The failure without management

Truths behind the Seiho crisis in the Heisei era

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Preface

More than 10 years have passed since I started covering the insurance industry as a ratings analyst. During this period the Japanese insurance industry has undergone repeated upheavals. Non-life insurance firms, particularly large ones, were swept into waves of realignment while weakened midsize life insurance firms went bankrupt one after another and large life insurers were downgraded.

With the stock market beginning to recover in 2003 and insurers' nonpayment exposed in 2005, the focus of attention has shifted from "uncertainty about management" to "distrust of management." Considering the large number of inquiries received from the outside, the insurance industry still seems to command great attention. It is said that economic magazines featuring insurance are all selling well.

While the public showed much interest in the insurance business, questions about the failed life insurers which I had covered as an analyst kept nagging at me.

I continued to ask myself these questions, for example: Why were large amounts of high-risk investments and loans made only during a specific period? Why did a company created by an actuarial expert come to suffer a heavier burden of negative spread than other companies? Why did a company pursuing a tie-up with foreign companies conclude a capital tie-up with another company? Why did the asset structure become distorted in the latter half of the 1990s?

In Japanese society where the saying "let bygones be bygones" has greater appeal than "failure is the mother of success," my questions found no answers no matter how long I waited. I wished to do some work and unravel the truth by myself if I had a chance to do so. Fortunately, I got an opportunity to start research on the insurance industry at Waseda University in 2005. I had no hesitation in choosing "a critical review of failed life insurers" as the subject of my research. It was not easy to balance my research with my professional duties as an analyst. Having now completed my research, I can say I did not just record what had happened in the past. I think my work reached the level where it may be useful for the management of the insurance business and government administration of the insurance industry as they are today.

A critical review of instances of failure, which forms the core of this book, would not have been completed without the warm support and cooperation of people who were involved in the management of failed insurers. Even though a certain period of time had elapsed, these people must have needed the courage to talk about the past failures. Some of them may have been uncomfortable looking back over the past. Many must have agreed to give an interview out of a certain sense of mission. I take this opportunity to express my deep gratitude to all the people who cooperated in my project. I wonder how far my analysis in this book succeeded in revealing the truth. Whatever the result, I am solely responsible for it.

Most of the interviews were conducted as part of "Case studies of failed financial institutions" commissioned by the Finance Services Agency. The contents and opinions expressed in the research report are ascribed not to the FSA but to this writer. Let me add that, although it is the FSA's commissioned research, the government has provided no internal materials concerning failed life insurance firms nor has it introduced me to the people of these firms and that I searched for the persons involved through my connections and asked them for an interview.

Finally, let me express my thanks to Professor Yoshimasa Nishimura of the Graduate School of Asia-Pacific Studies at Waseda University for his guidance on my doctoral thesis titiled, "a critical review of factors leading to the failure of life insurers in the Heisei financial crisis," upon which this book is based, Professor Mitsuru Iwamura of the University's Graduate School, who as a second reader gave me precious advice, and Professor Nishimura's seminar members who made various valuable comments. My thanks go as well to Kyoko, my wife who supported me through the days when I spent much of the time I was home working in my own room.

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Nobuyasu Uemura

Author's comment on the English-language edition

As the author of this book, I am very pleased that the English-language edition of "The Failure without Management: Truths behind the Seiho Crisis in the Heisei Era" has been published as a project of the Oriental Life Insurance Cultural Development Center.

I have been hoping for an English version of "The Failure without Management" since 2008, when the Japanese version was published. When I made presentations of my study overseas, I was often asked whether any of my research papers were available in English.

We cannot deny that a series of midsize life insurance firms failed from the late 1990s to the early 2000s, partly because of the challenging economic environment in Japan that followed the bursting of the bubble economy. However, as discussed in this book, detailed examinations of individual cases have revealed that the series of failures of life insurers were not caused by structural problems stemming from Japan's economic and financial conditions at those times, but that internal factors unique to individual companies, including the business model, management, and the management structure, had important implications. I do not think that the assumption applies only to the Japanese life insurance industry, but I believe, rather, that there is something universal and helpful overseas in the assumption.

I feel that I have finally completed my work now that the English version has been published, about three years after the publication of the Japanese version.

Financial crisis and Japanese life insurance industry

The global financial crisis occurred immediately after the publication of this book (the Japanese version). Giant insurance and financial groups, including AIG, ING, and Hartford, were supported by the government, and the financial strengths of Japanese life insurers were adversely affected. Japanese life insurers retained as many earnings each term as they could, however, to enhance their margins of solvency based on the lessons that they learned from the Seiho crisis. As a result, with few exceptions, they survived the financial crisis.

I interviewed people at 25 major Japanese insurance companies in 2009. The interviews revealed that life insurers' awareness of risk management and their risk management technology have advanced since the 1990s, when many life insurers failed, but that the effectiveness of their awareness and technology varied. I often heard people say, "Management is not interested in risk management." Others said, "Management thinks that risk management is the responsibility of the division in charge of risk management." I assumed that although risk management systems had been developed, there was still considerable room for improvement in terms of the use of the systems in management. In this book I wrote that inadequate corporate governance increases bankruptcy risk. I felt that improvements to corporate governance by insurers were only half done.

Benefiting from the experience of failures of life insurers

I left the rating agency where I worked for more than 10 years in March of 2010. I am in charge of insurance administration at the Financial Services Agency. Using my experience as an analyst, I am monitoring individual insurance companies and developing supervisory regulations with the aim of ensuring the soundness of insurance companies.

Working for an insurance watchdog agency, I am especially interested in the enterprise risk management (ERM) of insurance companies.

The purpose of ERM is that companies achieve sustainable and stable enhancement of their corporate value while maintaining their financial health. Naturally, insurers should actively conduct ERM as part of their self-management instead of being encouraged to do so from the outside.

Nevertheless, regulatory authorities pay attention to ERM because they believe that steady improvements in corporate value will help to protect policyholders. For example, the Financial Services Agency comprehensively reviewed its insurance inspection manual in February of 2011. The agency added a new category called "integrated risk management system," clarifying its policy of having its inspectors inspect the ERM of insurers. With regard to solvency regulations, the agency is considering not only setting minimal capital requirements, including a solvency margin ratio, but also establishing a framework in which the authorities examine insurance companies' reports in their own evaluation of their management risks and equity capital.

I could say that the Financial Services Agency is seeking to enhance ERM not because emphasizing ERM is an international trend, but because the agency is aiming to apply lessons from the failures of life insurers.

I believe Japan's experience will provide useful information for countries in Asia where the life insurance industry is developing rapidly. I would be delighted if this book is of any help.

著者より英訳版に寄せて

このたび公益財団法人アジア生命保険振興センターの事業として「経営なき破綻　平成生保危機の真実」の英訳版が誕生することを、著者として大変うれしく思っています。

英訳版を出したいという思いは、「経営なき破綻」を出版した2008年当初からありました。また、海外で研究内容について発表する機会があると、しばしば「論文の英語版はないのか」という問い合わせをいただきました。

1990年代後半から2000年代初頭にかけて起きた中堅生保の相次ぐ経営破綻は、バブル経済崩壊後の日本の厳しい経済環境が影響したことは否定できません。しかし、本書を読んでいただくとわかりますが、個別事例を詳細に検証した結果、一連の生保破綻は当時の日本の経済・金融情勢に起因した構造的な問題ではなく、破綻に至るには、ビジネスモデルや経営者、経営組織といった、その会社固有の内的要因が重要な意味を持っていたことが浮き彫りになりました。おそらくこれは日本の生命保険業界に特有の話ではなく、海外でも参考になる普遍的なものを含んでいるのではないかと考えています。

ですから、日本語版の出版から約 3 年たつとはいえ、英訳版を出すことができて、ようやく一つの仕事を完了することができたという気持ちです。

金融危機と日本の生保業界

本書（日本語版）を出版した直後に世界的な金融危機が発生し、AIG や ING、ハートフォードといった巨大保険・金融グループが政府の支援を受ける事態に発展しました。日本の生保の経営体力も圧迫されましたが、各社はかつての生保危機を教訓に、毎期の利益を可能な限り内部留保し、支払余力の充実に努めてきたことが功を奏し、一部の例外を除き、金融危機を無事乗り切ることができました。

ただ、筆者が 2009 年に日本の主要保険会社 25 社に対して行ったインタビュー調査によると、破綻会社が続出した1990年代当時に比べれば、生保のリスク管理に対する意識も技術も大きく進展したとはいえ、その実効性は様々でした。「そもそも経営陣にリスク管理に関心を持ってもらえない」「経営陣に『リスク管理はリスク管理担当部門の仕事』という意識がある」といった声もしばしば聞こえてきました。リスク管理態勢の整備は進んだものの、経営への活用という点でまだまだ改善の余地が大きいのでしょう。本書で明らかにした「コーポレート・ガバナンスの不備が破綻リスクを高める」ことへの対応は道半ばといった感がありました。

生保破綻の経験を生かす

個人的な話で恐縮ですが、筆者は 2010 年 3 月に 10 年以上勤務していた格付会社を退職し、現在は日本の金融庁で保険行政の現場に身を置いています。アナリストとしての経験を生かして個々の保険会社のモニタリングに関わるとともに、保険会社の健全性確保を目的とした監督規制等の整備に取り組んでいるところです。

なかでも、保険会社の ERM（エンタープライズ・リスク・マネジメント）には監督当局として強い関心を持っています。

ERM の目的は、会社が自らの健全性を確保しつつ、企業価値を持続的、安定的に向上させることです。当然ながら、本来、ERM は外部から促されて実施するものではなく、保険会社が自己管理の一環として行うべきものです。

それにもかかわらず監督当局が ERM に注目するのは、企業価値の安定的な向上が契約者保護に資するという考え方があるからです。例えば、金融庁では 2011 年 2 月に保険検査マニュアルを全面的に見直し、新たに「統合的リスク管理態勢」のカテゴリーを設け、検査官が保険会社の ERM を検証する姿勢を明確にしました。ソルベンシー規制についても、ソルベンシー・マージン比率のような最低資本要件の設定のほか、保険会社が自らの経営リスクと自己資本等の評価を行い、これを当局が報告を受け、検証するといった枠組みを併用することを検討しています。

このような取り組みの背景には、単に ERM 重視が国際的な流れだからというのではなく、かつての生保破綻の教訓を生かそうという意識があると言えるかもしれません。

生命保険業の発展著しいアジア諸国でも、日本の経験が参考になるのではないかと考えています。この本が少しでもお役に立てば幸いです。

On the occasion of the publication of the English-language edition of "The Failure without Management: Truths behind the Seiho Crisis in the Heisei Era" by Nobuyasu Uemura

I would like to offer my congratulations on the publication of the English version of "The Failure without Management: Truths behind the Seiho Crisis in the Heisei Era" by Mr. Nobuyasu Uemura.

As described in the foreword, the author did not just record what had happened in the past but wrote the book so that it will be useful for the management of the insurance business and government administration of the insurance industry as they are today as well. The administrative authorities with supervisory power have been preoccupied with preparing liquidation schemes and safety nets and have not conducted full-scale investigations or analyses of the cause of failure. Against this backdrop, the book has great value as an academic resource.

Mr. Uemura says that the assumption that the only reasons for the failure of life insurers are external factors—including falling stock prices, low interest rates, and inadequate oversight of the insurance industry—is "extremely superficial." Through detailed examinations of individual cases, he makes it clear that internal factors unique to individual companies, such as business models, management, and management structure, played a significant role in the bankruptcies.

Of particular note is the fact that Mr. Uemura has adopted the oral history method for the detailed examinations of individual cases, a first for Japan. He interviewed more than 30 people, including key figures in management. The outline of the book is based on statistics and business results, but the readers can close in on the "truths behind the Seiho crisis in the Heisei era," by reading quotations from the people involved.

In our research as academics, we encounter great difficulty obtaining data and material on the management of insurance companies. Needless to say, we would like to ask people in the insurance industry to actively disclose information. At the same time, working on research on the management of insurance companies, we have a lot to learn from the publication of a serious study like this by using the oral history method, although Mr. Uemura was in a position different from ours as a ratings analyst in charge of the insurance industry when he wrote the book.

In Chapter 3, Mr. Uemura clearly classifies internal factors within management that are considered likely to increase the risk of failure into three categories: factors related to the business model, factors related to manager, and factors relating to the management structure. Factors related to manager accounted for about 60% of all factors and are classified into eight subcategories, including top executive's competency problem, top executive's influence, lack of management awareness, and error in business judgment. I assume that Mr. Uemura needed a lot of patience when he extracted common factors from the interviews, in which the people answered from different standpoints, and classified them. I greatly respect his efforts.

In Chapter 4, Mr. Uemura interviews people involved in three midsize life insurance firms that did not fail (Taiyo Life Insurance, Daido Life Insurance, and Fukoku Mutual Life Insurance) and points out the following differences between them and life insurers that did go under:

- They developed unique management strategies that were different from those of large life insurers
- They did not increase high-risk investment in the bubble economy
- The management had leadership and did not follow the examples of other companies.
- The management did not assume management equals sales and distanced themselves from the sales division.

Those points appear to be simple, but management at insurance firms should consider them when they assess the situation at their own companies.

Having learned lessons from the failures of insurers, the insurance industry has undergone great change from the situation that prevailed up to the 1990s. Insurers have introduced advanced asset-liability management (ALM) and integrated risk management. However, there is still ample room for improvement, says Mr. Uemura. He is concerned about a lack of people in industry oversight positions, saying, "The authorities should still take on a great role. With few personnel appearing to be well versed in the insurance field, …"

I believe that this concern has been reduced considerably now that Mr. Uemura has become an official at the Financial Services Agency, given that he is one of the few experts in Japan who have analyzed the management of insurance companies. I am looking forward to his success in his new position.

Lastly, I hope this book will be read widely by people involved in the insurance industry in countries in Asia who are interested in the failures of Japanese life insurers and their liquidation procedures, and will contribute to the interests of insurance consumers and to the healthy development of the industry.

Masahiko Ezawa
Professor in the Academy of Commerce at Waseda University
President of the Japanese Society of Insurance Science

植村信保著『経営なき破綻　平成生保危機の真実』英語版に寄せて

この度の植村信保氏の著書『経営なき破綻　平成生保危機の真実』の英語版出版に当り、心よりお慶び申し上げたい。

「まえがき」にもあるとおり、本書は、単に過去の記録を残したということではなく、現在の保険経営や保険行政の参考になりうるものとして書かれている。特に監督権限を有する行政当局が破綻処理スキームやセーフティーネット整備等に追われ、破綻原因に関する本格的な調査・分析が行われなかったこともあり、本書の学問的資料としての価値はすこぶる大きい。

植村氏は、生保会社の破綻要因を「株価下落」、「低金利」、「保険監督の不十分さ」といった外部要因にのみ求める主張を「きわめて表面的」であるとし、個社の事例を詳細に検証することで、会社破綻にはビジネスモデルや経営者、経営組織といった当該会社固有の内的要因が重要であることを明確にした。

また特筆すべきは、植村氏が、こうした個別事例の詳細な検証のために、わが国で初めて関係者（経営のキーパーソン等）30 数名へのインタビューを実施し、それにより収集した「オーラル・ヒストリー」（口述記録）を用いるという研究手法を採用した点である。記述された各種統計や業績数字にもとづいて輪郭は描かれつつも、随所にカッコ書きで記される関係者の発言内容により、読み手は、まさに「平成生保危機の真実」に肉薄できるのである。

われわれ学界に身をおくものは、研究を進める際、保険会社の経営に関するデータや資料へのアクセスの面で多くの困難を経験する。もちろん保険業界各位には積極的な「情報開示」を要請したい。他方、植村氏が、執筆当時、格付アナリストとして保険業界を担当されていたという立場の差はあれ、「オーラル・ヒストリー」を用いるという研究手法により本書のような本格的な研究書を上梓されたことは、われわれが今後保険経営に関する研究に取り組む折、参考にすべき点も多い。

本書第 3 章においては、破綻リスクを高めると判断される経営内部の諸事象を、「ビジネスモデルに関するもの」、「経営者に関するもの」、「経営組織に関するもの」の 3 つに分け、大変明快な整理がなされている。全体の約 6 割を占めたのが経営者に関する要因で、それはさらに「トップの適性の問題」、「トップの影響力の強さ」、「経営意識の欠如」、「経営判断のミス」他、8 つの小グループに細区分された。個々人がそれぞれの立場で答えたインタビュー内容について、その趣旨の共通項を抽出し、類型化するといった作業はかなり根気を要するものであったと推測される。植村氏の払われた努力に敬意を表したい。

また本書第 4 章においては、経営破綻に陥らなかった中堅３社（太陽生命、

大同生命、富国生命）の関係者にもインタビューを試み、それにより以下のような破綻生保との違いを明らかにした。すなわち、これら 3 社は

・大手会社とは異なる独自の経営戦略を採用した。
・バブル期にハイリスク運用に傾斜しなかった。
・経営陣にリーダーシップがあり、他社に追随しなかった。
・経営＝営業という意識をとらず、経営が営業部門と距離を置いていた。

こうした指摘は、それ自体シンプルとも思われるが、保険経営に携わる者にとり、各自の状況に応じて顧みるべき点であろう。

経営破綻という教訓から、生保業界においては 1990 年代までとは様変わりして、高度な ALM（資産負債総合管理）や統合的なリスク管理が行われるようになった。しかし、植村氏は未だ改善の余地が大きいという。そしてそうした面での「行政の役割は引き続き大きいはずだが、現在でも保険分野に精通した人材は少ないようであり、・・・」と保険監督における「人材不足」を憂慮されていた。

私は、植村氏自身が、保険会社の経営分析に関する日本で数少ない専門家から、金融庁の担当官へと転身されることで、そうした懸念は相当程度払拭されたと考えている。氏の新天地での大いなる活躍を期待したい。

また最後に、本書が、わが国の生保会社の破綻とその処理に関心を有するアジア各国の
保険関係者に広く読まれ、かつ保険消費者の利益の向上と保険業界の健全な発展に資することをご祈念申し上げ、結びとしたい。

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Introduction
Truths behind the failure of life insurers in the Heisei era

1. Failed life insurers not scrutinized enough

No Japanese life insurance companies had fallen into a management crisis for 50 years after the end of the World War II. In April 1997, however, Nissan Mutual Life Insurance Co. received a business suspension order from the Ministry of Finance, the then regulatory authority for insurers. Since the collapse of the myth that life insurers would never fail, in just four years up to March 2001, seven midsize insurers failed, creating enormous losses for policyholders.

Only seven companies failed, but the combined assets of these companies accounted for over 10% of the total assets held by the life insurance industry. Moreover, liquidation procedures for the failed life insurers, in principle, caused a burden on existing policyholders and policyholders of other insurers via the Life Insurance Policyholders Protection Corporation of Japan and other safety nets, while public funds were injected into financial institutions (including banks, credit associations, and credit cooperatives) that went under at around the same time these insurers failed to fully guarantee deposits.

In the case of a 30-year-old man taking out whole life insurance with failed Kyoei Life Insurance Co. in 1992, for example, insurance benefits were reduced by 58% from the initially guaranteed amount. Funds contributed from safety nets amounted to a total of ¥700 billion.

These instances of failure were large-scale, causing enormous damage to policyholders, but unfortunately the government and the Diet made few efforts to investigate and analyze individual instances to put the lessons to good use. In March 2007, the Financial Services Agency publicly announced “Case studies of failed financial institutions,” its commissioned research in which I was involved. The contents and opinions expressed in the research report were written by outside authors, not representing the FSA’s official views, however.

There appear to be a number of reasons why adequate review of these instances of failure has not been conducted until now. The business environment surrounding life insurers has grown increasingly harsh since the late ’90s, driving many insurers into a management crisis. Amid such circumstances, both the government and the industry must have been too busy dealing with the problems at hand, such as establishing a scheme for the liquidation of failed insurers and reviewing safety nets, to take time for learning lessons from what these failed companies went through. After all, it is only very recently that the regulatory authorities started overhauling rules on solvency margin ratios and others to gauge the financial soundness of insurers.

Table-Introduction 1: Overview of past bankruptcy procedures

	Nissan Mutual	Toho Mutual	Daihyaku Mutual	Taisho	Chiyoda Mutual	Kyoei	Tokyo
Going bankrupt	April 1997	June 1999	May 2000	August 2000	October 2000	October 2000	March 2001
Completing liquidation	October 1997	March 2000	April 2001	March 2001	April 2001	April 2001	October 2001
Procedure	Administrative procedure	Administrative procedure	Administrative procedure	Administrative procedure	The Act on Special Treatment of Corporate Reorganization Proceedings and Other Insolvency Proceedings of Financial Institutions	The Act on Special Treatment of Corporate Reorganization Proceedings and Other Insolvency Proceedings of Financial Institutions	The Act on Special Treatment of Corporate Reorganization Proceedings and Other Insolvency Proceedings of Financial Institutions
Amount of negative net worth	¥302.9 billion	¥650.0 billion	¥317.7 billion	¥36.5 billion	¥595.0 billion	¥689.5 billion	¥73.1 billion
Subordinated loans and other general liabilities	Unknown	Unknown	Unknown	Unknown	All waived	All waived	All waived
Funds provided by the Policyholders Protection Corporation and other safety nets	¥200.0 billion	¥366.3 billion	¥145.0 billion	¥26.7 billion	none	none	none
Reduced policy reserves	0%	10%	10%	10%	10%	8%	0%
Goodwill	¥123.2 billion	¥240.0 billion	¥147.0 billion	¥7.0 billion	About ¥320.0 billion	¥364.0 billion	¥32.5 billion
Assumed rate of return							
Before going bankrupt (average)	unknown	4.79%	4.46%	4.05%	3.70%	4.00%	4.20%
After going bankrupt (upper limit)	2.75%	1.50%	1.00%	1.00%	1.50%	1.75%	2.60%
Deduction for early termination	7 years	8 years	10 years	9 years	10 years	8 years	10.5 years
Successor or restructuring sponsor	Aoba Life Insurance Co.	GE Edison Life Insurance Co.	Manulife Life Insurance Co.	Azami Life Insurance Co.	U.S. American International Group Inc.	U.S. Prudential Financial Inc.	Taiyo Life Insurance Co. and Daido Life Insurance Co.

*Aoba Life was established by the Life Insurance Association of Japan and then sold to France-based Artémis Group. It merged with Prudential Life Insurance Co. in 2004.
*Azami Life was launched as a joint venture between the former Yamato Mutual Life Insurance Co. and SoftBank Corp., which later withdrew from the business.
*Chiyoda Mutual Life, Kyoei Life, and Tokyo Life were renamed as AIG Star Life Insurance Co., The Gibraltar Life Insurance Co. and T&D Financial Life Insurance Co., respectively.
*GE Edison Life came under the umbrella of AIG Group (becoming AIG Edison Life Insurance Co.) in 2003.

(Data) compiled by the author from a variety of sources

2. Delving into the inside of failed life insurers

Overseas countries have also seen their life insurers go under. For example, 547 life insurers and health insurance companies fell into a management crisis in the U.S. during the period from 1976 through 2002, according to a survey by A.M. Best Co., a U.S. rating firm.

Many of them were considered to be small-scale companies, but several second-tier life insurers, including Executive Life of California and Mutual Benefit Life, were also forced to fail. In the U.K., Equitable Life Assurance Society, a second-tier company known as the world's oldest life insurer, had to stop underwriting new contracts in December 2000 due to problems arising from policies with guaranteed annuity rates, substantially falling into bankruptcy. In South Korea, Japan's closest neighbor, a number of life insurers, especially relatively young companies, were forced to go under amid the financial crisis that started in 1997.

Japanese cases are characterized by the fact that many midsize life insurers with long business histories and a large scale of operations went under in a short period of time, rather than newly established or small-scale companies that are generally deemed to be financially vulnerable. A few midsize life insurers having as long business histories as those that went under, however, have also managed to maintain (their) financial health. This suggests that the failure of Japanese life insurers was not merely caused by the bubble bursting and other external factors common to all industry players, but rather by the combination of these external factors with other strong factors.

In the wake of the previously mentioned failure of Equitable Life, the U.K. government released the "Penrose report" (or the Report of the Equitable Life Inquiry), its report on the investigation into the cause of the life insurer's failure, in March 2004. The report takes a careful look at the circumstances leading to the insurer's substantial failure and closely analyzes the financial standing of the firm. It also sorts out issues related to corporate governance of mutual companies, accounting audits, actuarial professionals, rational expectation of policyholders, and supervisory regulations. The investigation, including interviews with executives, took more than two years for completion.

Following this Penrose report, this book analyzes the causes for the failures of Japanese life insurers in the financial crisis of the Heisei era, using publicly disclosed data and conducting interview-based investigations. In addition to materials generally available to the public such as insurers' disclosure brochures and statistics, "inspection reports (attached materials)" issued by the Ministry of Finance, I have also gathered other materials not generally available to the public—by filing right-to-know requests—and conducted large-scale interviews with officials of failed life insurers (including managers and staff members of planning, actuarial and financial divisions of that time) to collect testimony on management in an effort to unveil what was actually happening within those failed midsize insurers.

As a credit analyst at a rating agency, I have been engaged in analyzing the credit worthiness of the Japanese insurance industry, including failed life insurers, for more than a decade and consider myself one of those few experts in analyzing the insurance business. Undisclosed information that I happened to know during credit rating investigations cannot be used, but I believe that it is important for an analyst engaged in the analysis of life insurers credit worthiness for a long time to study and analyze instances of failure individually, thereby trying to draw lessons from past experiences.

3. Internal factors related to managers are important

A chain of failures among midsize life insurers are generally considered to have been caused mainly by powerful external stress to the entire life insurance industry (or to a group of companies having certain special attributes) because such failures occurred amid harsh economic conditions after the bubble burst, or caused naturally by the business environment during the bubble period. In other words, many market observers think these failures occurred because "stock prices dropped after the bubble burst," "insurers marketed too many savings-oriented policies that promised high yields," or "the regulatory authorities had failed to adequately oversee life insurers."

To be sure, the yield on 10-year JGB, which temporarily topped 8% in 1990, dropped to a record low of 1%, while the Nikkei average, which rose to 39,000 in December 1989, had long slumped later and dipped below 10,000 in September 2001 for the first time in 17 years. Unexpectedly faced with deteriorating external environments, not only midsize life insurers but also larger players were certainly doing business under extremely harsh conditions. Thus, many observers believe that a chain of bankruptcies among life insurers resulted from structural problems rather than problems of individual insurers, and that these insurers could do nothing to avoid failures no matter how hard they tried.

However, detailed examinations of individual cases have proved that such understanding is extremely superficial, highlighting the fact that internal factors inherent in each company, such as business models, management, and management structure played a significant role in leading to bankruptcy.

Not just one, but multiple internal factors are often involved. The addition of changes in business environment (external factors) to these internal factors led to deterioration of financial structure, generating other signs of future management crisis. The management could have avoided the management crisis that happened later if they had noticed such signs at this stage and taken appropriate steps. Certain internal factors were at work again, however, keeping the management unable to take appropriate action. In other cases, the management took inappropriate steps, and further changes in the business environment (external factors) occurred; a chain of these internal and external factors drove the companies into bankruptcy.

The most important internal factor is concerned with managers. In other words, the inadequate corporate governance of failed life insurers increased their bankruptcy risk.

4. How to learn lessons from instances of failure in the past

First, a life insurer's risk management system, governance and other self-discipline must function well to avoid business failure. This doesn't mean it has to reduce risk to a minimum level, but rather, it has to appropriately recognize the risk that it holds and keeps such risk under control.

Second, in terms of policyholder protection, the government has to continue providing discipline. It must always improve the framework for maintaining the health of insurance companies by using monitoring indexes represented by solvency margin ratios.

Moreover, market discipline via disclosure, rating agencies, stock markets and mass media can also play an important role. Frankly speaking, with the insurance business and products becoming increasingly diversified and complicated, we cannot leave all judgments to the regulatory authorities. The government also could make wrong judgments.

The life insurance industry is not the only one to seek to comprehensively utilize the above mentioned three kinds of discipline. As is well known, new capital ratio requirements (the so-called Basel II rules) introduced to banks at the end of fiscal 2006 have adopted a "three-pillar approach": the minimum capital requirements as the first pillar, self-discipline based on banks' risk management and the supervisory authority's review process as the second pillar and market discipline as the third pillar.

When individually examining the instances of failed midsize life insurers, I have discovered that any of the self-discipline by these insurers, discipline by the government, or market discipline did not functioned well. Besides, discipline provided by the government and the market, which, after all, were both external parties for insurers, had its limits as a chain of internal and external factors led to the business failures of life insurers. The most important lesson that can be learned from the instances of failure in the past, therefore, may be how to control internal factors that increase the risk of failure—in other words, how to make the self-discipline by insurers work effectively.

In this book, I will first examine the impact of external factors on the management of failed life insurers in Chapter 1, highlighting the fact that the culprit of all was not the bubble economy or its collapse. I will then closely examine what was happening to the inside of the failed companies in Chapter 2, discuss the internal factors found in Chapter 2 that increase failure risk and present the relationship between the internal and external factors in Chapter 3.

Chapter 4 will examine the situations of midsize life insurers that have not failed, and find out what has made these companies different from the failed insurers. Chapter 5 will describe a failure case in the U.K. that happened independently of the bubble bursting, and that will also talk about a South Korean case in which a number of life insurers failed around the same time that Japanese players collapsed. I will explain how the management of Japanese life insurers has changed or has not changed following a series of failures in the final chapter, showing that the lessons learned from the review of instances of failure are extremely useful for the current management of life insurers.

Chapter 1
Examining external factors – Is the bubble bursting the culprit of all?

1. Little-known earnings and risk structures of life insurers and the regulatory environment

(1) Three reasons that make it difficult to understand the management of life insurers

Before discussing the factors for the failures of midsize life insurance companies, I would like to briefly talk about the earnings and risk structures of life insurers and their regulatory environment from the viewpoint of a ratings analyst.

The reasons why the management of life insurers is difficult to grasp can be summarized in the following three points. The first reason is concerned with terminology unique to the life insurance industry and financial statements.

For example, an insurer's balance sheet (Table 1-1) does not have the sections of "current" and "fixed" that nonfinancial firms usually have. The liabilities part of the balance sheet is largely occupied by the item "policy reserves". The statement of income is also unique in that it doesn't have the sections of "operating" and "non-operating" with profit and loss from both insurance operations and asset management operations listed as "ordinary profit and loss."

The second reason lies in the earnings structure unique to insurance operations. In most businesses, costs are determined before sales amounts are confirmed. In the insurance business, however, costs are not determined until insurance claims or benefits are paid, or contract terms end. Life insurance contracts in particular run decades, and therefore insurers calculate their policy reserves (reserves in preparation for the payments of insurance claims or benefits in the future) based on certain estimates and recognize profit and loss for every period. More specifically, the current insurance accounting does not necessarily reflect the earnings and risk structures of life insurers.

The third reason stems from inadequate information disclosure and weak analyst function. Disclosure by life insurers, though having improved compared to disclosure in the past, is still far from adequate. Moreover, until Daido Life Insurance Co. went public in April 2002, only media specialized in the insurance industry, insurance critics, and rating agencies had analyzed the operations of life insurers externally and sent information to the public. Rating agencies are bound by confidentiality obligation, and moreover, it was not until the late 1990s that rating agencies virtually started the analysis of Japanese life insurers.

Table 1-1: Financial Statements of Nippon Life Insurance Co.

Balance sheet

100 million yen

	March 2007		March 2008	
		Composition ratio		Composition ratio
Cash & deposits/Call loans	10,653	2.1%	6,967	1.4%
Monetary assets held in trust	1,956	0.4%	1,705	0.4%
Investments in securities	373,302	72.0%	340,038	70.6%
Stocks	120,256	23.2%	87,624	18.2%
Loans receivable	97,267	18.8%	95,534	19.8%
Tangible fixed assets	16,637	3.2%	16,753	3.5%
Allowance for doubtful accounts	-332	-0.1%	-349	-0.1%
Total assets	518,419	100.0%	481,353	100.0%
Assets in special accounts	22,792	4.4%	18,603	3.9%
Policy reserves and other reserves	418,873	80.8%	422,098	87.7%
Policy reserves	403,825	77.9%	407,396	84.6%
Reserves for price fluctuations in investments in securities	4,673	0.9%	4,873	1.0%
Deferred tax liabilities	15,104	2.9%	1,382	0.3%
Total liabilities	460,102	88.8%	446,515	92.8%
Foundation funds	2,500	0.5%	2,000	0.4%
Reserves for redemption of foundation funds	6,500	1.3%	7,000	1.5%
Surplus	4,081	0.8%	3,957	0.8%
Land revaluation differences	-850	-0.2%	-889	-0.2%
Total valuations, conversions and others	45,229	8.7%	21,874	4.5%
Total net assets	58,317	11.2%	34,838	7.2%
Total liabilities and net assets	518,419	100.0%	481,353	100.0%

Statement of income

100 million yen

	March 2007	March 2008
Ordinary revenues	65,141	65,095
Premium Income and Others	48,543	48,890
Investment income	14,097	13,526
Interest, dividends and other income	11,563	12,345
Other ordinary revenues	2,501	2,668
Reversal of policy reserves	-	-
Ordinary expenses	61,835	61,978
Insurance Benefits Paid	38,311	42,129
Provision for policy reserves	10,192	3,923
Investment expenses	2,963	5,558
Operating costs	5,475	5,529
Ordinary income	3,306	3,117
Extraordinary gains	462	12
Extraordinary losses	525	329
Impairment losses	54	46
Provision for reserves for price fluctuations in investments in securities	260	200
Net surplus before taxes for the year	3,243	2,800
Income taxes and residential taxes	1,412	1,033
Deferred income taxes	-1,172	-998
Net surplus for the year	3,003	2,764
Unappropriated net surplus for the year	2,926	2,813

(Data) compiled from the earnings announcement data of Nippon Life Insurance Co.

(2) Earnings structure of life insurers

I will now compare the earnings structure of life insurers with that of banks. The traditional banking business is to collect deposits from individuals and lend these funds to business entities. Besides, public and corporate bonds and other securities make up a large part of asset holdings at regional banks that only have a few prime borrowers because their loan-deposit ratios are low. Banks' profits mainly consist of interest income from lending operations (or earnings from securities investments) after deductions of expenditures such as payments of deposit interest and personnel expenses.

Meanwhile, life insurance companies receive insurance premiums from policyholders and lend these funds to businesses as banks do. They also invest part of their premium revenues in securities including public and corporate stocks and bonds, or real estate. Thus, insurers' profits are similar to banks' in that the spread calculated by subtracting yields promised to policyholders (the assumed interest rate) from interest income from lending operations or earnings from securities investment is one of the revenue sources for insurers.

Unlike bank deposits, however, premiums received by insurers are not all applied to the future payments of insurance claims and benefits as the amount necessary to cover expenditures and risk margin (loading for contingency) are already included in the premiums. Therefore, life insurers have no need to use their spreads to absorb expenditures as banks do, and these charges, along with spreads, have become important sources of revenues (expense profits and mortality profits). Banks would have to gobble up their capital if they ended up with negative spreads, but life insurers would be able to make up for their negative spreads with expense profits or mortality profits.

Term insurance and term insurance riders—which are representative examples of death coverage insurance (in other words, compensation for a bereaved family)—are basically "non-savings type" products that steadily generate expense profits or mortality profits and are not significantly affected by investment performance. Savings-based endowment insurance and individual annuity insurance policies, on the other hand, only provide a small amount of expense profits or mortality profits and are largely affected by asset investment performance. The so-called negative-spread contracts mainly refer to these policies sold from the 1980s through the early 1990s that set high assumed rates of return.

Life insurance also includes group insurance where companies and other business corporations become policyholders and provide coverage to their employees as part of their welfare programs and group annuities, asset management products targeted at corporate pensions (such as employee pension funds and tax-qualified pension plans), in addition to individual insurance policies and individual annuity contracts where consumers individually enter into a contract with an insurance company.

Japanese group insurance is, in principle, required to be renewed every year and therefore does not result in negative spreads. Its profitability is generally extremely low because most mortality profits are returned to policyholders as dividends. Group annuities generate few mortality profits or expense profits as they are asset management products for businesses, and a large part of their investment returns belong to policyholders, meaning that the effective profitability of these products is also low (the negative spreads of group annuities rather weighed down insurers' operations). Therefore, most of the profits made by life insurers can be said to come from the individual insurance sector.

Table 1-2: Comparison of balance sheets between banks and life insurers

Bank's balance sheet

<Assets>	<Liabilities>
Loans	Deposits
(Allowance for doubtful accounts)	
Securities	
	Corporate bonds Others
others	
	<capital>

Life insurer's balance sheet

<Assets>	<Liabilities>
Yen interest-bearing assets (mainly public and corporate bonds)	Policy reserves
Stocks	
Others	<Contingency reserves> <capital>

(Data) compiled by the author

(3) Profitability of the third sector is high

Here, I discuss medical insurance and other "third sector" policies. The third sector refers to insurance that covers damage mainly from diseases and injuries, and is different from life insurance (called the "first sector") offering a certain amount of payouts for people's death and nonlife insurance (called the "second sector") covering damage arising from accidents.

Accident insurance has been traditionally marketed by non-life insurance companies, while medical insurance was effectively segmented into "rider-types sold by major life insurers" and "stand-alone types sold by foreign-affiliated players, midsize, and smaller life insurers" until recently, due to the government's special consideration of foreign-affiliated life insurers and a delay in deregulation caused by stalled insurance talks between Japan and the U.S.

"Medical insurance" and "cancer insurance" remind us of the names of foreign life insurers such as American Family Life Assurance Co. of Columbus and Alico Japan, a unit of American Life Insurance Co., but since "disaster protection riders" (providing hospitalization benefits to disaster victims) were established in 1964, a wide variety of medical-related riders have been launched, becoming mainstay products of major and midsize life insurers. The most recent data (for fiscal 2007) have shown that premium income from the third sector accounts for roughly 30% of the annualized new business premiums at major nine life insurers and also about 20% of the total insurance in force.

The third sector insurance is generally said to boast high profitability although the unit price of premiums for these products is low compared to that for death coverage products. Especially, the sales efficiency of rider-type products is high because they are attached to death coverage products which are the main contracts and are marketed together. With the terms of insurance usually set at 10 years or so, few rider-type policies result in negative spreads. It can be safe to say that mortality profits generated by the third sector insurance have greatly contributed to the earnings of major and midsize life insurers, although we cannot affirm it due to a lack of official data.

(4) Characteristics of management risks

The management risks of life insurance companies mainly include an insurance underwriting risk, asset management risk, liquidity risk and operational risk as well as risk inherent in the insurance business itself.

I will also compare the risk structure of life insurers with that of banks. In the traditional banking business, the biggest risk is the credit risk, that is, the risk of being unable to collect funds due to the business deterioration of borrowers. A mismatch between funding (deposit) rates and investment (lending) rates is also a serious risk. Moreover, we cannot ignore the liquidity risk in which funds flow out at once as a result of a run on deposits caused by credit concerns, or in which banks are faced with difficulties procuring funds, running into cash flow problems.

Meanwhile, the bad loan problems of life insurers didn't become as serious as those of banks (excluding some companies). That is because life insurers in the 1980s preferred to invest in foreign bonds that could provide generous interest and dividends or stocks via money trusts rather than to extend loans to businesses. With life insurance contracts usually spanning extremely long periods, however, life insurers are more susceptible to the risk of facing negative spreads resulting from a mismatch between their assets and liabilities. The price volatility risk of their asset holdings is also great. The financial standings of life insurers substantially worsened due to the drop in share and land prices in and after the '90s.

Life insures' underwriting risk, including the mortality rate and incidence rate, on the other hand, has never become a problem. The mortality rate seldom worsened drastically, but rather improved year after year, having a good impact on the management of life insurers. With respect to the liquidity risk, U.S. life insurance companies struggled with sudden outflows of funds in the time of high interest rates in the early '80s and the management crisis of life insurers in the early '90s, but few Japanese insurers faced funding problems and went under despite a flood of cancellations caused by deepening credit concerns probably because they held a relatively large amount of readily marketable assets.

(5) Stock companies and mutual companies

Some insurers are stock companies, while others are "mutual companies," which are a unique structure of insurance operations. A stock company is a profit-making corporation designed for the benefit of its shareholders, but a mutual company is an intermediate corporation designed neither for profit-making nor for public interest with its policyholders serving as parties to the contracts and participating in business operations as members for the company at the same time. The decision-making body of a mutual company is a representative members meeting comprising representatives chosen among its members (that is, policyholders). The operating funds of a mutual company are known as “kikin”, and contributors to kikin, unlike shareholders, only possess a creditor’s right. Many rating agencies also consider kikin as not capital, but “effective non-perpetual subordinated debt” according to Rating and Investment Information, Inc.

Essentially, a mutual company is formed under the belief (called “the actual cost principle”) that its members can achieve reasonable, high-quality coverage by autonomously managing the company, using only actual costs needed for the management of operations. A conflict between policyholders and shareholders does not occur in a mutual company because there is no shareholder, meaning that the company can return a large part of its business outcome to policyholders. Meanwhile, the disadvantages of a mutual company are that it cannot raise funds through the issuance of shares and the way for bolstering the ability to pay claims is limited to internal reserves from periodic profit and loss. The business monitoring function by members and external parties is also weak because of its structural features.

Insurers adopting the mutual company structure became a strong presence in the U.S., the U.K., and Canada, but many major mutual companies converted into a stock company amid intensifying competition with insurance groups taking the stock company structure. With the two largest life insurers Prudential Insurance Co. and MetLife Inc. having demutualized, major life insurers currently adopting the structure of a mutual company in the U.S. are The Northwestern Mutual Life Insurance Co., New York Life Insurance Co., and MassMutual Life Insurance Co. only. The U.K. and Canada now have no major mutual companies.

In Japan, most newcomers, successors to failed life insurers, and sponsors are also stock companies, while such mutual companies as Daido Life, Taiyo Life and Mitsui Life Insurance Co. converted into a stock company, starting in 2000. The market share of stock companies has therefore expanded recently with only six companies—the major four players (Nippon Life Insurance Co., The Dai-ichi Life Insurance Co., Sumitomo Life Insurance Co. and Meiji Yasuda Life Insurance Co.), Asahi Mutual Life Insurance Co. and Fukoku Mutual Life Insurance Co. —still operating as mutual companies.

Nevertheless, mutual companies had occupied an overwhelming share in the Japanese life insurance market until the '90s. Of 44 life insurance companies, only 16 were mutual companies as of the end of fiscal 1996, but their total asset shares accounted for over 90%, according to Tanaka (2002).

Table 1-3: Stock company and mutual company

	Stock company	Mutual company
Characteristics	Corporation designed for profit-making (established under the Commercial Code)	Intermediate corporation designed neither for profit-making nor for public interest (established under the Insurance Business Act and not categorized as companies under the Commercial Code)
Capital	Capital invested by shareholders (company members)	Funds, or kikin, contributed by fund contributors (not company members but mere creditors)
Membership	shareholders	Members, that is, policyholders
Decision-making body	General meeting of shareholders	General meeting of members (meeting of representatives chosen from members)
Insurance relationship	Profit-making insurance (An insurance relationship arises from an insurance contract)	Mutual insurance (A member relationship and an insurance relationship arise concurrently. A contract based on a non-member relationship is also allowed.)
Where profits and losses belong	Shareholders (but, dividends to policyholders are stipulated by laws) In other words, the distribution of the business outcome is decided by shareholders and therefore, a conflict of interest arises between shareholders and policyholders.	Members In other words, a large part of the business outcome can be returned to policyholders under the member autonomy and actual cost principles.
Number of companies		Six out of 40 life insurers are mutual companies, while all nonlife insurers are stock companies (excluding branch-based insurance companies)
advantages	The business monitoring function by the market can work.	No conflict of interest arises between shareholders and policyholders.

