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CEO Brief

# Japanese Insurers' Response to Low Interest Rates

ABSTRACT

In the late 1990s, the Japanese insurance industry faced difficulties due to the asset bubble collapse and low interest rates; however, insurers coped with the difficulties by adjusting product structure, improving asset portfolios, and maximizing loading surplus and mortality savings. Insurers adopted policy replacement and increased new contracts with modified product structures and innovative services. For asset management, the proportion of loans and stocks was reduced and the proportion of bonds was increased. To mitigate negative spread, insurers reduced sales cost, secured mortality savings, and set aside additional reserves. Korean insurance companies and the financial regulator need to take measures and establish policies for the profitability and stability of the insurance industry.

## 1. Key fact

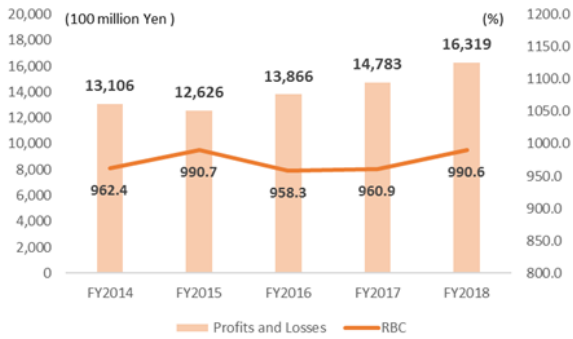
The Japanese insurance industry faced difficulties in the late 1990s due to the collapse of the bubble economy and low interest rates. However, Japanese insurance companies are currently showing stable profitability and financial soundness.

In the 1980s, when the asset bubbles were created and expanding, the Japanese insurance companies competed for quantitative expansion by raising their assumed interest rates and pushing the sales of savings-type products.

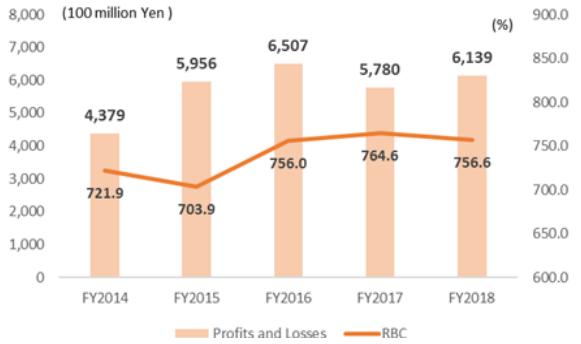
Deterioration of assets due the asset bubble collapse in the early 1990s and negative spread due to low interest rates caused seven life insurers and one non-life insurer to go insolvent from 1997 to 2001.

To overcome the crisis, Japanese insurers took the following measures and now they maintain steady profits and RBC ratios (see 〈Figure 1 and Figure 2〉).

〈Figure 1〉 Japanese Life Insurers' P&L and RBC




〈Figure 2〉 Japanese Non-life Insurers' P&L and RBC




Source: Japanese Financial Services Agency

First, Japanese insurers adjusted their product structures by lowering the assumed interest rates, reducing costs, and product differentiation. Although they cut the assumed interest rates on new contracts right after the asset bubble collapse, the effect on total in-force contracts was insignificant; therefore, they adopted policy replacement. The ratio of replaced contracts was about 40% to 50% of all new contracts from 1996 to the 2000s. The policy replacement was made from endowment insurance with term rider to whole life insurance with term rider and from whole life insurance with term rider to whole life insurance providing higher coverage with term rider.

Small and medium life insurers introduced lower-priced products, such as insurance products with health discounts, non-smoker discounts, no or low surrender value, while large insurers pursued innovation through the development of additional services rather than price differentiation. Japan Life, one of the large insurers, launched additional services that manage whole life insurance, health insurance, and pensions in one comprehensive account.

Second, they reduced the proportion of risky assets in their asset portfolio and formed an ALM-based portfolio. While the asset of the Japanese life insurance industry consisted of 38% of loans, 22% of stocks, and 8% of bonds in 1990, its asset consisted of 13% of loans, 7% of stocks, and 42% of bonds in 2010. On the other hand, to improve the profitability, life insurers increased the ratio of foreign securities in their assets from 14% in 2010 to 25% in 2018. Japan lifted its foreign exchange restrictions in 2012.

Third, to alleviate interest rate risk, Japanese insurers maximized their loading surplus and mortality savings and set aside additional reserves. To secure the loading surplus, they modified sales expense structure, closed regional headquarters, integrated branches, and introduced automated operations to customer service. To improve mortality savings the cycle of mortality table was extended from 5 years to 11 years. Also, Japanese large life insurers have reduced the negative spread since 2007 by holding additional reserves on insurance contracts with high assumed interest rates.

## 2. Implications

Japanese insurers' price and service competition was a measure to ease the negative spread on in-force business, although the measure reduced their profits and increased expenses in the short term. With their efforts, the industry growth rate turned positive from negative in 2010. In the early 1990s, leading small and medium insurers and large insurers reorganized promptly their asset structures; however, insolvent insurers failed to do that due to preexisting management processes and practices, which caused a slower response.

Korean insurers could cope with lower interest rates by lowering assumed interest rates, differentiating products and services, reducing expenses, and establishing management plans for insurance contracts with high assumed interest rates.

Also, the financial regulator needs to relax its foreign investment limit (30% of assets) and establish policies to induce additional reserves and to better manage high assumed interest rate insurance contracts.

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