

# Regulatory Administration of Life Insurers

## 1. Introduction

Mark-to-market accounting has been introduced from fiscal 2000. At the same time, the Financial Services Agency (FSA) has begun to enforce stricter standards of the solvency margin ratio. Furthermore, with the March, 2001 failure of Tokyo Life Insurance Co., the number of life insurance companies to fail during 1990's has grown to seven. Stock prices were dealt a great blow after the terrorist attacks in the US in September. They have brought on fears that the US economy will falter, and they will probably continue to be unstable. How have the life insurers changed in response to this very severe business environment? And how has the regulatory administration of life insurers adapted?

In the analysis in this report, we look into the administration of life insurance companies -- their finances, their solvency margin standards, how the past failed life insurers have been dealt with, and the methods in that they have reorganized from mutual to stock companies.

## 2. Financial situation of life insurers

### 2.1 Assets

The condition of the assets as the 10 major life insurers, reported in their fiscal 2000 financial statements, is shown in Table 1. Looking at the average over the ten lifers, 62.4% of their investment assets are in fixed return assets such as bank deposits, public and corporate bonds and loans. Their fixed return assets are high since we see that a large portion of their liabilities are in policy reserves -- funds accumulated over the long-term to pay future insurance claims. It is only natural that their asset profile will be composed of such items that provide the steady, long-term income.

Although some of the life insurers have reduced their holdings of public and corporate bonds due to the risk of interest rates rising, most of them are increasing their investment assets in order to secure stable income. As a result, their share has increased 2.8 percentage points over fiscal 1999. On the other hand, loans have declined by 1.4 percentage points due to such factors as lower demand for funds and the sale of bad loans.

There are restrictions on investments under the Insurance Business Law regarding investments into assets subject to price fluctuations. Of these assets that face these restrictions, domestic stocks have fallen 3.3 percentage points to 17.2%, and real estate has decline by 0.3 percentage points to 5.0%. Stocks, in particular, at the end of fiscal 2000, the Nikkei Average fell along with the US stock markets. It fell 36.1% from the beginning of the fiscal year and fell to 12,999.70 yen, resulting in a very severe investment environment, and for all ten life insurers, the share of stocks declined.

### 2.2 Liabilities

Since death claims of life insurance policies will increase as the ages of the insured rise. Disbursements of claims will be less than the premiums earned in the first half of the insured period, while in the latter half of the insured period, the payouts will be more. To prepare for the payout of these obligations in the future, life insurers must put funds into policy reserves at the closing of their books every year.

Insurance premiums affect the insurers ability to contribute to these reserves. These premiums are calculated based on 1) expected death rates 2) assumed guarantee rates of return on their investments and 3) expected business expenses. Of these three factors, the expected return on investments was only around 3-4% in fiscal 2000, falling about 0.3 percentage points over fiscal 1999. Currently, life insurance companies are facing a “negative spread” situation in which, they cannot secure their planned interest, i.e., the payouts they have guaranteed their policyholders with the returns on their investments, and this is putting pressure on their profits.

Table 3-1. Share of Asset Types in Total Assets  
(as at end of fiscal 2000, on a market value basis)