(Data) compiled by the author

(6) Regulatory environment for life insurers

The insurance business is highly public in nature, and unless it is conducted in a sound and appropriate manner, the lives of individual policyholders and the management of companies could be seriously affected. The government, therefore, has implemented legal regulations and exercised administrative supervision to protect the interests of policyholders.

In Japan, the government administration of insurance was a typical “convoy-fleet” approach until the Insurance Business Law was revised in 1995 and deregulation proceeded gradually. The approach adopted was based on the substantial supervision principle that granted the regulatory authority (the Ministry of Finance) a broad range of power, allowing it to get involved in all of the business stages of insurers from the start of insurance operations (acquisition of license) to the management of operations, final liquidation of struggling businesses and mergers under the former Insurance Business Law wholly revised in 1939, pre-World War II.

The ministry’s oversight of insurance companies extended to the entire management including the extent of operations, products, premium rates, dividends to policyholders, insurance soliciting systems, and asset management. Detailed business reports were submitted to the Ministry by insurers every year, and on-site inspections (so-called MOF inspections) were conducted as necessary. Moreover, the MOF had the authority to force companies falling into a management crisis to comprehensively transfer their contracts to other insurers and to change the basic rates of existing contracts, including the assumed interest rate (these authorities were terminated in the revisions to the Insurance Business Law in 1995).

New entries into the insurance market have been increasingly accepted due to external pressure from the international community, which had been extremely difficult until the mid-1990s. Products and premium rates were almost the same at all insurers, and dividends paid to policyholders were not much different among major life insurers. Midsize players having lower cost efficiency than larger players were allowed to pay less dividends compared to larger insurers’. The collaborative framework, led by major companies, generally worked out despite the competition with postal life insurance and mutual aid insurance, or the fierce sales race within the industry.

(7) Introduction of solvency margin standards

In response to increasing moves toward financial deregulation and system reform at home and abroad, the Insurance Business Law was wholly revised in 1995 for the first time in half a century. The pillars of the revisions were "to promote deregulation and liberalization," "to maintain the financial soundness of the insurance business," and "to ensure fair business management." These three pillars successfully showed the future direction of the government administration of insurance, although their implementation was inadequate immediately after the revisions.

The framework for regulations concerning the financial soundness of life insurers has also greatly changed. In the era of the "convoy-fleet" system, the regulations focused on returns to policyholders rather than ensuring financial soundness against the backdrop of abundant latent stock profits. In order to detect and help troubled companies at early stages, the revised Insurance Business Law introduced the solvency margin (Excess amount of assets an insurer has over its liabilities) standard as the regulatory authorities' measure for preventing insurers' management crisis, and it also became the criterion for issuing a prompt corrective action in April 1999.

As a result, while bound to put aside reserves to deal with risk within normally expected levels as they did before, life insurers have been required to hold solvency margins to prepare for risk beyond those expectations. Thus, the financial soundness of insurance companies has been ensured not only by capital adequacy rules but also two other pillars, policy reserves, and solvency margins.

Moreover, insurers were required to introduce a system where actuaries, their in-house experts, check the adequacy of policy reserves. Those actuaries run simulations based on a given scenario to see, for example, if their companies can set aside required policy reserves in the next five years even though low interest rates continue (future cashflow analysis).

However, the revisions to the Insurance Business Law have given the impression that the government's measures to maintain the financial soundness of the insurance business were rather too late probably because the revisions only came in the harsh business environment after the bubble burst.

The solvency margin standard was introduced in fiscal 1996, but before that, discussions had been underway at the follow-up study group on insurance accounting, a private advisory body to Director of the Insurance Department of the Banking Bureau of the Ministry of Finance with trial calculations being performed on two patterns—the A standard (counting 90% of latent stock profits in an insurer's claims-paying capacity) and the B standard (reckoning in 45% of such gains)—starting in around fiscal 1993. While seven midsize life insurers posted pretax losses in fiscal 1994, however, highlighting worsening financial positions of life insurers, the solvency margin ratio actually introduced was more lenient than the A standard. As a result, in addition to Nissan Mutual Life, which failed in April 1997 shortly after the introduction of the standard, several insurers went under although their solvency ratios publicly disclosed just before the failure exceeded 200%, the level triggering a prompt corrective action.

Table 1-4: Solvency margin ratio

Solvency margin ratio = total amount of solvency margin / total amount of risk x 1 / 2

Criteria for issuing a prompt corrective action

200% or more	Exempt
100% to less than 200%	Submission and implementation of a management improvement plan
0% to less than 100%	Submission and implementation of a plan to bolster the claims-paying capability Prohibition or limitation of dividends or directors' bonuses Change in calculation method of premiums for policies to be newly underwritten Limitation of operational costs Closing of part of the business branches or premises Downsizing of operations at subsidiaries and others
Less than 0%	Total or partial suspension of operations

* The criteria for issuing a prompt corrective action also include the level of "real net asset-liability balance."
If the solvency margin ratio is less than 0%, the regulatory authorities can issue a business suspension order.

(Data) compiled by the author

2. Examining structural factors—External factors for the whole industry

(1) View that "the life insurers' crisis" is a structural problem

Failures among midsize life insurers are generally considered to have been caused mainly by powerful external stress to the whole life insurance industry (or to a group of companies having certain special attributes) because such failures occurred amid harsh economic conditions after the bubble burst, or caused naturally by the business environment during the bubble period. In other words, many people believe that a chain of bankruptcies among life insurers were the result of structural problems rather than problems of individual insurers, and that these insurers could do nothing to avoid failures no matter how hard they tried.

As an example, I will quote part of the comments made by Fumio Masada, then President of the NLI Research Institute, which were first quoted by Asatani (2004).

“The definitive cause for failure was generally “negative spreads” that resulted from a drastic change in financial and interest environments far beyond the duty of care owed by managers and the generally expected predictive ability, although the conditions of individual cases were slightly different if examined closely.”

Nishimura (1999) also indicates that he considers the failures of life insurers as a consequence of their structural problems, by saying, “Insurance companies aggressively marketed variable insurance and other high-risk products touting high returns during the bubble economy era and therefore, it’s not that they were not to be blamed for their failures. Life insurance, however, can be essentially managed in a stable manner for a long time on the premise of sensible interest rates. If rates remain at extraordinary levels for not just a short period, but such a long period of time, that would naturally damage their operations”.

I will now look at various external factors cited in a variety of literature that are deemed to have adversely affected the management of life insurers.

(2) Impact of the bubble bursting

Generally, negative spreads that occurred after the bubble burst, depletion of latent stock profits and bad loan problems are considered to have largely worsened the management of life insurers in the 1990s and thereafter. I will quote some representative descriptions from business books.

From “Review of the Seiho Crisis” written by Mr. Mitsuhiro Fukao, published by the Japan Center for Economic Research, in 2000

“The worsened investment environment following the bubble burst, including sluggish stock prices and a prolonged period of ultra-low interest rates, has left most life insurers saddled with large negative spreads, gradually weakening the management bases of these insurers. (Page 1)"

From "What Will Happen to Seiho?" published by Nikkei Inc. in 2003

"Stock prices plunged with the bubble bursting. Interest rates dropped to near zero levels due to monetary easing measures introduced by the Bank of Japan to stimulate the economy. Falling land prices made it difficult to invest in real estate. With every lucrative investment vehicle having disappeared, life insurers with huge funds have entered a period of total darkness since the bubble burst. (Page 12)"

"The biggest cause for the financial difficulties of life insurers lies in 'negative spreads,' or the gap between the yields promised to policyholders at the time of executing contracts and actual investment return. … The business conditions of insurers have been deteriorating due to weak investment performance amid ultra-low interest rates and falling stock prices. (Page 109)"

From "Overcoming the Seiho Crisis" written by Mr. Yasuo Kofuji in 2003

"The negative spread problem is just the cause for as many as seven life insurance companies going bankrupt in a short period of time. As interest rates changed constantly, life insurers faced the historically low interest rates and suffered negative spreads brought by mainly the products with high assumed interest rate acquired in the bubble era. Life insurers that became unable to make up for these negative spreads started to fail. (Page 20)"

I also say as follows in my book "Seiho's Business Model Will Change" (2003).

"It's wrong to put the blame for Seiho's deteriorating business solely on external environments, but who on earth could have imagined that the Nikkei Average would plunge to less than 8,000 at the end of March 2003, 13 years after hitting 39,000 in December 1989? ... Plunged levels of interest rate for a prolonged period of time is also beyond our imagination. (Page 16)"

Using the business results data of that time, I will examine the impact of the bubble bursting on the management of life insurers. Domestic stocks accounted for 20% (25%

if money trusts are considered as stocks) of the combined total assets of life insurance companies, while general loans and real estate accounted for 32% and 6%, respectively. At that time, stocks were valued at acquisition cost, which suggests that the percentage of stocks in the total assets was likely to be much higher on a market value basis (probably more than 40%).

These assets were largely damaged following the bubble bursting. Unlike now, the lower of cost or market value method was adopted to evaluate stockholdings, requiring life insurers to book valuation losses if the stock prices dropped below the acquisition costs. Every year from fiscal 1990 through 1997, except in fiscal 1995 when stock prices recovered, the major three life insurers (Nippon, Dai-ichi and Sumitomo) all had to post more than ¥100 billion in valuation losses on securities holdings, which weighed heavily on their earnings. In fiscal 1994, as the year-end approached, stock prices fell further and the yen advanced, forcing many midsize life insurers to book pretax losses and even major players to draw down price fluctuation reserves and other internal reserves, due to a large amount of valuation losses.

In the ’80s, life insurers paid special dividends funded from capital gains as well as regular dividends. They also started tapping into capital gains in the ’90s to secure a certain level of dividend levels for policyholders, while dealing with a massive amount of valuation losses.

Capital gains were booked via “sales to lock in profits” rather than “so-called one-time sales” with stocks sold at acquisition cost and bought back at market value in a number of cross transactions. Some sales to lock in profits were transactions that did not accompany trading of stocks to book capital gains, which were permitted only for insurance companies under Article 84 of the Insurance Business Law (Article 112 of the law at present). In the industry as a whole, capital gains of more than ¥500 billion were posted each year in fiscal 1992 and 1993.

Write-offs of bad loans also started to weigh heavily on their earnings in around fiscal 1993. As I discuss later, life insurers invested mainly in foreign equities and money trusts because they focused mostly on direct-yields and therefore, insurers’ bad loan problems never became as serious as banks’. But Sumitomo Life, for example, wrote off a total of ¥1.5 trillion in bad loans during the period from fiscal 1993 through 1997 as real estate-related investments and loans it actively engaged in during the bubble years ultimately backfired. Nippon Life and Dai-ichi Life also incurred a large amount of bad-loan cleanup costs, though their amounts were not as large as that of Sumitomo Life's. These bad-loan cleanup efforts were mainly funded by latent stock profits. Insurers also used their latent stock profits to deal with currency losses from foreign equity investments caused by the appreciation of the yen.

Life insurers saw their latent stock profits largely shrink as a result of booking profits on cross traded shares to secure funds for dividend payments and dispose of bad loans as well as being hit by drops in share prices. This is in stark contrast to non-life insurers, which continued posting a certain amount of latent profits even after the bubble burst. The combined latent profit of the life insurance industry is believed to have plunged to around ¥5 trillion in fiscal 1994 from the peak level of ¥47 trillion recorded at the end of 1989.

For example, the largest player Nippon Life's latent stock profit shrank to ¥2.3 trillion at the end of fiscal 1994 from the ¥8.9 trillion reported at the end of fiscal 1989. Sumitomo Life and Mitsui Life saw their latent profits nearly depleted at the end of fiscal 1994. These facts suggest that the impact of a drop in asset prices in the 1990s was extremely severe for even major life insurers.

Meanwhile, the negative spreads of major and midsize life insurers became obvious, probably around fiscal 1992. The officially disclosed amount of negative spreads for fiscal 1995 was ¥420 billion at Nippon Life and slightly less than ¥300 billion at Dai-ichi Life and Sumitomo Life, which all exceeded their surplus for the year (¥260 billion, ¥160 billion, and ¥200 billion, respectively). Because the assumed interest rate for group annuities was lowered from 4.5% to 2.5% in April 1996, each of the three companies saw their amounts of negative spreads shrink by around ¥100 billion in fiscal 1996, but every year after that, they still posted hundreds of millions of yen in negative spreads, which weighed heavily on their earnings.

Major insurers, though, substantially made up for their negative spreads with expense profits and mortality profits and therefore had no need to dig into capital gains or internal reserves. That is because their profitability was high thanks to scale merits, and they marketed a large number of death coverage insurance as their mainstay products. Meanwhile, the profitability of many of the failed midsize life insurers was low in the first place, making it difficult to cover their negative spreads with expense profits and mortality profits.

(3) The business environment in the 1980s (Part 1: Maturation of the death coverage market)

We cannot ignore the fact that the business environments of life insurance companies in the 1980s was behind the depletion of latent stock profits, severe negative spread, and bad loan problems that occurred after the bubble burst. The major environments include maturation of the death coverage market, a hike in the assumed interest rate and high levels of dividends to policyholders and attitudes of the regulatory authorities.

For quite some time, life insurance referred to “endowment insurance,” under which benefits would be paid either at the time of death or the expiration of the insurance terms, but around 1960, the mainstay products of life insurers started to shift to endowment-with-term insurance and other policies focusing on death coverage. From the 1970s when the penetration rate for households exceeded 90%, death coverage grew in size (in the amount of coverage), and fixed-term whole life insurance policies with term insurance riders 20 or 30 times the size of whole life insurance became leading products. Behind the expansion of the death coverage market was the accelerating trend toward nuclear families (with a single wage earner per family, the importance of paying benefits to bereaved families increased), rising income levels and expanded marketing forces.

The number of new contracts peaked out in the 1980s, however, indicating that the growth of the death coverage market was already reaching its limit. Customer needs were shifting from death coverage to living benefits such as medical policies and annuities.

Nevertheless, the life insurance industry did not necessarily respond to the change in customer needs and kept death coverage products at the center of their product lineups, continuing the traditional strategy of seeking the growth of death coverage and the expansion of marketing forces. Insurers appear to have concluded that they otherwise would be unable to cover the labor costs of their sales personnel because the profitability of individual annuity insurance and small-lot medical insurance was low compared to that of high-end death coverage products. To stimulate the sales plateau for death coverage products, life insurers raised the assumed interest rate (meaning a reduction in insurance premiums) and introduced systems of lowering premiums at the beginning of insurance terms such as a renewal type contract and step-up payment system (in both of which the amount of premiums goes up after a certain period of time).

Regarding these steps taken at that time, Mr. Masatoshi Furuse, then Professor of Ritsumeikan University, says as follows in a research paper published in 1994, shortly after he moved from Nippon Life to take the position: "The last decade was characterized by the fact that the value of new individual insurance policies increased substantially year-on-year in the years (1981 and 1985) when low rates were implemented (*premium rates were lowered: the author's annotation). Then, as the growth rate slowed later, the next low rates were implemented as a measure to boost the contract amount. (Furuse, 1999)"

Meanwhile, contrary to life insurers' intention, sales of individual annuity insurance policies increased with savings-based single-premium endowment insurance receiving investor attention again. For example, single-premium endowment insurance attracted attention as a "*zaitech,*" or financial engineering product in the 1980s, as "customers lined up outside sales offices," and "media advertised the insurance on their own" (according to staff members working at the headquarters of Chiyoda Mutual Life at that time). Individual annuity insurance policies also sold well at both major and midsize companies and accounted for 6.8% of the combined policy reserves at all life insurers in fiscal 1989, up from a mere 3% in fiscal 1986. These contracts later resulted in large negative spreads, weighing heavily on the management of life insurers.

In the corporate field, sales of group annuities expanded. Looking at changes in returns on employee pension plans on a market value basis, dividends of 2 or 3% were always added to the guaranteed yield of 5.5% in the general account of group annuities in the late 1980s. Because the yields of rival trust banks were basically lower than those of life insurers, funds concentrated on group annuities offered by life insurers. These funds also became a heavy burden on the management of those insurers until the assumed interest rate was lowered to 2.5% in 1996.

(4) The business environment in the 1980s (Part 2: Raising the assumed interest rate)

Nikkei Research Inc.'s "Report on case studies of failed financial institutions" says, "Life insurers made lenient estimates for the assumed interest rate (in other words, set the assumed interest rate high) during the economic bubble to expand their assets, thereby winning competition with other financial products, but this led to negative spreads after the bubble burst, weighing on the management of life insurers and forcing them into bankruptcy (Page 85)," suggesting that setting the assumed interest rate high and focusing on marketing of savings-based high-yield products were important factors resulting in life insurers' failures.

In the retail field, the assumed interest rate hovered at around 4% for quite some time during the post-war period. The rate was raised three times in 1976, 1981, and 1985, which undoubtedly deepened the problem of negative spreads in the 1990s and thereafter. The assumed interest rate for new contracts was lowered in line with market interest rates, starting in 1990, dropping to about 1.5% at present. In the retail insurance field, however, the burden associated with high yields guaranteed to policyholders will continue until the contracts terminate, and the assumed interest rate for new contracts is never applied back to contracts acquired in the past.

Looking at major life insurers' balance of policy reserves by contract year (in the retail insurance field), the portion of fiscal 1981 through 1995, including the era of high assumed interest rate, still accounts for around 60% of the total outstanding balance, weighing heavily on the management of those insurers.

Until the Insurance Business Law was revised in 1995, there were no regulations stipulating the relationship between the assumed interest rate and market interest rates. "The assumed interest rate should be set at lower than interest levels for the general business world in terms of stability of the life insurance business, which puts the protection of policyholders first (Page 94)," according to "Japan's Life Insurance" (1994) compiled by Director of Insurance Division I, Banking Bureau, the Finance Ministry. Mr. Haruaki Deguchi of Nippon Life (in 1990) writes, "When I joined Nippon Life in 1972, older colleagues told me that the assumed interest rate was usually around half of market rates." Moreover, market interest rates (yields on 10-year JGB) peaked out in 1980 and followed a downward trend until around 1987.

Nevertheless, life insurers kept the assumed interest rate high during the 1980s because of (1) a request for a rate increase made by a report of the Insurance Council to the Minister of Finance (2) competition with postal life insurance and (3) a lack of ALM (asset liability management) as well as growing needs to stimulate sales with the maturation of the death coverage market as described earlier. I will now comment on each one of these.

<Request for a rate increase made by a report of the Insurance Council to the Minister of Finance>

More precisely saying, this is a view that "How the insurance business should be in the future" the Report of the Insurance Council to the Minister of Finance of 1975 (generally called "Showa 50-nen Tohshin"), led to the increase in the assumed interest rate afterward.

The report says, "Now that calls for insurance products with low rates and low dividends (meaning both premium rates and dividend payout ratios are set low: the author's annotation) are growing, it's not good to factor in too much security and set premium rates low while holding down the assumed interest rate. It is necessary to consider raising the assumed interest rate from the current 4% level in response to changes in general interest rate levels, actual asset investment yields and the move taken by postal life insurance in December last year to raise its assumed interest rate to 5% (5.5% for policies with the insurance terms of less than 20 years). Especially, higher assumed rates of return should be applied to contracts with the insurance terms of 10 years or less because projections of future yields on asset investment may be possible to some extent," strongly urging life insurers to raise their guaranteed yields. In fact, following this report, the first increase in the assumed interest rate was carried out in 1976.

It is not necessarily clear, though, whose intention was reflected in the report. To a request for advice made by the regulatory authorities in 1974 concerning the assumed interest rate, the Institute of Actuaries of Japan showed its careful stance, saying, "We do not think the current rate should be raised" and "A rate hike, if any, should be limited to around 1% for only short-term (10 years or less) products," according to "A Hundred Year History of The Institute of Actuaries of Japan" (2000), which suggests that the rate hike was in response to a strong intention by the Ministry of Finance.

However, according to the parties concerned, major insurers were not in complete solidarity on this matter. The hike in the assumed interest rate was not based upon a unified opinion of the industry, but the Ministry of Finance and the life insurance industry may have reached an agreement to choose the option of raising the assumed interest rate amid a general perception that “life insurers were making too much money.”

<Competition with postal life insurance>

As mentioned in the report of 1975, postal life insurance raised its assumed interest rate from 4% to 5.0-5.5% in 1974 ahead of private sector life insurers, and since then, the rate hike competition between postal life and private sector companies had continued for a while.

To be sure, postal life had been steadily expanding its operations by seeking unity with postal savings and raising the limits of insurance amounts, and therefore we cannot say that there were no overlapping operations between the two types of insurers. However, unlike the customer bases of private-sector life insurers (especially, major players), people served by postal life were not a type of customers who paid tens of thousands of yen in monthly premiums. The mainstay products were also effectively segmented into 10-year maturity endowment insurance sold by postal life and large-scale death coverage products sold by major life insurers.

It is reasonable to assume that the rate hike came not because private-sector insurers were preoccupied with winning the competition with postal life, but rather because they succumbed to the charm of lowering premium rates as well as the public pressure to raise guaranteed yields.

<Lack of ALM (asset liability management)>

In essence, this problem was larger than the other two. ALM stands for Asset Liability Management and refers to the technique of controlling market risk, including interest-rate risk, and liquidity risk by comprehensively managing assets and liability.

As mentioned earlier, yields promised to policyholders at the time of concluding contracts continue for a long period of time for most life insurance products, excluding group annuities and variable insurance. The implementation of ALM, which completely matches changes in assets and liabilities, can be an option for life insurers to avoid the risk of having negative spreads in the future. In reality, with cancellations and expirations sometimes surging due to economic conditions and interest rate levels, it is difficult to grasp changes in liabilities precisely. Moreover, the terms of life insurance contracts usually exceed 20 years, and therefore it's not still easy to secure assets that can match such long-term liabilities. Besides, with premiums for life insurance products usually paid monthly, merely balancing the terms of assets and liabilities is not enough for the matching of cash flow (interest-rate swaps and other means are necessary).

Thus, life insurers' ALM had technical hurdles, requiring them to exercise ingenuity, including setting the assumed interest rate conservatively low, in order to reduce the risk of having negative spreads.

Life insurers in the 1980s engaged in investment that fully depended on ever-increasing assets and ample latent stock profits, and even major players had little idea about liability-conscious ALM. In other words, life insurers didn't realize the risk associated with guaranteeing rates of return for a prolonged period. Because they raised the assumed interest rate despite the downward trend of market rates, yields on 10-year JGB fell below their rate of return in the late 1980. The inverse relationship between funding costs including dividend burden and market interest rates was even greater than that between the assumed interest rate and market interest rates. To deal with the problem, life insurers didn't lower their assumed interest rate or review their product strategies, but instead devoted themselves to investment in stocks (including money trusts), foreign securities and other high-risk vehicles to cover high funding costs.

This lack of ALM consequently increased the asset management risk and negative spread risk of life insurers.

Insurers were also late lowering their assumed interest rate. The Ministry of Finance asked the life insurance industry in June 1988 to review their rate of return, according to news reports. "That is because the ministry worried in the context of finance if insurers could keep their high rate of return for lump-sum endowment and other '*zaitech*' products that continued attracting a huge amount of funds, while the trends of low interest rates were expected to continue for a long time. Besides, the ministry saw yields of life insurance products far exceeding those of other financial products as a problem from the viewpoint of financial order" (according to the Asahi Shimbun dated December 5, 1988).

Life insurers, however, did not lower their assumed interest rate because they bowed to the general tone that "it wouldn't be acceptable to cover foreign exchange losses with a price increase" and postal life insurance kept its rate of return unchanged. It was not until stock prices entered a downward trend in 1990 that life insurers actually lowered their rate of return.

(5) The business environment in the 1980s (Part 3: Burden of policyholder dividend payment)

Many people point out that in addition to a high assumed interest rate, a high level of policyholder dividends in the 1980s eroded the financial health of life insurance companies.

Furuse, who I mentioned before, writes (in 1994), "Life insurers' asset management strategy during the bubble period was increasingly shifted to investment in foreign currency-denominated assets, *tokkin* specified money trusts and other high-risk investment vehicles to secure financing sources for high guaranteed yields and high dividend payouts. During that time, they sold stocks to lock in profits in order to maintain high dividend payouts and make up for foreign exchange losses. As a result, the book prices of stocks were inflated." He thus indicates that a high amount of dividends raised the acquisition costs of stocks, making life insurers vulnerable to a drop in stock prices.

The Report of the Insurance Council to the Minister of Finance of 1975 calls for lowering insurance premiums rather than policyholders' dividends by saying, "Many consumers want insurance products with low rates and low dividends rather than those with high rates and high dividends." In reality, however, premium rates dropped further via a hike in the assumed interest rate, while the high level of dividend payouts was also maintained, resulting in products with "low rates and high dividends." Life insurers' funding costs (combining assumed interest rate, interest dividends and special dividends for long-term contracts) hovered around 10% during the period from the early 1970s through the 1980s, according to Mr. Deguchi, who I mentioned before. He writes (in 1990), "From an international standpoint, the high funding costs of Japanese insurers, in relation to market interest rates, can be summed up in the single word, abnormal" and "Insurers should not be able to manage their operations in a sound manner if they continue offering such products with low rates and high dividends."

Fumio Masada of Nippon Life (in 1994) says in his research report (in 1994), “Life insurers lowered their assumed interest rate only in an extremely gradual manner in the late 1980s, the so-called bubble period, despite a plunge in money market rates.”

I will express my views on the following three key words: (1) income dividend principle (2) special dividend and (3) race for group pension money.

<Income dividend principle>

Life insurers’ dividends paid to policyholders come in two types: regular dividends paid each year and special dividends paid at the time of lapse of a contract or after the elapse of a certain period. Regular dividends employed the contribution method, and the source of interest profit, which is a capital of interest dividends, was limited to interest and dividend income (income gain) under the Insurance Business Law before its revision in 1995. Article 86 of this law required insurance companies to set aside the profit on the sale of securities (capital gains) as a reserve, so as to prevent them from misusing the capital gains.

The introduction of special dividends (in 1972), which will be described later, made it possible to pass capital gains on to policyholders. However, the life insurance industry favored single-year book closing and stuck to the principle of paying income dividends alone even in the 1980s. For life insurers, the purpose of asset management was to maximize the income gains.

For example, when the interest rate level declined in the 1980s, life insurers increased investment in foreign securities, particularly U.S. Treasuries carrying high interest rates, in order to secure larger income gains. They continued to boost foreign securities investment even though, with the yen surging against the dollar in 1985 and thereafter, they were suffering a large amount of exchange loss from year to year. There might have been some influence from the change, such that the upper limit of the percentage of the overseas securities to the total asset was raised from 10% to 30% in1986. So it is reasonable to assume that life insurers were trying to secure income gains to ease the exchange loss, which caused by the strong yen, with the latent stock profits. Foreign bond investments, in which life insurers expected the latent stock profits, were no other than the conversion of capital gains to income gains for them.

Another example of the income dividend-paying principle distorted life insurers' investment activities was also observed when they expanded investment in money trusts, structured bonds and foreign-currency investment trusts. In 1984, the range of investment vehicles of specified money trusts was expanded from government bonds alone to include all kinds of securities, making it easier to turn capital gains into income gains. Life insurers were allowed to use the investment return on money trusts as a source of regular dividends. If an investment loss was incurred, they were able to offset it by latent stock profits. They used structured bonds and foreign-currency investment trusts mostly to generate high dividends. According to testimony from insurance business people, many investment products purchased by life insurers were designed to pay a higher dividend than the actual return in the initial year. As these products incurred heavy latent losses in the 1990s, they became a drag on the management of life insurers in many cases.

The income dividend principle continued to hold sway until the Insurance Business Law was revised in 1995. Even without this principle, life insurers may have engaged in "management dependent on latent stock profits" in the 1980s. Still, this principle was one factor that distorted life insurers' asset management without doubt.

<Special dividends >

Special dividends are paid out of profits on the sale of stocks and real estate and come in two types: special dividends at the time of lapse (mu (μ) dividend) and dividends for long-term contracts (lambda (λ) dividend). Under Article 86 of the former Insurance Business Law, life insurers were supposed to set aside profits on the sale of assets as a reserve, as mentioned earlier. This article had a proviso to the effect that insurers did not have to set up a reserve like this if they obtained permission from the competent minister in charge. According to a notification from then Director-General of the Banking Bureau, insurers were exempted from the duty of setting up a reserve required under Article 86 if they used the money to pay special dividends. This rule was introduced in 1972 to mitigate the effect of inflation because life insurance contracts usually extend over a long time, price increases may erode the insured amount.

The Report of the Insurance Council to the Minister of Finance of 1975 stated that: "it is necessary to make positive efforts to pass capital gains on stocks to policyholders while ensuring equality among policyholders." With this, life insurers shifted their focus from coping with inflation to passing latent stock profits on to policyholders.

There was no reasonable rule for payment of special dividends, and the dividend amount was decided each year through the talks between the Ministry of Finance and life insurance industry, according to insurance business people. In fact, life insurers, big and small, paid largely the same special dividend. The previously mentioned Report of the Insurance Council to the Minister of Finance of 1992 stated that: “it is necessary to sort out and clarify the functions of latent stock profits (1) providing against stock price fluctuations, (2) serving as a financial source of special dividends to be returned to policyholders and (3) serving as a buffer in business management) and to improve the dividend payment system to one based on gross earnings including capital gains.” It appears that, even in the 1990s, there was no reasonable rule applied when it comes to paying dividends out of latent stock profits.

When life insurers saw their latent profits increase amid the stock market boom in the second half of the 1980s, they came under pressure to return more of their profits to policyholders. In 1987, the administrative authorities (Mr. Masahiro Sakata, then Director of Insurance Division I, Banking Bureau, the Ministry of Finance) said that “latent stock profits have sharply expanded with the stock price increases in the past three years, and we need to check whether this is reflected in the special dividends paid by life insurers” (according to the Nikkei Financial Daily dated November 25, 1987). Under guidance from the Ministry of Finance, life insurers reduced the interest dividend and raised the special dividend. As a result, they reported a large amount of securities-related profit and loss (capital gain minus capital loss and appraisal loss) every year from fiscal 1986 to 1990. Life insurers were supposed to set aside capital gain as a reserve under Article 86, as mentioned earlier, but they did not do so. In those days it was considered common to take advantage of the proviso of Article 86, according to the parties concerned.

As they continued to pay special dividends in the absence of reasonable rules, life insurers came to purchase shares at higher and higher prices and ended up weakening their own management strength.

<Race for group pension money>

Corporate pension funds used to be managed exclusively by life insurers and trust banks until investment advisory companies were allowed into the field in 1990. In the 1980s, life insurers held shares of companies whose pension funds they managed. By guaranteeing returns and paying stable dividends, they enjoyed a growing share of the corporate pension market.

Japanese corporate pension funds, such as employee pension funds and tax-qualified pension funds, are of the defined-benefit type, which promises to pay a certain amount of benefits in the future and collects premiums accordingly over the years. The assumed return, which is one of the basic pension rates, was uniformly set at 5.5%. This means that it was absolutely necessary for corporate pension fund managers to secure an annual investment return of 5.5%.

Let us look at the investment returns for employee pension funds in the second half of the 1980s. Trust banks, which were rivals of life insurers, showed investment returns ranging widely from 1% to 12% every fiscal year to year, while the returns for life insurers' general account were stable ranging from 7% to 9%. Life insurers in their general account guaranteed an assumed 5.5% rate of return and on top of that, paid a dividend as well. All life insurers paid the same amount of dividend until three midsize insurers dropped out in fiscal 1991. For corporate pension funds, life insurers were something they should be very grateful for.

Life insurers could afford to do all this because, for one, they had a large amount of latent stock profits and, for another, they managed personal insurance and group annuity contracts in a pooled account without using separate accounts for different product categories. Although personal insurance and group annuity are very different types of products in terms of assets and cash flow characteristics, life insurers managed them together in a slipshod manner. The newsletter "Pension Information" (issued by Rating and Investment Information, Inc.) dated May 11, 1992 carried a comment that "many people still hold the view that 'life insurers' strength lies in their pooled account. By lumping various assets together, they can spread out the risks of lending, investing in domestic stocks and investing overseas'."

With their accounting practice like this, it is most likely that life insurers moved money from personal insurance contracts to group annuity contracts to cover the shortfall in the latter and achieve a high investment yield for group annuity contracts. This is because the personal insurance business has a long history whereas corporate pension products were introduced as recently as 1962 and it is reasonable to assume that life insurers accumulated latent stock profits over a long time mostly from the personal insurance business. Moreover, all life insurers paid the same amount of dividend regardless of their investment performance. This means that life insurers who had poor investment results must have been forced to turn to latent stock profits.

From the viewpoint of ALM also, general-account group annuity is a very risky product for life insurers. A group annuity contract has no concept of “maturity.” It is assumed that a fixed return is guaranteed unless the contract is canceled by the customer. In and after 1994, the investment environment deteriorated so much that life insurers were forced to lower the assumed investment return in a gradual manner from 5.5%. All the same, they had to treat group annuity as a long-term yield-guaranteed product when they were entrusted with money. Group annuity has almost no other profit source such as the expense profit and the mortality profit which accrue in the case of personal insurance. Moreover, basically a contract can be cancelled at any time after a certain period of time has elapsed, and products back then could be cancelled without any penalty clause. The ALM of debt-like products of this kind should be no easy job, but it is unlikely that life insurers of that time were aware of this and operated the group annuity business accordingly.

From the viewpoint of corporate pension funds, life insurers’ general account was a very good thing. It guaranteed a certain return and, if good investment results were achieved, paid a dividend as well. It was like buying a call option without paying the option premium. For life insurers, however, their general account was not a good thing. If they had a large balance of general-account annuity contracts, which may be canceled at any time without penalty on the part of customers, it meant that they carried the constant risk of losing a significant portion of pension assets in addition to the burden of paying the assumed interest rate.

(6) The business environment in the 1980s (Part 4: Position of the regulatory authorities)

As stated earlier, Japanese regulators adopted a typical “convoy-fleet” system in overseeing the insurance industry. It adopted the concept of substantive supervision which means that, under the former Insurance Business Law, the authorities give specific instructions at every stage of management of an insurance business. The Ministry of Finance laid out specific regulations and provided guidance on individual cases, including discretionary judgment, to insurance companies to help with their business management. Insurance companies could not have raised the assumed interest rate or pay a policyholder dividend without the approval of the Ministry of Finance.

<Administrative policy promoting net premium reserve>

Before the solvency margin standards were introduced upon revision of the Insurance Business Law in 1995, the Ministry of Finance urged life insurers to set aside a policy reserve based on the net premium in order to ensure their sound management.

Mutual companies dominated the life insurance market until the 1990s. Unlike joint stock companies, they had no capital. Because it was believed that “there is no such thing as the capital of mutual companies,” the idea of improving their capital base did not occur to the regulators. The balance sheets of mutual companies of that time showed that their “capital” was very small. The 16 mutual life insurance companies had an average capital-to-asset ratio of only 0.02% at the end of fiscal 1990. Even if capital-like liabilities such as the contingency fund and the price fluctuation reserve were included, the capital-to-asset ratio was less than 3%.

For mutual companies, it was more important to pay dividends to policyholders than to build up internal reserves. In the 1980s, 99% of the net surplus went into the reserve for payment of policyholder dividends. Life insurers in the form of stock companies such as Kyoei Life and Nippon Dantai Life were instructed to do business in the same way as mutual companies and, like mutual companies, they were “undercapitalized,” as was clear from the settlement data and testimony by the people concerned at that time.

The Ministry of Finance was trying to ensure the sound management of life insurers by having them build up substantial policy reserves under the net premium method. There are two typical ways of building up a policy reserve—the Zillmer method and the net premium method. The most costly part of the life insurance business is when the insurer acquires a new contract. Under the Zillmer method, the insurer initially sets a smaller reserve in step with the higher initial cost and amortizes assets over the period of several years. Under the net premium method, the insurer does not allow for the initial high cost but starts setting up a reserve on a par with the net premium in the initial year. When the Zillmer period (amortization period) has elapsed, the reserve levels under the two methods would be the same.

Administrative guidance promoting the net premium method was started when the Banking Bureau of the Ministry of Finance issued a notification about "how to improve the policy reserve" in 1968. This principle was reaffirmed when the Report of the Insurance Council to the Minister of Finance of 1979 was made to the effect that "to ensure the 'soundness of the life insurance business,' the regulators should have life insurers build up a reserve based on the net premium method as they have done." Under the "standard policy reserve system" introduced upon revision of the Insurance Business Law in 1995, the net premium policy reserve was adopted and has been in use to this day.

It is true that the net premium administrative principle demanded a high policy reserve level of life insurance companies. However, for insurers who have a high percentage of existing contracts as compared with new contracts and who have already attained the reserve level commensurate with the net premium, the government principle gives no incentive to enhance the soundness of their management. A review of the Report of the Insurance Council to the Minister of Finance made in the past shows that more than half of life insurance companies had attained the policy reserve level required under the net premium method as early as 1975. To take major life insurers for example, Fukoku Mutual Life was the first to attain the level, in 1962, Dai-ichi Life in 1971, and Yasuda Mutual Life in 1974. In the early 1990s, 21 out of the 30 life insurers used the net premium method while nine used the Zillmer method.

More importantly, the problem is that, if life insurers set a high assumed interest rate, their policy reserves, whether built up under the net premium method or the Zillmer method, would be insufficient. The currently required policy reserve level is calculated by discounting it at the assumed interest rate as of the time of acquiring a new contract. Even if the interest rate falls subsequently, the discount rate would be left unchanged (under the lock-in system). This means that, where contracts with a high assumed interest rate are concerned, the policy reserve would be insufficient. The use of the net premium method does not automatically ensure the soundness of a life insurer's management.

It is unlikely that the regulators had no knowledge of this mechanism of the policy reserve system in the 1980s. All the same, they permitted life insurers to raise the assumed interest rate and pay special dividends by tapping latent stock profits. All they did about the policy reserve buildup was to recommend the use of the net premium method. They did not urge them to secure internal reserves, either.

<Checking the policy reserve level>

A system that makes up for the drawback of the lock-in system for determining the necessary policy reserve level is the cash flow analysis (also called cash flow test). Under this system introduced after revision of the Insurance Business Law in 1995, each insurance company's actuary checks whether the company can secure a sufficient policy reserve in the future under a certain stress scenario, and a copy of the actuary's report is submitted to the regulatory authorities. If the actuary concludes from his analysis that the policy reserve built up so far is not sufficient, he will present a written opinion asking the company to set aside the necessary amount.

In the second half of the 1990s, some of the life insurance companies which were later to fail were unable to eliminate the negative spread for each term simply by tapping the expense profit and the mortality profit, so they broke into the latent profit on assets and the internal reserve and even changed the policy reserve level required. They must have been short of one year's policy reserve, not to speak of five years'. We reviewed the published reports but found no company that set aside an additional policy reserve in this situation. Whether an additional policy reserve is needed or not is primarily a matter of judgment by the actuary. At any rate, the regulatory authorities did not point out the insufficiency of the policy reserve, according to the parties concerned.

It is most likely that, before the cash flow analysis was introduced in 1996, the authorities made almost no checks on life insurers' policy reserves from the viewpoint of ensuring their sound management. As can be seen, for example, in published reports on the inspection of life insurers which later failed (attachments in the 1990s), the authorities assessed the insurers' assets and noted the amount of latent profit or loss on securities, but their only reference to liabilities was "excess or deficiency of the net premium policy reserve."

This clearly shows that the Ministry of Finance of that time inspected life insurance companies in the same way as it inspected banks as far as their financial affairs were concerned. Considering that these inspection reports came out after the negative spread became an issue, it is unthinkable that the Ministry of Finance made a detailed analysis of policy reserves in the 1980s. A person from Chiyoda Mutual Life testified that: “the regulators (the Ministry of Finance) focused their attention on single-year settlement results, assets, and the business details of each division. They did not inspect policy reserves until the Financial Supervisory Agency did it in 1999.”

Another person in the industry says that the Ministry of Finance (including the Financial Supervisory Agency and the Financial Services Agency) had almost no actuaries who attended to insurance matters until recently. Nikkei Business magazine dated October 6, 1997 says that: “there were only three people who majored in mathematics at university and were hired as actuaries by the Ministry of Finance after World War II. They joined the Ministry of Finance between 1951 and 1963.”

From the above, let us make an overall judgment of the behavior of the regulatory authorities of that time. Although life insurers’ business environment and liability structure underwent a major change in the 1980s, regulators continued to depend on the net premium-based reserve and latent stock profit to ensure the sound management of life insurers and allowed them to raise the assumed interest rate and pay a high dividend to policyholders, and ended up exacerbating the life insurers’ crisis that ensued subsequently.

(7) Impact of financial deregulation and globalization

Japan experienced the failure of as many as 180 financial institutions (deposit-taking financial institutions) from the 1990s to early in the 2000s. This is ascribed not only to negative factors such as the fall in post-bubble stock and land prices and deterioration in the real economy but also to the impact of financial deregulation and globalization on the management of financial institutions, as pointed out by many people.

“In and after the 1990s, the financial system was rapidly adapted to the global standard. As a result, players were required to act individually, and each player had their lack of international competitiveness exposed.” (Nishimura, 2003, P423)

“When the bubble was forming in the second half of the 1980s, an optimistic view of the Japanese economy spread and real estate and stock prices climbed, and banks continued their pursuit of ‘volume.’ Before they had time to build a business model suited for financial deregulation, banks entered the bubble period.” (Nikkei Research, 2007)

Financial deregulation and globalization, on the other hand, generally did not have much direct impact on life insurers. The life insurance industry has become a member of the Financial System Research Council since 1988, and expressed its opinion on the entry of banks, brokerages and insurers into one another's field. However, little progress was made throughout the 1980s in the deregulation of the insurance system under which they operated. Whereas deposit interest rates were deregulated in stages in the 1980s (until the deregulation was completed in 1994) and regulations for each sector of the financial industry came under review in the second half of the 1980s (the Financial System Reform Law was established in 1992), it was not until 1989 that the Insurance Council launched a drastic reform of the insurance system. The reform was a step-by-step process. The deregulation of the insurance system to permit the mutual entry of life and nonlife insurers into each other's field and to abolish the dividend approval system had to wait for the revision of the Insurance Business Law in 1995. The Report of the Insurance Council to the Minister of Finance of 1992 included a cautionary note to the effect that, in reviewing the system, it is desirable to give a clear direction, take appropriate mitigation measures if necessary, and promote changes in stages."

As shown above, the reform of the life insurance system did not begin until the second half of the 1990s. As the reform was a step-by-step process, it hardly had any direct negative impact on the management of life insurers of that time.

<Concentration of money into life insurers>

This does not mean that in the 1980s life insurers were totally spared the influence of the financial deregulation and globalization. For example, as interest rates were deregulated, consumers became selective about the interest rate level. When market interest rates declined, life insurers' single-premium endowment insurance as a high-return financial product had explosive sales, as stated earlier. The product was so popular that in 1985 the Director of the Insurance Division I of the Ministry of Finance sent out a memo asking insurers to refrain from selling it. Single-premium endowment insurance remained popular until around 1989, when the market interest rate rose and the product lost its appeal as a financial product.

As the sales of savings-based products such as single-premium endowment insurance and individual annuity expanded, life insurers quickly gained a higher position among financial institutions. Life insurers' total assets increased at the rate of about 20% each year, more than quadrupling over a 10-year period. Their share in the financial market rose from around 5% to nearly 10%.

