the same conditions (Table 2).

Table 2. Premiums on Individual Fixed Term Insurance Policies

Policy terms: 30 year-old male, ten-year term, insured value of 30 million yen, monthly payments through bank transfer. (Yen)

	A Co.	B Co.	C Co.		D Co.		E Co.
				Health discount		Health discount	
Annual premium	79,265	81,117	74,520	37,440	60,840	57,240	71,640

Note1: C Co. requires nonsmoking for policies receiving health discount.

Note 2: As Companies A and B offer participating policies, dividends were estimated from the most recent dividend rates on comparable product dividend examples as disclosed by both companies and then were subtracted from annual premiums.

Sources: Policy descriptions and disclosure materials of each insurer.

Policy premiums for traditional life insurance companies A and B, which rely mainly on sales staff, are up to about 30% higher than those of life insurance companies C and D, which are foreign companies relying mainly on agents and mail

order sales. If customers take advantage of the discounts for good health (available when a health examination shows a policyholder to be in good health) and for nonsmoking policyholders available from companies C and D, differences in insurance premium rates are greater still, even as large as two-fold. It is believed that these large differences in insurance premiums reflect the cost structure of the companies' respective sales channels. Customers can easily compare policies when buying through outlets such as agents handling policies of a number of insurers, so customer convenience is enhanced.

It will be difficult for traditional life insurance companies to maintain this high-cost structure given the diversification of sales channels and changes in customer needs. In light of intensifying competition from foreign insurers and casualty insurance subsidiaries marketing life insurance, it will be more important than ever for life insurance companies to choose and rebuild their sales channels strategically. Sales channels also play an important role for policyholders as the outlets through which they choose among insurance policies. Along with enhancing customer convenience, it will be important for companies to rebuild sales channels which stress customer protection efforts, including the obligation to fully explain policy terms.

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