	Cash and Deposits	Money in trust	Bonds	Stocks	Foreign currency bonds	Foreign currency stocks	Other Securities	Loans	Real estate	Others	Total	Fixed return assets	Foreign currency assets
Nippon	2.8% (0.7)	1.4% (0.2)	26.1% (0.9)	21.6% (-3.9)	6.3% (-0.0)	3.9% (0.1)	1.5% (1.2)	30.4% (-1.3)	4.6% (-0.5)	1.4% (2.6)	100.0%	59.3% (0.3)	8.9% (-0.8)
Dai-ichi	5.8% (-0.4)	0.4% (0.1)	31.3% (2.3)	18.8% (-3.7)	8.4% (1.3)	1.1% (-0.4)	0.3% (-1.1)	22.7% (-2.2)	5.0% (-0.7)	6.2% (4.8)	100.0%	59.8% (-0.3)	7.6% (0.5)
Sumitomo	1.4% (-1.7)	0.3% (-0.6)	30.2% (5.3)	14.3% (-2.8)	7.8% (-0.8)	3.4% (0.4)	1.6% (-2.7)	28.1% (-1.5)	5.2% (0.0)	7.8% (4.3)	100.0%	59.7% (2.2)	0.9% (-2.8)
Meiji	7.0% (2.7)	0.3% (-0.3)	26.9% (1.4)	20.3% (-2.7)	2.8% (0.1)	2.7% (0.1)	0.2% (0.1)	33.2% (-2.1)	5.9% (0.1)	0.9% (0.7)	100.0%	67.0% (2.0)	4.8% (0.4)
Asahi	4.0% (-2.2)	1.3% (-1.4)	26.0% (5.2)	15.4% (-3.7)	6.1% (0.7)	4.5% (3.0)	0.5% (-0.9)	32.5% (-2.6)	7.3% (-0.2)	2.5% (2.1)	100.0%	62.4% (0.4)	6.0% (0.2)
Yasuda	5.2% (1.5)	5.3% (-1.4)	19.9% (-0.3)	13.5% (-3.1)	8.3% (1.1)	3.1% (-0.7)	0.9% (-0.1)	36.7% (1.8)	4.3% (-0.3)	2.7% (1.6)	100.0%	61.8% (2.9)	8.4% (0.1)
Mitsui	6.8% (-8.4)	0.3% (-0.1)	26.0% (7.1)	15.0% (-3.7)	10.6% (2.9)	3.6% (1.5)	0.8% (-0.2)	30.0% (-0.3)	4.5% (-0.1)	2.5% (1.3)	100.0%	62.8% (-1.7)	11.8% (2.7)
Taiyo	3.8% (0.1)	1.2% (-0.0)	37.5% (4.0)	10.2% (-2.0)	4.2% (-3.0)	2.1% (-0.7)	1.5% (-0.3)	33.7% (-0.7)	2.9% (-0.2)	3.0% (2.8)	100.0%	75.0% (3.4)	3.7% (-3.6)
Daido	7.8% (3.4)	4.3% (-1.3)	46.9% (0.9)	6.7% (-1.9)	5.3% (-1.6)	3.1% (0.7)	1.9% (-0.4)	19.7% (-0.3)	3.1% (-0.5)	1.4% (1.0)	100.0%	74.3% (4.0)	7.1% (-2.0)
Fukoku	3.2% (-6.8)	4.0% (-0.6)	36.7% (7.0)	12.2% (-1.2)	4.0% (-0.5)	0.9% (0.1)	0.2% (0.0)	30.4% (-0.4)	5.5% (-0.1)	2.8% (2.4)	100.0%	70.3% (-0.1)	3.1% (-0.2)
Average	4.3% (-0.5)	1.3% (-0.3)	28.9% (2.8)	17.2% (-3.3)	6.7% (0.2)	3.0% (0.3)	1.0% (-0.4)	29.2% (-1.4)	5.0% (-0.3)	3.5% (2.8)	100.0%	62.4% (0.9)	6.5% (-0.5)

Notes:

Figures in parentheses show the percentage point change in their share of total assets based on fiscal 1999 market values.

In the “Other” category are Monetary Claims Purchased, Trading Securities, Deferred Tax Assets and Loan Loss Reserves.

Regarding foreign-currency denominated assets, some shares cited from General Account Assets of their disclosure materials.

Source: Each company’s disclosure materials. (this will be the same for other tables)

### **2.3 Equity**

Such owner's equity items as funds and subordinated debts, and subordinated debenture are mainly contributed by financial institutions. The relationship between life insurers and banks in their equity -- At the end of fiscal 2000, banks have contributed a total 2.1 trillion yen of the funds and subordinated loans of the ten major life insurers. At the same time, the same major ten lifers own about 5.4 trillion yen of bank shares on a market value basis, and the contributed about 5.1 trillion yen of subordinated loans and subordinated debentures. Compared to fiscal 1999, the ten lifers have augmented their capital base by 220.2 billion yen in funds and 88.7 billion yen in subordinated debt. Furthermore, Nippon Life has used an SPC (Special Purpose Company) to solicit 180 billion yen in funds.

At the same time, the bank shares held by the life insurers fell by 2 trillion yen over fiscal 1999, but this is largely due to the decline in the stock prices, and there is no apparent change in the number of shares held.