In the meantime, the high-growth period came to an end, financial deregulation enabled business companies to diversify their funding means, and the financial needs of large companies dwindled. As a result, life insurers gradually shifted its money from lending loans to companies to investing in securities. The percentage of loans in life insurers' assets remained above 50% until the early 1980s. In particular, in the final phase of the high-growth period from 1970 to 1976, the percentage was more than 60%. The figure dropped sharply during the 1980s, falling below 40% in the latter half of this decade.

During this period, the percentage of securities rose from about 30% to nearly 50%. Life insures invested in such securities as government bonds, which were issued in increasing volumes amid the nation's fiscal difficulty, U.S. Treasuries from which they sought gains on the difference between Japanese and U.S. interest rates, and domestic stocks included in the money trust schemes. Life insurers transformed themselves from marginal financial institutions into giant institutional investors.

As life insurers' money grew rapidly and their asset structure changed, their management risk increased. Up until 1980 or so, life insurers enjoyed a favorable environment, raising funds at a low cost (assumed interest rate), and managing them in the form of high-interest and stable lending to large companies. Their business underwent a major change in the 1980s, when the funding cost became higher and, as a result, savings-based products increased. Moreover, life insurers started investing in public and corporate bonds amid the declining interest rate level and also in assets carrying the exchange risk and the stock price fluctuation risk. All this should have required stricter investment risk management and asset liability management (ALM). However, as stated earlier, managers of life insurance companies and administrative authorities were rarely aware of the need for stricter risk control and were generally defenseless against the growing risk.

3. Effects of scale expansion race, customer base, and constraints of company type

(1) Were there external factors peculiar to midsize life insurers?

So far we have reviewed external factors that must have negatively affected the whole life insurance industry. Each of these factors should have had a considerable effect on the management of life insurers.

However, is it possible to say with certainty that the failure of one life insurer after another was due largely to structural problems rather than each failed company’s own problems? If the failure had been structural, all life insurers would have failed. It does not seem that structural factors alone can explain the “failure of life insurers in the Heisei era” in which many but not all of long-established midsize life insurance companies went bankrupt.

Let us now focus on three external factors applicable to companies with specific attributes, such as “midsize life insurers’ scale expansion race,” “whether they had a customer base such as the workforce of specific companies” and “constraints of company type” and their relevance to business failure.

The “midsize life insurer” is not always clearly defined. In newspapers and business magazines, it was common to label large long-established life insurance companies—Nippon, Dai-ichi, Sumitomo, Meiji, Asahi, Mitsui, and Yasuda—as the “seven major companies” (in the 1990s these and Chiyoda were commonly called the “eight major companies”) and Chiyoda, Taiyo, Toho, Kyoei, Nippon Dantai, Daido, Daihyaku, Fukoku, Nissan, and Tokyo as the “10 midsize companies” (or the “nine midsize companies”). We follow this practice and call the 10 companies including Chiyoda “midsize life insurers.”

(2) Midsize life insurers vying to grow bigger

Let us first examine the hypothesis that the competition among midsize life insurers to increase their total assets during the bubble period brought about a crisis.

Table 1-5 Midsize life insurers' competition in total assets

<FY 1985>	Total assets (¥100 million)	Share (%)	<FY 1989>	Total assets (¥100 million)	Share (%)	Compared with fiscal 1985 (times)
Nippon	126,027	23.4	Nippon	248,814	21.4	2.0
Dai-ichi	83,484	15.5	Dai-ichi	173,608	14.9	2.1
Sumitomo	69,882	13.0	Sumitomo	148,617	12.8	2.1
Meiji	45,661	8.5	Meiji	100,856	8.7	2.2
Asahi	40,904	7.6	Asahi	79,545	6.8	1.9
Mitsui	30,662	5.7	Mitsui	63,028	5.4	2.1
Yasuda	26,374	4.9	Yasuda	54,209	4.7	2.1
Taiyo	23,534	4.4	Chiyoda	45,189	3.9	2.6
Chiyoda	17,058	3.2	Taiyo	44,005	3.8	1.9
Toho	14,752	2.7	Toho	40,759	3.5	2.8
Kyoei	12,124	2.3	Kyoei	30,009	2.6	2.5
Daihyaku	10,599	2.0	Nippon Dantai	24,950	2.1	3.1
Fukoku	9,029	1.7	Daido	24,556	2.1	2.9
Daido	8,453	1.6	Daihyaku	23,613	2.0	2.2
Nippon Dantai	7,975	1.5	Fukoku	21,620	1.9	2.4
Tokyo	4,049	0.8	Nissan	16,270	1.4	4.4
Nissan	3,680	0.7	Tokyo	10,091	0.9	2.5

Source: "Life Insurance Statistics"

In the 1980s the life insurance industry was expanding its assets year by year by selling savings-type products such as single-premium endowment insurance. The competition among midsize companies to expand their scale intensified particularly in the latter half of the 1980s. The combined total assets of midsize life insurers grew 2.5-fold from the end of fiscal 1985 to the end of fiscal 1989, more than the twofold growth shown by the seven major companies.

At about this time, midsize life insurers as ranked in terms of total assets switched their rankings frequently. Nippon Dantai Life ranked 15th at the end of fiscal 1985 and rose to 12th at the end of fiscal 1989. Nissan Mutual Life rose from 17th to 16th at the end of fiscal 1987 and remained there. Chiyoda Mutual Life rose from 8th to 7th at the end of fiscal 1989. Even companies that remained in the same place or which fell in the ranking saw their asset size grow 2.5- to 2.8-fold during this period.

One reason midsize life insurers rushed to expand scale in competition with one another was that, with consumers learning to select products according to their interest rate and corporations jumping on the zaitech investment bandwagon, the demand for savings-type products increased and this made it easier for midsize life insurers to expand their business scale. Up until then, midsize life insurers who had adopted the same business model used by larger insures fell behind in terms of sales strength, customer base and the size and productivity of the sales force. Now, if they developed a zaitech-oriented investment product, they could sell it because of its attractive yield.

Among them, Nissan Mutual Life developed and marketed, jointly with a bank, a product using a bank loan to pay the premium in a lump sum, and increased its assets more than fourfold in just four years. This made a big impact on other midsize life insurers, stimulating Nippon Dantai Life, Tokyo Life and Chiyoda Mutual Life to offer similar products in cooperation with banks. Toho Mutual Life came up with an investment product called "Kenko Nenkin" (health annuity) and sold it to corporate customers. Nippon Dantai Life actively promoted mutual-aid corporate pension plans made up of contributions from individuals. Chiyoda Mutual Life and Tokyo Life focused their efforts on acquiring contracts of group annuity which was a high-yield-guaranteed product and which brought them a large amount of money at once.

We may point out that life insurers of that time basically aimed at expanding their scale of operation. As they were used to doing business for quite some time in a world where the interest rates and dividends were uniform across the industry, they felt as if "we just need to grow bigger and then the profit will follow," according to comments by several people in the industry.

This trend is seen, for example, in Nissan Mutual Life's five-year plan started in 1985, which set targets for indicators of scale such as the "total amount of insurance in force," "premium income," "total assets," "number of sales employees" and "number of non-sales employees." Also in Tokyo Life's "three-year plan for expansion and net increase through reform and creation," launched in 1987 ahead of its 100th anniversary, the basic goal was to "achieve a higher position in industry in terms of total amount of insurance in force" and numerical targets were set for the "total amount of insurance in force," "value of new contracts," "premium income," "total assets" and "sales force."

All midsize life insurers but two that expanded their scale of operation at about this time eventually collapsed. One of the two companies that survived was Nippon Dantai Life, which came under the control of AXA Group of France. The other was Daido Life, which almost tripled its asset size in four years and maintained a high credit standing after the collapse of the bubble by cutting costs and reducing the weight of stocks in its investment portfolio. Midsize life insurers such as Taiyo Life and Fukoku Mutual Life maintained sound management without rushing to expand their business scale. Meanwhile Daihyaku Mutual Life increased its assets only at about the same rate as the industry average, but its negative spread was a serious problem that eventually brought it down.

(3) The problem of customer base

Let us now review the hypothesis that failed life insurers had no solid customer base like that of larger insurers, and that this impeded their operations.

Major life insurers had close relations with large corporations through mutual shareholding and corporate groupings and secured contracts for group insurance and annuity from these corporations and also contracts for personal insurance from their officers and employees. When we look at the roster of policyholders' representatives of each major life insurance firm to get a glimpse of its customer base, we see the names of heads of large corporations. According to disclosure materials for 2007, company executives accounted for 43% at Nippon Life, 34% at Dai-ichi Life and 31% at Sumitomo Life of policyholders' representatives (including housewives who may be relations to executives of large corporations).

When Japanese corporations were not as sensitive to security matters as they are now, life insurers found a very attractive business base in the workforce of companies to which they were close. They were permitted to promote sales on the premises of target companies and achieved a higher sales efficiency than when selling products door to door to individuals in homes and regional communities. Life insurers also had a chance to corral customers who were still young. Better yet, the officers and employees of large corporations are said to have a low death rate because they are healthier than the average person.

In contrast, many midsize life insurers tried to change or expand their business base but without much success because their target customers who were the workforce of large corporations had been taken by major life insurers. Toho Mutual Life's business originated from military draft insurance of prewar years. Nissan Mutual Life's core customer base was limited to people in Hitachi and Nissan groups. Daihyaku Mutual Life was originally a unit of Kawasaki zaibatsu conglomerate, but had to look for customers in homes through door-to-door sales. Tokyo Life was a Nomura Group member, but its contracts with affiliated firms dwindled through competition with rivals paying better dividends. Midsize life insurers' weaker customer base as compared with larger rivals' must have been an indirect factor in failure to shed their low-profit structure and growing dependence on savings-type products during the bubble period.

Fukoku Mutual Life does not hold as large a volume of shares as major life insurers but has secured a foothold in the market serving the workforce of companies, a field dominated by major insurers. Not all the customers of Fukoku Mutual Life are its affiliated firms. Chiyoda Mutual Life was one of the big five life insurers in prewar years. It had many close affiliates including Tokai Bank and Tomen and secured its place in the market catering to the people of large companies before its failure in 2000. Kyoei Life was a latecomer but built a solid customer base in a niche market that served teachers and teachers' unions. Still, it did not escape the crisis that hit the industry.

As seen so far, the quality of an insurance company's customer base may have been an indirect cause of its crisis but not a decisive factor.

(4) Constraints due to company type

The third factor to consider is the hypothesis that the mutual company system limited the chance for survival. In fact, many of the failed midsize life insurers were mutual companies. Let us give consideration to "constraints on fundraising" and "governance issues."

<Constraints on fundraising >

Of the seven failed life insurers, five (other than Kyoei Life and Taisho Life) were mutual companies. While joint stock companies can improve their solvency margin by increasing capital, about the only way for mutual companies to improve their solvency margin is to turn their earnings into internal reserves. A mutual life insurance company may increase net assets on the balance sheet by re-inviting subscriptions to its fund (money from contributors under the Insurance Business Law). The fund is like a fixed-term fixed-interest subordinated debt from an economic point of view and needs to pay principal and interest to contributors. When returning the fund, the life insurer is required to set up a fund amortization reserve equivalent to the amount returned, by transferring money from each term's surplus. Thus, there is a limit to the amount that can be raised.

Other options are using debt with a subordination agreement (such as subordinated loans and subordinated bonds) and taking out financial reinsurance (ceding a certain block of insurance contracts to get immediately needed funds in the form of a commission from the reinsurance company). These options are less effective than a stock company's capital increase because they make it necessary to repay the debt later or to break into future profits.

Like many other life insurers that went under, Nippon Dantai Life (now AXA Life), a stock company, was struggling under the burden of paying high assumed rates of returns for savings-type products put on sale in the latter half of 1980s. It concluded a capital tie-up with AXA Group of France in 2000 and, thanks to massive financial support from this group, improved its solvency margin and regained its credit standing in a short time. Heiwa (now MassMutual Life), a small life insurer in the form of a stock company, barely managed to retain its creditworthiness through a capital tie-up with Aetna Group of the U.S.

Other failed insurers such as Toho Mutual Life and Daihyaku Mutual Life (both of them are mutual companies) each concluded a tie-up with a foreign partner. Under the tie-up scheme, the Japanese insurer transferred its sales force to its partner and received funds in return, and devoted itself to the maintenance and management of existing contracts taken in the past. The two insurers sought to survive by selling the system and functions of acquiring new contracts, but failed to improve their credit status and went under only one year after the tie-up. Other mutual companies such as Chiyoda Mutual Life and Tokyo Life had historically close relations with major banks, but were unable to get financial assistance from them.

From these instances, it may seem that the view that the difference in company type was a deciding factor in the survival or failure of a life insurer is convincing. We should note, however, that Nippon Dantai Life, a stock company, had the option of adopting a scheme for separating existing and new contracts just as Toho Mutual Life and Daihyaku Mutual Life did. In fact, such a scheme was suggested to other midsize life insurers who were stock companies.

When Equitable Life, a U.S. mutual company, fell into a crisis in the early 1990s, it sought investment from AXA Group on condition that it be demutualized. In Japan, after the revised Insurance Business Law was put in force in 1996, a mutual company had the option of being demutualized, although it may have had to sort out practical problems. In and after the latter half of the 1990s, however, not a single tie-up deal was made in which a troubled mutual life insurance company was to turn itself into a stock company and receive capital infusion from its tie-up partner. Instead, troubled life insurers who found a tie-up partner adopted a scheme for separating existing and new contracts, retaining business related to existing contracts, and transferring the rest to their partner. It would be natural to conclude from this that Japanese midsize life insurers failed to receive financial support not because their mutual company system was a problem but because investors did not think that these insurers, unlike Equitable of the U.S., were worth demutualization and capital fusion.

In and after the latter half of the 1990s, major banks were struggling with an accumulation of bad loans and capital shortfall. They could not afford to acquire even a closely affiliated life insurer and infuse it with a healthy amount of funds. As major banks were reorganized and regrouped, their historically formed groups underwent a rapid change.

<Governance issue>

Another point of issue is the governance of mutual companies which are prone to mismanagement. In the mutual company system, the company is managed autonomously by policyholders who are its members (policyholders' representatives make decisions on important matters). The problem is that policyholders are rarely aware of their role as participants in the management of the company. According to testimony by several industry people, the representatives of policyholders of an insurance company are chosen practically by the company. This creates a structural problem of weak governance. To overcome this weakness, it is necessary to make each mutual company's operations even more transparent than a stock company's and eliminate the information gap between managers and policyholders. However, not much progress has made in this regard.

This does not mean that a stock company had no governance problem. In the latter half of the 1990s, stock companies such as Nippon Dantai Life and Kyoei Life rushed to foreign securities investment which was no better than "gambling" as we look back now, and ended up with huge losses. If they had been listed companies (on a stock exchange), something might have checked their reckless operation. There is no evidence that the shareholders' checking system functioned effectively.

There is an insurer whose stock company status proved fatal. Taisho Life, a small life insurer, saw its solvency margins decline in the latter half of the 1990s because of its deteriorating basic earning power and bad loan problems. As things showed no improvement for some time, the Finance Services Agency issued an order for prompt corrective action in 2000, urging the company to take drastic measures such as a capital increase. Taisho Life found itself in a tight corner, so it concluded a capital tie-up with the investment company Claremont Capital Holding, to which it issued and allocated new shares to increase capital. As it turned out, President Yoshihiko Kokura of Claremont, becoming the top shareholder, defrauded Taisho Life of a large sum of money and was arrested for fraud. Taisho Life in effect fell into a negative net worth and collapsed.

All things considered, we may say that the company type was a factor in bringing about failure but was not a decisive factor.

(5) External factors alone cannot explain failure

We have examined external factors that brought about the failure of life insurers, dividing them into factors applicable to the whole industry and factors applicable to individual companies with specific attributes.

To be sure, the erosion of asset value and the decline in interest rates in the wake of the burst of the bubble had a big negative impact on the earnings and financial situation of life insurers. The raise in the assumed rates of return, payment of high dividends to policyholders and dependence on the profit on sale of stocks in the 1980s had the effect of amplifying the impact of the burst of the bubble. While life insurers' asset and liability structure changed amid financial deregulation and globalization, regulatory authorities of that time relied so much on the net premium policy reserve and latent stock profits as a means to ensure soundness that they were unable to control the subsequent industry crisis. There is no denying that midsize life insurers' competition to expand in the latter half of the 1980s as well as the lack of a solid customer base and the type of company, whether a mutual company or a stock company, played a part in bringing about the failure of life insurers.

All the same, these external factors serve only to explain superficially why one life insurer after another failed. They may not be essential factors that unravel the true nature of failure. In other words, external factors alone did not cause bankruptcy. It is fair to assume that each failed company had some internal factors that may have led to its downfall and that these internal factors coupled with external factors have increased the risk of failure.

4. Roles played by rating and disclosure

(1) Disclosure of life insurers

To ensure the sound management of insurance companies, each company's self-discipline in the form of risk control and governance system and the institutional and regulatory framework for ensuring soundness are not enough. It is necessary that external audit, rating by rating agencies, and market discipline through disclosure should function properly. Let us now change our perspective a little and see what kind of role has been played by disclosure and rating, which may function as external checks on management.

Life insurance companies are required to disclose information through the following two channels.

For one, they follow the disclosure standards set up by the Life Insurance Association of Japan. Since the LIAJ established the industry's uniform disclosure standards in 1979, its member firms have disclosed their business data voluntarily. In fiscal 1989, life insurers started preparing financial statements which were supposed to contain as much details as required to securities reports of listed companies, including "items to be disclosed without fail" and "items to be preferably disclosed." In fiscal 1990, they began to issue first-half reports (corresponding to midterm financial statements of listed companies).

For another, life insurers disclose information under Article 111 of the revised Insurance Business Law which came into force in 1996. With this law revision, life insurers' disclosure changed its nature from industry-wide voluntary action to a legally required procedure. Each insurance company assumed the duty of preparing documents explaining their operations and financial situation and making them available to the public at the head office and branches, in accordance with the provisions corresponding to Article 21 of the Banking Law introduced in 1981. Initially, there were no specific rules about the items to be disclosed, nor was there any penalty for failure to disclose information. After the law was revised in 1998 to tighten control, items to be disclosed were specified in a ministerial ordinance and the penalty was introduced.

Upon request to disclose information on these two fronts, each life insurance company compiles a disclosure magazine, titled something like "The Present Situation of _______ Life Insurance," each year after the annual meeting of policyholders' representatives or shareholders. The disclosure magazine is made available at the company's head office, branches and website and also at the LIAJ's website. Anyone, not just policyholders, insured persons and creditors, can get information they need about life insurers.

Granted that, before disclosure rules were introduced into the Insurance Business Law, the LIAJ's standards did much toward improving the disclosure level of life insurers, the industry's uniform standards had their limits. Take the market value of securities, for example. It was not until fiscal 1995 that Nissan Mutual Life, which went under in 1997, started disclosing the latent profits on securities. In the year preceding its collapse, Nissan Mutual Life disclosed the market value of less than 50% of securities it held.

For reference, let us note that life insurance companies started disclosing their solvency margin ratio in fiscal 1997 when Nissan Mutual Life's failure raised growing concern about the management of life insurers. It was not until fiscal 2000 that life insurers began to disclose the negative spread under the industry's standards and the "core profits" as an indicator of earnings.

(2) Disclosure of failed life insurers

As we have seen, life insurers' disclosure improved gradually and legal requirements changed. Given that the disclosure system was aimed at preventing bankruptcy through market discipline, we cannot help feeling that the system was not developed fast enough.

By making a detailed analysis of how much information Toho Mutual Life, which failed in June 1999, and Kyoei Life, which failed in October 2000, disclosed several years before their collapse, we will see in concrete terms how far it was possible to grasp their precarious situation before collapse and what was wrong with disclosure by the failed insurers.

<Toho Mutual Life>

When going bankrupt (at the end of 1998), Toho Mutual Life announced it had a negative net worth of ¥198.6 billion (the amount eventually totaled ¥653.0 billion after detailed investigations were conducted to check the firm's financial conditions). With respect to the insurer's financial statements for fiscal 1998, an auditing firm pointed out that "they broke laws and ordinances as well as the articles of incorporation, not accurately showing the firm's assets, profits and loss". The insurer gave up continuing its business as it was revealed that the firm would fall deep into the red if it added changes as pointed out by the auditor.

Changes mainly suggested by the auditor include (1) additionally setting aside loan-loss reserves of ¥96.3 billion for receivables to be written off and loans with insufficient collateral, (2) posting valuation losses on ¥100.1 billion worth of securities whose market prices drastically dropped with no possibility of recovery, (3) posting foreign exchange losses of ¥20.1 billion on foreign securities and foreign currency denominated loans and (4) not allowing deferred tax assets of ¥9.1 billion because of insufficient taxable income based on future earning capacity.

It's difficult to grasp, from the disclosure (for earnings results in fiscal 1997) made just before the collapse, that Toho Mutual Life's asset deteriorated so much. Surely, 80% of loans were extended unnaturally to "finance, insurance and securities," "real estate," and "service" sectors. However, the combined amount of disclosed "risk management loans," that is, the total amount of "loans to borrowers in legal bankruptcy," "past due loans in arrears by six months or more," "past due loans in arrears by three months or more," and "restructured loans," stood at ¥127.4 billion, only roughly 10% of general loans, and the insurer also posted loan-loss reserves of roughly ¥30 billion. Moreover, the firm wrote off bad loans of more than ¥40 billion in fiscal 1997, mainly using ¥70 billion worth of profit from transfer of goodwill associated with its tie-up with U.S. GE Capital Corp. It may be quite unthinkable that the insurer was asked to set aside another ¥100 billion or so in just a year.

Information on securities' market prices also shows that Toho Mutual Life's latent losses stood at only ¥46.1 billion as of the end of March 1998, mostly losses on stockholdings. However, market prices for a large number of securities were not disclosed because only 34% of foreign securities and 22% of other securities were subject to disclosure. A chain of failures of major financial institutions occurred in the late 1990s, spurring anxiety about Japan's financial system. Caught in waves of such anxiety, Toho Mutual Life, deemed as "a risky life insurer," faced a rush of policy cancellations with its total assets decreasing to ¥3 trillion from the previous year's ¥4.5 trillion. Assets with unrealized losses may have remained after the firm sold assets with unrealized gains to deal with the outflow of funds. Even so, it is nothing less than astounding that the insurer was asked to post valuation and foreign exchange losses of more than ¥120 billion in just a year.

The solvency margin ratio, which began to be announced officially in fiscal 1997, was 154%, falling below the 200% line triggering government intervention, but not plunging to less than 0%.

Toho Mutual Life's earnings were even more unclear. While posting operating losses for two consecutive years in fiscal 1993 and 1994, the firm secured a net surplus in both years, and returned to an operating profit in fiscal 1995 and thereafter. However, in reality, the insurer was in the state of being unable to cover losses from interest differential (negative spreads) only with expense profit and mortality profit, according to materials distributed at a meeting of policyholders' representatives on January 14, 2000. The precarious financial state of the insurer is expressed well in the following citation from materials used for a meeting of policyholder representatives held after the insurer's failure: "The amount of negative net worth would continue rising if this situation remains."

In those days, the amount of negative spreads was already disclosed to the media, but with data on basic profit not available, there was no clue for assessing the severity of the financial state of the insurer.

I, therefore, calculated "revised operating profits" for fiscal 1993 and 1994, when the firm reported an operating loss for two years in a row, by excluding profit on sales of securities and other temporary profits and losses from operating profits and losses. The calculations led to strikingly different results with a loss of ¥53.8 billion for fiscal 1993 and a profit of ¥50.1 billion for fiscal 1994 despite the fact that an operating loss was posted in both of the both years. Although the insurer's "insurance benefit payouts" did not increase so much in fiscal 1994, policy reserves shifted from "provision" to "reversal," which implies that the firm abandoned a conservative way to set aside policy reserves in order to post profit. Changes in revised operating profits for the ensuing years suggest, though, that this index has its limits as a clue to measure the severity of negative spread burden.

Table 1-6: Balance Sheet of Toho Mutual Life (as of the end of March 1999)

100 millions of yen

	After revision	Difference from the amount before revision		After revision	Difference from the amount before revision
Cash & deposits	645	0	Policy reserves and other reserves	25,331	0
Call loans	480	0	Policy reserves	24,715	0
Monetary assets held in trusts	554	0	Loans payable	215	0
Investments in securities	11,486	-1,162	Loan-loss reserves	1,204	963
Public and corporate bonds	1,368	0	Reserves for price fluctuations	62	0
stocks	3,021	-245	Total liabilities	27,694	962
Foreign securities	5,316	-467	Foundation funds	100	0
Others	1,780	-451	Legally mandated reserves	12	0
Loans receivable	9,304	-40	Surplus	-2,098	-2,236
General loans	8,613	-40	Unappropriated surplus for the year	-2,112	-2,236
Real estate & movables	1,953	0	Total net assets	-1,986	-2,236
Total assets	25,708	-1,274	Total liabilities and net assets	25,708	-1,274

(Data) compiled from materials used for Toho Mutual Life's meeting of policyholders' representatives in 1999

Table 1-7: Statement of income of Toho Mutual Life

100 millions of yen

	March 1994	March 1995
Operating income	13,781	12,298
Income from insurance and reinsurance premiums	10,264	8,136
Investment income	3,360	2,043
Interest, dividends and other income	1,929	1,826
Profit on sales of securities	1,300	107
Other income	157	2,118
Reversal of policy reserves		2,099
Operating expenses	13,978	12,746
Insurance claims and other payments	9,826	10,208
Surrender benefits	4,884	3,493
Provision for policy reserves	1,775	35
Investment expenses	1,148	1,361
Loss on sales of securities	577	307
Loss on revaluation of securities	463	932
Operating costs	1,107	1,033
Operating profit	-198	-449
Extraordinary gains	615	671
Gains on disposal of real estate, movables and others	615	620
Extraordinary losses	73	29
Losses on disposal of real estate, movables, and others	18	26
Net surplus before taxes for the year	345	194
Net surplus for the year	233	134
Unappropriated net surplus for the year	234	135

	March 1994	March 1995
Operating profit	-198	-449
Profit on money trust	129	46
Profit on sales of securities	1,300	107
Loss on sales of securities	577	307
Loss on revaluation of securities	463	932
Foreign exchange loss	15	40
Provision for loan-loss reserves	11	0
Provision for contingency reserves	23	-177
Revised operating profit	-538	501

(Data) compiled from materials used for Toho Mutual Life’s business results announcement

<Kyoei Life>

Let us look at the case of Kyoei Life next. The insurer had a negative net worth of ¥185.9 billion at the time of its bankruptcy in October 2000 (an appraisal of property proved that the firm's losses was ¥293.8 billion). It ended up with a huge negative net worth in just little more than six months from the end of March 2000 (when its assets exceeded its liabilities by roughly ¥80 billion), probably due to expanding valuation losses on securities holdings and costs for bad-loan disposals as well as the burden of negative spreads.

Kyoei Life was already saddled with ¥129.6 billion worth of latent losses on securities holdings as of the end of March 2000, according to the firm's disclosure materials (for fiscal 1999) released just before its business failure. Unlike Toho Mutual Life, which disclosed information on only a limited number of securities, 99.8% of Kyoei Life's securities holdings were subject to disclosure. In fiscal 1997, the year when the regulatory authorities started allowing insurers to use the book value method, the firm's latent losses on securities holdings exceeded ¥100 billion for the first time ever. The increase in latent losses is largely attributed to falling stock prices, a rise in acquisition costs of stocks after gains on sales were posted and a failure in investment in foreign securities. Latent losses appear to have expanded further following sagging stock prices in fiscal 2000.

With respect to loans, Kyoei Life disclosed the breakdown of its risk management loans and the classification of borrowers of such loans by type of business, and the amount of classified loans. The firm's risk management loans accounted for merely 3.6% of its general loans, but classified loans reached 13% of general loans, with loans in classification II (assets requiring appropriate risk management on an individual basis) reaching about ¥200 billion. The then Financial Supervisory Agency conducted a round of inspections to some midsize life insurers in the previous year. Therefore, data disclosed by the life insurer appeared to be trustworthy because they were not just the results of self-assessment.

As a result of latent losses on securities holdings and bad-loan disposals, the solvency margin ratio of Kyoei Life went down to 210% at the end of March 2000. However, it's questionable whether these data alone were enough to determine that the firm's financial state was so bad that it would go under in six months.

Kyoei Life's earnings were as unclear as Toho Mutual Life's. At that time, it was struggling with huge negative spreads and depending on gains on sales of assets for the portion that was not covered by its expense profit and mortality profit. However, looking at the firm's revised operating profits, the figures calculated by excluding profit on sales of securities and other temporary profit and loss from operating profit, in chronological order, I couldn't obtain information implying such financial crisis. For example, the figures extremely differed by year with a profit of ¥34 billion for fiscal 1998 and a loss of ¥36.5 billion for fiscal 1999. The insurer conducted financial reinsurance transactions and posted ¥40 billion in reinsurance commissions received in fiscal 1998, which may have inflated the revised figure. The result shows, however, the limits of the revised operating profit.

Table 1-8: Balance Sheet of Kyoei Life

As of October 23, 2000before the appraisal of property 100 millions of yen

		Difference from the amount as of the end of March			Difference from the amount as of the end of March
Cash & deposits	835	535	Policy reserves and other reserves	41,344	-2,771
Call loans	3,350	-4,212	Policy reserves	40,232	-2,707
Monetary assets held in trusts	3,860	3,160	Loans payable	455	0
Investments in securities	17,457	-2,146	Retirement reserves	158	-15
Public and corporate bonds	12,391	-1,380	Reserves for price fluctuations	0	0
stocks	2,110	-855	Total liabilities	42,707	-2,590
Foreign securities	1,577	10	Foundation funds	576	0
Others	1,379	78	Legally mandated reserves	4	2
Loans receivable	13,653	-2,139	Surplus	-1,541	-1,766
General loans	13,072	-2,080	Unappropriated surplus for the year	-1,647	-1,778
Real estate & movables	1,445	-18	Net unrealized gain on available-for-sale securities	-897	-897
Loan-loss reserves	-198	-52	Total net assets	-1,859	-2,661
Total assets	40,848	-5,252	Total liabilities and net assets	40,848	-5,252

(Data) compiled by the author from the rehabilitation plan

Table 1-9: Statement of income of Kyoei Life

100 millions of yen

	March 1999	March 2000
Operating income	11,777	12,354
Income from insurance and reinsurance premiums	7,265	6,268
Investment income	1,981	2,111
Interest, dividends and other income	1,348	1,056
Profit on sales of securities	428	797
Other income	2,531	3,975
Reversal of policy reserves	2,452	3,918
Operating expenses	11,567	12,311
Insurance claims and other payments	9,320	9,731
Surrender benefits	2,349	2,846
Provision for policy reserves	25	11
Investment expenses	954	1,366
Loss on sales of securities	538	927
Loss on revaluation of securities	31	13
Operating costs	1,149	1,080
Operating profit	210	43
Extraordinary gains	100	79
Gains on disposal of real estate, movables and others	100	2
Extraordinary losses	27	14
Losses on disposal of real estate, movables and others	12	13
Net profit before taxes for the year	117	-2
Net profit for the year	41	-9
Unappropriated net profit for the year	180	131

	March 1999	March 2000
Operating profit	210	43
Profit on money trust	26	54
Profit on sales of securities	428	797
Loss on sales of securities	538	927
Loss on revaluation of securities	31	13
Foreign exchange loss	-56	-134
Provision for loan-loss reserves	112	91
Provision for contingency reserves	-42	-454
Revised operating profit	340	-365

(Data) compiled from materials used for Kyoei Life's business results announcement

(3) Why did life insurers' information disclosure system fail to function as it should?

We examined the operations of Toho Mutual Life and Kyoei Life, using information disclosed by the two firms just before they collapsed. While experts may understand that the insurers had barely been running their businesses if they make close analysis, we couldn't tell that the two firms had fallen into (or had nearly fallen into) negative net worth. Thus, it may have been almost impossible for general consumers unfamiliar with life insurance management to grasp, from disclosed information, how their businesses were going.

The life insurance industry is not the only one providing inadequate disclosure. Judging from information actually disclosed, however, factors unique to life insurers appear to have played a significant role. Such factors include the difficult-to-understand financial statements of life insurers and disclosure that does not reflect operational characteristics (in the first place, the insurance accounting does not fully show the operational characteristics of the industry).

Life insurers’ disclosure has focused on asset-related information. To be sure, if their predicament was caused by the bad-loan problem, insurers must focus on disclosure of asset components. The deterioration of asset components is just part of their problems, though. They, nevertheless, have disclosed little information that are deemed to be effective for proper understanding of underlying problems, such as “if they have been able to cover their negative spreads with insurance income and expenditure such as expense profit or mortality profit” and “if they will be able to continue covering their negative spreads with insurance income and expenditure in future even though the number of insurance contracts drops and historically low interest rates continue.”

Besides, in the first place, few people used information disclosed. Since the insurance business deteriorated in the 1990s, main analysts of the industry had been limited to mass media, insurance critics and some insurance scholars. Some books and articles in economic magazines written based on misinterpretation were found often times, and they just revealed authors’ lack of basic knowledge about insurance management.

Such articles say, for example, “An insurer is in financial crisis if the figure obtained by subtracting payments of insurance benefits, pension benefits, surrender benefits and others from premium income is below zero,” while others propose to assess insurers’ “durable years” by comparing the cumulative amount of disclosed negative spreads with the broadly defined capital base (the amount of capital base to which unrealized gain or loss on assets is added).

The former doesn’t understand the relationship among premium income, provision for policy reserves, insurance claims and other payments, and reversal of policy reserves on the statement of income at all. The latter’s proposal is also wrong as the amount of negative spread recorded in each accounting period is part of periodic profit and loss and therefore is not a cumulative figure.

A book published recently also denies solvency margin ratios and rating, proposing to assess the financial soundness of life insurers with an index called “the ratio of set-aside policy reserves.” It insists that “a company including (setting aside?) only a small amount of their insurance income as policy reserves is risky.” As the author of the book says, life insurers are certainly obligated to set aside part of their premium income to prepare for future insurance payouts. "Provision for policy reserves" on the statement of income is the figure obtained by offsetting provision with reversal, however, and "the amount of provision" tends to be low if an insurer pays insurance benefits for a large number of savings-base products. With that said, the author's statement "Insurers must be facing severe financial constraints because they have used funds to be put aside despite the law requiring them to do so," doesn't explain the situation accurately.

In no other industries, such misunderstanding on basic components of operations has continued for years and kept a certain power of influence. The authors of these books should be criticized for their lack of study, but such misunderstanding may also be part of the evidence that adequate disclosure has not been provided.

(4) Role of rating

Next, I would like to talk about credit rating (referred to as "rating" hereafter).

Rating is the assessment of the future claims-paying ability and financial power of each firm by a rating agency, or a group of experts in corporate analysis, using signs such as A and B. As a complement to disclosure, it is playing the role of maintaining the soundness of life insurance management via market discipline.

As we have seen by now, it is difficult for general policyholders to grasp, on their own, how their life insurers are carrying out operations, and an analysis requires costs. The solvency margin ratio can be used for reference, but as I said earlier, companies whose solvency margin exceeded the 200% line triggering prompt corrective action went under one after another, undermining the reliability of the index. Moreover, the solvency margin ratio only shows the cross section of the financial condition of an insurer at a particular point of time in the past and does not necessarily predict the firm's future financial condition. For example, suppose that Company A and Company B happen to have the same solvency margin ratios at present. If Company A cannot cover its losses caused by negative spreads with other profits and is eating up its claims-paying capacity at every accounting period, while Company B is generating a stable profit at every period due to a relatively small burden of negative spreads, a huge gap must occur in the financial soundness of the two firms in a few years.

Meanwhile, because rating shows life insurers' capacity to meet their insurance commitments with simple letters, it is easy to understand and allows a cross comparison among insurers. If you want to know just letter designations, it is available for free on websites of rating agencies or through other means. Rating is not just simplification of disclosed information, but an outlook on what an insurer will be like in the future based on analysis of undisclosed information offered by the company requesting rating or meetings with the insurer's management. In other words, disclosure and solvency margin ratios show facts in the past, while rating makes a projection of an insurer's future claims-paying ability and also holds confidential information.

There is a problem on how to judge the quality or reliability of rating, though. Rating is an opinion of a rating agency regarding the certainty of a life insurer's capacity to meet its commitments, and whether the letter designation is right or not can only be confirmed in the far future.

Major rating agencies doing their businesses in Japan are two Japanese firms including Rating and Investment Information, Inc. (R&I) and Japan Credit Rating Agency, Ltd. (JCR) and three foreign-affiliated firms including Moody's Investors Service, Inc., Standard & Poor's Financial Services LLC (S&P) and Fitch Ratings Ltd. Of these agencies, two American firms Moody's and S&P boast histories of more than 100 years and dominate the U.S. and global markets. Rating agencies that have not been well received by the market should be shuffled out, therefore the long histories of the two firms may be a piece of powerful evidence showing the high quality and reliability of their rating services.

Japan only has a very short history of rating of life insurers, however. The rating is said to have begun in the 1980s, but it was not until 1996, when S&P released the ratings of major eight life insurers (of that time), that Japanese institutions started the full-fledged service of assigning ratings to Japanese life insurers and such rating began receiving public attention as credit information. In other words, when it comes to rating of Japanese life insurance companies, both Japanese and U.S. rating agencies practically have experience of only 10 years or so.

Many rating agencies release their annual "default studies", showing the relationship between rating and default (legal bankruptcy or changes in conditions of debt obligations). These studies indicate that a correlation exists between rating and default rate with a company with a higher rating showing a lower default rate. These reports, however, are based on the statistic of all companies around the world or “all issuers incorporated in Japan that have a record of acquiring a rating from R&I”. Unfortunately, no rating agencies release default studies that focus solely on Japanese life insurance companies.

The use of rating information by administrative authorities can also be a measure of assessing the quality and reliability of ratings. For example, the Financial Services Agency recognizes R&I, JCR, Moody’s, S&P and Fitch as “external credit assessment institutions (ECAI)” in Basel II. The five agencies are also designated as “designated rating institutions” under the “Cabinet Office Ordinance concerning Disclosure of Corporate Affairs and others,” and their ratings can be used in securities registration statements and disclosure materials, including prospectuses. These things reflect the government’s efforts to bring rating in their financial regulations, not administrative regulations on such rating firms and can be evidence showing the credibility of rating agencies.

(5) Failed life insurers and rating

In the U.S., the history of rating of life insurance companies extends back 100 years, and rating agencies including A.M. Best Company, Inc., a rating firm specializing in the insurance industry, are releasing their default studies. Firms other than A.M. Best don’t have much experience in the rating of insurance companies, though, as they only entered the insurance field in the 1980s and thereafter.

Besides, when major and second-tier life insurance companies collapsed or fell into a management crisis in the early 1990s, U.S. rating agencies allegedly failed to find the mismatch between assets and liabilities of those insurers until immediately before such crisis was revealed. For example, Executive Life, a second –tier life insurer that went under in April 1991, was rated highly by A.M. Best, S&P, Moody’s and other major rating agencies until 1990. Rating agencies also drastically downgraded their ratings for Mutual Benefit just several months before the life insurer collapsed in July 1991.

In the failure of Japanese insurers, I found no case involving companies that had maintained high ratings just before their collapse. In bond rating, BB+ (double B plus) or lower is generally considered as a “speculative grade.” A total of five life insurers (Daihyaku, Taisho, Chiyoda, Kyoei and Tokyo) have failed since 2000. Ratings to these insurers by four rating agencies had remained at speculative grades, with some exceptions, since April 1998 when R&I was launched.

Table 1-10　Changes in ratings of failed life insurers (R&I)

	Nissan	Toho	Daihyaku	Taisho	Chiyoda	Kyoei	Tokyo
199704	Failure (At this point, JBRI was not assigning credit ratings to life insurers)						
10		BBop	BBop		BBB-	BB+	
11		BB-					
12							BBB-
9803				BBop			
04							
05			Bop				
09		B+		Bop	BB	BB	BB+
9906		Failure					
09					B+	B+	BB
11			CCC+op				
200005						B	
06			Failure				
08				Failure			
09					B-		BB-
10					Failure	Failure	
0102							B
03							Failure

(Note)　Ratings assigned for March 1998 and before were given by JBRI.　JBRI and NIS merged into R&I in April 1998.　"op" means voluntary rating.
(Source)　Prepared by the author.

Iemori and Asai (2004) say, "We need to reserve our judgment on JCR, but the remaining three (R&I, S&P and Moody's: the author's annotation) appear to have avoided mistakenly judging failed insurance companies as safe," thus evaluating these rating agencies favorably.　Meanwhile, some critics are scathing them.　Kubo (2005) says, "Many of the failed companies were rated B in the previous fiscal year.　Only one of the seven companies saw their ratings downgraded to C, the level of strong warning, while the rating of one insurer was downgraded from BB to B just a month before it went bankrupt, and even the rating cut may have not been enough."

Indeed, excessively conservative rating may allow rating agencies to ward off criticism, but could only bring confusion instead.　For example, when Moody's downgraded its ratings on major life insurers by two or three notches at once in March 2002, the then Chairman of the Life Insurance Association of Japan Ryotaro Kaneko (also then President of Meiji Life Insurance Co.) stated, "I was surprised at such huge downgrades" and "I must say that a three-notch downgrade is quite significant, but Moody's has failed to provide an adequate explanation despite the significance of its announcement." The ratings of eight major life insurers were upgraded by one or two notches in May 2005, three years after the downgrades, and four companies also saw their ratings upgraded by one or two notches in August 2006. Thus, Moody's ended up changing its ratings on life insurers again in just a short period of time. The relatively small number of life insurers makes them less suitable for default studies, but more time may be needed for the market to appreciate the quality and reliability of rating.

I have to add, in terms of a complement to disclosure, information sent by rating agencies is not limited to rating letters. For example, R&I released a comment on Kyoei Life and Tokyo Life on September 9, 1999, saying, "Their basic profitability remains poor, forcing them to rely on profits on sales of assets," thus offering more in-depth information suggesting that the two insurers had failed to cover their negative spreads with other profits.

It is safe to say, at least, that the reliability of rating has increased in relative to administrative authorities and solvency margin ratios. Every time a failed life insurer was revealed, the authorities repeatedly announced in such a way as the Imperial General Headquarters during World War II that "no company was in danger," thus, along with solvency margin ratios, losing public confidence.

Chapter 2
Where did things go wrong? – Reviewing instances of failure individually

1. Study of individual instances of failure

(1) What was happening inside failed life insurers?
In chapter 1 we examined the relationship between business failure and external factors by reviewing specific instances. Granted that external factors made a considerable impact on the management of life insurers, we felt that they alone did no more than superficially explain the failure of life insurers.

Now let us delve into the internal workings of failed life insurers and examine the role played by internal factors in the operation of each company. Specifically, we will review each case of failure to find out about (1) behavior that was a direct cause of failure, (2) reason the insurer behaved that way, and (3) the manager of the time and the company's checking and monitoring functions and actual state of risk management system, by drawing on each company's disclosure materials and statistics, reports on newspaper and business magazines of that time, inspection reports on failed life insurers which were created by the Ministry of Finance and obtained by us through filing requests for disclosure, and oral history data collected through interviews with the parties concerned under the first large-scale project of its kind in Japan. In this way we hope to unravel what really happened inside the failed insurance companies.

When we say "the party concerned" or use a similar phrase, we refer to someone who once served as the company's head or some other key person or someone who was close to a key person, or an employee who was in a position to know the real situation of the company.