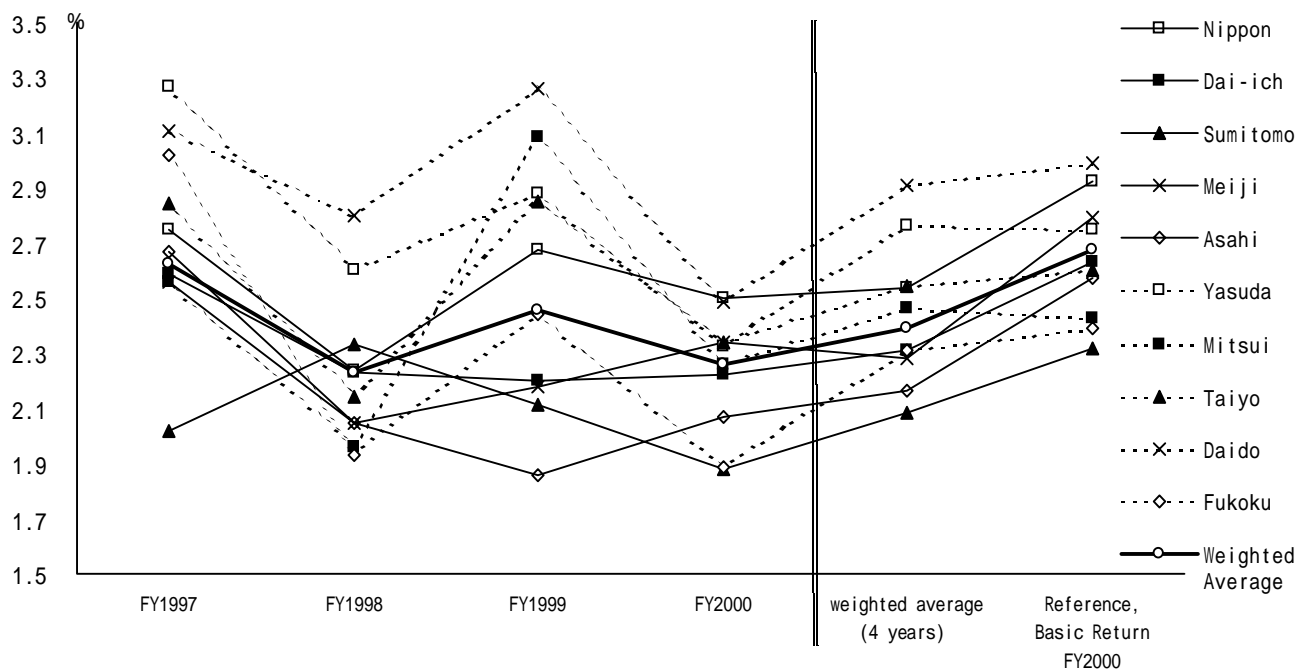
As we can see here, there does not appear to be any great departure from the life insurers and banks cross holding each other's subordinated loans and stocks (or funds), although there is some trend towards securitization of the funds. As a result, it remains to be the case that when one of the two sectors' experiences instability, then the other sector will also be affected, thus leaving the door open for an upset in the entire financial system.

### **2.4 Profit/Loss situation**

As a general rule, a life insurance company's regular dividend is covered for by income revenue. We find and plot the yield on investment except the dealing and sale profit of securities as in Figure 3-1.

Although the average assumed guarantee interest rates (to be paid out to policyholders) was not so decline, for some insurers the decline in the yield on investment except the dealing and sale profit of securities was falling at an even greater rate, making the negative spread wider. The negative spread losses resulting from the interest rate differentials have been covered by their mortality gain or the surplus gained from expense savings. However, if these low interest rates are to continue into the future, then the strength of the life insurance companies will be significantly compromised and the life insurance business will be under intense pressure.

Figure 3-1. The Yield on Investment Except the Dealing and Sale Profit of Securities



Notes:

The yield on investment except the dealing and sale profit of securities = {(interest and dividend income + investment gains on money in trust (income portion) + gain from redemption of securities + foreign exchange gains + other investment gains) – (interest paid + losses from redemption securities + foreign exchange losses + other investment losses)}/average daily balance.

Investment returns from money held in trust for fiscal 2000 are only for those companies that disclosed this information in their income revenue portion of their statements.

### 3. The FSA’s revisions of the solvency margin standard and its issues

#### 3.1 Revised solvency margin standard.

Since the FSA introduced the solvency margin standard in 1996, they have revised the methods of its calculation. Along with the introduction of mark-to-market accounting (using current market values of financial instruments) from fiscal 2000, the calculation standard for finding the solvency margin ratio has been revised.

For this current FSA revision of the standard, the numerator – that signifies the solvency of the company or the ability to pay – now has stricter standards as to what can be included. At the same time, the denominator – an indicator of the risks, will have a broader definition and more items may be included. We see this as improvement over the last standard.