The objects of our study and analysis are six out of the seven life insurance companies that failed during the crisis and do not include Taisho Life, a small insurer. We studied the case of Taisho Life and interviewed its people, just as in the case of the six midsize firms, but decided to present findings about it only as reference information, excluding it from the scope of direct analysis in this book. This is because Taisho Life's case is quite different from other cases in that the company fell victim to fraud after falling into a crisis and also because we failed to gather sufficient information about the company.

Table 2-1　Failure of Life Insurers

1995	Insurance Business Law revised (solvency margin standards and the disclosure system introduced).
1996	U.S.-Japan insurance agreement reached (non-life insurance premium rates deregulated).
1997	Nissan Mutual Life ordered to suspend business.
1998	GE Edison Life established (taking over business rights from Toho Mutual Life).
	Insurers allowed to evaluate shareholdings on the cost method.
	Life Insurance Policyholders Protection Corporation of Japan established.
1999	Early correction measures introduced.
	Manulife takes over business rights from Daihyaku Mutual Life.
	Daiichi Mutual Fire & Marine and Kyoei Life conclude a business and capital tie-up.
	Toho Mutual Life ordered to suspend business.
2000	Daiichi Mutual Fire & Marine ordered to suspend business.
	Daihyaku Mutual Life ordered to suspend business.
	Claremont Capital underwrites shares issued by Taisho Life.
	Insurance Business Law revised (rehabilitation procedures introduced).
	Taisho Life ordered to suspend business.
	Taisei Fire & Marine announces merger with Yasuda Fire & Marine and Nissan Fire & Marine.
	Chiyoda Mutual Life applies for protection under the Act on Special Treatment of Corporate Rehabilitation Proceedings and Other Insolvency Proceedings of Financial Institutions.
	Kyoei Life applies for protection under the Act on Special Treatment of Corporate Rehabilitation Proceedings and Other Insolvency Proceedings of Financial Institutions.
2001	Tokyo Life applies for protection under the Act on Special Treatment of Corporate Rehabilitation Proceedings and Other Insolvency Proceedings of Financial Institutions.
	Taisei Fire applies for protection under the Act on Special Treatment of Corporate Rehabilitation Proceedings and Other Insolvency Proceedings of Financial Institutions.
2003	Insurance Business Law revised (change of contract terms made possible).
2005	Insurance Business Law revised (safety net reviewed).

(The above table was compiled by the author.)

(2)　Oral history

Oral history, a method we used for our analysis, is the process of making a record of what individuals and organizations went through by interviewing the people concerned and handing down the record to later generations. It has been established in recent years as a method for study in the field of history and political science. Mikuriya (2002) described it as “an oral record of public figures by professionals for the general public.” Oral history is very useful when published materials are scarce or when a statistical approach is difficult to adopt, such as this case.

A drawback of oral history is that testimony given by the parties concerned may not always be credible. It is possible that an account given by the interviewee may be twisted in his favor or the interviewee’s memories may be blurred. To remedy this problem, we interviewed a number of persons involved and cross-checked their accounts wherever possible to ensure the reliability of information they gave. To make things easier for the interviewees, we prepared a chronological table and the list of the management team members and their profiles. Of course, the author's experience as a rating analyst (which does not mean undisclosed information) was put to full use in the interviewing process.

Table 2-2 Key questions asked in interviews with the parties concerned

1. Relationship between your business model and failure
   (1) Features of your business model
       - How was your management style different from that of other companies?
   (2) Managers' behavior and judgment that brought about a crisis
       - What marked a turning point, and under what circumstances?
         (sales policy, asset management, management organization, etc.)
   (3) Managers' behavior and judgment when they were in a crisis
       - At what point of time did you realize you were in a crisis?
       - What kind of action did you take (or should you have taken) when you realized you were in a crisis?
       - What measures did you actually take?
2. Business monitoring and risk management system
   With regard to 1-(2), 1-(3) above,
       - What system was in place?
       - Where did the problem lie?
       - Was there a system for restraining the top management?
       - What role was played by regulatory authorities, policyholders' representatives, affiliated financial institutions, etc.?

At first we tried to arrange interviews on the understanding that what was said during the interview would be disclosed, because the interview record itself was valuable material for study. However, we found that only a fraction of the people concerned would agree to give an interview under such terms, so we changed our tactics and decided not to disclose the interview record or the names of the interviewees. We also made sure that the interviewees would not be identified from the published material. We decided to use such terms as "a member of the head office staff (including executives)" and "an actuary" when quoting from the interview record. We decided to disclose the real names of only those who once headed the company in question. A total of 33 people from failed life insurance companies alone agreed to give an interview for our research (from January 2006 to August 2007).

Just for your information, Mikuriya (2002) has the following to say:
"Today, everybody avoids talking about the financial crisis of the 1990s as if to say it is a thing of past that should better be forgotten. This may be because the matter is still pending in court. It is imperative to analyze the situation to get clear answers to questions such as how banks, brokerages and other companies acted in response to the crisis and why they failed to respond properly to the crisis…. Oral history may help us answer these questions. One of the academic challenges today is to unravel not just

human history but also the history of an organization."

2. Rapid expansion of business scale was fatal – Nissan Mutual Life Insurance

(1) Direct cause of failure

Nissan Mutual Life went under in April 1997. The biggest factor in the behavior of Nissan managers that brought down the company was that they collected too large a volume of individual annuity insurance contracts with a high assumed interest rate in cooperation with financial institutions in the latter half of the 1980s. As the external environment deteriorated, the company's inappropriate measures taken in preparation for term-end settlement of accounts made things worse.

Nissan Mutual Life was heavily dependent on Hitachi and Nissan groups because of its historical background. Up until the first half of the 1980s, it had difficulty increasing the number of individual insurance contracts. The company's management of that time tried to switch to an aggressive policy ahead of the 80th anniversary of its founding (1989), but their efforts to expand business by mobilizing the sales staff as in the case of larger rivals did not go very far. Sometime after Nissan began looking for a new sales channel, the frontline staff suggested a "premium loan," an insurance product combined with a bank loan. The management jumped at the idea. Their primary concern was how to expand the scale of operation and eliminate the loss from the difference between actual and expected expenses. Nissan managers of the time were hardly aware of the burden of paying high assumed interest rate and the risk of becoming dependent on sales of specific products.

Nissan managers gave too much weight to single-premium individual annuity and quickly attracted a large amount of funds that guaranteed high interest rates to policyholders. They invested these funds primarily in domestic stocks and foreign securities which were susceptible to wide price fluctuations, and suffered severely from swings in the stock and exchange markets. When settling accounts for fiscal 1991, Nissan Mutual Life, burdened by a large appraisal loss on securities, broke into its policy reserve and posted profits on sale of real estate. From fiscal 1993 onwards, the company failed to earn three types of profit because of the negative spread (that is, lost the ability to earn core profit). If the unrealized losses on assets were taken into account, the company was in effect in a state of negative net worth. Worse, in preparation for accounts settlement, it rushed to invest in Nikkei Average-linked bonds and other structured bonds and derivatives. The market downturn that came on subsequently exacerbated the company finances. In and after fiscal 1992, the company cut costs but this made little difference.

As we have seen, Nissan Mutual Life was in effect bankrupt in fiscal 1994 and had broken into its policy reserve. It was not officially bankrupt until 1997 because the balance sheet showed no excess of liabilities over assets and the Ministry of Finance was not in a hurry to wind up the company. In those days, the safety net for bankruptcy was not yet in place and the Ministry of Finance was under fire for the *jusen* (Note from translator: government housing loan corporation) problem.

Table 2-3 Nissan Mutual Life's brief history

1909	Starts business as Taihei Life Insurance Co.
1940	Comes under the wing of Nissan Group (changes name to Nissan Mutual Life).
1947	Separates new and old accounts and makes a fresh start under the name of Nisshin Mutual Life Insurance Co.
1954	Changes name to Nissan Mutual Life (accepts capital and executives from seven Nissan Group companies in the following year).
1967	Masao Fujimoto (from Nippon Life) becomes president.
1976	Yasunori Yazaki becomes president.
1985	Medium-term management plan "Powerful 80" launched. Time deposit with cancer insurance put on sale.
1987	Sales of individual annuity with a bank-affiliated loan started. Ichirozaemon Sakamoto becomes president.
1988	Attains ¥10 trillion in total amount of policies in force.
1989	Total assets surpass ¥1 trillion (up 90% over the previous term).
1992	Current profit drops sharply to ¥900 million in fiscal 1991 (1/30 of the previous year's level).
1993	Total amount of individual annuity policies in force begins to decline.
1994	Practically in a state of negative net worth, with ¥96.1 billion liabilities in excess of assets, in fiscal 1993 (undisclosed). Hiroshi Yonemoto becomes president.
1995	Current loss in fiscal 1994. Accepts executive from Nissan Fire & Marine.
1997	Ordered to suspend business.

(2) Launch of annuity insurance loan

Nissan Mutual Life had close ties with the Hitachi Nissan group. "Nissan Mutual Life did business by selling group insurance to client companies and individual insurance to their officers and employees. Most of its individual insurance contracts were made from the Hitachi Nissan group," says a head office staffer of that time. The Insurance Statistics shows that a greater weight was given to group insurance at Nissan Mutual Life than at other companies and that the total amount of group insurance in force was larger than that of individual insurance unlike in the case of most other insurers. (The only companies that were like Nissan Mutual Life in this respect were Nippon Dantai Life and Tokyo Life). "About 70% of our group insurance contracts came from the Hitachi Nissan group," says the staffer. Up until the latter half of the 1980s, the total amount of policies in force was slow to grow. While the total amount of individual insurance policies in force grew at an annual rate of 8% in the whole industry in the first half of the 1980s, that of Nissan Mutual Life grew at less than 5% a year. The number of contracts in force was leveling off at above 600,000.

To break out of this situation, the company launched a medium-term five-year management plan called “Powerful 80” in April 1985 under the leadership of President Yasunori Yazaki and professed to do business aggressively with an eye on the 80th anniversary of its founding. Under this plan, the company gave top priority to expanding its sales force and strived to develop new sales channels, such as tie-ups with financial institutions to sell products. After the Ministry of Finance authorized insurers to sell products combined with a bank deposit in March 1985, Nissan Mutual Life developed and marketed such products as “time deposit with cancer insurance” and “time deposit with medical insurance,” but without much success.

In 1986, the company developed, jointly with financial institutions, a system for paying the single premium (premiums for all terms paid in advance) with a loan. The first product on this system was the “nursing insurance loan.” In 1987, this product was incorporated into individual annuity insurance and put on the market as an “annuity insurance loan.” As this product paid a high yield and was greatly beneficial to financial institutions, it drew the interest of banks across the country. Nissan Mutual Life ended up concluding a business tie-up with more than 160 banks for sale of annuity insurance loan.

Take, for example, “Hamashin annuity insurance loan,” a product of Hamamatsu Shinkin Bank touted in The Nikkei’s local economic page (Shizuoka) on April 22, 1988. The product had an annual yield of 7.14%, with a maximum loan amount of ¥10 million and a loan period of at least one year and up to 10 years. The customer used this loan to pay a single premium to Nissan Mutual Life and repaid the loan to Hamamatsu Shinkin. “Because the premium is paid in a lump sum in advance and a discount is made on the advance payment, the customer is to pay a lower premium and receive a greater amount of annuity than in the case of monthly payment. This product is attractive in that the sum of the discount on advance payment and the extra annuity amount is greater than the loan interest” (quoted from the Nikkei article).

A head office staffer of that time says that “a member of the group close to President

(Ichirozaemon) Sakamoto brought up the idea of a bank-affiliated loan product." The product suited the needs of management personnel of the time who were looking for ways to expand sales channels. "The frontline staff happened to suggest the insurance premium loan product around that time and someone close to the president took the idea to the president. The product was to pay an 8% interest plus a dividend to those who paid the premium in advance," says the staffer. Sakamoto's predecessor Yazaki said in an interview after his company failed, "(Midsize life insurers) cannot increase the total amount of policies in force without using a new sales system. We thought the suggestion a good idea and decided to adopt it on the spot and entered into negotiations with financial institutions" (quoted from Nikkei Business dated October 13, 1997).

This product, marketed under the cooperation between Nissan Mutual Life and banks, had explosive sales, not exactly because Sakamoto promoted it but rather because banks were aggressively selling it. The interest on the bank-affiliated loan was 7% to 8% on the average, and this generated a profit margin of around 4%, allowing for the funding cost of banks of the time. Although the paid-in amount per contract was no more than ¥2 million-plus, the right of pledge was established for the insurance policy. This means that banks had no risk of loan loss unless Nissan Mutual Life went bankrupt.

This was not the only thing beneficial to banks. Even though the product was actually sold by the bank staff, banks were prohibited from directly selling insurance products under the Law Concerning the Control of Insurance Solicitation (predecessor of the current Insurance Business Law). Because of this (law), insurance agents handled the insurer-bank affiliated products. Nissan Mutual Life paid commissions to these agents. In many cases, there was an agreement between Nissan Mutual Life and a bank that the insurer would deposit part of the premium at the bank for a certain period in return for the bank's cooperation in selling insurance products. Banks had a chance to earn a profit margin from this kind of "cooperation deposit." The insurer used to deposit, say, "50% of the premium for one year," according to the parties concerned.

Table 2-4　Changing in total assets

(in units of ¥100 million, %)

	Nissan Mutual Life		Total for all life insurers	
		Year-on-year change		Year-on-year change
FY1985	3,680	19.1%	538,706	17.8%
FY1986	4,441	20.7%	653,172	21.2%
FY1987	6,964	56.8%	792,684	21.4%
FY1988	13,230	90.0%	970,828	22.5%
FY1989	16,270	23.0%	1,173,439	20.9%
FY1990	18,555	14.0%	1,316,188	12.2%
FY1991	19,443	4.8%	1,432,341	8.8%
FY1992	20,285	4.3%	1,560,111	8.9%
FY1993	21,029	3.7%	1,691,221	8.4%
FY1994	21,461	2.1%	1,779,655	5.2%

Source: “Life Insurance Statistics”

(3)　Was there no move to control the rapid expansion of assets?

The annuity insurance loan became a big hit and the premium income increased 2.35 times in fiscal 1987 and 2.19 times in fiscal 1988 over the respective previous years. The total assets amounted to a little over ¥300 billion at the start of the medium-term management plan.　Five years later, at the end of fiscal 1989, the amount reached ¥1.6 trillion, far greater than the ¥600 billion target set for the later phase of the plan. According to a survey by the Life Insurance Association of Japan, Nissan Mutual Life earned ¥1.4 trillion in premium income in three years from fiscal 1987, and nearly 60% of this or ¥800 billion came from individual annuity insurance contracts.　Of these contracts, 90%, or about ¥730 billion, were contracts for single-premium products with an assumed interest rate of 5.5% to 6.0% and a period of 20 to 30 years.　About ¥700 billion of these contracts bank loans.　Moreover, the weight given to individual annuity in the policy reserve was as much as 56% at Nissan Mutual Life as against the industry average of 7%.

Wasn’t there any move to put the brakes on the rapid expansion of scale and excessive concentration on a specific product?

A head office staffer of that time says, “In 1987 (when Sakamoto became president), our finance division and actuary division considered the payment of an annual 8% yield as a problem, but they could not restrain the sales division…　We had many discussions on the advisability of expanding assets so fast.　At around the time when the total assets topped ¥1 trillion (in 1988), an actuary informally gave a warning to the management.

The warning fell on deaf ears… All the information that reached President Sakamoto was ‘things are all right because ________’ or something like that.” In an interview with Nikkei Business as mentioned earlier, Yazaki said, “I felt things were rather imbalanced, but we had come too far to go back...”

Table 2-5 Weight given to individual annuity in liability reserve

FY1986		FY1989	
Nissan	Total for all life insurers	Nissan	Total for all life insurers
12.3%	2.9%	55.9%	6.8%

Source: “Life Insurance Statistics”

Table 2-6 Changing amount of three types of profit

(in units of ¥100 million)

	March 1988	March 1989	March 1990	March 1991	March 1992	March 1993	March 1994	March 1995
Expense profit	-38	22	22	-9	-27	15	13	37
Mortality profit	104	154	183	205	207	208	230	242
Interest profit	80	78	100	101	32	-16	-241	-280
Total	146	254	305	296	212	208	3	-2

(Compiled from inspection reports)

Another factor that made it difficult to restrain the scale expansion was that the company showed good numerical data on the surface. Many midsize life insurers including Nissan Mutual Life operated on a small scale and with low sales efficiency and did not earn a premium income large enough to cover the actual costs. As a result, they suffered an “expense loss.” Wiping out this loss was a long-standing challenge for them. With the amount of policies in force increasing dramatically in the latter half of the 1980s, Nissan Mutual Life finally achieved an expense profit in fiscal 1988. It enjoyed a stable interest profit and a growing mortality profit. However, the company had to pay high assumed interest rates and took such actions as increasing cooperation deposits at banks (a factor reducing the interest profit), realizing latent stock profits under the money trust scheme and taking on the exchange risk in return for high interest income. These actions resulted in a wide gap between the numerical data and the actual state of business.

In a way, banks took the initiative in selling insurance products and the insurer lost control, as shown in a case reported by the weekly Toyo Keizai dated October 18, 1997. When a certain regional bank was suspected of having violated the Law Concerning the Control of Insurance Solicitation in 1988, Nissan Mutual Life asked this bank to refrain from selling its products. The bank refused, and did not stop selling the insurer's products until the employees union raised objection and the matter became an issue in the Diet. Other banks that had sold Nissan Mutual Life's products under a similar arrangement continued to sell them aggressively.

As the investment environment deteriorated, Nissan Mutual Life at last requested banks to hold back on sales in fiscal 1990 and thereafter, but most of them refused to oblige. When asked about this in an interview with Nikkei Business mentioned earlier, Yazaki answered, "There were only two banks (who accepted our request without protest)." Sales began to decline only when the loan rate rose with the market interest rate and the affiliated product became less attractive.

Table 2-7 Nissan Mutual Life's asset structure

(in units of ¥100 million)

	End of FY1986		End of FY1989	
Total assets	4,441	100.0%	16,270	100.0%
Cash and deposits	348	7.8%	1,227	7.5%
Money trust	138	3.1%	1,111	6.8%
Bonds	578	13.0%	1,761	10.8%
Stocks	775	17.5%	3,501	21.5%
Foreign securities	581	13.1%	3,408	20.9%
Other securities	37	0.8%	71	0.4%
Loans	1,646	37.1%	4,226	26.0%
Real estate and movables	223	5.0%	587	3.6%

Source: "Life Insurance Statistics"

(4) Steps taken after the external environment worsened

When the investment environment deteriorated in the 1990s, the heavy burden of paying guaranteed yields came to the fore. Earlier, when the company leaned toward stock investment while its assets were expanding, it purchased stocks at high prices. These stocks now incurred capital losses and valuation losses, making it difficult for the company to make a good showing when settling accounts. In fiscal 1991, the company earned about ¥30 billion in the three types of profit while its valuation loss on securities reached ¥90.3 billion and the current profit shrank to a thirtieth of the previous year's level. The value of individual annuity contracts as a percentage of the policy reserve was above 50%. Most of such contracts had a high assumed interest rate and a high interest rate for those who made advance payment. Even after individual annuity products became less salable in the 1990s, the policy reserve continued to build up.

Meanwhile, latent stock profits were depleted. When settling accounts in fiscal 1991, the company cut dividends, booked a profit on sale of real estate and lowered the policy reserve level.

The company reported an interest profit on the surface, but its interest and dividend income was inflated by derivative-containing products designed to make a good showing when closing the books. The actual earning power was less than what it appeared to be. The company record shows that "foreign securities" increased sharply in fiscal 1991 and "other securities" grew noticeably in fiscal 1993. Part of these securities were products designed to make a decent showing at the term end. "(Nissan Mutual Life) initially earned high yields from Nikkei Average-linked bonds purchased in the early 1990s, but their forecast of the stock market turned out wrong and the principal was eroded in the end… Investment in derivatives using foreign bonds caused more losses. These were products whose yields were initially high but were reduced over time," according to an analysis given in the weekly Economist dated June 17, 1997.

The company used the "net premium method," the most conservative method for building up a policy reserve (including a contingency fund), in fiscal 1986. However, "in fiscal 1991 we started to take measures to reduce liabilities before settling accounts. We broke into our contingency fund, lowered the policy reserve level and cut dividends… We initially adopted the 10-year Zillmer method, so it was as if we just returned to the previous state. The discounts for advance payment put a heavy burden on us, though," says a former head office staffer.

The Nikkei Financial Daily dated March 7, 1994 carried an article titled "The plight of three life insurers in Shibuya (Toho Mutual, Nippon Dantai and Nissan Mutual)." It was reported that "the three companies whose asset quality had deteriorated took a last-resort measure. They broke into the policy reserve (reserve to prepare for insurance payouts) to make a good showing when closing the books… Nissan Mutual Life's reserve decreased so much that it fell even below the minimum reserve level the Ministry of Finance had instructed insurers to maintain. According to a generally agreed view, it is difficult to further relax the method of setting up a reserve from an actuarial point of view." Actually, the company's reserve level was brought down further in fiscal 1994.

What was worse, most of Nissan Mutual Life's individual annuity products were of the type in which the premium was paid in advance. The insurer guaranteed a yield even on the prepaid and unearned premium, but “was not conservative in setting up a policy reserve for unearned premiums (that is, the yield guarantee was not properly reflected in the reserve amount)” as pointed out by an officer of a major life insurer.

The Ministry of Finance, during its inspection of Nissan Mutual Life in 1991, realized that the company was going into deep water and ordered it to submit a profit improving plan on several occasions in fiscal 1992 and thereafter. Nissan Mutual Life started cost reduction in fiscal 1992. It set the goal of cutting operating expenses by 10% and closed the New York office and reduced new hires. However, all this “did not amount to drastic restructuring,” says a former head office staffer.

Inappropriate measures taken to prepare for book closing exacerbated Nissan Mutual Life’s business condition, bringing the company practically to a state of negative net worth in fiscal 1993.

Table 2-8 Breakdown of liabilities in excess of assets at Nissan Mutual Life

(in units of ¥100 million)

Term	March 1994	March 1995	March 1996	March 1997 (Projection)
Unrealized profit/loss	-961	-1,482	-1,314	-1,328
Securities	-1,218	-1,571	-982	-897
Loans	-5	-15	-143	-136
Real estate	262	104	-189	-295
Net profit/loss	0	0	0	-525
Liabilities in excess of assets	-961	-1,482	-1,314	-1,853

Source: Yomiuri Shimbun dated April 27, 1997

(5) Managers of that time

President Yazaki worked his way up from the sales field. His successor Sakamoto, who became president in 1987, was from the personnel field and became representative director and vice president in 1981. Sakamoto was in charge of drawing up and directing the medium-term management plan from 1985. According to a head office staffer of that time, Sakamoto “was not the autocratic type, but a group of four or five people in the financial and other fields, led by Sakamoto from the personnel field, had influence within the company… President Sakamoto was not much of a salesperson (in the company where the sales division carried a lot of weight). He publicly admitted that ‘I cannot take on sales work.’ He was very pleased to see banks aggressively selling affiliated loan products."

In the 1990s, the company found itself falling into difficulties. However, "the president didn't take the leadership in starting efforts to reconstruct business. He just told others to 'do something about it' and did not act on his own initiative… When we received a notice from the Ministry of Finance pointing out our problem and an order to take remedial action, and informed the president about the matter, he just said 'we cannot possibly do such a thing.' He saw the problem not as something the company should address but as a disaster that fell upon him… He was not like a manager but was rather like someone merely holding an honorary post. The principle of competition did not work in a mutual company of that time. One who stayed in this environment for decades would end up as a manager like that," says a former head office staffer.

President Sakamoto resigned in July 1994, and actuary Hiroshi Yonemoto took over as president. At this point of time, Nissan Mutual Life was practically in a state of negative net worth. It was not as if the new president could do something about it.

(6) Lack of ALM

In the latter half of the 1980s, Nissan Mutual Life saw a sharp increase in its fund which guaranteed high assumed interest rates. This put a heavy burden on its asset management. The company "overstrained itself in investment activities," says a head office staffer of that time. There are related newspaper and magazine interviews. "Nissan Mutual Life doubled its total assets in one year (fiscal 1988) by selling premium loan products and diverted the increased assets to high-yield foreign-currency deposits during that term. However, it suffered a loss from mismanagement of exchange forward contracts and ended up covering the loss by capital gains from stock trading," said the economic newspaper Nikkei dated December 23, 1989. "(After incurring loss from exchange speculation) the company shifted the weight of asset allocation to stocks and tripled the stock investment balance over three years from fiscal 1986. Moreover, it scrambled to buy stocks under the corporate investment fund scheme. As a result, the balance grew 4.5-fold in three years to the end of fiscal 1989," reported the journal Nikkei Business dated October 13, 1997.

Annuity insurance loans were enjoying growing sales at that time. The company's management as well as the actuarial division and the finance division were hardly aware of the interest rate risk (ALM risk). "If they had taken a severer stance on the interest rate (fluctuations), the liabilities would not have ballooned to this extent. In those days no one realized that 'the assumed interest rate equals the cost of liability.' All they cared about were stock prices. It never occurred to them to reduce the assumed interest rate earlier than other companies," says a head office staffer of that time.

In those days the company had no system for having a future cash flow analysis made by an actuary. "To calculate the target figures for the medium-term management plan, the company made projections by postponing reporting expenses on the profit & loss statement. It was assumed (too optimistically) that stock prices, interest rates and exchange rates would be unchanged while the amount of policies in force would increase. Despite the increasing mortality profit, a review of the figures alone showed that the company was not in good condition. Even so, the latest figures (such as three types of profit) were good enough and there was no alternative that would keep the sales division in check," says a former head office staffer.

The finance division and the actuarial division were not in good terms with each other. "The finance division made no effort to gain an accurate grasp of the liabilities (of which the actuarial division was in charge). The actuarial division dared not try to get financial details… We didn't hear of any fund manager going overboard, but it was not until 1994 or so that the finance division and the actuarial division came to cooperate with each other," says a former head office staffer.

(7) Meeting of policyholder representatives, affiliated corporate groups

Nissan Mutual Life was a mutual company. It was at a general meeting of representatives of policyholders that decisions were made on managerially important matters. The trouble was that such meetings had almost no checking functions. Reporting on the meeting of policyholders' representatives where they decided on the company liquidation procedure in July 1997, Mainichi Shimbun dated July 31, 1997 noted, "About 60% of representatives were people from member firms of the Hitachi Nissan group which was close to Nissan Mutual Life. The issue was decided by the overwhelming majority." Obviously, a meeting of policyholders' representatives had become a mere formality.

When Nissan Mutual Life was practically bankrupt, its part-time directors and auditors were from eight companies of the Hitachi and Nissan groups.. Instead of fulfilling their role as a watchdog, these part-time officers "did not take their role seriously but felt they had simply taken over an executive post that had been handed down from their predecessors. Frequency of their attendance at board of directors meetings was low… There is no evidence that part-time directors or auditors were deeply involved in the management of Nissan Mutual Life," as reported in Nikkei Sangyo Shimbun dated June 9, 1997. At the time of the company's failure in 1997, a director from Hitachi, Ltd. was angry because "we had little information," according to a party concerned.

Nissan Fire & Marine was the only exception among Hitachi Nissan group firms. At the request of Nissan Mutual Life in July 1996, it contributed a ¥1 billion fund and sent in a former chairman and a senior managing director to support the life insurer. Nissan Mutual Life and Nissan Fire & Marine concluded a business tie-up under which their products combining life and non-life insurances were sold by Nissan Fire & Marine's affiliated agents. Nissan Fire & Marine was so supportive because, when it became a greenmailer's target sometime in the past, Nissan Mutual Life came to its rescue.

The executive sent from Nissan Fire & Marine to Nissan Mutual Life as its director and advisor sought the support of the Hitachi Nissan group and "worked hard to carry through reforms including the introduction of revenue analysis for each branch. He was the first manager who was really like a manager. Nissan Mutual Life had not had this kind of manager before," says a former head office staffer. All the same, the situation was already very serious. Nissan Mutual Life sought financial support from major companies of the Hitachi Nissan group from the summer of 1996 onwards, but all it got was Nissan Fire & Marine's support. It never received any support from other companies. Nissan Mutual Life collapsed before achieving the results of reform.

In an interview with Nikkei Business mentioned earlier, Yazaki admitted, "We were self-indulgent and thought that the Hitachi Nissan group would come to our rescue in the end." Actually, the group companies gave Nissan Mutual Life the cold shoulder.

(8) Ministry of Finance

"Before concluding tie-ups (Note from translator: tie-ups to sell annuity insurance loan products), Nissan Mutual Life informed the Insurance Division 1, the Insurance Department, the Ministry of Finance about its desire to handle a bank-affiliated product (insurance premium loan). The Ministry of Finance answered that they would 'decide whether to approve the product or not after making sure that the product will not recommended as a zaitech investment product and its sales will not cause trouble with consumers',” reported by the weekly Toyo Keizai dated November 8, 1997. The company put its product on the market with the approval by the Ministry of Finance. As the affiliated product was actually sold as a bank's financial product and became a hit, the Ministry of Finance requested the life insurance industry in 1988 to “refrain from tying up with banks to sell zaitech products like insurance premium loans. Such a product defeats the real purpose of insurance,” but this request was largely ignored.

During its inspection in 1991, the Ministry of Finance began to realize that Nissan Mutual Life was sinking into deep water, as mentioned earlier. Subsequently it ordered the company to improve earnings. The inspection by the Ministry of Finance of that time “primarily consisted of assessment of assets on the financial side. On the revenue side, the inspectors looked only at three types of profit on a single-year basis,” according to the parties concerned. It is most likely that the Ministry of Finance was unaware of Nissan's interest rate risk (the loss will increase if the interest rate drops). The Ministry of Finance may not have been aware, either, of the tactics used by the company to keep loss from appearing on the books.

Given that life insurers needed the approval by the Ministry of Finance to cut down the policy reserve level or to pay policyholder dividends, the Ministry of Finance should have known that Nissan Mutual Life's business was deteriorating year by year. From Nissan Mutual Life's behavior and witness accounts of the parties concerned, however, it seems unlikely that regulators of the first half of the 1990s strongly urged the company to improve its operations.

The company fell practically into the state of negative net worth in fiscal 1993. It did not collapse until three years later. During this period the Ministry of Finance did not start the liquidation procedure. Under the Insurance Business Law effective at that time, the Ministry of Finance might have taken drastic action such as forcible transfer of the whole business. However, it dared not do so in the absence of established rules for closure of the insurance business or a safety net.

Nissan Mutual Life's liabilities in excess of assets increased during this period. The ¥200 billion fund put up by the Life Insurance Policyholders Protection Corporation of Japan, a newly established safety net, was not enough to cover the insurer's debt. Policyholders had to bear the remaining burden of debt. In contrast to bank deposits which were fully protected at that time, policyholders' assets were only partially protected. This exacerbated consumers' anxiety about life insurers with low credit standing.

3. Inappropriate management by top executives—Toho Mutual Life Insurance

(1) Direct cause of failure

Toho Mutual Life collapsed in June 1999. The collapse was triggered by an adverse opinion issued on the firm's fiscal 1998 financial statements by Deloitte Touche Tohmatsu LLC. Asked by the auditing firm to additionally book latent losses on securities holdings, bad loans, and others worth a total of roughly ¥231.3 billion, the insurer was found to be falling into negative net worth of about 200 billion if they recorded the entire amount.

Toho Mutual Life entered into a business partnership with U.S. major nonbank GE Capital in the year before receiving the adverse opinion. By taking advantage of "goodwill" earned through the transfer of its marketing force and other revenue worth up to ¥120 billion, the insurer was supposed to "have recovered its financial strength and built up substantial internal reserves (according to the insurer's disclosure materials for fiscal 1998)," but it failed to survive even the first fiscal year when it formed an alliance with GE.

The management crisis of Toho Mutual Life is largely attributed to volume sales of high-return asset-based products in the late 1980s and massive non-performing assets following the bursting of the bubble, resulting from growing dependence on real estate-related investments and loans and other high-risk high-return investments. Besides, as a distinguishing factor for Toho Mutual Life, we may have to point out the inappropriate way of management taken by the top executives and people close to them.

With its top executives clearly pursuing an expansion strategy in the late 1980s, Toho Mutual Life accelerated its efforts to sell asset-based (savings-based) products. It aggressively sold high-yield mutual aid pensions, single-premium endowment insurance which was a symbolic product for money management technique (zaitech), loan products offered in tie-ups with financial institutions (single-premium individual annuities), "zaitech" insurance "*kenko nenkin* (health pension)" and others. As a result, its total assets as of the end of fiscal 1989 expanded by 280% from the level as of the end of 1985. The firm sold these products, touting their high yields, and the sales were based on the premise of tapping into unrealized gain on its assets.

Table 2-9: Brief History of Toho Mutual Life

1898	Established as Japan's first "military service insurance company".
1909	Seizo Ota became President (Management by the Ota family began).
1947	Restarted as New Nippon Life Insurance Co. (renamed as "Toho Mutual Life" in the following year).
1975	The head office building in Shibuya, Tokyo was completed.
1977	Seizo (Shintaro, before renamed) Ota became President.
1978	Started marketing whole life annuities.
1984	Assisted failed Riccar Co.'s restructuring efforts.
1987	Dispatched its managing director to Kaken Pharmaceutical Co. to have him assume the presidency of the firm.
1988	An affiliated firm of President Ota became a major shareholder of Nippon Lace Co.
1990	Stepped up sales of "zaitech" insurance "*kenko nenkin* (health pension)."
1992	New online system "Toho-System 21 Plan" put into operation.
1994	Reported an operating loss for fiscal 1993.
1995	Reported an operating loss for two consecutive years. Ridai Sakogawa became President. A management advisory committee was launched.
1996	Entered into a business partnership with Mitsui Marine and Fire Insurance Co.
1997	Started marketing "Pegasus," insurance exclusively for healthy people.
1998	Formed a tie-up with GE Capital and became a company only managing existing contracts.
1999	Received a business suspension order.

(Honorifics omitted)

The insurer increased investments in soaring stocks and a variety of structured bonds to earn yields for surging savings-based products. The firm's assets appear to have already substantially worsened in the early 1990s, although the details were unclear due to limited disclosure. It posted massive losses on sales of foreign securities for two consecutive years in fiscal 1993 and 1994 when it posted operating losses.

Moreover, the insurer was saddled with massive bad loans after the bubble burst. Many of those loans are said to have included problematic deals executed by the then president and people close to him.

(2) Leaning toward asset-based products

Toho Mutual Life was a military service insurance company in the pre-war periods. Military service insurance was a kind of endowment insurance and had a feature of savings-based products by adopting a scheme where people took out insurance when their children were still young and received insurance benefits when the children were called up for military service. The insurer was weak in sales of coverage-based products in urban areas as it developed its operations mainly through sales forces in regional rural areas. Being unable to keep up with the rapid economic growth and the trend toward population concentration in large cities in the 1970s and thereafter due to these weaknesses, the firm struggled with slow growth in earnings and its financial standing gradually deteriorated. Moreover, without affiliated firms, the insurer had a hard time penetrating into the market serving the workforce of companies.

President Ota, who assumed the position in 1977, set up the "business development department" to strengthen the firm's sales in urban areas, which were weak compared with those of other industry players. Thus, he tried to rebuild the firm's operations targeting the market for large companies and exploit new customers such as government offices and their neighbors, labor unions and others. Initially, Toho Mutual Life expanded its earnings by exploiting markets not served by major players and offering a broad range of products without focusing on particular policies or markets. It gradually turned to asset-based products, however, because such products made it easier for the firm to exploit new customers. The sales of high-yield products raised the firm's fundraising costs, leading to deterioration of its revenue structure. Ota clearly set out an expansion strategy in the late 1980s, and the firm's goal at that time was to "exceed Chiyoda Mutual Life (which was increasing its presence as a major life insurer) in terms of asset scale."

Of asset-based products, "mutual aid pensions" were high-yield products created by improving individual contribution-type corporate pensions and introduced to exploit markets for labor unions and corporate customers. They were not designed primarily to satisfy pension needs, but rather to meet the investment needs of customers having surplus funds. With the number of strikes falling, labor unions of that time had surplus strike funds to invest. "The entry into the labor union market was successful, in terms of marketing. Sales were based on the premise of tapping into latent stock profits to offer high returns, however, as we made a sales pitch, saying, 'The product will generate a return of 8% or so'" (according to a head office staffer of that time).

Toho Mutual Life also stepped up sales of individual annuities using tie-up loans with partner financial institutions, although not as aggressively as Nissan Mutual Life. Such policies were a type of insurance requiring policyholders to make an advance premium payment for all periods. These policies also brought a heavy burden of policy reserves to the insurer later.

Table 2-10: Profit or loss on securities relative to surplus for the year

(in units of ¥100 million)

	March 1985	March 1986	March 1987	March 1988	March 1989	March 1990	March 1991
Surplus for the year	528	541	730	715	792	949	875
Profit or loss on securities	76	234	411	398	305	195	199
proportion	14.3%	43.3%	56.4%	55.7%	38.5%	20.5%	22.7%
Proportion (all companies combined)	6.2%	11.0%	42.7%	32.4%	27.4%	22.8%	16.5%

(Data) "Life Insurance Statistics"

Around 1989, the firm started marketing "*kenko nenkin* (health pension)," an individual annuity with an extremely short period of deferment (mainly three years). The product also served as a "zaitech" product that offered high-returns by devising payment methods. "It was initially developed as a door opener. We sold policies worth hundreds of billions of yen, though, because we could earn loading from the product. Some policies sold were large-lot contracts where annual premiums paid by one company reached ¥20-30 billion" "The effective yield was 8%. We sold the product as an investment vehicle for surplus funds of manufactures and their affiliated companies" (both comments made by head office staffers of that time).

Toho Mutual Life at that time was desperate to eliminate expense losses and realize dividends on par with the levels of major insurers, as well as to expand the scale of its assets. "Management often said 'Having strong potential, Toho can beat major insurers if offering the same levels of dividends as those major players do'" said a head office staffer of that time. The firm earned loading (part of insurance premiums that cover an insurer's costs) by expanding sales of *kenko nenkin* and other savings-based products and finally realized dividends on par with the levels of major insurers in financial results for fiscal 1989. "We were all excited that our company realized the same levels of dividends as major insurers offered, but in order to achieve the levels, we bit off more than we could chew. As a result, we were forced to struggle with the burden of offering high-yields and the high book values of shareholdings. Moreover, our sales rather worsened as we ended up lowering dividend payouts again in financial results for the following fiscal 1990" (said a person in charge of actuarial works).

(3) Top executive's behavior

Since the Meiji era, the Ota family had assumed the position as President of Toho Mutual Life for generations. When Seizo Ota, who became President in 1977, joined the insurer as auditor in 1953, he was promised the presidency of the company. Ota was known as a unique manager rather than as president of a life insurer, because he showed enthusiasm for reconstructing other businesses and called for the construction of a worldwide free trading area. However, the “Weekly Diamond,” in its issue dated October 27, 2001, shows its view that “Ota, who would only dabble in shady deals, happened to be President when Japan was in the midst of the bubble economy. That was unfortunate for both employees and policyholders of Toho.” Several head office staffers of that time say, “Ota liked PR activities, but he had no management principle. We were not allowed to run our business properly as a financial institution”, “With money and status in his pocket, he wanted to earn his place in history” and “He had many grand ideas, but they were all expansive delusions. We wanted him to come up with viable plans.”

There is a media report that “Ota saved a failed company, invested in speculative stocks, had a friendship with Kyo Eichu (Heo Young Joong), the defendant of the Itoman fraud case; he thus ran the business in an erratic way” (“Weekly Diamond” dated October 27, 2001). A head office staffer of that time admits the report is true and reveals there are a number of stories that have not been reported. “Ota apparently went out into deeper water to recover his loss and lost his fortune. He diverted Toho Mutual Life’s funds into a family-run enterprise to eliminate its debts and as a result, became unable to differentiate the company’s funds from his personal funds,” according to a staff member in the planning department.

Ota didn’t seem to be very interested in the life insurance management. A head office staffer of that time admits, “the president said to us, ‘I don’t know much about management, and so I just want to have the power to shuffle personnel,’” In fact, he had a great interest in personnel issues. For example, he surrounded himself with yes-men, eliminating influential figures such as Mr. A, who supported the accounting department of Toho Mutual Life in the post-war period, and Mr. B, who was responsible for rebuilding Kaken Pharmaceutical (and also became a member of the management advisory committee set up by the insurer in 1995). Rather than his being autocratic, people around him stopped saying anything to him. He also “tended not to appoint wise men as board members” and “the tenure of board members were usually short”.

(4) Behavior of those close to the top executive

Under the leadership of President Ota, the life insurer is said to have been divided into a pro-president group and an ultra-conservative force (a kind of people who are unenthusiastic and only handle work at hand) with no moderate force growing. Those who had assumed the position of branch manager largely occupied the posts of board members. A staff member in the planning department recalls, “None of them took any action even when we faced the possibility of falling into the red in fiscal 1993. In the first place, they didn’t understand the severity of the problem. Even though we said, “The Ministry of Finance will never protect us,” their stance was: ‘there will be no way that the Ministry won’t protect such a big insurer like us.”’

Regarding Ridai Sakogawa, who became the first president not coming from the Ota family in 1995, head office staffers of that time say, “He was a nice person, but was not familiar with any field,” “The only thing we can appreciate about him is that he didn’t disturb young employees.” When still serving as vice-president, Sakogawa said in an interview, “I feel we didn’t have enough courage to speak up in front of the president. Come to think of it, we hesitated to express our opinions probably because he had a strong presence in the company (according to Nikkei Business magazine dated August 1, 1994).

However, it can be also said that people close to Ota overly flattered the president in order to do whatever they wanted to do. For example, a man close to President Ota induced him to invest in speculative stocks and have a friendship with Kyo Eichu. The man left the company in 1983 after launching the business development department that I mentioned before, became an advisor, and then set up “Toho Kikaku,” a firm engaging in insurance agency and management consulting operations. As a major shareholder, he became the president of Nippon Lace and is said to have gotten involved in the trading of speculative stocks and the case of overissue of notes. “He and his father worked for Toho Mutual life, achieved outstanding sales performance in Osaka and other places and won the favor of Ota. However, he would withdraw the company’s funds for lending and gain contracts in return for such funds” (according to a head office staffer of that time). Even after his retirement from Toho Mutual Life, the man allegedly withdrew funds from the insurer and carried out shady investments and loans.

Besides, an executive in charge of investment at that time took control of the financial affairs department having the president’s trust at his back and was called “Emperor” within the company. A staff member in the planning department says, “The power to make final decisions was meaningless if the president said “OK,” which eventually drove us into high-risk investments.” Another head office staffer of that time says, “The executive completely mixed up public and private matters so that he personally used the hotel owned by the company in Hawaii and took a round-the-world trip every year by using the company’s money.… He is believed to have gotten involved in the president’s own loans and investments. So, the president couldn’t get rid of the executive no matter what he did.”

(5) Steps taken after business turned worse

Even when being directly hit by a fall in stock prices in the 1990s, “We were in the mood to “go ahead” by around 1992. For example, a new online system (Toho-System 21 Plan) was launched in 1992. However, some people had already realized the situation we were facing and had been trying to take control of it,” a person in charge of actuarial works recalls.