However, it is still not a good indicator of the health of a life insurance company from the perspective of the policyholder. In Japan, a solvency margin of under 200% incites prompt corrective action on the part of the FSA, and so solvency margins of over 200% are seen as an indicator of a life insurer with a healthy management. Solvency margins released at the end of fiscal 2000 using the newly revised calculation method, showed that all of the life insurers had solvency margins of over 200%.

### **3.2 Issues with the solvency margins**

Some of the problems that remain with newly revised solvency margin standards include the following: 1) risk of price fluctuations, included in the asset investment risk component, does not accurately reflect the recent price changes in stocks and in land. 2) The standard operates under the going concern basis, that assumes that the life insurance company will continue to exist. 3) Banks and other financial institutions continue to cross-hold each others subordinated debts.

### **3.3 Outline of Japan Center for Economic Research’s adjusted solvency margin ratio**

We now take the publicized solvency margin ratios and make some adjustments to find our “Adjusted Solvency Margin Ratios”. In order to maintain the objectivity of the degree of the adjustments, we adopted the US RBC (Risk-Based Capital) standard.

#### ***1) Market value assessments of assets, adjustment of the risk coefficient, and the adjustment from the going concern to the liquidation basis accounting standards. (Stage 1 adjustment).***

Here, our aim is to mirror (approach) the RBC standard. We take securities, land and all other assets and give them market values to the greatest extent possible, and correct the solvency margin for latent losses. Moreover, we impose a single standard on the handling of bad loans. Depending on the category of the bad loan, each insurer will make loan loss provisions for the same share of their bad loans. As for the denominator, we raise the risk coefficient of such risks as the price fluctuation risk to the standard of RBC, so that asset price changes are reflected. Furthermore, we adjust the margin to one of liquidation basis accounting by focusing on the ability of the company to pay in the event of bankruptcy, exempting those items that have no liquidation value.

#### ***2) Removal of subordinated debts (Stage 2 adjustment)***

Here, we hope to come up with a standard slightly more stringent than the US RBC standard. In addition to the first adjustment, we remove all subordinated debt. When we consider that subordinated debts is money that has been lent to the entity, then any subordinated debts above and beyond its solvency should not be included in the calculations of the solvency margin.

### **3.4 Results of our analysis (as at end-March, 2001)**

We adjusted the solvency margins of the ten major life insurers. To maintain the objectivity of the degree of the adjustment, we adopted the spirit of the US RBC standards. The results of the estimation are classified by government intervention standards according to the RBC ratios.

However, there are two major differences between the RBC standard and the trigger where Japan will take prompt and corrective action. First, in Japan, if the solvency margin ratio is above 200%, the company is considered healthy and not subject to any corrective measure. However in the US, even if the RBC ratio is over 200%, if it is under 250%, then the company must undergo a trend test. If, as a result of the test, the capital is viewed as being on a rapidly declining trend, then it will be treated in the same way as a company with solvency margins of below 200%.

Furthermore, in Japan, if the solvency ratio is below zero, then the company must either restructure or begin liquidation proceedings. However, in the US, the corresponding ratio is 70% and much higher than Japan’s. Both of these differences result in the US regulations being much more stringent than the Japanese. Moreover, in the US, much importance is placed on those insurers under 100% that can be placed under the direction of the insurance supervisory body. In the next section, we will refer

to these standards and conduct only Stage 1 adjustment on the Adjusted Solvency Margin ratio.

**1) Distribution of solvency margins after Stage 1 adjustment**

With this first stage adjustment of the solvency margin ratio, there are a total of three life insurance companies that fall under 200%. Of these, two are over 150% -- that is, below 200% and under RBC standards thus requiring some action on the part of the life insurer. The other company is in a worse state and over 100%, but under 150% and would require some action on the part of the supervisory body. If this were in the US, the insurance supervisor would conduct an investigation, and there would be an order to improve the operations. Although the FSA has revised these solvency margin standards, we can clearly see that they are inadequate measures of the health of the life insurance company. Another thing we should take into consideration is that at the end of the fiscal year, the Nikkei average was around 13,000 yen, and is already 3,000 yen lower than today’s average.