The insurer incurred huge valuation losses when share prices started sliding in the 1990s and thereafter mainly due to increased investment in stocks in the bubble period and heavy reliance on capital gains to generate dividends for savings-based products. Its valuation loss on securities holdings amounted to ¥162.2 billion in fiscal 1991, reaching more than 20% of its total stock holdings. Severe financial results continued in the ensuing periods, and the insurer ended up with an operating loss in fiscal 1993 for the first time ever (maintained a net profit, though, by covering losses with profits on sales of real estate).

Savings-based products, which greatly contributed to the surge in assets in the late 1980s, provided little mortality profits, usually put the heavy burden of ensuring high yields, and squeezed the insurer’s earnings immediately when market interest rates went down. Looking at the three sources of profits and losses, we see that Toho Mutual Life started incurring an interest loss in fiscal 1992 and that it had become unable to cover its interest loss with its expense profit and mortality profit since then. Moreover, the insurer’s latent stock profits shrunk from ¥390 billion as of the end of fiscal 1989 to ¥16 billion at the end of fiscal 1991. Then-vice president Sakogawa said in an interview, “We incurred latent losses on foreign securities held in the form of investment trusts in fiscal 1991 and 1992. They were high-return funds, but types of products generating losses later…. The company was already saddled with huge latent losses on securities holdings and latent losses on off-balance assets in 1992 and was operating in the red due to these losses as well as high assumed interest rate,” according to a staff member in the planning department.

Table 2-11: Valuation losses on securities holdings (as of the end of March 1992)

(in units of ¥100 million, %)

	Valuation loss	Balance of stocks	Proportion
Nippon	4,510	67,507	6.7%
Dai-ichi	3,891	49,614	7.8%
Sumitomo	4,109	41,264	10.0%
Meiji	2,382	29,604	8.0%
Asahi	1,810	23,119	7.8%
Mitsui	1,627	19,383	8.4%
Yasuda	1,178	13,782	8.5%
Chiyoda	1,219	12,906	9.4%
Taiyo	251	7,418	3.4%
Toho	1,622	7,484	21.7%
Kyoei	1,251	6,027	20.8%
Nippon Dantai	1,290	5,123	25.2%
Daido	468	4,926	9.5%
Daihyaku	465	6,892	6.8%
Fukoku	489	4,330	11.3%
Nissan	903	2,744	32.9%
Tokyo	125	2,498	5.0%

(Data) "Life Insurance Statistics"

Therefore, Toho Mutual Life lowered the standards for setting aside policy reserves at early stages to get through its earnings results announcement. In an effort to handle its massive valuation losses in fiscal 1991, it first shifted from the net premium method (including contingency reserves) to the Zillmer method to generate profits, according to parties involved. Later on, the firm lowered its standards several times, including in fiscal 1994, and as a result, its policy reserves came to the levels under the 10-year Zillmer method or lower.

Toho Mutual Life already received a variety of suggestions regarding its assets and others at the time of the inspection by the Ministry of Finance in 1990, but steps taken by the insurer were obviously aimed to turn things around in just one shot, rather than to carry out management reform. A person in charge of actuarial works admits, "We once tried to post profits from reinsurance transactions with a struggling U.S. life insurer, but the firm eventually failed, and we ended up with additional losses."

Materials attached to the inspection report for 1993 reveal that the insurer's classified assets (on a basis of assessment by the authorities) rose to 13% of its total loans receivable from 1% in 1990. It had ¥70 billion worth of latent losses on securities holdings as of May 1993 and the levels of its policy reserve also plunged. All of these data suggest that the company was stuck in serious financial condition. Moreover, its statements of income for the early 1990s showed little sign of the insurer speeding up disposal of bad loans. It was not until fiscal 1995 that the company wrote off a large amount of bad loans.

(6) Management reform by a group of junior staff

A “group of junior staff” began gaining control of management around the time that the Finance Ministry of Finance inspected the insurer in 1993 and that the company posted an operating loss in fiscal 1993. Later, President Ota resigned to take responsibility for the company’s two consecutive years of operating losses, and the group of junior staff started a “new management plan” under the leadership of President Sakogawa, who took up the position in July 1995. They introduced an early retirement plan and other restructuring measures, formed a partnership with Mitsui Marine and Fire Insurance Co. (at that time), strengthened its agent network, developed a new product (launched in 1997 as “Pegasus”, insurance exclusively for healthy people) and took other steps one after another.

At the same time that the new management plan was launched, the group of junior staff set up a “management advisory committee” as an advisory body to the board of directors. Members of the committee included the representative of Milliman and Robertson Japan, the Japanese unit of a U.S. consulting firm specializing in actuarial science, and president of Kaken Pharmaceutical Co. (a former member of Toho Mutual Life Insurance) with a former employee of the Ministry of Finance assuming the post of Chairman of the committee. Another former employee of the Ministry became an outside auditor.

At this point, the group of junior staff was already thinking that the insurer wouldn’t be able to survive on its own and therefore, their management reform was based on the premise of a capital alliance with an outside party. For example, they apparently expected the representative of Milliman to calculate the corporate value of the insurer and introduce a possible partner to them.

The president and new management members are not said to have interfered with the reform by the group, but they were considered as a secret body within the company. They are believed to have received criticism later from people saying “they abandoned a self-restructuring plan in the first place."

(7) Tie-up with GE Capital

The group of junior staff initially visited major life insurance companies to talk about a possible partnership, but couldn't sit at a negotiating table. Instead, they found their company's main market targeted by those major players and "had a terrible experience" (according to a head office staffer of that time). The group started negotiations with foreign-affiliated companies around the beginning of 1997, but due to the collapse of Nissan Mutual Life, public trust in the life insurance industry deteriorated, leading to an increase in policy cancellations.

Moreover, large-scale companies such as Hokkaido Takushoku Bank and Yamaichi Securities Co. went under, setting off a new round of financial unrest and forcing the insurer to receive a record number of cancellation requests. A person in charge of actuarial works says, "We never faced a funding crunch. We still had assets to cash in," but in order to deal with massive cancellations, the company had no choice but to sell its prime assets. With the insurer's corporate value falling day by day, negotiations didn't go smoothly. Loans that turned sour, in addition to bad loans held by its affiliated non-bank, rose to the surface one after another. The assumed interest rate was also high; the average rate was 4.79% at the time of the insurer's failure (in fiscal 1998) and the rate for individual insurance and individual annuities alone reached 5%.

A plan to form a partnership with major Dutch insurance group Aegon N.V. fell apart right before implementation. "The proposed framework was to separate the sales network from Toho and create a new life insurer with Aegon with Toho becoming the management company for existing contracts. The two insurers had already reached a basic agreement and were about to make an official announcement. However, Aegon became reluctant to invest in Japan and other Asian markets after the Asian financial crisis in 1997 and pulled out of the plan at the last moment" (according to The Nikkei Financial Daily dated February 5, 2003).

Although negotiations were once suspended, the company eventually formed a partnership with GE Capital under the scheme of splitting itself into a new one and an old one, the same method considered in tie-up talks with Aegon. The adopted scheme put Toho Mutual Life at a disadvantage because it required the Japanese insurer to transfer its new marketing force to GE Edison Life Insurance Co., a firm jointly set up by the two companies, and to become a company specializing in maintaining and managing insurance policies acquired in the past. GE Capital not only blocked Toho Mutual Life's financial risk, but also demanded that part of the consideration for goodwill be paid on a fee-for-performance basis. Regarding financial reinsurance contracts, a person involved in the tie-up deal of that time says, "They were also very unfair contracts".

Therefore, head office staffers at that time and people in charge of actuarial works of that time say, "The partnership was a complete failure" or "Some of our personnel executed an unfavorable contract in a short period of time." Management members and the group of junior staff of that time insist, however, that "We were already unable to do our business under the name of Toho Mutual Life," "With our weakness well known to the partner, we just had to accept various conditions, but we had no better option (aside from a bankruptcy)," and "Without a safety net, we had to avoid the worst situation" (according to several head office staffers at that time).

(8) Corporate management checking and risk management system

Under the leadership of Ota, the insurer's internal control system and risk management system barely functioned. For example, as long as the president gave a green light, the power to make final decisions was apparently meaningless.

An executive in charge of investment at that time, who took control of the financial affairs department having the president's trust at his back, "stopped submitting the detailed report of asset management to meetings of managing directors in the late 1980s. He also stopped presenting data needed to calculate solvency margin ratios to the actuarial department in the early 1990s, saying, 'We will make a calculation on our own.' He later started showing data when the company really got in trouble, though. Initially, the planning department was telling to the investment department about the ceiling amount the investment department was allowed to handle. The ceiling was removed at a certain point, however, and the investment department started hiding their investment data. At any rate, the executive took control of everything. I feel pity for his subordinates," says a staff member in the planning department.

In the late 1980s, a "young employee" explained about the issue of a mismatch between assets and liabilities to the executive at many times, but the executive is said to have pushed the employee away from him, considering the young worker to be among the critics. An administrator says, after examining the results of investigations following the collapse (undisclosed), “The insurer only had an inadequate internal management system and carried out inappropriate asset management.”

Meanwhile, no coordinated efforts were made to hold down rapid expansion of assets in the late 1980s. “Even if actuarial personnel showed their concern, their opinion never got through because of powerful influence exerted by the president and people close to him. Some employees left the company in an unexplained manner”…. “Even the actuarial department lacked the idea of ALM. The actuarial and financial affairs departments didn’t work together, but listened to each other and just used the results reported by the other department,” said several parties concerned.

Toho Mutual Life’s actuaries are said to “have been granted certain power because they were involved in drawing up measures for financial results announcements and developing products” (according to a person in charge of actuarial works), but a staff member in the planning department says, “As early as 1992, actuaries found the company’s liabilities exceeding its assets, but they failed to properly convey the results of their analysis to the management”…. “Actuaries were respected in Toho Mutual Life and also had certain influence on the industry until Ota became President. Their standards then dropped, and they basically became the president’s puppets,” a head office staffer of that time reveals.

(9) Role played by external discipline

Managerial check from external parties barely functioned. Toho Mutual Life took the form of a mutual company as Nissan Mutual Life did, and its meeting of representatives also did not seem to function well as the president chose people he liked as representatives (according to a head office staffer of that time).

It is said that President Ota was not appreciated by his family either. Nevertheless, the family took no concrete action to kick him out of the president’s chair. Ota’s cousin, who served as president of Kyusyu Kangyo Co., an asset management firm for the family, once became vice-chairman of Toho Mutual Life (during the period from 1988 through 1995), but there was no sign indicating that he played a certain role in terms of governance. Ota’s uncle, his predecessor, “presented opinions on the management of Toho Mutual Life even after he retired from his position as president. He eventually stopped doing that because Ota didn’t listen to him at all. There was also a feud between the two over the timing of when Ota assumed the presidency, according to a head office staffer of that time.

The labor union didn't take any major actions either. President Sakogawa once served as vice-chairman of the executive committee of the insurer's labor union, and one of the vice-presidents who resigned in 1994 also had a close tie with the labor union.

Meanwhile, the Ministry of Finance questioned the management of Toho Mutual Life at relatively early stages. However, President Ota consistently took an adversarial stand against the Ministry (he offered positions to several ex-employees of the Ministry, on the other hand).

As I mentioned earlier, the Ministry of Finance already raised a question over the insurer's assets when it conducted an inspection in April, 1990. However, no major action was taken until the next inspection (in 1993). The Ministry allowed the company to cut its policy reserves standards for fiscal 1991, but whether it was already aware of the liability issue is questionable.

In the inspection of 1993, the insurer's net capital base in a broader sense (the amount of capital base after taking into account latent profit or loss on securities holdings, 50% of class III classification loans and 100% of class IV classification loans) dipped to minus ¥65.9 billion, compared to the positive ¥495.0 billion in 1990. Assets classified as class II also rose to ¥200 billion.

However, the Ministry of Finance focused its efforts on urging the insurer to change its top management rather than urging them to improve the soundness of their assets, according to a head office staffer of that time and others. "The inspection by the Ministry in 1993 lasted roughly three months, much longer than its ordinary inspection (which usually takes less than one month). The Ministry viewed bypass loans extended to a family-run corporation as a problem and demanded that the president and the executive in charge of investment step down," says a head office staffer at that time. Unfortunately, the results of the inspection themselves were undisclosed, but it may be exceptional for the Ministry to demand resignation of a company's top management when conducting an inspection. A staff member in the planning department says, "The Ministry of Finance took a firm stance of not allowing us to issue financial statements until resignation of our top management." Nevertheless, President Ota didn't resign soon, and finally stepped down in 1995.

The Ministry of Finance is said to have generally taken a cooperative attitude toward the management reform by the group of junior staff. A former employee of the Ministry became the chairman of the “management advisory committee,” and the Ministry approved of the insurer’s partnership with GE Capital in 1998. The scheme adopted under the partnership was to split Toho Mutual Life into new one and old one, which wouldn’t necessarily enhance the insurer’s credit, and the cash flow plan itself was based on the premise that stock prices and long-term interest rates would gradually rise. Thus, “It was like walking on an extremely narrow path,” says a head office staffer of that time. Besides, if a bankruptcy occurs after the execution of a partnership, the scheme would virtually require the failed insurer to comprehensively transfer insurance policies to the partner company, putting the insurer in an obviously disadvantageous position during negotiations on liquidation procedures.

The Ministry’s personnel involved in the tie-up deal on a practical level were very reluctant to approve the proposed scheme, according to people concerned in those days. Nevertheless, the Ministry issued a notice lifting a ban on financial reinsurance in December 1997 to support the tie-up deal and finally gave its approval to the deal.

Behind the Ministry’s decision lies the fact that after funds worth a total of ¥200 billion set aside as a safety net got used up for the liquidation procedures for failed Nissan Mutual Life in 1997, no safety net had existed until the establishment of the Life Insurance Policyholders Protection Corporation of Japan in December 1998. The Ministry’s decision is also attributed to growing public concern over the nation’s financial system spurred by a series of large-scale bankruptcies in the fall of 1997.

4. Fettered by low earnings structure – Daihyaku Mutual Life Insurance

(1) Direct cause of failure

Daihyaku Mutual Life failed in May 2000, one year after Toho Mutual Life’s failure. Faced with an increasingly severe business environment, Daihyaku Mutual Life concluded a tie-up with major Canadian life insurer Manulife Financial in 1999 and strived to improve the quality of assets and add to its internal reserves by drawing on funds secured through the transfer of business rights and financial reinsurance.

Soon thereafter, cancelations increased markedly in the wake of the failure of Toho Mutual Life, which had teamed up with GE Capital in almost the same scheme (separating new and old contracts and taking over only old contracts while transferring new contracts to its partner). Moreover, Daihyaku Mutual Life incurred loss from high-risk foreign securities investment started shortly after concluding the tie-up. Also, the company had obtained a subordinated loan in an inappropriate manner in March 1999, as was revealed by the Financial Supervisory Agency's inspection in January 2000. When the company was advised by its audit corporation against posting deferred tax assets in fiscal 2000, it followed this advice and as a result fell into the state of negative net worth and gave up continuing its business.

Daihyaku Mutual Life fell into a crisis not because it had a major specific problem, but rather because various smoldering factors erupted all at once. The bad loan problem "was not fatal" (according to a head office staffer at that time) and there was no manager whose arbitrary behavior caused a problem.

The company mainly sold pure endowment insurance (saving insurance) from prewar years, so it was slow to break dependence on the unprofitable saving insurance business. In postwar years, the company endeavored to develop new products but the proportion of small-lot security-type contracts increased. As a result, the company ended up with an unprofitable structure.

What was worse, the company sought to adopt the same business model as that of larger insurers by half measures. As a result, they became dependent on latent stock profits to secure funds for dividend payment. "The company's strategy was to do everything larger insurers did, such as handling products like variable insurance and group pure endowment insurance. It adopted an all-around policy without selection or focus," says a head office staffer at that time. In the latter half of the 1980s, the company began effort to increase its total assets in competition with others in the industry, a little later than other midsize insurers. As part of this effort the company promoted sales of single-premium savings-type products. The high assumed interest rate on these products became a burden in the 1990s, and drove the company to become even more dependent on latent stock profits. In 1990 and subsequent years, the falling stock prices depressed the value of assets at the company.

The management team was not quick to recognize this problem while Daihyaku Mutual

Life’s business was deteriorating, and therefore failed to take remedial action. The company had the task of reducing strategically held shares, but made little progress in this regard. “(The company was) slow to take notice and take action after the bubble period. It was not that a big problem brought down the company, but various factors came together at once to finish it off,” says a head office staffer at that time.

(2) Not much improvement in earnings structure

Daihyaku Mutual Life was a company affiliated with the former Kawasaki conglomerate. Its customer base consisted of individuals in homes. Mainly handling saving insurance, the company showed a lower profitability than life insurers whose main sellers were security-type products. The company had switched to a two-pronged policy based on “saving insurance and life insurance (security-type product) by the 1970s, but the sales staff had difficulty switching to the sales of security-type products. Most of the security-type products they sold were small-lot contracts that did not require medical examination of the insured.

Saving insurance reaches maturity at intervals of, say, three years or five years. Insurance companies, if they had a number of customer registration cards, achieved certain results automatically, so there was no need to try to find new customers for saving insurance. This was not the case with death security products, which insurers could not sell to customers without giving consultation. It took a considerable time for the sales staff, who had mainly dealt in saving insurance, to learn to handle security-type products: The proportion of small-lot security-type contracts increased and some salespeople rushed to gain contracts from young people who had no need for such products. They persuaded people to sign a contract out of a sense of obligation and let them cancel the contract soon thereafter…. Daihyaku Mutual Life’s successful salesperson had as many as 500 customer registration cards. With death security, salespeople could not have collected so many cards. Their sales power was weak…. The company hesitated to drop the saving insurance business, after all. Despite its limited size, the company sought to sell both ‘saving insurance and life insurance in balanced proportions’ and ended up without achieving much in either area,” according to witness accounts of the head office staffer.

Although the company made great efforts to develop new products and introduced first-in-the-industry products one after another, saving insurance still accounted for as much as 73% of the premium income for individual insurance in fiscal 1980. In fiscal

1985, nearly 60% of the premium income came from saving insurance.

Table 2-12: Brief History of Daihyaku Mutual Life

1914	Nikka Life Insurance Co. founded (by Kawasaki conglomerate).
1941	Kawasaki-affiliated Nikka Life, Fukutoku Life and Kokka Chohei Life merge (to become Daihyaku Seimei Chohei Insurance Co.). Survivor's insurance (saving insurance) becomes one of the main products.
1947	Starts afresh under the name of Daihyaku Mutual Life Insurance Co.
1962	Starts selling "new life insurance."
1965	Daijiro Kawasaki becomes president.
1967	"Full-package insurance" becomes a hit.
1973	Minoru Kawasaki becomes president.
1976	The life insurance division and the survivor's insurance division are integrated.
1977	Head office relocated to Chofu.
1987	Katsuo Fukuchi becomes president.
1989	CI (Corporate Identity) started (announced publicly in 1991).
1993	Information system management outsourced to Nomura Research Institute.
1995	Current loss for fiscal 1994.
1996	Yoshio Komori becomes president.
1998	Nonsmoker insurance "Suimasen" put on sale. Shinjiro Kawasaki becomes president.
1999	Teams up with Manulife and becomes a company devoted to management of existing contracts. Mitsumasa Akiyama becomes president.
2000	Ordered to improve business. Ordered to suspend business.

(Honorifics omitted)

With this tight earnings structure, the company continued to incur an expense loss and earned only a small mortality profit. Up until the 1980s, the mortality rate, the expense loading and the dividend rate were set practically by a committee of the Life Insurance Association of Japan so that even inefficiently operated companies were able to stay in business. "Daihyaku Mutual Life with its low earning capacity represented the benchmark on this," according to a person from a major life insurer.

The company held discussions on its profit-earning structure many times. "Around 1980, several section chiefs were given special assignments to make proposals on various managerial issues (such as problems of savings companies, large number of small-lot contracts concluded without medical checkup, low operating cost efficiency, diversification of business, etc.). These proposals, including raising collection fees, were not entirely ignored, but changes came only slowly," says a head office staffer at that time. "Eliminating the expense loss was a pending issue for ages, and this was invariably included into every management plan. They made a plan but did not execute it. As we had a large interest profit and a large latent stock profit, failure (to eliminate the expense loss) did not matter very much," says another head office staffer at that time.

The company's actuarial staff sounded the alarm on several occasions. The actuary who served as managing director and retired in 1996 made a future cash flow analysis in the early 1990s and became seriously concerned. "When he called for a review of the company's profit structure at a management meeting around 1992, the management came up with measures to 'cut costs,' 'expand sales of security-type products,' 'restrict stock investment' and 'restrain the corporate pension business.' They could not carry out the proposed measures other than to restrain the corporate pension business," says a member of the actuarial staff.

(3) Difference from Taiyo Life

Just like Daihyaku Mutual Life, Taiyo Life, now a member of T&D Group, catered to individuals in homes and mainly sold savings-type products until recently. This was largely because Magodayu Daibu, who was working for a then Kawasaki conglomerate, was hired away by the Nishiwaki family who owned Taiyo Life at that time, and this man introduced Daihyaku Mutual Life's saving insurance into Taiyo Life. Because of close connections between the top executives of the two firms, a merger was proposed in 1962 (but the idea was later dropped).

Taiyo Life followed an independent path, streamlined operations to the utmost and provided products different from what its rivals offered. Although its profitability was not high, Taiyo Life became a profit-earning company through its efforts, adopting a unique sales style such as a couple of women employees making unsolicited visits to prospective customers, simplifying the sales organization and developing products whose actuarial assumptions were different from those of rivals. The way the company cut down on expenses was "astounding" to Daihyaku Mutual Life's head office staffer at that time. Taiyo Life adopted a product strategy of its own and did not draw on latent stock profits to generate money for the payment of special dividends.

Daihyaku Mutual Life tried to bring its business model closer to that of larger life insurers, but failed to reduce costs to the utmost, and they were still trapped in a low-profit structure that depended on latent stock profits. The company "spent a considerable sum of money transferring its head office to Kokuryo (in 1977). It was financially weak," said a head office staffer at that time. It was not until 1976 that the three divisions of the sales unit – the life division (handling life insurance contracts with annual or semiannual premium payment), the monthly payment division (handling life insurance contracts with monthly premium payment) and the thrift and saving insurance division (handling saving insurance contracts) – were integrated. Previously, the wage rules and the business structure of the three divisions were different from each other. This meant lack of efficiency.

(4) Steps taken after business turned worse

The problem of the profit-earning structure came to the surface in the 1990s when the investment environment worsened so much that the company was no longer able to earn an interest profit. The company began to suffer a negative spread in fiscal 1992. The sum of the expense profits and the mortality profits was not large enough to cover the interest losses in and after fiscal 1993. In this year, capital gains from the sale of securities came close to ¥100 billion.

In fiscal 1994, the company suffered a large valuation loss from a drop in stock prices as well as three types of loss, and posted the first current loss in postwar years. It broke into the reserve under Article 86 and lowered the required policy reserve level from the one based on the net premium method to the one based on a five-year Zillmer method.

The members of the management team were not particularly alarmed. “The budget division once presented the results of its future cash flow analysis to the management, pointing out that ‘the company will not stay afloat according to several scenarios’ and that ‘there is a 20% to 30% chance that the company will go bust.’ Half of the members did not take the matter seriously, saying ‘when such a scenario becomes reality, Japan itself would be in a mess,’” says a staff member of the actuarial division.

After reporting red-ink results, the company announced a three-year plan in April 1995 in which it set out to improve services for individual policyholders and rebuild the system for sales to corporate clients in order to increase the total amount of policies in force. “We tried but were unable to cut costs as much as we wanted to. The sales division complained, ‘We can’t do business if costs are cut down to this level,’” says a head office staffer at that time.

The profit-earning structure was weak, business results depended heavily on stock prices and the latent stock profits were almost depleted. “Even when Nissan Mutual Life failed in April 1997, our people talked as if ‘it was something that occurred to Nissan (and had nothing to do with us),’” says the head office staffer.

Table 2-13: Change in three types of profit over the years

(in units of ¥100 million)

	March 1987	March 1988	March 1989	March 1990	March 1991	March 1992	March 1993	March 1994	March 1995
Expense profit	-49	-36	16	105	53	17	25	39	36
Mortality profit	159	182	176	189	268	296	318	331	353
Interest profit	199	167	161	262	232	141	-161	-552	-624
Total	309	313	353	556	554	454	181	-181	-235

(Data) compiled from inspection reports

Under the medium-term management plan from fiscal 1997, drawn up under the leadership of then vice-president Mitsumasa Akiyama (who became president in 1999), the company made various attempts to "strengthen its managerial base" and "build a stable profit-earning structure." It received ¥19 billion in contributions to the "fund" or the capital of a mutual company, from four affiliated banks including Joyo Bank. On the sales front, the company launched a "campaign to visit all policyholders" and sent employees tasked with preventing cancellations to all parts of the country. It also put effort into product development and became the first in Japan to sell nonsmoker insurance, called "Suimasen (Note from translator: sumimasen means I don't smoke)," in March 1998.

With major financial institutions going under one after another, the insurer found itself in an increasingly severe business environment. A rating agency gave Daihyaku Mutual Life a credit rating as low as BB. The surrender/lapse ratio (for individual insurance contracts) rose to 19.1% in fiscal 1997 from 13.3% in the previous year. In fiscal 1997, "the interest and dividend income decreased sharply while the loss from sale of foreign securities and the cost of disposing of bad loans increased. In this situation, the company could not balance the books even under the full-term Zillmer method," says a head office staffer at that time.

Under the circumstances, the company concluded a financial reinsurance contract with major U.S. reinsurer RGA and received a ¥10 billion commission, and added this amount to the policy reserve. It also obtained ¥38 billion in subordinated loans from Westdeutsche Landesbank and others (of which ¥30 billion was from this bank) in a bid to "strengthen its capital base."

The subordinated loan obtained from this bank did not qualify as capital. While receiving this subordinated loan, Daihyaku Mutual Life acquired a credit-linked note linked to its own credit risk from Westdeutsche Landesbank Group for a price equivalent to the subordinated loan. This means that, if Daihyaku Mutual Life fell into financial difficulties and became unable to repay the loan, the credit-linked note would become worthless. The insurer made it look as if its capital base had been strengthened, but this was not really the case.

(5) Reducing strategically held shares

Table 2-14: Changing weight of shareholdings (as a percentage of total assets)

	March 1990	March 1991	March 1992	March 1993	March 1994	March 1995	March 1996
Daihyaku	23.6%	22.8%	23.7%	23.5%	23.8%	20.7%	16.2%
Daido	18.9%	19.5%	14.8%	11.3%	11.5%	10.8%	9.7%
All firms	21.8%	22.1%	21.7%	20.3%	19.7%	18.8%	17.2%

(Data) "Life Insurance Statistics"

The percentage of shares held by Daihyaku Mutual Life in its total assets was around 23% in 1990, a little higher than the average for all life insurers. As the stock prices slipped in the 1990s, the risk of holding shares came to the fore. However, life insurers hesitated for some time to sell shares. The balance of shareholdings reached a peak in fiscal 1993.

Daido Life, an insurer about the same size as Daihyaku Mutual Life, sold shares in fiscal 1992 and 1993 and reduced the percentage of shares in the total assets from a peak of nearly 20% to close to 10% in a short time. Daihyaku Mutual Life decided to sell shares at a management meeting around 1992. "It was Katsuo Fukuchi (who was the first president chosen from outside the Kawasaki family) who decided to sell shares. Actually, the company did not sell shares until fiscal 1994, because the sales division put up opposition and the Kawasaki family's Daijiro and his son were fond of shares…. After the company sold whatever shares it was able to sell, all that remained unsold were bank shares," says a head office staffer at that time. The shares of financial, insurance and securities companies accounted for over 50% of all the shares held by Daihyaku Mutual Life at the end of March 1996.

In or after 1997, the company tried to sell strategically held shares and "decided 'how much to sell' at a meeting of managing directors. But little progress was made because ‘we cannot get the approval of our cross-shareholders.’ In our company, the sales division was powerful while the management was weak,” says a head office staffer at that time.

(6) Steps taken around the time of tie-up with Manulife

In April 1998 the Kawasaki family’s Shinjiro (Daijiro’s son) was named president to bring a greater unifying force to the business management. Meanwhile, the management team began looking for a partner, around the fall of 1997, on judgment that the company would not survive without an outside partner. “At first, we approached affiliated banks to ask for support, but did not even get subordinated loans. In the spring of 1998, we appointed an investment bank as our advisor and explored the possibility of a tie-up with a foreign partner. There were several prospective partners, and we settled on a tie-up with Canada’s leading life insurer Manulife Financial…. Our tie-up with Manulife was modeled on Toho Mutual Life’s scheme. We thought this was the only way for a mutual company to obtain funds from an external source,” say several head office staffers at that time. Daihyaku Mutual Life announced in February 1999 that it would form a comprehensive tie-up with Manulife and establish a new company to which it would transfer business rights as part of the tie-up scheme.

As in the case of the tie-up between Toho Mutual Life and GE Capital, Daihyaku Mutual Life adopted the method of “separating new and old contracts.” This method involved the transfer of business rights including the sales force to the new company and the infusion of over ¥80 billion into the capital of the new company through financial reinsurance to improve the quality of assets and replenish internal reserves. Daihyaku Mutual Life turned itself into a company devoted to the maintenance and management of existing contracts as well as asset management.

Shortly after this tie-up, Toho Mutual Life collapsed, in May 1999. Cancellations increased sharply at Daihyaku Mutual Life, whose tie-up scheme was similar to that of failed Toho Mutual Life. As a result, “the surrender ratio rose and, at the end of last September, our figures reached the level where a review of our contract (with Manulife) was necessary,” then President Akiyama told the press at the time of the failure. The company incurred several tens of billion yen of loss from ill-advised hedging of high-risk foreign bond trading and “most of the money we obtained through the tie-up was gone by summer,” says a head office staffer at that time.

In the Financial Supervisory Agency's sweeping inspection of life insurers started in August 1999, Daihyaku Mutual Life was instructed to reassess its own assets and make a significant change to the previously announced figure. Its subordinated loan obtained from Westdeutsche Landesbank as mentioned earlier was found to be problematic, and the company received a business improvement order in February 2000. The company's people explained at a press conference following the finding: "The loan was purchased without the approval of the decision-making body, which was the board of directors. (The management of Daihyaku Mutual Life) was unaware of the purchase of this debt. Shinjiro Kawasaki, then director of asset management, and two executives in charge of finance at that time were aware of the matter," reported The Nikkei Financial Daily dated February 15, 2000. The truth of the matter remains unknown. The solvency margin ratio fell (from 304%) to less than 200% after the effect of the subordinated loan was discounted.

After an administrative action was taken against the insurer, cancellations increased further. The audit corporation demanded additional amortization of owned assets and exclusion of deferred tax assets from the balance sheet. As a result, the company fell into a state of negative net worth and was ordered to suspend business by the Financial Supervisory Agency.

The company failed only one year after the tie-up. The failure was due not so much to the tie-up scheme but to the following circumstances, as recalled by the head office staffer at that time: "The authorities refused to recognize the validity of Westdeutsche Landesbank's subordinated loan, and a large loss was incurred from exchange trading. This killed the plan for merger with Manulife five years later. It had been agreed that merger would not take place if the insurer's financial strength was short of a certain level. Moreover, cancellations increased so much that the additional goodwill value became uncertain…. Manulife was cooperative until an exchange loss was incurred and Westdeutsche Landesbank's problem arose, but withdrew its cooperation when these issues came to the surface."

(7) Managers

Daihyaku Mutual Life was a Kawasaki family-affiliated company. Everyone who served as its president was a member of the Kawasaki family until Fukuchi became president in 1987. Daijiro Kawasaki (who was president from 1965 to 1973) was known as a person who restored prosperity to the family business. Daihyaku Mutual Life came to be called “a pioneer in new-type insurance” when he was president. After retiring as president, he remained a director until 1987 and retained influence over management. “His son Shinjiro was working at the company. He was seen as a future president from the time he joined the company. The management team had to keep Daijiro always in mind when making decisions. They could not make bold decisions such as ‘giving up saving insurance’ or ‘selling off bank shares,’” says a head office staffer at that time.

The company began to expand its scale of operation around 1987, according to a head office staffer at that time. Some people in the company said, “We are shifting from savings to life insurance, so we need not get upset when our place on the ranking list of insurers in terms of total assets drops.” Some people close to Daijiro, known as the person who restored prosperity to his family business, strongly insisted that “it is necessary, after all, to expand the size of assets by selling savings-type products.” Accordingly, the company promoted sales of individual annuity insurance combined with a bank loan and single-premium endowment insurance. “It is not that we promoted sales of single-premium products. To be more accurate, the products sold much more than we had expected,” says another head office staffer at that time.

Fukuchi was the first president (from 1987 to 1996) chosen from outside the Kawasaki family. He had a strong sales background. Yoshio Komori, who joined the company at the same time as Fukuchi (and became president in 1996), was in charge of asset management. “President Fukuchi was willing to listen to others’ opinions but had few brains to turn to for advice, so he was unable to come up with a large-boned policy,” says a head office staffer at that time. For example, “he became involved in CI (corporate identity) at Daihyaku Mutual Life in 1989, but ended up making superficial changes to the logo, contrary to the original intentions.”

Among Daihyaku Mutual Life managers including Fukuchi, there were few who exercised strong leadership in the company. “A warning was issued in the company from time to time. But a life insurer’s business management was not very visible and it was difficult for some officers to share their concerns with others. They would end up going along with a majority view. The management did not have a strong will to exercise authority,” says a head office staffer at that time.

The management made one plan after another to change the low-profit structure, but had no system for analyzing the results of change and modifying the plan accordingly. “An easy-going atmosphere pervaded the place…. Whenever we sat down to discussion, the same old themes such as "expand sales of security-type products," "reduce costs" and "sell shares" came up. But we did not discuss whether the idea was feasible or not. As soon as we got down to work, the idea would turn out unrealistic," according to several head office staffers. As the company enjoyed a large interest profit and a large unrealized profit from shareholdings up until the 1980s, failure to achieve managerial objectives did not matter and no one was held responsible.

(8) Actuary

Actuaries were given important posts at Daihyaku Mutual Life. This was partly because, as "a pioneer in new-type insurance," the company put much effort into product development. "Actuaries were respected in our company. People outside the company said Daihyaku Mutual Life had an excellent set of actuaries. We once had an actuary who served as the president of the Institute of Actuaries of Japan," says a member of the actuarial staff.

In the 1990s an actuary was promoted to managing director (serving from 1991 to 1996). He had quite an influence in the company. He made a future cash flow analysis and became strongly concerned about the company's financial state. He expressed his opinion many times at managing directors' meetings. "Daihyaku actuaries did a good job in involving themselves in management, but the business details were not shared by members of the management team. Figures alone did not tell everything about what lay behind them. The managers often told us that 'actuarial matters were difficult to understand.' They were therefore slow to take action. They depended too much on administrative authorities and did not take the initiative in operating business…. They came up with a compromise before accomplishing the initial goal. They did not follow through with their opinion and ended up going along with the majority view," according to the head office staffer at that time.

(9) ALM

Up until the 1980s, Daihyaku Mutual Life had neither culture nor technology to deal with risks. "In the latter half of the 1980s, the only thing actuaries saw as a negative factor was operating expenses. The company's goal was to achieve a policy reserve required under the net premium method, and assets did not enter the picture…. It was all very well that an ALM committee was set up in 1990 or so, but a bank's ALM was not fit to be applied directly to the insurer. The company had no idea what to do, after all," says an actuarial staffer at that time.

Then, in 1994, the company matched its assets with its liabilities in some accounts in the ALM process. "We adopted segment accounting, but there was so much old money that matching was almost impossible," according to the staffer.

The finance division and the actuarial division did not cooperate with each other. "The actuarial division said shares should be sold. The finance division sold what they could sell easily. It is not that the finance division hid something. As the two divisions did not interfere with each other, the company ended up accumulating bank shares. This was not what they had initially intended," says the staffer.

(10) Role played by external discipline

There was almost nobody outside the company who kept an eye on its business management. The meeting of representatives of policyholders of a mutual company was "almost like a ceremony."

Asahi Shimbun dated July 18, 1988 described the meeting of policyholders' representatives of Daihyaku Mutual Life: "The company people seemed to be determined to 'make the meeting a success because all the attendees were our valued customers'…. The meeting took 38 minutes, seven minutes less than expected…. No questions were raised. It was assumed from the beginning that there would be no questions to answer. It was just as well…. The Ministry of Finance instructed insurers to raise the attendance rate. The number of attendees an insurer managed to attract to its meeting of policyholders' representatives was a measure of its commitment." Governance had no place in that meeting of policyholders' representatives.

Daihyaku Mutual Life sent trainees to Mitsubishi Bank and Joyo Bank with which it historically had close relations. The two banks did not get involved in Daihyaku's business. All they did for this insurance company was to make contributions to its fund and provide subordinate loans (this became difficult in and after 1997).

The Ministry of Finance was the only one that played the role of external discipline. Even so, it is unlikely that the Ministry of Finance singled out Daihyaku Mutual Life for special monitoring, even in the mid-1990s. When the company consulted the Ministry of Finance about the possibility of lowering the policy reserve level in the fall of 1994 because it anticipated poor business results for fiscal 1994, the Ministry of Finance official in charge asked back, “Why is it necessary for a well-managed company like yours to lower the level?” (according to a head office staffer at that time). The Ministry of Finance raised almost no objection to the insurer’s tie-up with Manulife, perhaps because Toho Mutual Life’s case provided a precedent.

After the Financial Supervisory Agency took over as the watchdog body, “We received no visible backup. We had the feeling that the regulators thought ‘the failure of several companies would be necessary’…. Our company made a fresh start with official approval to continue our business in 1999, but the authorities now applied new rules to us,” say several head office staff members.

5. Investments and loans during only two and a half years proved fatal—Chiyoda Mutual Life Insurance

(1) Direct cause of failure

Chiyoda Mutual Life filed for corporate rehabilitation proceedings and collapsed in October 2000. The insurer’s bad loan problem already came to the surface in around 1993 and it often received media exposure as a representative of “risky life insurers.” As a way to overcome the problem, the company started seeking an opportunity for a capital tie-up with a foreign-affiliated firm around the end of 1997 and at the same time, received assistance, including contributions to funds, from close financial institutions. However, it failed to turn itself around.

Factors leading to the management crisis can be summarized as follows: (1) rapid expansion of assets via sales of high-yield, high-dividend savings-based products (especially group annuities) in the late 1980s, (2) growing dependence on risky asset management such as real estate- and nonbank-related investment to secure high-yields and (3) bulk buying of stocks in return for insurance contracts with large-lot corporate customers (so-called the problem of “strategically held shares”).

Factors relating to management activities taken after the company fell into a crisis include, in addition to severe external environments, (4) a delay in disposal of bad loans and sales of strategically held shares, (5) a delay in drastically overhauling the existing business model and (6) follow-up measures taken after credit concerns came up to the surface.

Unlike other failed life insurers, Chiyoda Mutual Life was able to cover its periodic losses arising from negative spreads with its expense profits and mortality profits even in and after the mid-1990s, because it had a prime customer basis, including the market catering to the people of large companies. However, the company struggled with massive bad loans that occurred after the bubble burst. Such bad loans increased to ¥550 billion at the end of March 1993, accounting for around 20% of its total loans receivable.

Besides, via sales to lock in profits, the acquisition cost of strategically held shares rose, damaging the company's management. The insurer was required to have "finances that could contribute to sales results" in the late 1980 and therefore often made investments and loans in return for contracts entered into by corporate customers. The insurer's growing dependence on loans to large-lot problematic deals was largely attributed to this policy, which was called "unified activities of sales and finance departments." As a result of stock purchases made in response to requests from the corporate sales department, the balance of stocks as of the end of fiscal 1989 tripled from the level as of the end of fiscal 1986. The insurer couldn't accelerate its sell-off of these stocks even after its business deteriorated and became saddled with latent stock losses worth more than ¥100 billion, starting at the end of fiscal 1997.

(2) Leaning toward savings-based products

Chiyoda Mutual Life was one of the five biggest life insurance companies in the pre-war period. However, it was late to shift its marketing method from regional agents (the Keio University network) to the channel based on sales personnel in urban areas and also failed to keep up with the trend in product strategy toward "term insurance" (shift from endowment insurance to endowment-with-term insurance). Losing its customers to other companies using sales forces for their marketing activities, the insurer saw its position in the industry gradually decline, as a person of a major life insurer says, "Sumitomo Life Insurance Co. (which got into the business late) went on an offensive, targeting Chiyoda Mutual Life's customers." The insurer's efficiency of operating costs was substantially lower than those of major companies, and the difference in dividend levels widened. The company took a product strategy that was difficult to compare with those taken by other players, but the strategy impeded the company's sales activities. In financial results for fiscal 1978, the amount of policy reserves "would have fallen below the level under the 5-year Zillmer method if our reserves had been just ¥5.4billion short of the amount," says a head office staffer at that time.

Table 2-15 Brief History of Chiyoda Mutual Life

1904	Chiyoda Mutual Life Insurance Co. was established (as Japan's second mutual company. Ikunoshin Kadono of Keio University became the first president).
1928	Achieved the No. 2 position within the industry in terms of insurance-in-force.
1948	Became the industry's first to sell "group term insurance."
1950	Became the industry's first to sell "group annuity."
1961	Became the industry's first to sell "group credit life insurance."
1970	Formed a group called "Satsuki Association" with Chiyoda Fire and Marine Insurance Co., Tokai Bank, Chuo Trust & Banking and Tomen Corp.
1978	Masao Nakajima became president. A "three-year reform plan" began in the following year.
1982	Yasutaro Kanzaki became president.
1984	Started marketing "medical insurance" and launched a "three-year plan to achieve a net increase in insurance-in-force."
1992	The issue involving Hotel New Japan surfaced.
1993	Disclosed ¥231.6 billion worth of bad loans.
1995	Reported an operating loss for fiscal 1994.
1996	Reiji Yoneyama became president.
1997	Raised funds worth ¥50 billion.
1998	Announced a sales partnership with U.S. major nonlife insurer Unum Group.
1999	Raised funds worth ¥50 billion and drew up a new "management reform plan" (selection and concentration strategy).
2000	Conducted financial reinsurance transactions and filed for corporate rehabilitation proceedings.

(Honorifics omitted)

Table 2-16 Breakdown of policy reserves

	<FY 1986>		<FY 1989>		<FY 1995>	
	Chiyoda	All companies combined	Chiyoda	All companies combined	Chiyoda	All companies combined
Individual insurance	63.1%	74.8%	56.0%	67.0%	41.9%	55.8%
Individual annuity	3.5%	2.9%	7.8%	6.8%	8.2%	9.5%
Group insurance	0.5%	1.2%	0.3%	1.1%	0.3%	0.4%
Group annuity	32.7%	20.2%	35.6%	24.2%	49.3%	33.2%

(Source) "Life Insurance Statistics"

Meanwhile, President Masao Nakajima stepped up the insurer's sales activities and reduced operating costs under the "three-year reform plan" launched in 1978 to rebuild its management. When the plan started bearing fruit, Yasutaro Kanzaki became President (in 1982) and took the stance of aggressive management, setting up a target of "returning to a major insurer." Under the leadership of a stern executive in charge of sales activities, the company made steady efforts to strengthen its sales personnel and also started selling medical insurance policies in 1984 (these policies contributed to the expansion of mortality profits later). However, the insurer's sales personnel generally accepted funds that businesses held to invest in "*zaitech*" products and focused on marketing of savings-type products, which gave them instant sales results.