	Under 70%		70-100%	100-150%	150-200%	200-250%	250% and above
	Under 0%						
Number of companies (total 10)	0	0	0	1	2	1	6

**2) Distribution of solvency margin ratios after Stage 2 adjustment**

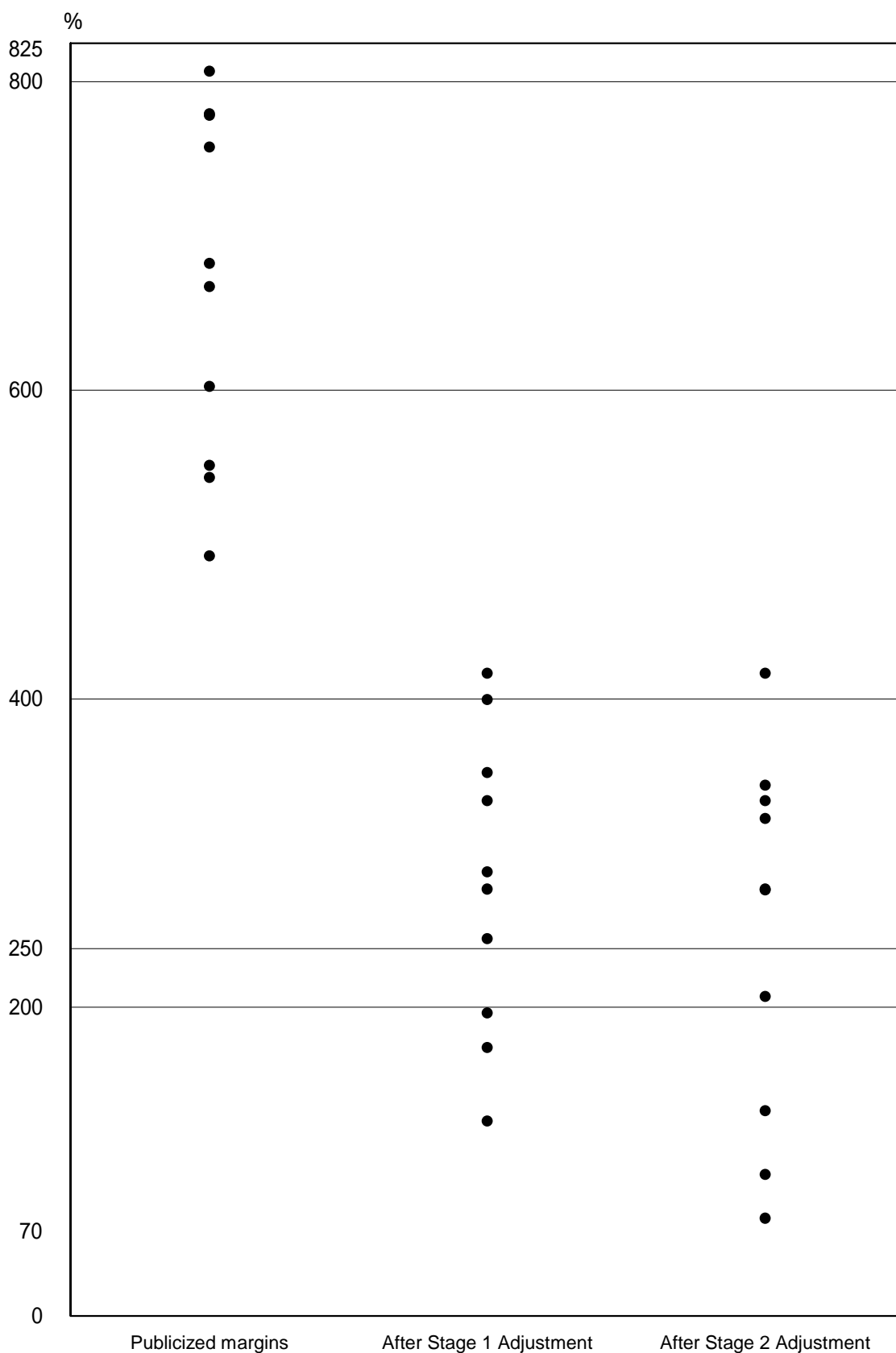
In addition to the adjustments at the first stage, here we do not consider subordinated debts to be a capital component and have removed them all from the data, making this standard somewhat more stringent than the US one. If the life insurer has a ratio of over 250% at this point, we would consider it quite healthy. Of the ten major life insurers, 6 companies are above the 250% point. (See Figure 3-2)

**3.5 Expectations for regulators**

The FSA is obligated to guide those life insurance companies with unhealthy management, to rehabilitate them into healthily managed life insurers through the decision to implement, and the actual implementation of prompt corrective actions. In this section, we recommend the further review of the standards of the former. However, the true problem may be that there is not enough guidance given to the life insurers. Even if the prompt corrective measures are implemented, since they do not give convincing guidance, this translates into the “soft” FSA solvency margin ratios. If this is the case, then what needs to be reformed may be the FSA itself.

If they are unable to make the standards stricter, then it is imperative that specialists from the private sector be called in. This should not be an impossible task for the FSA.

Figure 3-2. Distribution of Adjusted Solvency Margin Ratios (as at fiscal year end, 2000)



#### 4. Are current bankruptcy procedures appropriate?

##### **4.1 The chain of bankruptcies of life insurers in the late 1990s.**

###### **(1) The mutual company in the 1996 Insurance Business Law**

In April 1997, Nissan Life Insurance went bust. This was the first life insurer to go bankrupt since the Second World War. In the four years since this, seven companies went under, of which 5 were mutual companies.

Life insurers are either mutual companies or stock companies. Before the Insurance Business Law was amended in 1995, the two kinds of companies were clearly separated. However, when the Law was revised, it was decided that policyholders of both mutual and stock insurance companies should be treated equally in the event of bankruptcy under the understanding that “policyholders do not differentiate mutual or stock insurance companies when they enter into contracts with a life insurer”. Moreover, the regulation saying “mutual companies may reduce the insured amount on a decision by the meeting of representatives” was removed at the same time. Furthermore, the regulation saying that the basic rate of premium liability reserves can be changed on the order of the Minister of Finance was also removed.

By making these changes and attempting to treat policyholders of both mutual and stock companies equally, has altered the nature of the mutual company. For it was with these two clauses (on the order of the meeting of representatives or the Minister of Finance, the insured amount can be changed), that the mutual company was protected from falling into an excess debt situation.

###### **(2) Securing solvency**

After the 1996 revision to the Insurance Business Law, the only time that an insured amount or the basic rate of premium liability reserves can be changed is when the life insurer has gone bankrupt. Thus, it has become even more important that the insurer secure its solvency. The Ministry of Finance that, at the time was the supervisory agency of life insurance companies, adopted the solvency margin ratios as an indicator to judge the management of the companies. Solvency margin ratios began to be publicized by the Life Insurance Association of Japan, the industry organization from June 1998. Each life insurer had to ensure that their solvency margin ratios were over 200%, the generally accepted threshold for a safe company.

From December of 1997, subordinated debts were allowed to be brought in. Subordinated debts can also be incorporated in the calculation of the solvency margin ratio. The amount that can be included is up to the amount of their owner’s equity. However, as we mentioned in Section 3, the supervisory agency’s definition of this equity is much broader than reality.

In addition, there is a trend for the life insurers with worse capital positions to bring in more subordinated debts. According to the Insurance Business Law, in the course of bankruptcy, subordinated debts must be paid back to the creditor. In the case that a life insurer does go bust, its final debt excesses will expand by this amount. The burden of this final debt excess will then fall on the shoulders of the policyholders. Thus, the FSA should be closely monitoring the basis of recognizing the subordinated debts, and the basis for allowing them to be included in the solvency margin calculations.

### **(3)Prolonging the life of the mutual company**

Nissan Life Insurance that declared bankruptcy in 1997 was a mutual company. However, it did not implement the regulation saying that it can reduce insured amounts, although this would have been permitted under the former Insurance Business Law. The representative meetings of the mutual companies have become unresponsive, no longer functioning as a body effectively monitoring management. In addition, once the mutual company falls into a situation of financial difficulty, it is very difficult for other companies to come and rescue it. This is because contrary to the situation with stock companies, it cannot increase its capital base, nor can there be a rescue merger to save the company. For a bankrupt mutual company to continue to exist, it can do one of two things. One is to sell the company’s sales network. The other is to receive the full funding support of their bank. Neither method, however, will definitively save the company.

## **4.2 Framework of bankruptcy proceedings**

### **(1)Changing the conditions of the contract**

Even when a life insurance company goes bankrupt, the contracts in force are maintained. However, there are changes to the conditions of the contract. These changes are 1) reductions in the policy reserves and in the method in that the contributions are made 2) changes in the basic rate of premium liability reserves and 3) the establishment of an early surrender clause. To assume that the policyholder will be protected by continuing the policy has the risk of protecting only the failed life insurer and its concerned parties. We analyze the bankruptcy system from this perspective.