Especially, Chiyoda Mutual Life leaned toward group annuities. The insurer had maintained a strong presence in the group annuity market from the very start as it had focused on the corporate market. The company achieved its five-year target in just one year partly because it "succeeded in acquiring contracts with corporate customers of Tokai Bank, members of the medical association and others by using top executives' personal connections" (according to a staff member in the planning division). Armed with cross shareholdings and high-dividends, it continued increasing contracts, which accounted for 50% of its policy reserves at its peak.

With respect to the market for individual customers, head office staffers at that time and others say, "We never set a target or made organized efforts for sales of savings-type products, although some sales employees focused on such products. Rather, we just naturally leaned toward them"…. "Unlike other midsize life insurers, we didn't give incentives to sales employees to step up sales of savings-type products to retail customers."

Regarding savings-type products designed for individual customers, the insurer "changed its reward scheme so that products would not sell well in order to prevent its sales force from getting weakened" and "unlike Nissan Mutual Life, never systematically encouraged financial institutions across the country to step up sales. We rather tried to put a brake on such sales" (according to a staff member in the planning department). Nevertheless, the company eventually sold a massive number of lump-sum savings-type insurance policies in the market for individual customers as well. The rehabilitation plan reveals that premium revenues from lump-sum insurance products accounted for nearly 40% (the average for the industry was around 25%) of the company's total premium revenues in around 1989, when the insurer most heavily depended on sales of lump-sum insurance.

Of those insurance policies, lump-sum endowment insurance policies happened to have various maturities (an insurer usually sold 5-year and 10-year maturity products), and

6-year maturity endowment insurance started attracting a lot of attention as a tax-saving product at a certain point in time with customers lining up in front of branch counters to buy the insurance, according to parties concerned. Head office staffers at that time say, “Media advertised the insurance on their own” “This was the first and last time that we saw customers standing in line in front of sales windows to buy our insurance products.”

Department heads or those in higher positions at that time were desperate to “regain lost ground.” “Since Kanzaki became president, our major performance indicators such as insurance-in-force, total asset and premium revenue had recovered, and external parties started calling us one of the ‘eight life insurers,’” says a staff member in the planning department. Kanzaki was very popular among sales personnel. However, “the insurer’s comeback as a major player happened to coincide with the beginning of the bubble economy, which probably resulted in significant impact on the company,” according to another staff member in the planning department.

(3) Going ahead with high-risk investments and loans

While selling a large volume of high-yield, high-dividend savings-type products in the late 1980s, “the company increasingly leaned toward loans to real estate-related companies and nonbanks, stock investment, and other risky investment instruments such as *tokkin* specified money trust and structured bonds to secure high-yields” (quoted from the insurer’s rehabilitation plan). During a two-and-a-half-year period from 1988 through 1990, the company executed a substantial number of large-lot problematic deals including those with the Yokoi group, Aichi, Matsumotoyu Shoji, Aijishi and GGS Co. Looking back, many say, “These things all happened just in a short period of time” “We suddenly realized that it was too late.”

Those close to President Kanzaki largely got involved in investments and loans that turned nonperforming later. Several head office staffers at that time say, “Kanzaki was not a type of person who directed someone to do something or made proposals on his own”…. “He was not a sort of person who could act arbitrarily on his own authority. In the first place, he was not able to do anything on his own”…. “These investments and loans were largely executed by people called ‘President Kanzaki’s right-hand men’ including Mr. A in charge of financial affairs, Mr. B in charge of sales and Mr. C in charge of real estate deals.”

Table 2-17 Problematic deals that received media coverage

(1)	"Toyo Yusen K.K." and other group firms led by Hideki Yokoi = outstanding loans worth roughly ¥80 billion
(2)	Moneylender "Aichi" (special liquidation) group = outstanding loans worth roughly ¥80 billion
(3)	Moneylender "Matsumotoyu Shoji" group = outstanding loans worth roughly ¥37 billion
(4)	Real estate firm "Aijishi" group = outstanding loans worth roughly ¥35 billion
(5)	Golf club membership sales company "GGS" (virtually failed in 1991) group = outstanding loans worth roughly ¥20 billion

(Source) "THE MAINICHI NEWSPAPERS" dated on December 10, 2000

Table 2-18 Deals for which the administrator sought damages from Mr. D and others

(1)	A redevelopment project in Shinagawa Ward in which the company used a dummy corporation to raise land prices (in violation of the Insurance Business Law)
(2)	Additional lending to Golf club membership sales company "GGS", which the insurer had known from information obtained by a bank was about to go bankrupt
(3)	Lending to a group firm of nonbank "Aichi" despite insufficiency of collateral

(Source) "Asahi Shimbun" dated on March 24, 2001

Of those people, Mr. A, who was put in charge of financial affairs in 1987, appears to have played a significant role. Many head office staffers at that time say, "Kanzaki made a big mistake in personnel changes (staff deployment). That is, his mistake was to put Mr. A in charge of financial affairs"…. "While assets were surging, Mr. A was assigned the task of managing financial affairs and injected massive funds into problematic deals. Several years later, most of such deals turned nonperforming."

Mr. A, who took charge of financial affairs, made his mark after Kanzaki became president, but had no experience in finance at all, according to staff in the planning and financial affairs departments at that time. He advocated "aggressive finance (positively speaking)" after pushing away an executive in charge of financial affairs, his predecessor, and taking power. He was a self-confident person and apparently didn't think that others would deceive him. As a result, he executed fishy deals introduced by young employees in the corporate insurance department one after another. Mr. A is said to have started directly meeting men cashing in on the bubble economy later, but in reality, "he was more like being deceived by these men" (according to a staff member in the financial affairs department).

Chiyoda Mutual Life's financial affairs department used to be considered most conservative in the industry. However, "the company was so conservative that it tended to be susceptible to those who tried to exploit its nature" and "the company had no choice but to highly treat people who can acquire contracts because its sales were weak," according to head office staffers at that time.

(4) Why was it possible to make high-risk investments and loans?

The same person took charge in both executing investments and loans and inspecting finances, enabling the insurer to carry out these problematic investments and loans. A staff member in the planning department at that time says, "The two operations were initially overseen by different persons, but starting in the late 1980s, Mr. A took charge of screening operations as well as execution of investments and loans. The person previously responsible for the screening operations objected to this personnel change, but he was eventually excluded from the business by Mr. A and others." The press also reports as a comment by a former executive, "A financial expert who objectively examined a borrower's credit risk was removed, and a layman close to the president was put in charge of screening operations. As a result, our traditional solid investment style was lost" (The Yomiuri Shimbun, dated January 8, 2001).

Settlement rules also had flaws. For example, the Yokoi group, which had ten or so units under its umbrella, could easily receive a huge amount of loans as a group because authorization for settlement was not granted on a group basis, according to head office staffers at that time and others. Moreover, even if loans were effectively long-term lending, a settlement by an executive was still enough to extend the loans as long as they were taking the form of three-month short-term lending. Besides, deals could be executed via a nonbank affiliated with Chiyoda Mutual Life. These rules are also believed to have been loosened in the late 1980s. "Changes to the existing rules were made at a managing directors' meeting. Because none of the members of the meeting knew about financial affairs, however, they failed to put a brake on unfavorable changes by Mr. A," according to a head office staffer at that time.

All of the personnel in the financial affairs department initially participated in meetings on the insurer's asset management policy, but "the number of participants gradually dropped to reduce criticism, leading to the system in which a person brought his plan directly to Mr. A", says a staff member in the planning department. The press also reports, "The head of the financial affairs department, a close ally to the president, went to the president's office beforehand and decided on everything. Managing directors all just agreed with what Mr. A said at a meeting because they knew that everything would be over if they raised any objection" (the evening edition of The Yomiuri Shimbun, dated January 10, 2001), thus supporting what the previously-mentioned staff member testifies. “I didn’t know what Mr. A and several others were actually doing even though I was also in the financial affairs department,” says a staff member in the financial affairs department. “In many cases, President Kanzaki learned about deals only after they were already executed. He stepped in sales activities, but when it came to financial matters, he apparently thought that it would be OK to just rely on Mr. A,” says a head office staffer at that time.

A staff member in the financial affairs department admits, “After all, nobody could stop what Mr. A did. Employees within the department who expressed their opinions to Mr. A were transferred to other departments or removed from their positions. We had traditionally had few employees going against their bosses (in turn, the company is said to have been good to work for). None of us interfered with Mr. A because we knew that he was supported by President Kanzaki and saw several people ousted after actually raising objections.”

(5) Occurrence of the bad loan problem

Following the bubble burst, these high-risk investments and loans developed into a managerial problem in and after the summer of 1991. The financial affairs department was completely renewed in April 1992 with Mr. A, the executive in charge of the department, demoted. Reiji Yoneyama, who took the company’s presidency later, was put in charge of the lending department, sorted out problematic loans receivable and decided on how to deal with those loans. Head office staffers at that time and others say, “Yoneyama received advice from several lawyers because he had no experience in finances”…. “He worked as hard as he could to recover claims. However, paintings pledged as collateral were only sold gradually, and there was no way left to sell golf courses.”

Yoneyama failed to take drastic accounting measures, though. He appears to have thought about setting aside reserves by using latent stock profits, but “he worried about the risk of rumors resulting from the provision of large reserves” and “the bad loan problem was recognized as a failure caused by the financial affairs division, not as a problem of the whole company” (according to head office staffers at that time). However, the amount of bad loans surged later, reaching around 20% of the total loans at the end of March 1993.

Initially, only a limited number of people knew about this problem even within the company. In 1993, however, a former executive (Mr. A's predecessor who retired from the executive position in 1990) leaked the insurer's information out of resentment against President Kanzaki and Mr. A, and many of the insurer's employees came to know about the bad loan problem from media reports. Head office staffers at that time and others say, "We eventually won a civil suit, but the incident easily became a factor spurring credit worries"…. "I learned about the problem first from a weekly magazine. Until then, many of us had thought that our problem lied in foreign exchange losses. When Mr. A was demoted in 1992, we realized that something had happened, but we had no idea about what actually happened at that time."

(6) Public disclosure of bad loans

In June 1993, the major eight life insurance companies disclosed the amounts of bad loans (loans to borrowers in legal bankruptcy and past due loans in arrears by six months) they had as of the end of fiscal 1992 for the first time ever. While Sumitomo Life Insurance, which was known for its aggressive style of management, reported bad loans of ¥36.7 billion, Chiyoda Mutual Life's amount was a staggering ¥231.6 billion. The announcement did not lead to immediate cancellations of large-lot contracts, but provided great impact on the company. "Until then, when a weekly magazine reported that 'Chiyoda's loans worth ¥500 billion had turned sour,' our public relations department answered that 'the figure was one digit different (that is, the actual figure was smaller).' So, I was really shocked by the fact that the figure reported by the magazine was closer to the reality. I thought that nobody would believe us even when the company said, 'No problem'", says a head office staffer at that time. "We implemented an expansion strategy and just achieved dividend levels equivalent to those of major insurers. Suddenly knowing that we had a negative net worth of hundreds of billions of yen, I just felt compelled to drink", says another head office staffer at that time. Since then, the public increasingly viewed Chiyoda Mutual Life as a "company struggling with bad loans."

The actual amount of bad loans was more than ¥400 billion, roughly twice the disclosed data, though. Because the disclosed amount did not include loans with waived or reduced interest payment, it is believed to have failed to accurately reflect the actual amount of bad loans (the media reported after the company's collapse that its bad loans amounted to ¥550 billion, but judging from what parties concerned say and inspection reports, the amount was more like ¥400 billion or above).

Table 2-19: Changes in profit or loss on three profit sources

(in units of ¥100 million)

	March 1988	March 1989	March 1990	March 1991	March 1992	March 1993	March 1994
Expense profit	111	153	214	216	199	236	309
Mortality profit	415	495	622	655	672	779	767
Interest profit	315	345	523	524	229	-62	-881
Total	840	993	1,359	1,395	1,099	952	195

(Data) compiled from inspection reports

The insurer’s financial state deteriorated further. It reported an operating loss of ¥41.1 billion and was forced to change its way of setting up policy reserves in fiscal 1994, although it managed to achieve a current surplus by posting gains on disposal of real estate and others. In an inspection conducted by the Ministry of Finance at around the same time (in February 1995), the insurer’s net capital base in a broader sense (the amount calculated by adding to capital base, latent profits or losses on securities holdings, 50% of class III classification loans and 100% of class IV classification loans) dipped to a minus ¥236.0 billion.

Nevertheless, the management was slow to respond to the problem. They carried out restructuring and cost-cutting efforts including scaling down the administrative department of the head office and transferring extra personnel to the sales department. However, the management did not do anything to drive out the corruption that had been festering inside the company at once” and “only made disclosure (of bad loans) without showing any roadmap,” according to head office staffer at that time.

Chiyoda Mutual Life had a larger expense profit and mortality profit than other failed life insurers had and therefore did not end up with a loss on three profit sources. The insurer saw its net business profit (a unique management benchmark close to the total profit or loss on three profit sources) expand to ¥72.4 billion in fiscal 1996 from the previous year’s ¥22.9 billion as the assumed interest rate for group annuities dropped from 4.5% to 2.5% in April 1996. Head office staffers at that time and others say, “I thought we could overcome the bad loan problem if we took some time because we still had an aggregate profit on three profit sources”…. “We ended up with an operating loss in financial results for fiscal 1994, but I still thought we had enough cash flow to deal with the problem. Even when Nissan Mutual Life failed, I considered their problem was different from ours.”

No one took any action to change the existing business model either. Head office staffers at that time say, “Our earnings results were not seriously bad until around 1996, so we only felt that ‘we just returned to the original state’”…. “Ahead of the scheduled enforcement of the revised Insurance Business Law and introduction of separate accounting and solvency margin ratios, we knew that we would not be able to continue relying on latent profits any more. Although young employees in the planning department discussed the issue and reported their opinions, the management did nothing. Their go-go attitude continued.”

(7) Selling strategically held shares

After Kanzaki became President, strategically held shares increased further in response to growing calls for finances that could contribute to sales results. “The financial affairs department conducted a screening for each issue after receiving an investment request from the sales force, not just accepting the request without examining each deal. Nevertheless, investment in bank shares especially increased, distorting the balance of our portfolio,” says a staff member in the planning department.

In the mid-1990s, the insurer discussed the need to sell its strategically held shares, but with people in the sales department strongly objecting to the idea, only ¥100 billion worth of shares were sold. Although the management discussed the issue from time to time later, every member is said to have been “for the idea in principle, but against the details.”

Faced by a surging number of policy cancellations following the collapse of Nissan Mutual Life in 1997, the financial affairs department proposed, out of a sense of crisis, that “the company sell most of its shareholdings, buy government bonds, use capital gains to step up disposal of bad loans and at the same time, boost the liquidity of assets to prepare for cancellations,” according to a staff member in the financial affairs department. The total assets at that time were worth ¥6 trillion. The liabilities side of the balance sheet was occupied by more than ¥4 trillion worth of contracts that might lead to an outflow of money such as group annuities and lump-sum endowment insurance, while the assets side included loans receivables and real estate with low liquidity worth as much as nearly ¥3 trillion with its liabilities exceeding its assets. People making the above-mentioned proposal thought that the company, which still had more than ¥200 billion worth of latent stock profit, would have to give up sales to corporations, but would still be able to survive.

“Although President Yoneyama favored this proposal, other executives severely criticized it, saying, “Stop fooling around!” The proposal was turned down because Chairman Kanzaki objected to it and other executives went along with him. Shares in member companies of Satsuki Association, Keio University-related businesses, the Mitsui group and the former Okura group (Kadono family) are among the insurer’s shareholdings. Executives said, “Our company may collapse”…. “We won’t be what Chiyoda Mutual Life has been”…. “We’d better go bankrupt than sell shares in X company,” according to staff in the financial affairs department.

(8) Credit uncertainty and outflow of policies in force
While the insurer’s latent stock profit recovered to ¥200 billion with the rebound of the stock market in fiscal 1995, its deteriorating financial standing became well known to the public, triggering withdrawals of group annuity contracts. When U.S. affiliated rating agency S&P released the ratings of major eight life insurers in January 1996, the company was rated “B,” the lowest among the eight insurers.

After Nissan Mutual Life went under in April 1997, Chiyoda Mutual Life became targeted by the media as the “life insurer likely to fail next.” Moreover, policy cancellations further rose amid growing concerns over the financial system. “Each time the burned-out site of Hotel New Japan was covered by TV as an icon of a risky life insurer, a large number of contracts were withdrawn. Major insurers also spread harmful rumors against the company when marketing their products. The mass media obtained stories about the insurer from the information leak incident, and their coverage had significant impact on the company’s business,” according to head office staffers at that time.

However, the management is said to have shown no clear policy. In 1996, Yoneyama assumed the company’s presidency, while Kanzaki stepped down and became Chairman. A head office staffer at that time says, “Grasping the whole picture of the financial condition of the company after he became president, Yoneyama said, ‘I have never thought that our financial standing is as bad as what I’ve just found.” However, he didn’t show any plan to consolidate the company’s operations yet. “As a restructuring measure, the president simply said, ‘Cut costs by 10% at every department.’ The message given to us from President Yoneyama and other top management was only ‘Hang in there’. We could do nothing about the situation,” says another head office staffer at that time.

Table 2-20: Changes intotal assets

(in units of ¥100 million, %)

	Chiyoda Mutual Life	Year-to-year basis	All companies combined	Year-to-year basis
FY 1990	51,544	14.1%	1,316,188	12.2%
FY 1991	56,214	9.1%	1,432,341	8.8%
FY 1992	59,829	6.4%	1,560,111	8.9%
FY 1993	63,166	5.6%	1,691,221	8.4%
FY 1994	63,963	1.3%	1,779,655	5.2%
FY 1995	64,425	0.7%	1,874,925	5.4%
FY 1996	58,163	-9.7%	1,886,590	0.6%
FY 1997	50,282	-13.5%	1,901,110	0.8%
FY 1998	43,599	-13.3%	1,917,684	0.9%
FY 1999	35,019	-19.7%	1,900,329	-0.9%

(Data) "Life Insurance Statistics"

Nevertheless, "President Yoneyama took the stance of setting aside policy reserves under the level premium reserve method and cleaning up bad loans, hoping to narrow down the company's problems to latent stock losses only," according to a staff member in the planning department. The insurer posted a latent stock loss of roughly ¥100 billion in fiscal 1997 as a result of changing its stock valuation method from the lower-of-cost-or-market-valuation method to the book value method, while raising ¥50 billion in funds and ¥77.5 billion in subordinated loans from Tokai Bank and other close financial institutions. It also applied the level premium reserve method to policy reserves drawn down for the announcement of earnings results for fiscal 1994 and disposed of bad loans worth ¥138.9 billion. The company raised ¥59.6 billion by subordinated borrowings and wrote off ¥92.7 billion worth of bad loans in fiscal 1998 as well.

In reality, however, "the insurer barely managed to report a net profit and maintain dividends to policyholders by posting capital gains from cross transactions of shares with unrealized gains, generating profits from structured bonds ahead of schedule and posting profits on sales of real estate (with unrealized gains) to affiliated firms" (quoted from the insurer's rehabilitation plan). The lapse and surrender rate remained high at around the middle of 10-20% with the value of group annuities in force shrinking to ¥1.2 trillion at the end of fiscal 1998 from its peak level of ¥3 trillion. Several head office staffers at that time say, "Policyholders stood in line each time the company was covered by the media"…. "Annuity contracts were cancelled by member companies of Satsuki Association and other very close companies."

(9) Tie-up negotiations with outsiders

"Around the end of 1997, when concerns over the nation's financial system emerged, the company started seeking a capital tie-up with another firm as a way to overcome the crisis, judging that 'there was nothing the company could do on its own,'" according to parties concerned at that time. Full-fledged negotiations didn't begin until 1998, though. "In November 1998, when the Long-Term Credit Bank of Japan failed, we judged that our company needed to find ways to alleviate credit risk concerns. We immediately started negotiations with a foreign company at the end of the year, but the negotiating partner eventually rejected tie-up talks. The corporate value assessed by us was different from the foreign company's assessment by hundreds of billions of yen and the huge gap hampered the negotiations"…. "We negotiated with several others later, but the talks didn't proceed smoothly because we were unable to fill the gap in calculations of corporate value," say staff in the planning department and others.

With tie-up talks with external parties making little progress, Chiyoda Mutual Life spent a year drawing up a new "management reform plan" that centered on drastic business restructuring measures. Under the new plan compiled in September 1999, the insurer narrowed down operations, through corporate split-ups and outsourcing, to its core business such as coverage products and medical insurance for retail customers, while substantially reducing its operating costs by carrying out a personnel cut. Financial institutions close to the insurer are said to have gotten involved in drawing up the plan. In January 1999, Chairman Kanzaki, who held a representation right even after leaving the position as president, stepped down and became an advisor to the insurer.

Besides, following the inspection by the Financial Supervisory Agency in 1999, the company set aside huge loan-loss reserves further and strengthened its *kikin*, or fund. It didn't raise new money for these purposes, but rather used money transferred from subordinated loans, though. Parties concerned at that time say, "We successfully implemented measures to buck the downhill trend that had continued since the failure of Nissan Mutual Life. This marked the only turning point in a positive direction we'd ever experienced"…. "I thought we would be able to barely survive as we had done all of these things." In the meantime, a head office staffer at that time recalls those days, saying, "Having already gone through tough situations for years, employees were all so exhausted because we still had no idea how long the hardship would continue" "Handling few positive works, employees had been worn out."

While the prices of shares held by the insurer again plunged, full-fledged tie-up negotiations with a foreign company resumed in the second half of fiscal 1999. Amid extremely severe external environments, "the insurer found its business results worsened every time data was updated," according to a staff member in the planning department. After all, the company failed to form a partnership with the foreign company partly because it was unable to obtain additional financial assistance from close financial institutions. It filed for corporate rehabilitation proceedings with Tokyo District Court on October 9, 2000. A head office staffer at that time explains the background leading to the failure in negotiations, saying, "In the tie-up negotiations, the foreign company sought to eventually form alliances with financial institutions close to us, along with a partnership with us. The realignment of the financial sector upset the plan."

(10) Managers at that time

Kanzaki, who served as Chiyoda Mutual Life's president from 1982 through 1996, had a long experience in sales and even after he became president, he got only involved in sales issues. Head office staffer at that time say, "Kanzaki is not the type of person who directed someone to do something or made proposals on his own"…. "Our problem did not lie in abuses of power by an autocratic president, but rather our failure to take control of actions made by people around the president"…. "Investments and loans that became a big issue later were not directed by President Kanzaki. His biggest problem, however, was to appoint a person having no experience in finance as the executive in charge of financial affairs and allow him to make risky investments and loans. Kanzaki made a big mistake in personnel affairs."

President Kanzaki "had the power to shuffle personnel for a long period of time and even got involved in appointing branch managers when it came to staff deployment in the sales department"…. "He had a service-minded personality, which in turn created factions within the company"…. "He had no management capability. The previous president would say, 'I don't need people who present no opposing arguments', but no one disagreed with Kanzaki. He had authority over personnel issues, and his approach for personnel allocation was based on whether or not he liked a particular person. This represents an adverse effect of Kanzaki's long-term regime"…. "Kanzaki's resignation in 1996 was his own decision, not forced by internal and external pressure. It was President Kanzaki who appointed Yoneyama as next president," according to head office staffers at that time.

President Yoneyama, Kanzaki's successor, tried to revive his company, but with the insurer's credit risk already well known to the public, he was busy dealing with customers and the media, drawing up measures to raise solvency margin ratios and other jobs to clean up the mess created in the past. A staff in the planning department says, "President Yoneyama had a strong sense of justice and was also a passionate man" "We had done what we could do, but the mass media was looking for a life insurer that was likely to go bankrupt next, and we could do nothing about it."

(11) Actuary

During the time when Kanzaki served as president, a business monitoring function within the insurer didn't work well. Actuaries, experts in actuarial science, were no exception.

Actuaries were not considered as important within the company at that time. The insurer did not have an independent actuarial department as other companies did and its actuarial division was put within the planning department. This is a piece of evidence suggesting that the actuarial operations were not valued within the insurer. "We were called 'mere calculators' by the management. They apparently thought that actuaries were 'only needed to satisfy the requirement set forth under the Insurance Business Law' and that 'the monitoring by the regulatory authorities would be enough,'" says a staff member in the planning department. The management is said to "have talked about their actuaries as convenient, but unreliable people," according to a head office staffer at that time. The company's actuaries are said to have lost the management's trust as a result of failing to well respond to inquiries made by the Ministry of Finance in the 1970s, when the insurer was struggling with a business slump. "In the 1980s, the number of actuaries was small for the company's size and its actuaries especially had little power against the sales department," many staff members in the planning department admit.

(12) ALM and attitude toward risk management

Chiyoda Mutual Life conducted institutional reform in 1983, dividing its financial investigation division into "the finance division" and "the financial inspection division" in an effort to strengthen the function of its financial affairs department. As I said earlier, however, since Mr. A took charge of screening operations as well as execution of investments and loans, the company's check and balance system had been lost. Various loopholes were also created in the settlement process.

The idea of risk control did not exist in the 1980s, but “Each department was aware of the risk of incurring losses. Then an inexpert (having a strong authority) came in and messed up everything” “The company’s structure was based on ‘the belief that human nature is fundamentally good’. Our problem largely lied in people,” say head office staffers at that time.

Yet I can’t help but wonder how far the management at that time understood the financial conditions of their company. A head office staffer at that time reveals an episode, saying, “We submitted a profit/loss report every month to the management. One day, President Kanzaki complained, ‘I don’t really understand these figures.’ In response to his complaint, the executive in charge rushed to us, demanding that we explain about the figures to him. We then decided to stop submitting our profit/loss report.”

Also, some people within the company at least raised concerns about the rapid expansion of assets. “When a trading house brought its surplus funds worth more than ¥1 billion to us in the mid-1980s, our accounting department objected to the underwriting. However, the sales department brushed off the opposition”…. “Actuaries and others in the planning department again tried to put a brake on the sales growth of savings policies in around 1988, but the sales department didn’t listen to concerns raised by the planning department at that time as well, and the company failed to stop the sales of such products”…. “Employees in the planning department and actuaries talked about some of our insurance contracts, concluding that ‘load charges for certain contracts should be retained because they came in by a fluke.’ Thus, we tried to reduce costs, but didn’t stop selling those products,” according to head office staffers at that time.

The financial affairs department hired those who learned math and science at college to conduct research on ALM (asset-liability management). However, “The company, as a whole, effectively failed to implement ALM to the last”…. “Nobody had an idea of strengthening internal reserves to prepare for risks associated with holding contracts with high guaranteed yields for a long period of time, although this also applied to other insurers, not only to Chiyoda Mutual Life,” say head office staffers at that time. Moreover, the company had constantly relied on capital gains to generate dividends since the Insurance Council released Report of the Insurance Council to the Minister of

Finance of 1975.

(13) Role played by external discipline

Chiyoda Mutual Life took the form of a mutual company. Many former employees say that a mutual company is subject to very little checking by external parties. “Both representatives and outside advisors are chosen by the company. It’s better than nothing, but everything depends on who will serve as representative or outside advisor. In fact, a word of warning was never given to Kanzaki at meetings of representatives”…. “A meeting of representatives was held like an event with important customers. We paid travel expenses and car fares for them, held a convivial party at a hotel after the meeting and prepared hospitality gifts,” several head office staffers at that time say. However, “After the bankruptcy of Nissan Mutual Life, the company started receiving questions like ‘Is Chiyoda Mutual Life O.K.?” from representatives, according to the head office staffers.

The company’s labor union used to be very active, and its member once served as head of the National Federation of Life Insurance Worker’s Unions (the ruling body of each labor union of life insurance companies). However, “That person was appointed as a board member later and since then, leading the labor union had become part of the career track at the company,” according to a head office staffer at that time.

Financial institutions close to the insurer didn’t step in on its management very much until 1997. After the insurer’s financial standing started deteriorating, however, they not only contributed to the company’s fund and provided subordinated loans, but also became thoroughly involved in the insurer’s business including drawing up a management plan and holding tie-up talks with foreign-affiliated firms (they eventually gave up providing assistance).

(14) Ministry of Finance

The supervisory authorities did not play a visible role in the bankruptcy case of Chiyoda Mutual Life.

In its inspection in November 1990, the Ministry of Finance didn’t raise any specific concerns about large-lot deals that the insurer got involved in. Loans worth ¥28.2 billion, only 1.5% of the total loans, were determined as classified loans during the regulatory assessment, according to materials attached to the inspection report.

Chiyoda Mutual Life is said to have informed the Ministry of Finance of its bad loan problem in 1992. Several employees in the planning department say, “By around 1992, the Ministry of Finance became aware of our bad loan problem and requested us to draw up a business improvement plan. Since then, we had often visited the Ministry to seek instructions whenever we came across problems, even those unrelated to inspections”…. “Employees had a feeling that the government would do something for the company because it had stepped in the company’s management very much.”

The insurer is said to have faced extremely severe inspections in 1995 and 1999, but unlike in the case of Toho Mutual Life, the resignation of its top management was not demanded by the supervisory authorities. “The regulatory authorities didn’t specifically play an active role in the management of the company” and “only showed their interest in earnings results and soundness of assets for a single fiscal year and operations of each department,” according to head office staffers at that time. A member in the planning department says, “The Ministry inspected our policy reserves while assessing our assets in the inspection of 1999. This was the first time that the regulatory authorities checked our policy reserves.”

6. “Managerial vacuum” caused failure – Kyoei Life Insurance

(1) Direct cause of failure

Kyoei Life collapsed in October 2000. Its negative spread put a heavy burden on the company. Its profit earning structure was such that the company had become dependent on the gains on the sale of assets by the latter half of the 1990s. Around 1999 the company started negotiating with Prudential of America. for a capital tie-up. Chiyoda Mutual Life’s failure on October 9, 2000 triggered a rush of cancellations at Kyoei Life. Kyoei Life applied for the commencement of the company rehabilitation procedure on October 20.

Kyoei Life did not get involved in high-risk real estate investment and loans during the bubble period. Its managers and people close to them did not go to extremes. What proved fatal was a large negative spread incurred each year as the company sold single-premium endowment insurance from the latter half of the 1980s to the 1990s. Kyoei Life initially took an independent path, but it later followed the footsteps of other insurers and began aggressively selling single-premium endowment insurance. The company continued to sell it until the mid-1990s, even after its rivals stopped doing so. Failure in asset management made things worse. In the latter half of the 1990s the company rushed to high-risk securities investment in a bid to shore up the three types of profit, but ended up with a large loss each year.

A managerial vacuum may be another factor. Saburo Kawai, founder and a competent actuary, had such a big presence in the company that everyone depended on him for everything. After Kawai practically retired from the company, the management team lost its unifying force so it was unable to join together and face up to the crisis. It was stated in Kyoei Life's rehabilitation plan that "people who joined the company sometime from the late 1950s to the early 1970s benefited from a favorable environment for so long that they were slow to take bold measures to improve business."

Still another factor was that the members of the management team did not share accurate details of the company's affairs. Only a handful of members were aware of the gravity of the situation even as late as the mid-1990s. A considerable perception gap emerged between members of the management. They were unable to decide in which direction the company should be steered until it went under.

(2) Unique management strategy

Kyoei Life was established as a reinsurance company before World War II. After the war, it made a fresh start as a direct life insurance company. It did not belong to a particular corporate group, so it had no ready-made market. This was why Kyoei Life tried to cultivate a niche market left untouched by other insurers where there were unmet needs for coverage. The company formed tie-ups with various trade associations having a nationwide network and offered unique products to members of such associations under the mutual aid system, thereby expanding its business base. Specifically, it sold group term insurance combined with endowment insurance named "Kyoko Hoken" to members of a teachers group called the Japan Educational Promotion & Teachers Mutual Benefit, and group term insurance named "Jieitai Hoken" to members of the Defense Agency's mutual aid society.

Endowment insurance was a mainstay product in the life insurance market at that time. Kyoei Life's main product was group term insurance, which offered coverage at a low premium. "Our idea was to become one with the market to develop products," says a head office staffer at that time. In the 1960s, it became an established practice for the sales staff to sell endowment insurance combined with term insurance (the first of its kind in the industry) as a complement to group term insurance. “Unlike other insurers, our company gave its sales employees a target customer base so that anyone could be a successful salesperson. They did not have to turn to their relatives and friends as initial targets…. Our sales employees were instructed not to sell products to someone they knew. Our company did not hire people who had sold insurance at other companies,” he says.

Kyoei Life was known for the strategic steps it took in anticipation of an aging society. It was one of the first to sell individual annuity insurance, in 1963, and opened “Kyoei Annuity Home” in 1965, using the lump-sum payment of premiums of individual annuity. The company became the first in the industry to sell adult disease insurance, in 1971. It adopted the separate death rates for men and women and offered discounts on large-amount policies ahead of other companies.

Kyoei Life’s unique strategy proved a success. In terms of the total amount of individual insurance in force, the company ranked 10th in the mid-1970s and rose to eighth in the mid-1980s, coming after the seven major life insurers.

(3) Launch of single-premium endowment insurance

Kyoei Life sold security-type products through groups with which it had formed partnerships. With this unique business model, the company achieved growth. It promised to pay an assumed interest rate of 3.75%, lower than that offered by other insurers. “Our company was constantly looking for a niche market…. Other companies said that ‘Kyoei Life’s insurance is hard to understand,’” said the head office staffer at that time.

In the mid-1980s, “The sales staff began demanding, ‘let us sell single-premium endowment insurance (like other companies).’ Kawai, who had been reluctant to sell this insurance, changed his policy in 1987. The company belatedly started aggressively selling this product and raised the assumed interest rate to 5.5%, about the same as offered by other companies,” say the actuarial staff at that time. In this connection, there were conflicting witness accounts. One said, “We started with a low assumed interest rate but various things pressured us into raising it to the level of other companies.” Another said, “The actuary at that time recommended raising the assumed interest rate and even brought in an actuary from another company to persuade Kawai."

Table 2-21: Brief History of Kyoei Life

1935	Kyoei Life Reinsurance Co. established (receives capital from private life insurance companies).
1945	Absorbed into the Central Life Insurance Council.
1947	Kyoei Life Insurance Co. established (with a vacant president post).
1948	Saburo Kawai becomes president.
1951	Underwrites group insurance for the National Police Reserve (predecessor of the Self-Defense Forces). Gains contracts for the teacher's mutual aid system in Shizuoka Prefecture.
1952	The total amount of direct insurance in force becomes greater than that of reinsurance.
1961	Kyoei Computer Center (now INES Corp.) established.
1965	"Kyoei Annuity Home" opened using individual annuity insurance.
1967	Oriental Life Insurance Cultural Development Center established.
1969	Brazil Kyoei Insurance established.
1971	Masayuki Kitoku (former Ministry of Finance official) becomes president.
1972	Receives the transfer of Okinawa Life contracts in block.
1986	Yoshio Tayama becomes president.
1992	Saburo Kawai retires as director.
1994	Shoichi Otsuka becomes president.
1995	Current loss, and ¥104.1 billion stock valuation loss, for fiscal 1994.
1999	Forms a business and capital tie-up with Daiichi Mutual Fire & Marine Insurance.
2000	Daiichi Mutual Fire & Marine ordered to suspend business. Applies for protection under the Act on Special Treatment of Corporate Rehabilitation Proceedings and Other Insolvency Proceedings of Financial Institutions.
	(Honorifics omitted)

"Kawai did not like the idea of assets decreasing five years later. To get a volume effect, he permitted sales of only products with a 10-year maturity," according to a head office staffer at that time. Kyoei Life ranked high in terms of total amount of policies in force, but ranked low in terms of asset size because its main sellers were security-type products. "Amid the intensifying race for scale expansion in the life insurance industry, Kawai must have judged that 'we need assets to become a big company,'" says a head office staffer at that time. Kawai did not think of making his company a large life insurer. Some say that he was already senile and "lacked judgment ability" or that "Kawai thought he was already a retiree."

Anyway, the drive to sell savings-type products at this time became a burden on the company later. "The turning point came in 1987. It was a year when Kyoei Life, which had followed an independent path collecting high premiums and paying high dividends, abruptly raised the assumed interest rate to the level offered by other insurers. Kawai's brainchild Annuity Home was mentioned in the Insurance Council's report. This made him and his staff very happy temporarily. Then things changed for the worse so that the company was in no position to demonstrate its uniqueness…. Kyoei Life had a unique management style and encouraged employees to try something new. As Kawai's influence waned, the company lost its uniqueness and began to imitate others," according to the actuarial staff at that time.

(4) Delay in discontinuing sale

The negative spread became a serious problem not only because single-premium endowment insurance had a long maturity of 10 years but also because the company did not quickly stop selling the product. While the growth in the total assets of other midsize life insurers, or of the whole industry, slowed down to a single-digit figure from 1990 onward, Kyoei Life's total assets continued to grow at a double-digit pace until fiscal 1993. As a result, the average assumed interest rate did not come down even in the second half of the 1990s. Even after other insurers began to hold back sales, Kyoei Life continued sales by giving incentives to the sales staff, according to the actuarial staff at that time.

Table 2-22: Changing total assets

(in units of ¥100 million)

	Kyoei Life		All life insurers	
		Year-on-year change		Year-on-year change
FY1985	12,124	20.5%	538,706	17.8%
FY1986	15,037	24.0%	653,172	21.2%
FY1987	18,996	26.3%	792,684	21.4%
FY1988	24,601	29.5%	970,828	22.5%
FY1989	30,009	22.0%	1,173,439	20.9%
FY1990	35,034	16.7%	1,316,188	12.2%
FY1991	39,343	12.3%	1,432,341	8.8%
FY1992	44,803	13.9%	1,560,111	8.9%
FY1993	50,641	13.0%	1,691,221	8.4%
FY1994	54,357	7.3%	1,779,655	5.2%

(Data) "Life Insurance Statistics"

One reason Kyoei Life was several years behind other life insurers in discontinuing the sales of single-premium endowment insurance was that the product was targeted not at new customers but at members of associations with which the company had formed partnerships, who were the core customer base. Single-premium endowment insurance was seen and used as a receptacle for teachers' retirement money, and Kyoei Life was under strong pressure from the associations to sell the product. The sales division strongly resisted the idea of discontinuing sales, partly because it became heavily dependent on savings-type products and its sales power was waning. "Most of Kyoei Life's contracts were made with a specific group of customers such as teachers. Many said single-premium endowment insurance was a good product for investing and increasing teachers' retirement money. We discussed the possibility of reducing the assumed interest rate, but had difficulty going ahead with the idea, fearing that our relations with customers might be affected. We could not turn down requests (Note from translator: requests for the high-yield product) from the associations through which we got new businesses…. The sales staff's power to sell security-type products was weakening. To achieve a 10,000-person system, they rushed to sell single-premium endowment insurance…. It was very easy to sell single-premium endowment insurance when other insurers had stopped selling it…. The executives in charge of sales had a big say and did not let others put a brake on sales," say the head office staffers at that time.

"The actuarial division started a future cash flow analysis around 1990 at Kawai's instructions. It became obvious that 'disastrous results' lay ahead. However, in the expectation that 'the external environment will change in 10 years' time,' the company did not take drastic action such as discontinuing sales. Kawai merely showed displeasure when this matter was brought to his attention. He must have thought that, as the product had a 10-year maturity, things should improve during the life of the product," according to the actuarial staff at that time.

"In 1992 or so, even salespeople began to ask 'is it all right to continue to sell in this way?' The executive in charge of sales (who was one of those close to Kawai) opposed to the discontinuation of sales, and there was no way to put a brake on the sales drive," says an actuarial staffer at that time. The chances are that the executive in charge of sales had a poor grasp of the precise details of the company. As described later, Kyoei Life was quite secretive about its own affairs and made sure that its real situation was visible only to a few executives. A certain actuarial staffer of the time says that Kyoei Life was far from restraining the sales of savings-type products and sold a large volume of group survivor's insurance with high assumed interest rate in 1993 or so.

The company finally stopped selling single-premium endowment insurance in 1994, the year when it posted a current loss. "It was too late," said a head office staffer at that time.

(5) Steps taken after the external environment worsened

The company's negative spread first appeared in fiscal 1992. In fiscal 1994, the company suffered a securities valuation loss of more than ¥100 billion due to the stock market slump and, accordingly, lowered the required policy reserve level and booked profit from the sale of real estate to cover the valuation loss. In fiscal 1995 or so, the company fell into a situation where the expense profits combined with the mortality profits were not large enough to cover the interest losses. Its earnings structure became even more dependent on the profit from the sale of stocks and other assets. "When the company suffered a current loss owing to the stock price drop and the yen's appreciation in fiscal 1994, it tried to reduce the investment risk. Even though a large loss was incurred amid the stock market slump, the company still had net assets of ¥150 billion. The interest rate was low and the company became unable to pay high assumed interest rates. In an effort to fill the gap between the actual interest rate and the assumed interest rate, the company again began taking risks. It was trapped in a vicious cycle," says a head office staffer at that time.

A big factor that led to this situation was that the main insurance product had a long maturity of 10 years so that the assumed interest rate did not come down for a long time. "The company was slow to change its strategy. Because the problem lay in the interest loss, I suggested switching to different instruments and starting a campaign to promote cancellations. At first (the management) blasted 'You fool!' It took two years to get them to do these things," says an actuarial staffer at that time. The company went too far in selling real estate just to realize latent profit. "In 1995 and 1999, the company made loans to its affiliate Sanei Building Co., to which it sold off real estate holdings, and posted the profit from the sale as extraordinary profit. The loans totaled some ¥70.4 billion at the end of last March," reported Yomiuri Shimbun dated December 25, 2000. "An actuary would ask the finance division to generate a certain amount of profit in a particular year, and the finance division was free to do anything. If the company was unable to make both ends meet at the end of year, it resorted to selling off assets to realize profit," says a head office staffer at that time.

As the business environment deteriorated further, the company "fell into real difficulties and entered the world of gambling," says a financial staffer at that time. "As we initially adopted the lower-of-cost-or-market method for evaluating stocks, we took a chance on foreign bonds, which could be retained at a loss even if they incurred latent loss. This was spearheaded by the head office manager who saw Nippon Dantai Life achieve success in foreign bond investments. Sometimes our company did well, but in 1999 we were hurt severely in Range Forward Trade. We had to sell prime loans to realize profits…. For several years prior to bankruptcy, we annually had an interest loss of ¥100 billion, a mortality profit of ¥65 billion and an expense profit of ¥20 billion, which boiled down to a shortage of ¥15 billion. To cover this shortage, the company rushed to gamble on foreign bonds and stocks," says a head office staffer at that time.

As a result of all this, the company continued to post large losses from the sale of securities from fiscal 1997 onwards. The record for the second half of the 1990s shows that the losses from the sale of securities (on the general account) increased from ¥18.5 billion in fiscal 1996 to ¥47.7 billion (including ¥31.8 billion from the sale of foreign securities) in fiscal 1997, ¥52.3 billion (including ¥40.3 billion from the sale of foreign securities) in fiscal 1998 and ¥90.8 billion (including ¥72.5 billion from the sale of foreign securities) in fiscal 1999. "If the negative spread was the only problem we had to deal with, we had a means to survive. If we had avoided incurring a large loss year after year like this, we would not have fallen into a crisis," says an actuarial staffer at that time.

It was not that the company made no reform efforts. In 1996 it took measures to cut costs and shift to more profitable products, but these measures "did not go far enough.... The management reform made little progress, and the board member who spearheaded the reform retired," according to the then actuarial staff. In March 1998 the company raised about ¥25 billion capital by issuing shares to affiliates such as Sanei Building Co. and INES Corp. as well as Toda Corp.