### **(2)Insurance Business Law and Special Corporate Rehabilitation Law**

In 2000, the Special Corporate Rehabilitation Law was amended to allow a life insurer to have the court intervene in its bankruptcy procedure. The framework of the bankruptcy proceedings according to the Insurance Business Law dealt mainly with administrative proceedings and so general credits, funds and subordinated debts were required to be repaid. However, if there are court proceedings under the Special Corporate Rehabilitation Law, then these debts may be exempt from being repaid, thus lowering the burden of the policyholder.

Of the life insurers that have failed, four companies have undergone the bankruptcy proceedings of the Insurance Business Law and three of the Special Corporate Rehabilitation Law.

### **(3)What happens to the contracts?**

The excess debt of a bankrupt life insurance company is decreasing through the following four measures; 1) reducing the policy reserves, 2) exemption of general credits, 3) procuring funding aid from the Life Insurance Policyholder Protection Program, and 4) establish goodwill and procure future profits from the old or the new policyholders. The final excess debt of the bankrupt life insurance company is determined after negotiation between the responsible persons for the bankruptcy proceedings (the insurance company’s receiver or the legal trustee) and the sponsor. The company that is following bankruptcy proceedings of the Insurance Business Law would be 3) procuring funding aid from the Life Insurance Policyholder Protection Program and the companies undergoing the proceedings of the Special Corporate Rehabilitation Law would not.

#### **(4)The receiver and the legal trustee**

The person responsible for the bankruptcy proceedings according to the Insurance Business Law would be the receiver, while according to the Special Corporate Rehabilitation Law, it would be the legal trustee. The receiver is appointed by the supervisory agency, while the legal trustee is appointed by the court.

Until now, the receiver position was assumed by the Life Insurance Association of Japan, the industry association. All insurance companies that are licensed to conduct this business in Japan are members of the Protection Program and of the Life Insurance Association of Japan. For the Life Insurance Association of Japan that has played the role of receiver, it is difficult to decide to proceed with bankruptcy rather than choosing to provide financial aid.

#### **(5)The increasing role of the Protection Program**

The Protection Program was established in 1998 as a body that provides funding for bankruptcy. This is funded by the contributions of the domestic life insurers. The limit to the fund from the industry is 560 billion yen, but currently 531.2 billion yen has already been spent. In the future, when a life insurer goes bust, there will be public funds provided until March, 2003, but since this needs special approval by the Diet, actual public funding will be difficult. We need to consider the future aid funding of the Protection Program.

With the revision of the Insurance Business Law in 2000, the role of the Protection Program has expanded. When going bankrupt under the Insurance Business Law, the Protection Program can also become the receiver. When under the Special Corporate Rehabilitation Law, a vote will be taken when the revival plan is passed representing the policy holders. There is the danger here that because it is not in the interest of the Protection Program to provide the funds that the vote will not be in favor of the policy holders. In order for the bankruptcy proceedings to be fair, the role of the Protection Program should stop at that of a body providing funding aid, and should not be deciding if it will be providing financial aid during bankruptcy proceedings.

### **5. Issues regarding demutualization**

For the mutual life insurance companies in Japan, the Insurance Business Law was revised in 1996, and they are now allowed to become stock companies. Although the law was revised again in May of 2000, issues still remain on converting the companies to stock companies.

The regulations on the Insurance Business Law regarding demutualization focus on the compensation of membership rights, procuring retained surplus from the reorganization, and the protection of policyholders with dividends.

Thus, we consider two different types of demutualization. One is the “rebuilding” type whose objective is to rehabilitate the business upon the bankruptcy (such as was the case for Chiyoda Life and Tokyo Life). The other type is one that aims to expand their business, the “expanding” type.

#### **5.1 Rebuilding type of demutualization**

##### **(1)Compensation for membership rights and retained surplus from reorganization.**

In the case of demutualization, stocks are allotted to compensate for the membership rights. However, in the cases of both Chiyoda Life and of Tokyo Life, there was no compensation due to the

excess debt of the rehabilitating company. Normally, the distribution of stocks is a way of compensating the member (policyholder) of his membership rights (his share of the inheritance) when it was a mutual company. They are distributed based on the member (policyholder)’s contribution to the net asset formation of the mutual company.

It also appears there are no reorganization retained surplus due to the excess debt as well. The reorganization retained surplus is the amount contributed by the policy- holder to the owner’s equity whose contract has already expired. This is a uniquely Japanese system that aims to prevent owner’s equity from being distributed as dividends to shareholders.