(6) Tie-up negotiations with outsiders

With Nissan Mutual Life collapsing in 1997 and one major financial institution after another going under around that time, the business environment deteriorated further. The surrender/lapse ratio of individual insurance leaped to 14% from 10% in the previous year.

Several directors including Mr. A realized that their company could not survive without outside help, so they started full-scale efforts to negotiate for a tie-up. Most board members were not seriously concerned. "Mr. A proposed to start negotiations for a tie-up, saying, 'let us go about this just in case,' but had a difficult time getting things started in the face of strong opposition from other board members…. Most members of the management wanted to rebuild business on their own, but they thought it may become necessary to get outside help and therefore started negotiations under Mr. A's leadership…. The first one they approached was a major U.S. life insurer who suggested a method of separating new and old contracts. Negotiations with this insurer made little progress. Our company talked also to other insurers based in the U.S., Canada and Switzerland and major Japanese life insurers," according to the former head office staffers and others concerned.

It was after the failure of the Long-Term Credit Bank of Japan in 1998 that Kyoei Life seriously started negotiations with others. Investments and loans to LTCB-affiliated nonbanks became irrecoverable and this was a serious blow to the company. Although Kyoei Life had specific customer bases and was a stock company, which lent itself easily to a capital tie-up, there was an unfilled gap in the perceived corporate value between the negotiating parties. The negotiations made little headway.

"Most directors and advisors were unaware that their company was in critical condition. Members of the management were divided into those who pushed for a tie-up and those (majority) who insisted on reconstructing business without outside help. The two sides did not come together until the end. Those who favored self-reliant reconstruction had no specific measures but continued to say such things as 'the stock average will surpass 20,000' or 'education and military are the most important to the nation, so the administrative authorities would not permit the collapse of our company which has close relations with the government,'" according to a head office staffer at that time. "We can only say that they didn't want to do anything," says another head office staffer.

Under these circumstances, an unthinkable thing happened. In 1999, while those who favored a tie-up were in negotiations with Prudential of America their opponents who preferred self-reliant reconstruction proposed and carried out the idea of forming a capital tie-up with Daiichi Mutual Fire and Marine Insurance, which was in trouble. "The tie-up with Daiichi Mutual Fire was not promoted by a group negotiating with foreign institutions. The idea was outrageous to this group, but it raised great hopes among the majority of the management that 'money will flow into our company,'" says an actuarial staffer at that time.

When Claremont Capital Holding approached Kyoei Life and offered to put up capital in March 2000, those who favored self-reliant reconstruction warmed to the idea. Claremont President Yoshihiko Kokura took an equity in Taisho Life and gained control of its management at around this time, but defrauded this company of a large sum of money and was arrested by the Tokyo District Public Prosecutor's Office in August

2000. “Many members of the management almost jumped at Claremont’s proposal to put up ¥100 billion. Fortunately, they were advised in time by an investment bank that Kokura was a dangerous person. They would have most certainly gone along with his proposal if negotiations with Prudential were not making progress,” says an actuarial staffer at that time.

Daiichi Mutual Fire, with which Kyoei Life had formed a business and capital tie-up, collapsed in May 2000, and the ¥30 billion fund contributed in the previous year was lost. This loss, combined with a huge loss from exchange trading, sapped the strength of Kyoei Life. Meanwhile, the company negotiated with Prudential of America. for a capital tie-up and announced a basic agreement in June 2000. “Kyoei Life announced the basic agreement because its audit corporation refused to ‘endorse the financial statements without a tie-up agreement.’ Our company was negotiating with several Japanese firms at the same time,” according to the actuarial staffer.

The negotiations for a tie-up continued for some time. “It was agreed that the tie-up would not come into force unless the stock average reached 20,000,” according to the actuarial staffer. “Upon receiving a due diligence report from Prudential at the end of September, we considered whether the initial reconstruction plan was feasible. For reasons such as the stock market slump, the plan became difficult to carry out. In October we started discussing what we should actually do,” then President Otsuka said at a press conference shortly after his company’s failure. Chiyoda Life’s failure on October 9 triggered cancellations at Kyoei Life. Kyoei Life had no choice but to apply for the commencement of the corporate rehabilitation procedure on October 20.

(7) Presence of the founder

Founder Kawai played a big part in nurturing the latecomer Kyoei Life into a company comparable to major life insurers in terms of contract volume. Also, he was largely responsible for failing to guide the company out of its crisis. “The company rose and fell with its autocratic leader,” as a head office staffer at that time put it.

Kawai was an actuary and served as the chairman of the Institute of Actuaries of Japan. He not only managed Kyoei Life, but he involved himself in a broad range of activities, such as drawing up a plan for the national pension system as a committee member of the Ministry Health and Welfare and establishing the Oriental Life Insurance Cultural Development Center to nurture the life insurance business in Southeast Asian countries.

He was the first Japanese to receive the John S. Bickley Founder's Award Gold Medal for Excellence from the International Insurance Society, in 1995. An actuarial staffer who was close to Kawai says, "He was a man of ability, but most of his ideas led nowhere. Kyoko Hoken (teachers' insurance) developed into something as he continued to have a say in it. Other ideas blew up before getting anywhere. If he started something but left it to someone else after a while, it did not grow into a good business."

It seems, from the comments made by the parties concerned, that Kawai was the only person who made important business decisions until shortly before his death in 1998. He was replaced as president in 1971 by Masayuki Kitoku, a former official of the Ministry of Finance. Kitoku's stance was that "my job is to make the company bigger and I would like Mr. Kawai to make decisions."

The third and fourth presidents, Yoshiro Tayama (1986-1994) and Shoichi Otsuka (1994-2000), were close to Kawai and left him to make decisions. It is not known whether this was what Kawai wanted. At any rate, the company continued to depend on Kawai even after his resignation as president. It was Kawai who chose presidents and board members. "At Kyoei Life, Mr. Kawai was the only real manager and others were cogwheels. He still had a big influence after resigning as president in 1971," says a former officer. "Mr. Kawai and members of the management were like a parent and children. Members were just like a group of good friends. Mr. Kawai did not train anyone to become his successor. He went to great lengths to discourage the challenging spirit in his staff, so board members became yes-men who were eager to please their boss," says a head office staffer at that time. "Mr. Kawai was very strict with his successors such as Mr. Tayama and Mr. Otsuka who were as young as his children and was often heard yelling at them. These men had an obsessive idea that 'if I don't do what I am told to do, I would be fired,'" according to another head office staffer.

(8) Managerial vacuum

"Mr. Kawai had become old and lost his youthful energy by the second half of the 1980s. He retired from the director's post in 1992. Even after his retirement, the management was unable to make decisions without consulting Mr. Kawai. Mr. Kawai should not have been fit to make proper judgment at that time, but the managers were unable to get together and address important issues of the company as they were supposed to do. Even when Mr. Kawai was close to death, the managers went to the hospital where he stayed to seek his approval," says a head office staffer at that time.

Another head office staffer says, "In the mid-1990s, the managers belatedly agreed that a change of generations was necessary and tried to rejuvenate the board of directors in 1996. As previous members of the board remained with the company as advisors, the overall situation changed little…. From the latter half of the 1990s the board of directors frequently held a meeting but mostly ended up with a weasel-word resolution."

"Mr. Kawai thought he had retired from active duty in 1992. When his successors asked him for advice, Mr. Kawai merely expressed his feelings. Kyoei Life's managers interpreted Mr. Kawai's words in any way convenient to themselves…. They made decisions based on their guess about Mr. Kawai's intentions. So they made an incredible blunder such as getting a large volume of contracts that would instantly create a negative spread. Mr. Kawai himself should not have known that things were as bad as this," says an actuarial staffer at that time.

(9) Actuary

Founder Kawai was an actuary and made judgment about anything by looking at figures and going into details. The numerical data was prepared by another actuary—Mr. B, Kawai's protege. According to the parties concerned, Mr. B was described as "Kawai's arms" and "Kawai's electronic calculator" from the early 1980s onward. He was in charge of not only actuarial matters but also personnel affairs and general affairs. Kawai, Mr. B and an executive in charge of finance (another favorite of Kawai) were the trio who practically operated the company.

It is questionable whether Mr. B fulfilled the role of an actuary after things got worse at the company. From the mid-1990s onward, anyone who made a future cash flow analysis should have realized that the company was in a real mess. But it seems from the comments of the parties concerned that the actuary did not inform the management of his findings. "Mr. B was secretive. He exercised control in such a way that the real situation was visible only to a few executives. He was worried about the impact of disclosure of the truth…. Mr. B concealed the truth by saying that 'this would be misleading for nonprofessionals,'" according to the actuarial staff at that time. "The available data did not reveal what was really going on. No explanation was given. I was shocked when I learned the truth around 1998," a head office staffer at that time says. "Mr. B was aware of the reality of the business from early on and must have had real concerns. But he was no help (when it came to a tie-up with an outside partner)," says another member of the actuarial staff.

(10) Attitude toward risk management

Kyoei Life basically had no planning division until 1998 or so, according to the parties concerned. It had no place for discussion about managerial issues. A head office staffer at that time says that the planning division was set up temporarily for personal reasons on several occasions but it was not like a typical planning division. Most of the officers were accustomed to the company's culture so that no one suspected anything was wrong.

Kawai and actuaries close to him made decisions. Other board members followed them. Up until the mid-1990s, a board of directors meeting was a mere ceremony without substance. When a head office staffer tried to explain the financial situation to an executive in charge of sales, the executive refused to hear, saying, "I need not know about it." He apparently thought that he had only to carry the banner for sales even though he didn't know business details. "We may say the illusion that things were all right was planted in our mind," says an actuarial staffer at that time.

"In the mid-1990s, the actuaries calculated real net assets, the solvency margin ratio and the figures of the future cash flow analysis according to five different scenarios. They presented several scenarios excluding the worst-case scenario to the Ministry of Finance and presented only an optimistic scenario to the board of directors," according to the then actuarial staff.

Even if assets under management increased too fast, the finance division did not become concerned. The finance division was "a place where money coming from the outside was managed," as a financial staffer at that time put it. It did not interfere with the affairs of other divisions.

The concept of ALM was alien to the company. The company sought something that generated as high a yield as possible, be it loans to bank-affiliated nonbanks, loans to a third sector, or foreign bonds (such as sovereign bonds). It dabbled in few investments or loans typical of the bubble years, but the loan amount of each deal became larger.

(11) Role played by external discipline

Kyoei Life was a stock company but was unlisted and its major shareholders were the founder's relatives. "It was difficult to get the shareholders to attend a shareholders meeting. Former officers of the company were the only shareholders who spoke up at the meetings," says a head office staffer at that time. The groups with which the company had formed tie-ups such as teachers' mutual aid group made no demands in particular. Rather, they offered to put up capital after the company fell into difficulties, according to the head office staff of the time.

It was the labor union that made the most reasonable demands where governance was concerned. "From 1996 onward the labor union pressed for resignation of advisors or made other demands," a head office staffer at that time recalls. In 1999 the labor union became Kyoei Life's shareholder and tried to perform watchdog functions. The company "reluctantly created a labor union at the urging by the Ministry of Finance to begin with. No union official climbed the corporate ladder to a high post. The company did not treat the union decently…. The union told the management to 'just make sure that the company will not go under,'" according to an actuarial staffer at that time.

The Ministry of Finance hardly checked the company's status or provided any guidance. "The Ministry's inspection 1995 revealed that the company's negative spread had grown even more serious. And yet the company was not severely reprimanded, perhaps because the ratio of bad loans to the total loan balance was no more than 4%," says a head office staffer at that time. The Ministry of Finance took the position that, if Kyoei Life was to team up with a partner, the partner should be "a domestic company if possible."

An executive who was a former official of the Ministry of Finance was on the payroll of the company until the year preceding its bankruptcy. He was cooperative in concluding a tie-up with an outside partner but had not much influence inside the company. He was "treated like a guest" and "kept out of the loop" until the end, according to the head office staffer.

7. Is it true that "rumor caused the failure?" —Tokyo Life Insurance

(1) Direct cause of failure

Tokyo Life filed for corporate rehabilitation proceedings in March 2001. Chiyoda Mutual Life and Kyoei Life Insurance failed in October 2000, resulting in a surge in policy cancellations at Tokyo Life. To cope with the situation, the company sought demutualization to pave the way for a future tie-up with a foreign-affiliated firm. Daiwa Bank, a close business partner, had shown its willingness to assist the insurer, but eventually gave up providing financial assistance mainly because the financial standing of the insurer worsened due to sagging stock prices. As a result, tie-up negotiations fell apart.

“A series of bankruptcies of life insurers (Chiyoda Mutual Life and Kyoei Life Insurance) spurred credit concerns and created false accusations, leading to an increase in policy cancellations” President Kenichi Nakamura said in a press interview following the bankruptcy (according to the Yomiuri Shimbun dated March 24, 2001), thus implying that the impact of harmful rumors was partly blamed for the company’s failure.

However, comprehensively judging from a variety of materials and verbal evidence provided by the parties concerned, even without the increase in policy cancellations resulting from rumors, the company is deemed to have already been struggling with deteriorating finances when it sought a tie-up with an external party in 2000. Many employees at that time say, “Unfavorable rumors indeed hastened the failure of the insurer, but at any rate, the company would not be able to escape from bankruptcy without forming an alliance with a bank or others”…. “The company had a big structural problem and would go under anyway without the consecutive bankruptcies of Chiyoda and Kyoei.”

Tokyo Life fell into a management crisis without a big, specific problem. One factor pushing the company into a crisis was that a variety of problems such as a low-profit structure, rapid expansion of assets and inappropriate asset investment came to the surface at once in the 1990s. Another factor was that even after the company’s financial standing started deteriorating, the management failed to take the matter seriously enough and was slow to deal with the situation. “There was no single specific cause leading to the failure. Rather, we just did what we normally did and suddenly found ourselves in desperate trouble,” says a head office staffer at that time.

The company was part of the Nomura Group firms, but its business scale was small. “The insurer saw its share in the market serving the workforce of companies gradually shrink largely because its dividend levels were substantially lower than those of major insurers. As a result, sales personnel couldn’t help but turn to blood and territorial bonds when marketing products. The retention rate of sales personnel worsened, and adverse effects of mass hiring and mass dropout became conspicuous. A low-profit structure took root, forcing the company to struggle with chronic expense losses," according to a head office staffer at that time.

He also says, "Because the company used to be ranked high in the industry, its burden of paying special dividends at the time of lapse of a contract was large relative to its size. The dividends were paid out of latent stock profits, and therefore the profit structure heavily depended on latent stock profits that took root in our company."

The insurer apparently didn't seek investment vehicles that caught on in the bubble era during the late 1980s when its assets expanded, according to parties concerned at that time. However, it's undeniable that in order to cover surging costs, "the company leaned toward investment in stocks, foreign currency-denominated bonds, structured bonds and other high-risk high-return vehicles"(quoted from the insurer's rehabilitation plan).

(2) Decline in market share

Tokyo Life (Nomura Life) was a prominent life insurer counted as one of the four zaibatsu-affiliated companies (Sumitomo, Mitsui, Yasuda, and Nomura) following the five-largest players (Nippon, Dai-ichi, Meiji, Teikoku, and Chiyoda) in the prewar period. In around 1960, it entered the market for monthly individual insurance in response to industry trends and gradually established its sales forces. The company's market share started falling, however, as it failed to expand its coverage products.

The company's market share of insurance in force (including group insurance) stood at 1.7% in fiscal 1963, around the same level as those of Fukoku Mutual Life and Daido Life. In fiscal 1977, however, its share dropped to 0.9%, half the share of Fukoku Mutual Life and one third the level of Daido Life, which succeeded in implementing a tie-up strategy with small- and mid-sized businesses. Its share of total assets also fell from about 1.5% in the mid-1960s to 1.0% in the mid-1970s.

Contracts earned from the workforce of the former Nomura Group firms, close business partners with the insurer, accounted for about 30% of its total insurance in force until the mid-1970s. According to a head office staffer at that time, however, "the company was unable to break away from the structure generating expense losses, and the gap in dividend level widened between the company and larger insurers. As a result, the insurer failed to attract the workforce of companies and started losing group insurance contracts with its share gradually declining in the market related to its partner business groups as well."

Consequently, Tokyo Life's sales forces couldn't help but target local markets and sell products to members of "Tsutanokai", a nationwide sponsor organization based on sales personnel's blood and territorial bonds. Each branch office had a "Tsutanokai" body made up of policyholders and agencies as members, and the body referred customers and sales personnel to Tokyo Life. The company stepped up sales of coverage products, and the average size of policies issued gradually rose. According to a head office staffer at that time, however, "sales personnel increasingly sought contracts from their relatives and friends first, and its employee turnover rose." The company's rate of policy cancellation and termination exceeded the average rate for the industry, while its business efficiency worsened. The downward trend in the industry share also continued with its share of individual insurance in force and share of total assets dropping to 0.6% and 0.7%, respectively, in the mid-1980s.

Table 2-23: Brief History of Tokyo Life

1895	Started business as Shinshu Shinto Life Insurance Co.
1934	Renamed itself as Nomura Life Insurance Co. (Nomura Group).
1947	Restarted as Tokyo Mutual Life Insurance.
1977	Toshio Shibayama became President.
1986	Masakazu Yougai became President. Shiba Building was completed.
1988	Started marketing individual annuities via tie-up loans.
1989	New head office building was completed. The total assets topped ¥1 trillion.
1994	Kenichi Nakamura became President. Otemachi Nomura Building was completed.
1995	Celebrated its 100th year in business. Launched the Corporate Identity (CI). Reported an operating loss for fiscal 1994.
1996	Started a "new three-year management plan." Entered into a business partnership with Asahi Fire & Marine Insurance Co.
1997	Increased its fund to ¥15 billion.
1998	Formed a product development partnership with U.S. Reinsurance Group of America Inc.
2000	Requested Daiwa Bank to provide financial assistance. The real net asset value shrank to ¥500 million.
2001	Filed for court protection from creditors under the Act on Special Treatment of Corporate Rehabilitation Proceedings and Other Insolvency Proceedings of Financial Institutions.

(Honorifics omitted)

(3) Leaning toward savings-based products

The three goals set up by President Masakazu Yougai, who assumed the post in 1986, were to "strengthen sales abilities," "pursue aggressive and flexible asset management," and "improve the efficiency of clerical work." In fiscal 1987, the company also drew up a "three-year business plan to expand assets and increase policies in force under reform and creation ahead of its 100th anniversary," thereby focusing its efforts mainly on expansion of operations.

As part of its aggressive sales policy, the insurer started selling individual annuity insurance “Premium Loan” via partner financial institutions in January 1988. The product required policyholders to pay their premiums of individual annuity in a lump-sum by receiving loans from financial institutions. Nissan Mutual Life had already been selling a similar product that used a loan scheme for premium payments since 1986 and had succeeded in expanding sales. “Tokyo Life’s management was shocked by the ‘incident’ that Nissan Mutual Life had surpassed the company in terms of asset size,” according to a head office staffer at that time.

The incident apparently prompted the insurer to follow suit. Tokyo Life created a special division within the corporate business department and began aggressive marketing in tie-ups with banks close to the company and many regional financial institutions in an effort to catch up with Nissan Mutual Life. As a result, the insurer’s growth rates of total assets were substantially larger than the industry’s average rates during the four-year period that started in fiscal 1988. Its total asset value almost doubled in just three years from ¥530 billion at the end of fiscal 1987 to more than ¥1 trillion at the end of fiscal 1989. With the assumed interest rate and the guaranteed rate for premium prepayment set at as high as 5.5%-6.25% and 6%, respectively, however, “the corporation in need of rehabilitation shouldered large liability costs for a prolonged period of time, while its total asset had rapidly expanded” (quoted from the insurer’s rehabilitation plan).

In and after fiscal 1990, when loan rates rose, the number of premium loan contracts plunged. To make up for the drop in premium revenues, Tokyo Life focused its efforts on sales of group annuity insurance, a high-yield coverage product that could bring a large number of funds to the company. The value of group annuity policies in force surged to ¥500 billion in fiscal 1993 from ¥230 billion in fiscal 1989.

In the first place, group annuity contracts accounted for a large percentage of the company’s total policies in force because Daiwa Bank, a financial institution close to the insurer (and also a major commercial bank exceptionally allowed to conduct trust banking operations), referred small-scale corporate groups to the insurer when it couldn’t serve those groups on its own due to its small corporate size. According to a head office staffer at the time, however, “group annuity contracts undertaken around this time did not necessarily come from close corporations, but consisted mainly of large-lot contracts with government offices, labor unions, and others seeking high-return investment vehicles for their surplus funds." With the levels of interest rates already dropping, the insurer struggled with high yields promised to policyholders and tried to cope with the problem by selling stocks with unrealized gains, thereby losing its financial strength.

Table 2-24: Changes in total assets

(in units of ¥100 million, %)

	Tokyo Life		All companies combined	
		Year-to-year basis		Year-to-year basis
FY 1985	4,049	12.1%	538,706	17.8%
FY 1986	4,593	13.4%	653,172	21.2%
FY 1987	5,334	16.1%	792,684	21.4%
FY 1988	7,782	45.9%	970,828	22.5%
FY 1989	10,091	29.7%	1,173,439	20.9%
FY 1990	11,416	13.1%	1,316,188	12.2%
FY 1991	12,512	9.6%	1,432,341	8.8%
FY 1992	13,508	8.0%	1,560,111	8.9%
FY 1993	14,629	8.3%	1,691,221	8.4%
FY 1994	15,116	3.3%	1,779,655	5.2%

(Data) "Life Insurance Statistics"

Table 2-25: Breakdown of policy reserves

	<FY 1986>		<FY 1989>	
	Tokyo Life	All companies combined	Tokyo Life	All companies combined
Individual insurance	66.8%	74.8%	44.6%	67.0%
Individual annuity	3.9%	2.9%	30.1%	6.8%
Group insurance	0.8%	1.2%	0.4%	1.1%
Group annuity	28.1%	20.2%	24.6%	24.2%

(Data) "Life Insurance Statistics"

(4) Inappropriate asset management

As described earlier, Tokyo Life "leaned toward investment in stocks, foreign currency-denominated bonds, structured bonds and other high-risk high-return vehicles (in order to cover surging costs)" (quoted from the insurer's rehabilitation plan). The insurer didn't turn to high-risk investments and loans that caught on in the bubble era, but increased investment in foreign securities to earn interest and dividend income and also purchased structured bonds. Several head office staffers at that time say, "Our investments and loans were mostly deals referred by Daiwa Bank. Investment in structured bonds was mainly recommended by securities companies affiliated with the Nomura Group"…. "We had never experienced a surge in assets until then. So, we thought of these investment vehicles as just an extension of conventional investment options and made investments without paying particular attention to their liability profiles"…. "We shouldn't have purchased stocks and real estate, using funds from products guaranteeing a yield of 6%”…. “Stocks, real estate and other less-marketable assets remained after fund outflows occurred as a result of allocating increased funds in accordance with the traditional investment portfolio.”

They also say, “The company posted a capital gain of about ¥20 billion for every period to pay special dividends in the late 1980s. The acquisition prices of stocks were inflated because such capital gains were recorded via cross transactions (in which latent stock profits are realized by selling stocks and buying them back at the same time) rather than one-time sales” and “We had a huge burden of paying special dividends as the business scale of our company used to be relatively large.”

The insurer also invested a massive amount of money in real estate. It held a relatively large percentage of its portfolio in real estate and possessed good-quality, large-scale properties. In the early 1980s, it launched plans to rebuild its aging head office building and set up a business center to handle clerical work. The center (named Shiba Building) and the head office building were completed in 1986 and 1989, respectively. “It is strange indeed that a hotel was one floor down from our head office, but President Shibayama had long insisted that the company rebuild its head office and he promised to include Daiichi Hotel (a close business partner with the insurer) in the new building,” a head office staffer at that time reveals. The insurer also rebuilt the former Marunouchi Nomura Building and turned it into the Otemachi Nomura Building jointly with Daiwa Bank. The posh fitness club on the top floor of the building was run by Tosei Sports Club, a company affiliated with the insurer.

The rehabilitation plan points out the insurer’s investment in these properties, saying, “Amid surging premium revenues and expanding assets, the corporation in need of rehabilitation had become less aware of incurring long-term liabilities through these investments and drawn up plans to construct large-scale buildings, invest massive funds to upgrade its computer systems (*the plan was referred to as Ivy 21 system plan and started in 1989: the author’s annotation) and other business projects in anticipation of future expansion of operations, thereby gradually losing management consistency.”

(5) Management in the first half of the 1990s

With the levels of interest rates following a downward trend in the 1990s, the insurer’s negative spread first came to the surface in the financial results for fiscal 1992. “Considering it as a temporary problem, the management didn’t take any particular measure, and the insurer's dependence on capital gains further increased," according to the rehabilitation plan. The company also failed to break away from chronic expense losses. It temporarily posted expense profits from sales of lump-sum insurance products in fiscal 1989, but continued logging expense losses from the following year due to the heavy depreciation burden coming from investment in real estate and computer systems.

Meanwhile, internal strife came to light, and the company's top officials took problematic actions around this time. In April 1993, Mr. A, who served as executive director and was also deemed to be a rival of President Yougai, was demoted for allegedly being involved in creating a document that accused the insurer of hiding a sexual harassment problem within the company, according to "Asahi Shimbun" dated on June 27, 1993. It was also revealed that a bugging device was planted in Mr. A's home.

Chairman Toshio Shibayama (who served as president until 1986) paid a large amount of compensation to directors at his own discretion, while extending loans to a food company experiencing funding difficulties. The bankruptcy trustee sought damages for these incidents after the company failed. At a meeting of representatives in July 1990, Tokyo Life raised its ceiling on the overall amount of compensation for board members and also decided to discuss on the amount of compensation paid to each board member at a board of director's meeting. Chairman Shibayama decided on the amount on his own without consulting with other board members and auditors, however, and continued providing compensation worth a total of ¥220 million to board members over three years starting in July1991.

(6) Pretax loss and steps taken later

With interest rates continuing to fall, the insurer became unable to offset its negative spread with three profit sources in fiscal 1994. Moreover, its latent stock profits were depleted due to stock sales in the past to lock in profits or cover foreign exchange losses as well as a plunge in stock prices, forcing the company to report a pretax loss in fiscal 1994. To cope with the situation, the insurer lowered its standards for setting aside policy reserves by shifting from the net premium method to the 10-year zillmer method and also logged ¥13.3 billion worth of valuation gains (gains on stock valuation) in accordance with Article 84 of the Insurance Business Law.

Table 2-26: Changes in profit or loss on three profit sources

(in units of ¥100 million)

	March 1988	March 1989	March 1990	March 1991	March 1992	March 1993	March 1994	March 1995	March 1996
Expense profit	-29	-25	12	-15	-34	-30	-22	-36	-24
Mortality profit	123	143	156	153	157	139	164	168	186
Interest profit	70	60	119	95	66	-18	-141	-216	-275
Total	165	178	287	233	189	91	2	-85	-113

(Data) compiled from inspection reports

After reporting the pretax loss, the company drew up an earnings improvement plan centered mainly on cutting operational costs, closing unprofitable business bases, and reducing stockholdings in its portfolio. According to a head office staffer at that time, "The plan was basically designed to expand our business to mark the company's 100th anniversary. Nevertheless, it also represented the first restructuring plan drawn up by the company, and the management at that time thought they included drastic measures in the plan." However, "with the plan being created on the premise that insurance in force would expand, the company was not fully aware of the need to implement crisis management measures" (quoted from the insurer's rehabilitation plan). Although the closing of unprofitable business bases was included in the plan, "inefficient bases were left untouched as long as they managed to acquire new contracts, and therefore things didn't change so much," according to a head office staffer at that time.

He also talks about the company's failure to scale down its shareholdings, saying, "Even if we wanted to reduce the impact of a stock market downturn, we were unable to easily sell those shares because our shareholdings were mostly made up of those in Daiwa Bank related companies. We first planned to lower stockholdings in our portfolio from 20% to 15%, but eventually revised our target to 18% as many of our top officials voiced concerns that a drastic reduction would have an adverse effect on our prospect of business expansion."

The insurer's business standing further worsened in the late 1990s. With its latent stock profits being depleted, the company started recognizing unrealized gains on real estate in fiscal 1995. Although a cut in the assumed interest rate for group annuity insurance helped lift its earnings, the company incurred huge valuation losses due to a fall in stock prices and barely got through its business results announcement for fiscal 1996 by posting capital gains and others. Its loans receivable also deteriorated markedly. The insurer's classified loans rose to nearly 10% of its total loans receivable in 1996 from 3% in 1991.

(7) Distortion of asset structure

The collapse of Nissan Mutual Life in 1997 spurred policy cancellations at Tokyo Life, leading to drops in insurance in force and total assets. Less marketable assets remained, thereby distorting the company's asset structure, while the weight of stocks and other risky assets, which were relatively high in the first place, increased further in the insurer's investment portfolio. The total value of stocks, foreign and other securities, and real estate reached 48.6% of the company's general account assets as of the end of fiscal 1998. Head office staffers at that time say, "Amid fund outflows, the company started selling assets that could be easily sold, and as a result, stocks, foreign securities and real estate remained. People in charge of financing and budgeting had long insisted that the company sell stocks, but sales people objected to the idea, saying, 'Partners would be upset about us selling their shares'. Because the management also disagreed with the proposal, the company sold few shares"…. "We gambled on foreign securities. A manager at that time saw his friend, who was the president of a midsize life insurer, succeed in foreign exchange transactions. He engaged in similar investment and screwed up on it" "The company even recognized gains on public and corporate bonds that were not reflected in solvency margins in fiscal 1998."

The authorities allowed insurers to use the cost method in assessing their shareholdings, starting in fiscal 1997. The regulatory change made it easier for Tokyo Life to get through its business results announcement, but the company also became saddled with massive unrealized losses on securities holdings. The insurer had maintained its solvency margin ratios at more than 400% as financial institutions close to it helped boost its fund and offered subordinated loans. Being rated as low as BB (by Rating and Investment Information), however, the company was unable to ease credit concerns and continuously struggled with high levels of policy cancellations. The value of group annuity insurance policies in force plunged to ¥230 billion at the end of fiscal 1999 from its peak of ¥550 billion at the end of fiscal 1995 with total assets dropping to ¥1 trillion from its peak of ¥1.5 trillion.

The insurer's rehabilitation plan points out the impact of policy cancellations, saying, "In response to a surge in cancellations, the company was forced to raise cash by selling foreign securities and domestic stocks with latent losses. As a result, its investment balance deteriorated."

Table 2-27: Tokyo Life's portfolio (as of the end of fiscal 1996)

(in units of ¥100 million, %)

	Tokyo Life		All companies combined	
Total assets	14,685	100.0%	1,858,323	100.0%
Cash and deposits	1,033	7.0%	65,695	3.5%
Monetary assets held in trusts	357	2.4%	45,534	2.5%
Public and corporate bonds	1,680	11.4%	425,712	22.9%
Stocks	2,864	19.5%	317,749	17.1%
Foreign securities	2,081	14.2%	168,551	9.1%
Other securities	233	1.6%	19,669	1.1%
Loans receivable	4,908	33.4%	650,929	35.0%
Real estate and movables	1,036	7.1%	98,325	5.3%

(Data) "Life Insurance Statistics"

(8) Delay in handling the problem

Looking at the developments leading to the failure, we see that the management of Tokyo Life didn't necessarily properly recognize the company's financial standing and often took actions that third parties would find it hard to understand.

For example, as described earlier, the insurer focused on marketing of group annuity insurance that guaranteed high assumed interest rate to policyholders amid plunging sales of "Premium Loan" in the 1990s and bolstered its efforts to expand contracts until fiscal 1993. The management at that time was "simply delighted that they succeeded in making up for the fall in contacts for Premium Loan with group annuities," according to a head office staffer at that time. However, interest rates were apparently following a downward trend in 1991, and the insurer's negative spread already became obvious as early as fiscal 1992. It nevertheless leaned toward group annuity insurance around this time, thereby increasing its dependence on capital gains to secure high guaranteed yields.

Moreover, a head office staffer at that time says, "Even after business conditions started deteriorating, the company never reconsidered its construction of Otemachi Nomura Building, which began in 1991." The building was completed in 1994, while the second-phase of construction ended in 1997. "I don't know why we constructed the building during that period. Generally, a company must scale down or suspend its project if operational environments or business conditions have changed. However, Tokyo Life was in a corporate culture where a project would never lose steam once being started."

Even when its business worsened in the mid-1990s and thereafter, the management was little aware of the crisis faced by the company because "there was a sense of security that the company had the backing of the Nomura Securities group and the Daiwa Bank group in addition to massive unrealized gains on real estate," according to a head office staffer at that time. In fact, unlike other failed midsize life insurers, the company never had difficulties finding someone willing to provide it with funds or subordinated loans and was also able to maintain its solvency margin ratios at more than 400% thanks to procurement of funds from other parties and its ample unrealized gains on real estate. It was in fiscal 1999 when the company finally reviewed its business expansion strategy. However, its financial standing at that point was already so deteriorated that it wouldn't be able to survive on its own. A head office staffer at that time says, "Our business was too dependent on Daiwa Bank."

(9) Management reforms and tie-up negotiations with outsiders

Tokyo Life set up a "business strategy meeting" under the leadership of managing director A in fiscal 1999, while people at the department head level spearheaded restructuring measures such as early retirement plans and consolidation of operational bases. The company formed an alliance with U.S. reinsurance giant RGA in product development, reviewed its full-line strategy and started focusing its managerial resources on the fields of death coverage and medical insurance. A head office staffer at that time says, "We finally began wondering if we should continue pursuing the expansion strategy"…. "The company had never undertaken drastic reform other than cost-cutting measures until then. Members of the business strategy meeting discussed how the company should be one or two years later, but the focus of the latter part of these discussions was on how much the company should scale down its business to survive."

In the general inspection by the Financial Supervisory Agency in 1999, the insurer was ordered to additionally write off ¥15.7 billion worth of loans receivable. Its negative spread showed little sign of improvement, and "the company was deeply dependent on gains on asset sales with its basic profitability being inferior to other insurers'" (quoted from the news release of RandI dated September 9, 1999). A head office staffer at that time says, "Actuaries conducted a future cashflow analysis in light of the financial results for fiscal 1999 and ended up issuing an opinion that the company would face a shortfall of policy reserves in five years if taking no measures."

The failures of Daihyaku Mutual Life in May 2000 and of Chiyoda Mutual Life and Kyoei Life in October 2000 spurred concerns over the credibility of Tokyo Life. In November, the company released a new business strategy centered on such measures as cutting the number of office workers by 20%, outsourcing asset management operations and selling its head office building, but it had already faced difficulty turning itself around on its own. The scheduled enforcement of the market-price method in evaluating the value of financial instruments was also coming up. "Daiwa Bank employees joined the company's business strategy meeting and together drew up restructuring plans. President Nakamura excluded managing director A, who opposed forming a partnership with an external party, from the meeting members and sought a tie-up opportunity", according to a head office staffer at that time.

Daiwa Bank set out a policy to assist Tokyo Life, including contributions to the insurer's fund, and came up with a scheme, proposing that the insurer survive under the umbrella of a foreign-affiliated firm after switching to a stock company. "We received four offers for assistance from a total of four companies. At least two of them showed us plans worth considering," President Nakamura said in an interview (according to Nikkei Business dated April 2, 2001).

Daiwa Bank eventually gave up providing assistance to the insurer due to a fall in stock prices as well as its own weak financial strength, resulting in a failure of the tie-up scheme. President Nakamura commented on the termination of assistance from Daiwa Bank as "a bolt from the blue" in a press interview held after the insurer's bankruptcy. A head office staffer at that time says, "This scheme may have succeeded if Daiwa Bank had had more financial power. A plan to increase the amount of Tokyo Life's fund was voted down at a board meeting of Daiwa Bank, leading the insurer to declare bankruptcy."

(10) Managers at that time

At Tokyo Life, the "management" meant "sales". Shibayama, who maintained strong power within the company for a long time, had great interest in sales, and even after he retired from the post of president, people having sales experience continued assuming the position. The sales department held power within the company. "Many of the top management were unfamiliar with financial figures. Only those who had sales experience moved up the corporate ladder," says a head office staffer at that time

Shibayama, who became president in 1977, was a person related to the Nomura group in the prewar period. He started serving as a board member in 1957 and had held a representation right since 1969. "Shibayama was very autocratic"…. "President Shibayama led the company in an autocratic way. He made forceful remarks when it came to sales and even said to employees, 'Create an operational base in …'", parties concerned at that time reveal. He failed to put a brake on the prolonged downward trend of operations, however. The Yomiuri Shimbun dated July 20, 2001 quoted a former top official as saying, "Shibayama liked visiting regional branches and providing sales forces with encouragement. He was, therefore, popular among sales representatives, but his management philosophy was not clear"…. "The president bears a huge responsibility for having failed to raise his successor and pushed the company to doldrums," a member of the committee set up to investigate the causes for the insurer's failure also gave a comment to the same article on the newspaper.

Yougai assumed the presidency of the company in 1986 (Shibayama became representative director and chairman). He joined the insurer as a sales employee in 1954. He later became an office employee, which represented an "extremely rare case" for the company (according to a head office staffer at that time), but was engaged in the sales department throughout his career. Although Yougai became president, Shibayama appears to have effectively maintained power, and as described earlier, paid a large amount of compensation to executive officers at his own discretion and extended loans to a food company struggling with a cashflow problem.

Nakamura, who became president in 1994, "had also been in the sales field for about 40 years since he joined the company in 1955" and said in a press interview, "To survive hard times, we first need to strengthen our sales ability rather than come up with difficult plans"…. "I expect everyone, including those in management positions, to have the feeling that they are part of the front-line sales force active in the sales field. Even people in charge of investment and others outside the sales department should always think about how to contribute to the company's sales results during their work" (according to Asahi Shimbun dated August 3, 1994).

(11) Internal management checking functions

Tokyo Life's management was shocked when Nissan Mutual Life had surpassed the company in terms of asset size in 1987 and tried to catch up with the rival insurer. The accounting department at that time is said to have objected to the attempts made by the management, saying, “Why do we have to do such (unprofitable) things?”…. “We will suffer from the burden of paying high levels of assumed rates of return in the future,” but failed to persuade the management. The corporate sales department created a special division to expand tie-ups with banks, and the management endorsed the move.

Sales of the company’s stockholdings didn’t go smoothly either. A head office staffer at that time says, “The financial affairs and budgeting departments both insisted in the mid-1990s that the company sell its strategically held shares, but the sales department objected to the idea, and management also didn’t accept the proposal. The board members wanted to expand the number of insurance contracts and therefore couldn’t assert the company’s intention to cut down on the Daiwa Bank group-related shares to the bank.”

At Tokyo Life, people having a sense of crisis often expressed their concerns about the company’s management conditions, and the insurer held across-the-board discussions to deal with the problems, but always ended up with taking only half measures, according to a head office staffer at that time. For example, around 1973, the insurer set up a special committee in response to growing calls from employees insisting that “the company use the net premium method (for policy reserves) to prevent its business from turning sour.” As a result of discussions, the committee proposed that the company “improve the efficiency of sales” and “shift its focus to products generating mortality profits,” but effectively failed to change the existing situation. The insurer was also unable to change the status quo when the issues of improving sales efficiency and expanding mortality profits were raised on another occasion. “At each phase, someone always appeared expressing a sense of crisis about the company’s management. In response to such arguments, the company held across-the-board discussions, but always took the easy way out by implementing halfway measures and often left the problems unchanged” says the head office staffer.

He also reveals that the company focused its attention on the number of new contracts acquired for each period, overlooking the achievement of the mid-term business plan.

The insurer was little aware of the importance of risk management as well. A head office staffer at that time says, “We set up an ALM strategic committee to conduct comprehensive risk management across the company in 1996. In reality, however, risk management operations were centered on the assessment of loans, and we were not really aware of the asset price volatility risk and the risk of ending up with negative spreads." While other insurers were reducing risky assets in the late 1990s, Tokyo Life was taking risks, going against the industry's trend. The insurer created its mid-term business plan, but it merely served as a simple simulation of its future operations, and the company only looked at a profit or loss on three profit sources for each fiscal year.

For the company, the management meant sales, and therefore the management and actuaries are said to have been generally opposed to each other. A head office staffer at that time says, "Nakamura, the company's last president, listened to actuaries' opinions, but he did so on the premise that actuaries didn't interfere with the company's relationship with Daiwa Bank."

(12) Role played by external discipline

Tokyo Life's management was subject to very little external checking partly because it took the form of a mutual company. Meetings of representatives went smoothly until just before the insurer went under. Nevertheless, the concerned parties say, "We felt the limitation of a mutual company when considering a tie-up scheme."

The Ministry of Finance started realizing that Tokyo Life's business was deteriorating around the times when the company drew up an earnings improvement plan in 1995 and it conducted an inspection of the company in 1996. After those events, the Ministry appears to have continued collecting information on the insurer, but never gave strong instructions to the company because the insurer didn't have much influence compared to other failed companies.

Meanwhile, Daiwa Bank played an important role for the insurer. Of the former Nomura group firms, Daiwa Bank was the closest partner of the company as several head office staffers at that time say, "Tokyo Life wouldn't have existed without Daiwa Bank"…. "Our business deeply depended on Daiwa Bank." While Nomura Securities kept a certain distance from the insurer, Daiwa Bank maintained a close bond in sales activities, referring employees of its corporate customers and businesses seeking group insurance or corporate pension products to the insurer. The bank also often referred asset management deals to the company.

Amid worsening business conditions, “the relationship between the two parties had been strengthened further since Nakamura became president (in 1994). There appeared to be a common understanding among employees that ‘Tokyo Life could only exist with Daiwa Bank,’” says a head office staffer at that time. Daiwa Bank contributed to the insurer’s fund and provided subordinated loans in 1997 and 2000. Funds provided by the bank up to the insurer’s bankruptcy reached a total of ¥32 billion. Meanwhile, Tokyo Life was also a major shareholder of Daiwa Bank and offered subordinated loans, thereby strengthening a cross-shareholding relationship with the bank.

Moreover, “Daiwa Bank had increased its support since it realized the financial crisis of Tokyo Life through the business results announcement for fiscal 1999. Not only did the bank expand its sales support to the insurer via increased customer referral, but it also joined the company’s ‘business strategy meeting,’ together drew up a turnaround plan, and discussed a possible tie-up with external parties, seeking a way to rebuild the company’s business,” according to a head office staffer at that time.

Their close relationship was also reported by the media as follows: “Daiwa Bank has referred a total of roughly 1,000 corporate customers to the insurer since last spring (in 2000), and as a result, Tokyo Life has successfully executed insurance contracts with about 200 companies. The bank was just afraid of bringing trouble to the corporate customers it referred to the insurer and therefore couldn’t abandon the ailing company. There was also a strong feeling within the bank that ‘financial institutions affiliated with the former Nomura group had to support each other’” (“Nihon Keizai Shimbun” dated March 24, 2001).

8. Role played by internal factors in the management of failed life insurers

Looking at the failures of six midsize life insurance companies, we see that they had a number of common internal factors that increased their bankruptcy risk, although direct causes leading to their collapse varied.

First of all, their expansion strategy that started in the late 1980s resulted not just from better external environments or growing popularity of financial engineering products; that was largely attributed to the traditional business model they had built up or the process they had gotten through until then. Nissan Mutual Life was largely dependent on corporate groups close to it and its earnings were slow to grow for a long period. Toho

Mutual Life was desperate to eliminate expense losses and realize dividends on par with the levels of major insurers. At Chiyoda Mutual Life, the top management and those assuming managerial posts were eager to "make a comeback as a major player" and "expand their business scale" as the company experienced a downfall from being a leading life insurer.