## **(2)Policy towards protection of policyholders with dividends.**

Regarding the protection of the policyholders with dividends, there are differences in the bankruptcy proceedings between the bankrupt life insurers -- Chiyoda Life and Tokyo Life included. Many companies have the policy of distributing dividends after the goodwill has been amortized. However, there are many points left unclear about measures to avoid a conflict between shareholders who have decision making power and policyholders who have the right to receive the dividend regarding future profits.

As reorganization occurs, in order for the life insurance company to protect the expectations for dividends to those policies entitled to them, they may need such systems as seen in demutualization abroad, such as “Open Fund Method and “Closed Account Method” . These separate the account of the life insurer into policyholder dividends and shareholder dividends. Since in Japan, the life insurance companies mainly sell the insurance policies with dividends, it is expected that they will continue to sell those insurance policies even after the reorganization. From this perspective, a UK-style Open Fund method (or a similar method) might be more desirable. Tokyo Life has been able to take the best form of protection to the policyholder and has segregated the source of revenue for policyholders and that of dividends for shareholders without the involvement of the shareholders themselves. However, for us to analyze the case of bankrupt life insurers, we do not know clearly how they protected their policyholders under the reorganization due to the lack of full disclosures.

## **5.2 Expanding type of demutualization**

In Japan, there had not yet been any cases of the expanding type of demutualization having been completed. We analyze the case of Daido Life, however, that is in the midst of this kind of demutualization at the moment. If it succeeds, it will be the first case of this kind in Japan.

### **(1)Demutualization – objectives and procedure**

Daido Life plans to issue stocks with the objective of making it easier to procure funds and to establish an upstream holding company. In terms of procedure, there was no general vote by all policyholders, but instead they had made resolutions by the representatives meeting and utilized the objection system. Moreover, for the actuarial items that are considered difficult for policyholders to understand, it was a unique move on their part to publicize the opinion of an independent actuary.

### **(2)Membership rights – compensation and contribution rates**

Regarding the compensation for membership rights of Daido Life, shares were distributed

according to contribution, and there was no uniform compensation such as is often done abroad. With a large number of shareholders holding small numbers of shares, we can anticipate some difficulty with decentralization of the shareholders.

### **(3)Policies regarding protection of policyholders with dividend**

Daido Life by its application of segregated accounting has succeeded in incorporating something similar to the Open Fund method to protect its dividend earning policyholders. Also, they are going to take the policy that the dividend rules for policyholders when it was a mutual company be continued after demutualization.

### **(4)Retained surplus from reorganization**

The retained surplus from reorganization is set at a relatively low level at Daido Life. However, the general problems with these retained reserves are the following 1) if they are set at high levels, then there will be an accumulation of internal reserves, and then the shareholders will benefit from the rising stock prices 2) although this retained surplus should be used for the dividend earning policyholders, this is still an inadequate system. It would be better if a framework such as that of the Open Fund or Closed Account could be used.

## **6. Conclusion**

Currently, with the continuing decline in stock prices and the negative spread situation, Japanese life insurance companies are facing very severe business environments. With the increase in premiums due to declines in interest rates, and the revision of contracts due to stagnant incomes, the number of insurance contracts are slowly declining. Looking at the adjusted solvency margin ratios as at end March, 2001, there are companies that have lowered their margins by 100 percentage points over the previous year.

Moreover, the cross-holdings of capital between the banks and insurance companies continue to be immense, and so the risk of the failure in one sector having grave effects on the other continue to loom large. Recently, some life insurance companies are increasing their subordinated debts and funds from banks, while banks are also thinking of increasing their capital and having life insurers that they have strong relationships with provide the funding. The supervisory agency should not allow this kind of capital increase that will work to undermine the financial system as a whole.

This fiscal year, there has been discussion regarding introducing a system where the assumed rates of interest could be lowered before a life insurer goes bankrupt. However since a large number of life insurers are opposing the idea, it is likely that this will not be approved. Yet, since a lowering of this assume interest rate is tantamount to a default on the part of the life insurer, this should be handled through the bankruptcy laws. From this perspective, the Special Corporate Rehabilitation Law has spelled out some relatively quick and fair procedures. The FSA should move quickly to bring life insurers whose business conditions have deteriorated to this extent to begin these procedures. This will be the best way to protect the policyholders, which is after all, the mission of the FSA.