Most of all, the decisions and actions of top officials largely contributed to their companies' failures. The pattern of each bankruptcy case differed. At Toho Mutual Life and Chiyoda Mutual Life, top executives and people surrounding them implemented inappropriate management practices. In the case of Daihyaku Mutual Life, the leadership of the top management was weak, while at Kyoei Life, "the management was left blank" following the effective retirement of its top official.

These management-related problems became more visible after the companies' business conditions worsened. For example, concerned parties say, "The management couldn't change the traditional expansion strategy even after the company's business conditions worsened".... "Top officials failed to sell the company's strategically-held shares, although we decided to do so".... "The management considered the company's negative spread as a temporary condition and didn't take a specific measure to address it." These insurers' management just resorted to makeshift measures, thereby exacerbating their business conditions further. They also often gambled on asset investment, aiming for a dramatic reversal to get through their business results announcement.

The management of these insurers was subject to very little internal and external checking, and their risk management system barely functioned. The sales department generally held a strong voice within their companies. Although actuaries and people in the financial affairs department raised an alarm, they were hardly able to impress top officials because the management was close to the sales people. Even at a company implementing a certain risk management structure, the risk control function was rendered ineffective on the back of the significant influence of top officials. External discipline barely functioned at these insurers, whether they were mutual or stock companies.

When conducting research, I paid great attention to actions taken by actuaries, who are responsible for actuarial matters, because the life insurance business can only be carried out with their work. The influence of actuaries varied according to the company. Some companies like Chiyoda Mutual Life didn’t place much value on actuaries’ work, while others, including Daihyaku Mutual Life, valued them in running their business. At Kyoei Life, actuaries played an important role. The power of Daihyaku Mutual Life’s actuaries was not strong enough to change the decisions of its management, and Kyoei Life’s actuaries didn’t share its information with the management, thereby failing to keep the company afloat.

The Ministry of Finance at that time had great power in terms of its management checking function, allowing the top officials of these insurers to harbor the illusion that “the Ministry would eventually help us.” In reality, however, the Ministry hardly intervened in the businesses of struggling life insurers, which suggests that it didn’t have enough leadership to prevent the insurers from going under.

Chapter 3
Sorting out cause-and-effect relationships in business failures

1. Sorting out internal factors in failure

When we examined case studies of the six failed midsize life insurance firms in detail in Chapter 2, we found that, although the impact of external factors such as sudden change in the financial markets and the deterioration of the business environment could not be ignored, internal factors specific to each failed firm such as its business model, managers, and management structure had significance as factors leading to corporate failure.

We are now taking a closer look at factors that led to the failure of midsize insurers in the Heisei-era financial crisis. We will first extract internal factors inherent in each company that increased the risk of failure and categorize these internal factors. Based on our analysis made so far, we will next present the relationship between external factors and internal factors by way of specific examples.

(1) Sorting out internal factors

To better understand the failure of life insurers due to their own problems, we extracted internal factors inherent in each failed firm that led to its failure, and categorized them.

Specifically, we took the following steps. First, we extracted nearly 400 business-related events that the author judged to be internal factors, which increased the risk of failure, from oral history obtained from concerned parties of failed life insurers. Next we tried to find features common to these events. After repeatedly studying them, we classified the events into 19 subcategories, which we put into three categories. We will now explain each category.

Category 1 covers internal factors related to the business model. It includes six subcategories: “role played by historical background,” “impact of past experience,” “problem of corporate culture,” “founding family’s influence,” “problems of management strategy/business model adopted,” and “other structural problems.” “Problems of management strategy/business model adopted” may have been put into Category 2 (internal factors related to managers), described later. Considering that not all such problems arose from specific managers or their managerial behavior during a specific period, however, they were put into Category 1. Nearly half of the events in

Category 1 fell into this subcategory. Examples of events put in each subcategory are given below.

Examples

"Role played by historical background"

- The company was originally weak in sales, so it had to give favorable treatment to those who had worked as the sales staff.
- The company was founded after World War II, so the book value of shares it held was higher than that of larger insurers.
- The company was once a large-sized insurer, so it had the heavy burden of paying special dividends on contracts concluded in the past.

"Impact of past experience"

- The company began to wane after World War II.
- When the company was falling into difficulties in the past, its actuary failed to deal with the Ministry of Finance properly and lost the confidence of the management.
- The company initially specialized in conscription insurance and had a weak customer base in urban areas. It gradually lost its business base as the population flowed increasingly into urban areas.

"Problem of corporate culture"

- The corporate culture was such that employees were not supposed to question what their superiors said or did.
- Employees were so accustomed to the founder making decisions on everything that no one suspected something was wrong with this corporate culture.
- The corporate culture was such that once the company began to move in a certain direction, there was no way to stop it.

"Founding family's influence"

- Every decision was made with the founding family in mind. The management was incapable of making bold decisions such as to "discontinue sales of savings insurance" or "sell bank shares."
- The company was owned by a certain family, so everyone knew that Mr. A from that family would be the president in the future.

"Problems of management strategy/business model adopted"

- President B adopted "regaining a leading position in the industry" as a slogan and switched from conservative management to aggressive management.
- The company with a weak sales force tried to regain lost ground by quick means.
- The company was anxious to keep up with others and paid as high a dividend as larger insurers in the hope of becoming "mini-Nissay" or a miniature version of Nippon Life, the largest life insurer in Japan.

- (The company tried to shift from savings-type products to security-type products but) the number of small-lot contracts increased, with a small expense loading of premium. Eliminating the expense loss was a constant challenge.

"Other structural problems"
- Saving insurance has maturity (so that policyholders are expected to renew contracts upon maturity), which means they did not need to call on new potential customers as long as the company's sales staff had a number of "customer registration cards."
- Midsize life insurers had no loan customers, so they had to use their money mostly for investment in stocks and other securities.
- The company was unable to emerge from dependence on latent stock profits.

Category 2 covers factors related to managers. About 60% of all the events were in this category, which has eight subcategories: "top executive's competency problem," "top executive's influence," "inappropriate behavior of those around the top executive," "lack of checking functions within the management," "lack of management awareness," "weak management," "slow or inadequate recognition of the situation," and "error in business judgment." Events in Category 2, unlike those in Category 1, were not concentrated in particular subcategories.

Examples
"Top executive's competency problem"
- The top executive had the power to shuffle personnel. Someone's position in the company was determined by whether he was favored by the top executive.
- President C failed to see that someone had a questionable character.
- The top executive told others to "do something about it" but did not take the initiative.
- The top executive mixed up the company's money with his own money.

"Top executive's influence"
- The president had absolute power and those who lost favor with him could not stay with the company.
- Every president of the company was picked by Chairman D.
- Only someone like the president's henchman had a chance to survive as a board member.

"Inappropriate behavior of those around the top executive"
- It was not that the autocratic president went to extremes, but it was rather that no one had control over the behavior of those around President E.
- The actuary close to the top executive was very secretive and exercised control in

such a way that the real situation was visible only to some of the board members.

- Whatever an executive in charge of investment (who was close to the top executive) did, there was no way to remove him. As a result, he hardly made any distinction between his professional duty and his personal matters.

"Lack of checking functions within the management"

- Members of the board of managing directors did not know much about financial matters, so they acquiesced to what the officer in charge of finance told them.
- The board had the same members for such a long time that they felt like a group of good friends and were too relaxed about business matters.
- When President F said OK, the decision-making rule was meaningless.

"Lack of management awareness"

- The management had no strong determination to exercise its authority.
- The founder made calculations and made decisions on everything. Those around him were accustomed to this cultural climate.
- The management lacked the idea of "discontinuing something that should be discontinued.".

"Weak management"

- Decisions made by the board of managing directors were rejected by salespeople who said "they are unacceptable unless the customer's approval is obtained."
- The members of the board did not become one to the end.
- The managers said the right thing but failed to accomplish anything.

"Slow or inadequate recognition of the situation"

- Hearing the news about Nissan Mutual Life's failure, the company's people felt as if "that's what happened to Nissan (and has nothing to do with us)."
- Most members of the board believed until the end that "(the stock average) will surpass 20,000" or "a divine wind will blow."
- It was not until 1999 that the management questioned whether expanding business was the right thing to do.

"Error in business judgment"

- The president made an error in choosing the right person (for a particular executive job).
- The company tried to sell everything from variable insurance to group survivor's insurance that larger insurers handled.
- The company raised the assumed interest rate for single-premium endowment insurance from 3.75% to the industry-wide level of 5.5% at once.
- Even after premium loan contracts started decreasing, the company rushed to invest in high-risk investment products in a bid to increase total assets.

Category 3 covers events related to management structure and has five subcategories: “problems of communication functions,” “inadequate checking functions within the organization,” “poor risk management system,” “sales division’s strong voice,” and “lack of interdivisional cooperation.” “Inadequate checking functions within the organization” and “poor risk management system” account for two thirds of events in Category 3.

Examples

“Problems of communication functions”

- Only information such as “things are all right because _____” reached top management.
- Financial statements showed pretty good figures, but the company did something to make the three types of profit bigger than they really were.
- The results of cash flow tests around 1992 were not reported to the board of managing directors at its meetings.

“Inadequate checking functions within the organization”

- Mr. G was in charge of both financial planning and financial examination.
- Actuaries were treated simply as human calculators.
- About 60% of policyholders’ representatives were people from the Hitachi Nissan group, which was affiliated with Nissan Mutual Life.

“Poor risk management system”

- Various systems were built on the assumption that “human nature was good,” so they had loopholes which were taken advantage of on many occasions.
- Capital gains had become like income gains in the course of the dividend race. As a result, the management became blind to what was really a profit
- The management was concerned only about the stock prices and was not aware that the assumed interest rate equaled the debt cost.

“Sales division’s strong voice”

- (The planning division) tried to reduce strategically held shares but failed to do so because it met the opposition of the corporate sales division.
- As the sales division gained power, it became difficult to change the direction of the company.
- The corporate (sales) division set up a special section to get contracts from banks despite the opposition of actuaries, but the management gave its approval.

“Lack of interdivisional cooperation”

- The finance division made no attempt to accurately grasp the debt situation (of which the actuarial division was in charge). The actuarial division made no attempt to get the financial details.

- There was an unwritten rule that the finance division and the operations division should not interfere with each other. The finance division simply invested money collected by other divisions.
- The actuarial division and the finance division learned each other's findings and simply used them.

(2) Consideration on results of categorization

The internal factors we extracted as ones leading to corporate failure were not divided equally into Categories 1, 2, and 3. Category 2 (factors concerning managers) accounted for about 60% of all the events extracted. Category 2, together with Category 1's subcategory "problems of management strategy/business model adopted," accounted for about 70% of all. Category 1 (factors concerning the business model), and Category 3 (factors concerning management structure) accounted for 20% each.

The internal factors were extracted from witness accounts of concerned parties who voluntarily agreed to give an interview in this survey. They were selected on the author's judgment, so the data would not stand up to a statistical analysis. Even discounting this, it is obvious from the results of categorization that managers played a major role in causing the failure of their company. Interestingly, a breakdown of factors in Category 2 varied from one company to another.

Nissan Mutual Life

"Top executive's competency problem," "slow or inadequate recognition of the situation," and "error in business judgment" accounted for 80% of Category 2.

Toho Mutual Life

"Top executive's competency problem" was the largest subcategory accounting for 40% of Category 2. This was followed by "error in business judgment," "inappropriate behavior of those around the top executive," "top executive's influence," and "slow or inadequate recognition of the situation," in this order.

Daihyaku Mutual Life

"Weak management" was the largest subcategory accounting for over 40% of Category 2. This, together with "slow or inadequate recognition of the situation," accounted for over 70%. There were no internal factors categorized into "top executive's competency problem," "inappropriate behavior of those around the top executive" and "lack of checking functions within the management."

Chiyoda Mutual Life

"Inappropriate behavior of those around the top executive" was the largest subcategory accounting for 30% of Category 2. This was followed by "slow or inadequate recognition of the situation," and "top executive's competency problem." These three subcategories accounted for 70% of Category 2. This company had many factors under the subcategory of "problems of management strategy/business model adopted" of Category 1.

Kyoei Life

The three subcategories with the largest number of internal factors were "inappropriate behavior of those around the top executive," "error in business judgment," and "weak management." Other large subcategories were "lack of management awareness" and "slow or inadequate recognition of the situation." More than 80% of internal factors extracted at Kyoei Life were in Category 2.

Tokyo Life

Unlike in the case of Kyoei Life, only a little over 40% of all internal factors at Tokyo Life were in Category 2. All these internal factors in Category 2 were concentrated in three subcategories: "slow or inadequate recognition of the situation," "error in business judgment," and "weak management" with no other subcategories in Category 2. In Category 1, there were many factors in the subcategory of "problems of management strategy/business model adopted."

When we speak of internal factors concerning managers, the idea of the top executive going to extremes may come to mind. At Daihyaku Mutual Life and Tokyo Life, there were no internal factors put into the subcategory of "top executive's competency problem," but many factors put in the subcategories of "weak management" and "slow or inadequate recognition of the situation." It seems that the weak presence of the top management led to the corporate failure.

At Nissan Mutual Life, Toho Mutual Life, and Chiyoda Mutual Life, there were many factors in the subcategory of "top executive's competency problem." At Toho Mutual Life and Chiyoda Mutual Life, there were many factors also in the subcategory of "inappropriate behavior of those around the top executive." This suggests that the business crisis was not triggered by the errant top executive alone. When we speak of the top executive's competency problem at Nissan Mutual Life, the problem was that the top executive did nothing (when something had to be done) rather than that he did something wrong. This is somewhat different from the cases of Toho Mutual Life and Chiyoda Mutual Life. Many companies had a large number of internal factors in the subcategories of "slow or inadequate recognition of the situation" and "error in business judgment."

2. Undoing the chain of internal factors and external factors

As seen so far, all failed midsize life insurance firms, without exception, had something we may call internal factors that increased the risk of failure. Each firm had not a single factor but a number of internal factors. These internal factors, combined with external factors such as a change in the business environment, gave rise to premonitory signs of a crisis such as the deteriorating financial structure going forward.

If the firm noticed such signs at this stage and took appropriate action, it may have managed to avert a crisis. As it was, some internal factor was at work again, and the firm either continues to be unable to take appropriate action or takes inappropriate action. Then the business environment changed further (which was an external factor at work). In this way, the internal factors and external factors came one after the other, eventually driving the firm into bankruptcy.

Based on the results of categorization as explained earlier, we will give specific instances to show how internal factors and external factors came into the picture and played their parts at a major turning point of each failed midsize life insurer. (I, II and III refer to Categories 1, 2 and 3, respectively.)

(1) Launch of annuity insurance loan (Nissan Mutual Life, 1986)

External factors

- High assumed interest rate
- Change in the financial structure (financial surplus at large corporations, zaitech high-risk investment boom, etc.)
- The Ministry of Finance authorized insurers to sell products jointly with financial institutions.

Internal factors

- The company was historically heavily dependent on an affiliated corporate group and had difficulty increasing the total amount of policies in force. The persistency ratio and the turnover of sales employees were not good, either. (I. Historical background, past experience)

- The management tried to turn aggressive shortly before the 80th anniversary. (I. Management strategy)

⑵ Rapid expansion of high-cost funds and overconcentration on specific products (Nissan Mutual Life, 2nd half of the 1980s)

External factors

- Rise in the prices of assets during the bubble period
- Scale expansion race among midsize life insurers
- Financial institutions' aggressive sales stance (financial institutions benefited greatly by teaming up with insurers)
- Regulatory authorities' stance (They hardly saw the liability side.)

Internal factors

- Inhouse discussion was held a number of times and the actuary gave an informal warning to the management. All this did not keep the sales division from going aggressive. The warning fell on the deaf ears of the management. The president was informed only of such matters as "things are all right because ______." (II. Error in judgment, III. Sales division's influence)
- The company showed good performance in terms of three types of profit, but there was a gap between the reported figures and the actual business situation. (III. Communication functions)
- Financial institutions took the initiative in sales. Sales went out of the control of the insurer. (II. Weak management)
- The management, the actuarial division, and the finance division were barely aware of the interest rate risk (ALM risk). (III. Risk management)
- The Ministry of Finance requested the life insurance industry to "refrain from forming tie-ups to sell zaitech products like premium loans whose purpose is not what insurance is supposed to serve," but this had little effect. (III. Checking functions)

⑶ Leaning toward asset-based products (Toho Mutual Life, 2nd half of the 1980s)

External factors

- Rise in the prices of assets during the bubble period
- Scale expansion race among midsize life insurers

- Regulatory authorities' stance (They hardly saw the liabilities side.)

Internal factors

- The company started business as a conscription insurance firm before World War II and was not strong in sales of security-type products in urban areas. It had no corporate affiliates, so it had difficulty approaching and winning contracts from company employees at the place where they worked. The company set up the development business division but gradually inclined toward savings-type products for which it was easier to cultivate a market. (I. Historical background, past experience)
- The company sold high-yield mutual-aid annuity, single-premium endowment insurance, bank-affiliated loans (individual annuity insurance), and a kind of so-called zaitech insurance named "health annuity," emphasizing the attractive yields of all these products. The company offered high-yield products like those on the premise of selling assets to generate unrealized profits. (II. Error in judgment)
- The company's long-cherished desire was to expand its asset size, eliminate the expense loss and pay as high a dividend as larger insurers. To eliminate the expense loss, the company leaned toward single-premium products with a high expense loading of premium. (II. Error in judgment)

(4) Inappropriate behavior of the top executive and those around him increased the management risk (Toho Mutual Life, 2nd half of the 1980s)

External factors

- Mutual company system (lack of checking functions)

Internal factors

- Every president of the company was picked from the founding family. Mr. A from that family was supposed, from the time of joining the company, to become president in the future. President A removed one competent person after another and surrounded himself with yes-men. Only someone like Mr. A's henchman had a chance to become a board member. It was not exactly that Mr. A was autocratic. It was just that everyone around him stopped speaking up to him. (II. Top executive's competency)
- The top executive became involved in a corporate scandal and an economic scandal. He tapped into Toho Mutual Life's funds to pay off the debt of his relative's company. He mixed up business with his personal affairs. (II. Top executive's competency)
- Those around the president exalted him and did as they pleased. President A

dabbled in speculative stocks and became associated with a questionable character. The person who led the president to do these things drew money from Toho Mutual Life and used it for questionable investments and loans. (II. Behavior of those around the top executive)

- A board member in charge of investment gained President A's trust and took control of the finance division, so much so that he was called the "emperor." He blatantly mixed business with his personal affairs. He was presumably involved in President A's investments and loans. Whatever he did, there was no way to get rid of him. (II. Behavior of those around the top executive)
- Internal controls and risk management were not functioning. If the president said OK, the question of who had decision-making authority was meaningless. (III. Checking functions)

(5) Failure to shed the low-earnings structure (Daihyaku Mutual Life)

External factors

- Convoy-like protective administration (The company was able to keep itself afloat even if its profit was small.)

Internal factors

- The company's main product was saving insurance whose profitability was low. The company switched to a two-pronged policy of balancing savings (-type products) with life (security-type products), but the sales force had difficulty switching to sales of security-type products. The company continued to suffer an expense loss with only a small mortality profit. This was an unsound earnings structure. (I. Historical background and structural problems)
- The management came up with one plan after another, but there was no mechanism for examining and modifying such plans. Even if they failed to achieve the goals set out in the plans, they were not called to account. (II. Weak management)
- The company was affiliated with the Kawasaki family and its staff included members of this family. In this situation, the management dared not make bold decisions such as to "discontinue sales of saving insurance" or "sell bank shares." (I. Founding family's influence)

(6) High-risk investments and loans by those close to the president (Chiyoda Mutual Life, 1988-1990)

External factors

- Rise in the prices of assets during the bubble period
- Change in the financial structure (financial surplus at large corporations, zaitech high-risk investment boom, etc.)

Internal factors

- In the second half of the 1980s the company sold high-yield and high-dividend savings-type products in large volumes, putting pressure on the finance division to generate high returns.
- The president picked his right-hand man who had no financial experience and put him in charge of finance, and tried to get the finance division to earn profits in the same way as the sales division would. (II. Top executive's competency, error in judgment)
- The top executive saw the finance division as too conservative and tried to cultivate a new field. He was self-confident and thought he was not a man to be deceived. (II. Behavior of those around the top executive)
- The finance division's employees who expressed their opinion to Mr. B were transferred to a lower post or removed from their current positions. The president was behind all of this personnel shuffling. After several people who opposed Mr. B's policy were removed, no one dared to speak up. (II. Behavior of those around the top executive)
- Mr. B was responsible for both examining and implementing investment plans. Loopholes in the decision-making rules were created over time. To lessen criticism, the number of those who attended an investment policy meeting was gradually reduced. The rules changed further so that anyone who had an investment plan was supposed to take it directly to Mr. B. (III. Checking functions)

(7) Launch of single-premium endowment insurance (Kyoei Life, 1987)

External factors

- Rise in the prices of assets during the bubble period
- Change in the financial structure (financial surplus at large corporations, zaitech high-risk investment boom, etc.)
- Other companies were aggressively selling the product (so the sales people wanted to handle it).
- Scale expansion race among midsize life insurers

Internal factors

- While the scale expansion race was intensifying in the life insurance industry, Mr. C thought that "we need more assets to become a big company." (II. Error in judgment)
- By the second half of the 1980s, Mr. C (born in 1908) had become old and lost his youthful energy. Still, he was the only person who made important business

decisions. (II. Lack of management awareness)

(8) Delay in discontinuing sale of single-premium endowment insurance (Kyoei Life, 1st half of the 1990s)

External factors

- Scale expansion race among midsize life insurers

Internal factors

- The cash flow test showed that the situation was very serious, but the management thought that the external environment would change in 10 years' time, so it did not take drastic measures such as suspending sales. (II. Slow or inadequate recognition)
- There was no way to put a brake on the sale of the product in the face of opposition from the executive in charge of sales. As the sales force leaned toward savings-type products, their power to sell began to wane. (II. Error in judgment)
- There was a managerial vacuum. Mr. C thought he had retired from active duty in 1992. When asked for advice, he merely expressed his feelings. Board members interpreted his words in a way that was convenient for them, and went ahead with their plans, thinking that, "this must be what the chairman would have liked to do." (II. Behavior of those around the top executive)
- The actuary close to the top executive did not correctly report the actual situation to the management. He was very secretive and exercised control in such a way that the reality was visible only to certain members of the management. (II. Behavior of those around the top executive)

(9) Inappropriate measures to prepare for book closing made things worse (Nissan Mutual Life, 1st half of the 1990s)

External factors

- Fall in the prices of assets upon the collapse of the bubble (which led to the depletion of latent stock profits)
- Decline in interest rate levels (which led to a negative spread)

Internal factors

- Even after the company fell into difficulties, the president did not take the leadership to reconstruct business. He just told others to "do something about it" but made no moves on his own initiative. He saw the company's problem as a disaster befalling him. (II. Top executive's competency)
- The company started cost-cutting efforts in fiscal 1992 at the urging of the Ministry of Finance, but this did not lead to drastic layoffs because of the expectation that an

affiliated corporate group would come to its rescue in the end (II. Slow or inadequate recognition)

- The finance division concerned itself only with asset management and made no attempt to accurately grasp the debt situation (of which the actuarial division was in charge). The actuarial division made no attempt to learn how the finance division managed assets and what results it obtained. (III. Lack of interdivisional cooperation)

(10) Inappropriate steps taken by the management (Daihyaku Mutual Life, 1990-2000)

External factors

- Fall in the prices of assets upon the collapse of the bubble (which led to the depletion of latent stock profits)
- Decline in interest rate levels (which led to a negative spread)
- Revision of the Insurance Business Law (to introduce solvency margin standards)
- Failure of Nissan Mutual Life and major financial institutions

Internal factors

- The company tried to sell cross-held shares and decided "how much to sell in total" at a meeting of the board of managing directors. As it turned out, few such shares were sold because "we cannot get the other party's approval so we cannot sell shares," as the sales division put it. (II. Weak management)
- The budget division presented the management with the results of cash flow tests indicating that "the company will not stay afloat according to several scenarios" and that "the company has a 20-30% chance of going under," but half of members of the management did not take the matter seriously. (II. Slow or inadequate recognition)
- (Shortly after concluding a tie-up with Manulife) the company incurred a loss of several tens of billion yen from hedging high-risk foreign bond transactions. A subordinated loan the company obtained from Westdeutsche Landesbank was not recognized as such by the authorities. (II. Error in judgment)

(11) Inappropriate steps taken by the management (Kyoei Life, 1990-2000)

External Factors

- Same as (10) for Daihyaku Mutual Life

Internal factors

- Upon falling into the red with a current loss, the company reduced the investment risk. It became unable to pay high guaranteed returns and had to take risks again.

The company was trapped in a vicious cycle. As a result of rushing to invest in stocks and foreign securities, the company ran up a huge investment loss for every term and was sapped of its strength. (II. Error in judgment)

- Most of the directors and advisors (who were previously directors) were still unaware that the company was in a crisis. Members of the management split into those who pushed for a tie-up and those who insisted on reconstruction without outside help. The two sides failed to become one to the end. Those in favor of reconstruction without outside help said until the end that “the stock average will exceed 20,000” or “a divine wind will blow.” (II. Weak management, slow or inadequate recognition)
- The solvency margin ratio was calculated and a cash flow test was conducted according to five different scenarios, but only optimistic results were reported to the board of directors. (II. Behavior of those around the top executive)

(12) Inappropriate steps taken by the management (Tokyo Life, 1990-2000)

External factors

- Same as (10) for Daihyaku Mutual Life

Internal factors

- As “policy loan” contracts decreased sharply, the company strived to boost sales of group annuity with a high rate of return, for which contracts kept on increasing at a fast pace until fiscal 1993. However, it had become obvious by 1991 that the interest rate level was trending downward. In fiscal 1992 a negative spread came to the surface. (II. Error in judgment)
- Upon falling into the red with a current loss, the company drew up a profit improvement plan consisting of such measures as cutting operating costs, closing unprofitable offices and reducing the weighting of stocks. The scenario of the plan was based on the assumption that the total amount of policies in force would go on increasing. The managers/management lacked a sense of crisis management. The company was slow to reduce its shareholdings because the management was concerned that doing so might undermine business expansion efforts. It was not until 1999 that the question arose whether it was desirable for the company to maintain its expansionary policy. (II. Slow or inadequate recognition)
- The finance division and the budget division called for sales of strategically held shares, but the sales division objected. The management forestalled sales. (III. Sales division’s influence)

Chapter 4
What was the crucial difference?—The difference in the life insurers that survived

1. How were life insurers that survived managed?

We have explored internal factors leading to the failure of midsize life insurance companies in the time of the Heisei financial crisis, including factors that drove them into a management crisis, actions taken under crisis situations, internal and external checking of management, and risk control structures. Our examinations reveal that at failed insurers, the top management played an important role and that the business models those companies had built until their business turned sour or their past experiences more or less contributed to their failure. It was also revealed that the management of these insurers was subject to very little internal and external checking.

What about life insurers that managed to escape from bankruptcy around the same time, then? Didn't they have any of these internal factors that increased the risk of failure, or did they have only a few such factors?

(1) Managerial reform of Asahi Mutual Life

Asahi Mutual Life Insurance Co., which used to be one of the major life insurance companies, was severely hit by the impact of falling stock prices, growing concerns about the financial system, and a series of bankruptcies of midsize life insurers in around 2001. The failure to reach a final agreement in merger negotiations with former Tokio Marine and Fire Insurance Co. also accelerated customer churn, driving the company into a management crisis. The value of individual insurance policies in force fell to ¥65 trillion at the end of fiscal 2002 from 77 trillion at the end of fiscal 2000 in just a two-year period. The total assets plunged to ¥6.6 trillion from ¥11 trillion. The company's credit rating dropped to the B zone (in a rating by Rating and Investment Information), or the level suggesting that "the insurer's ability to meet insurance claims is questionable" and that "some factors require constant attention."

To deal with these problems, Asahi Mutual Life launched large-scale management reform projects named "Project R" and "Success A." It conducted restructuring measures such as reducing shareholding risk, cutting personnel expenses, and withdrawing from the corporate insurance field. Moreover, the company departed from major life insurers' traditional business model—designed to seek an increase in new contracts through expansion of the number of sales personnel. It set out unconventional measures to drastically change its earnings structure such as "shifting from benefit-based insurance management (emphasizing death coverage products) to premium-based insurance management (emphasizing the third sector insurance market)," "placing emphasis on maintaining policies in force rather than on acquiring new contracts," and "tightening the hiring process for sales positions and carefully training sales personnel." Nevertheless, the harsh conditions didn't improve for a while, forcing the insurer to cancel interest payments to providers of the company's foundation fund and suspend dividend payments to policyholders. The insurer has gotten over the crisis, thanks largely to a stock market upswing that began in 2003, and its downgraded credit standing has been on a recovery track.

⑵ Effectiveness of loose tie-up

In around 2001, Mitsui Life Insurance Co. also saw its financial condition deteriorate amid growing uneasiness of policyholders following a series of bankruptcies of midsize life insurers. The company tried to overcome the rough times by fully announcing strengthened partnership with close financial institutions. In autumn in 2001, the company released its decision to form a "comprehensive alliance" with Sumitomo Mitsui Banking Corp. (SMBC), Sumitomo Life Insurance Co., and Mitsui Sumitomo Insurance Co.(Note from translator: Mitsui Sumitomo Insurance Co. is a non-life insurer), while revealing its plans to procure funds from SMBC to bolster its foundation fund and convert to a stock company (it was demutualized in April, 2004). The alliance of these four companies was a "loose business tie-up" rather than a "comprehensive alliance," but concerns about the credibility of the insurer were eased later.

Why did Asahi Mutual Life and Mitsui Life fall into a management crisis and pull out of the crisis? Unlike many failed life insurers, the two companies were able to make up for their negative spread with other profit sources (in other words, they posted a basic profit for every period), and a stock market recovery from 2003 largely helped the companies turn themselves around. However, these were probably just part of the factors contributing to the business recovery of the two insurers, and moves taken within the companies are considered to have been largely related to the recovery.

For example, the failure to reach an agreement with Tokio Marine and Fire Insurance on business integration and the launch of reform projects in 2003 to depart from major insurers' business model are believed to have become a turning point for Asahi Mutual Life, and some internal factors probably played an important role at each of these phases. "Merely reducing costs by cutting jobs was not enough for us (to survive in the changing life insurance market). We had to bolster our earnings power by shifting to a business model designed to cope with new environments," then-President Yuzuru Fujita said in an interview with an economic magazine (the Nikkei Business dated December 15, 2003).

In reality, however, it is extremely difficult to explore the internal factors of existing companies. There is a limit on looking for internal factors from officially released materials, and such factors are closely related to confidential information within the company. I therefore have to give up making further analysis on these companies this time, but hope that related parties will give us an overview on the management crisis of life insurers and ways to pull out of such crises in the medium term.

2. Midsize life insurers that did not fail

Taiyo Life Insurance Co., Daido Life Insurance Co., and Fukoku Mutual Life Insurance Co., although being midsize life insurers, did not face a major managerial crisis, and their credit ratings stayed in the A zone or better (in the rating by Rating and Investment Information) even when credit concern spread to some major life insurers as well. It's very interesting to know how the internal management of the three companies differed from that of failed midsize life insurers.

Fortunately, officials of the three companies have cooperated with my research. Therefore, I will look at the inside of these midsize life insurers as much as possible to examine the roles played by the internal factors of these companies and highlight the differences between the three companies and failed life insurers.

(1) Taiyo Life Insurance

Taiyo Life mainly serves the household market in big cities and major regional cities, and many of its customers are middle-aged and elderly people as well as housewives (males account for a larger percent of customers for the life insurance industry as a whole). For example, 76% of the company's new contracts for individual insurance and individual annuity insurance came from female policyholders in fiscal 2001. While major life insurers mainly sold large-scale death coverage products in the market serving employees of major companies, Taiyo Life offered special endowment insurance chiefly via house calls and secured its customer basis by taking thorough retail strategies. Like other companies, its sales channel was sales personnel, but sales people worked in pairs, marketing short-term savings products (the insurer's mainstay products have recently been shifted to middle-sized death coverage insurance as well as medical and nursing care products).

Taiyo Life, whose mainstay products were savings policies, had a lower profitability than major insurers. Because it also focused on individual annuity insurance in the mid-1980s, the company ended up struggling with a huge negative spread in the 1990s amid falling interest rates. Moreover, the prices of major bank shares held by the company dropped in around 2002 and 2003, weighing heavily on the insurer's earnings as well.

However, Taiyo Life never fell into a management crisis even under such severe business conditions because (i) its earnings were propped up by profits coming from the morbidity margin for "*Kenko Himawari*," a ten-year special endowment insurance product, (ii) its unique investment style helped reduce the impact of the bubble bursting and (iii) the company had built financial buffers as represented by an "unallocated portion of reserves for policyholders' dividends." I would like to also point out that (iv) Mr. A, a manager having wielded the real power over a long period of time, played an important role.

In January 1999, a year and half after Mr. A died, Taiyo Life announced its plan to form a comprehensive alliance with Daido Life, revealing the management's decision to seek business integration with the company in future. The announcement came just before many midsize life insurers went under and therefore can be considered to have helped the insurer escape credit worries.

(i) Profits coming from lower-than-expected disease rates for "*Kenko Himawari*"

Until the mid-1990s, Taiyo Life had basically marketed monthly-premium special endowment insurance "*Himawari Hoken*" (five-year term) and "*Kenko Himawari Hoken*" (ten-year term) via house calls by female sales employees.

Endowment insurance pays death benefits or maturity benefits and has a strong nature of savings. However, "*Kenko Himawari Hoken*" launched by Taiyo Life in 1974 provided hospital confinement indemnity and surgical coverage, which enabled the insurer to earn profits from lower-than-expected disease rates. This is similar to the earnings structure of postal life insurance, which has been supported by mortality profits generated from hospital confinement riders. "We focused on marketing of "*Kenko Himawari*" in around

1980. The product helped boost our earnings by generating profit from lower-than-expected disease rates," says a concerned party.

(ii) Unique investment style

Stocks and real estate accounted for only small percentages in assets held by Taiyo Insurance, and most of the assets were denominated in yen. The company's weight of stocks (to total assets) was around 15%, while the industry's average was around 25%. The relatively low weight of stocks in the company's portfolio was largely attributed to the following facts. First of all, Taiyo Life had no need to hold corporate stocks for sales purposes because it mainly targeted the household market. Faced with the heavy burden of paying interest dividends to policyholders of savings products, the company also shied away from investing in low return stocks. Moreover, the company was not required to pay special dividends, using latent stock profits, as its mainstay products were short-term policies.

Unlike other companies, Taiyo Life didn't extend loans for the purpose of boosting its insurance sales either. It adopted the policy of "lending a large amount of funds to a good company," according to a concerned party, and didn't turn to real estate collateral. The insurer's borrowers were mostly large corporations. Although some of them, including the group firms of Nippon Shinpan Co., struggled with deteriorating earnings later, the bubble burst had a relatively small impact on the businesses of Taiyo Life.

Taiyo Life suffered a huge loss from the collapse of major U.S. securities holding company Drexel Burnham Lambert Group Inc. in 1990, which prompted the insurer to strengthen its control of investment risk. It decided not to resort to a "dividend capture" strategy (an investment method designed solely to pocket dividend income in the short run) and investment in structured bonds that failed midsize insurers often turned to and liquidated all related investment vehicles at loss in 1991.

(iii) Accumulation of financial buffers

Until the mid-1990s, life insurers had been asked to reward their policyholders with dividend payouts rather than to accumulate internal reserves. However, Taiyo Life ended up accumulating large internal reserves, and they were largely made up of the "unallocated amount of reserves for policyholders' dividends." Even though the company maintained the highest level of dividend payouts in the industry, ample reserves for policyholders' dividends still remained because the company's asset portfolio tended to generate higher returns than other companies' portfolios did.

Taiyo Life pursued unique business strategies, and therefore its product line-up was different from those of other insurers. As a result, the company didn't get involved in the dividend competition waged in the late-1980s (competition over the levels of special dividends and dividends for group annuities), which largely contributed to the insurer's success in building up its reserves for dividends to policyholders. "Taiyo Life was the only midsize company whose premium rates were unknown," an actuary of another midsize life insurer revealed.

(iv) Role played by Manager A

Mr. A is the "leading figure who had rebuilt Taiyo Life." He had served as president for 16 years starting in 1962 and continued holding substantial power as chairman and honorary chairman until he died at the age of 96 in 1997.

Recruited by the Nishiwaki family after the World War II, "Mr. A joined the insurer on the verge of collapse, becoming the largest contributor to turning it into a midsize insurer" (according to the Nikkei Business dated June 3, 1991). With trial and error, he managed to develop special endowment insurance policies and adopted a sales method requiring sales people to work in pairs, thereby creating a business organization suited to sell savings products. He didn't change these business strategies even though other insurers rushed to sell large-lot coverage products during the period of rapid economic growth.

Taiyo Life started focusing on individual annuity insurance in the mid-1980s. Meanwhile, the insurer marketed few lump-sum insurance policies for which rival companies were stepping up their marketing efforts because it was afraid of the risk involved in those products and Mr. A also objected to selling those policies. The company also stopped offering variable insurance products right after Mr. A judged that "sales of such products would cause trouble to policyholders later." When the sales department signed a corporate annuity contract during the bubble period, Mr. A ordered sales personnel to cancel the contract, saying, "It won't bring us a profit, so return it" and the contract was actually declined.

He was also well known for being strict about costs and thoroughly pursued efficiency in management. "When visiting the company's office, I found small rooms and bare shelves. With lights turned off for saving purposes, the rooms were dim. I was shocked to find Mr. A checking the company's pay slips on his own for any wasteful spending," said a head office staffer at Daihyaku Mutual Life of that time.

This unique investment style was also implemented by Mr. A, and he made final decisions by himself on large-scale lending to corporations. Taiyo Life invested a relatively large amount of funds in bank stocks because "the manager of former Meiji Life Insurance, a close friend of Mr. A, recommended bank stocks as good investment destination," according to a concerned party. When the company further lowered the weight of stocks in its asset portfolio in the mid-1990s, it also obtained approval from Mr. A for sales of stocks.

Looking at these things, we see that Mr. A's pursuit of different strategies from major insurers, high efficiency and unique investment policies greatly contributed to what Taiyo Life is today. However, the insurer would have faced difficulties correcting its business if Mr. A had made wrong decisions in steering his company. For example, "the company aimed to earn expense profits from sales of individual annuity products, but instead incurred a negative spread, which weighed on the company's earnings," said a concerned party.

(2) Daido Life Insurance

Daido Life Insurance has a strong business base in the small- and midsize-business market and sells individual term insurance to employees of smaller businesses. Its sales personnel work together with partner organizations such as "*Zenkoku Hojinkai Sohrengo,*" which is known as "Corporation Association," and the Federation of Tax Payment Associations to market a large-scale comprehensive insurance coverage package to member corporations of those organizations. The insurer also markets its products via members of TKC Corp., a major body of tax accountants, and other tax accountants and experts working as agencies for the insurer to client companies of those accountants. Daido Life was demutualized in April 2002, becoming the first company to do so among major and midsize life insurers, and went public.

The company maintained a high solvency margin ratio and solid earnings power as well as a good credit rating even after the bubble burst, mainly because (i) it shifted its focus to individual term insurance in the 1970s and (ii) drastically reviewed its asset portfolio in the early 1990s.

(i) Shift to individual term insurance

Daido Life used to take the strategy of selling life insurance products to individual customers via sales personnel as major insurers did. Its business performance had been poor until around 1970, however. “We were even unable to build enough policy reserves, and reserves for dividends to policyholders were so scarce that they were depleted in the middle of a fiscal year,” a concerned party reveals. Faced with desperate situations, the company took the strategy of specializing in individual term insurance which placed a lesser burden of building policy reserves.

The insurer was initially able to acquire only small-lot contracts from neighborhood associations and others, but the circumstances changed when it formed a partnership with Corporation Association and started providing an insurance coverage package to member companies of the body. The company also built on the momentum by individually receiving an official endorsement in tax affairs “allowing the insured corporation to write off the entire amount of premiums for a type of products requiring little accumulation of policy reserves.” Daido Life formed a partnership with TKC Corp. in 1974 and designated TKC’s member tax accountants as its agents. This way, the insurer established the business model of offering term insurance with a high-end coverage via its partner entities to small and midsize companies, which was different from the model adopted by major insurers. A concerned party says, “We offered coverage products more purely than now. The idea of selling life insurance to small and midsize companies did not exist in those days, and no company had entered into this market.”

Daido Life also expanded its asset size during the bubble period, but it sought expansion mainly in the group annuity field. The company kept focusing on term insurance in the individual-insurance field, aiming to expand the amount of policies in force, and it never saw its business model collapse. Looking at Nissan Mutual Life’s success in drastically increasing contracts for individual annuity insurance via tie-ups with financial institutions, it thought about following suit. However, President B raised a red flag not because he was concerned about deterioration of the company’s ALM, but because he thought that “those products would be sold without efforts of sales personnel, hence weakening the strength of its sales force.” His decision eventually played a big role for the insurer.

(ii) Drastic review of the asset portfolio

Daido Life mainly sold highly profitable large-scale individual term insurance in the 1980s, while paying one of the industry's highest levels of dividends to policyholders by using capital gains of stocks as funding sources. Despite having established its unique business model, the company still thought it had to maintain the highest level of dividends in the industry to protect its customer basis from larger life insurers facing the maturity of the death coverage market.

The insurer shifted its asset holdings from stocks to public and corporate bonds in the early 1990s because the investment department strongly insisted on sell-off of shareholdings out of concern that the company depended too much on unrealized capital gains of stocks. Domestic stocks accounted for nearly 20% of the company's total assets at the end of fiscal 1990, but the weight fell below 10% at the end of fiscal 1995. "Looking at the situations in the U.S., we came to know about the idea of ALM. We had generated capital gains to pay dividends, but realized that we would be in trouble once a stock market upturn came to an end," a concerned party said.

What the insurer did sounds easy. No life insurer took such a move in those days, however, and the proposal of selling stocks met objections within the company for a number of times. It was people at the section-head level of the investment department that strongly insisted on stock sales, according to concerned parties. Unlike other companies, the management of Daido Life eventually accepted the proposal made by its investment department largely because the company's core customer basis and business model were not related to its shareholdings. The weight of group annuities was relatively large at Daido Life. Those policies were not acquired from general companies, however, but were "sold individually" to member companies of its partner institutions. Nevertheless, the company put off discussing the investment department's proposal because the sales department strongly opposed the idea, and the president was from the sales department. The planning and actuarial departments didn't show their objections, while also not supporting the investment department. However, the investment department is said to have finally succeeded in persuading the top management after making the proposal over and over.

The success is partly attributed to the fact that the board member in charge of the investment department was from outside the company (the Ministry of Finance). He listened to opinions of his subordinates and brought the proposal of selling the company’s stockholdings to managing directors’ meetings for a number of times. “If he had been an internally-promoted board member, he wouldn’t have been able to make the same proposal for so many times,” said a concerned party.

President B eventually decided to sell the company’s stocks. He assumed his post while internal strife among the management was rising to the surface. In March 1988, then-President C, who served as president for 10 years, was replaced by Mr. D, an actuary. Following the sudden resignation of Mr. D in March 1990, Mr. C concurrently served as chairman and president in an exceptional move. Mr. B became president in July, keeping the mess within the company under control. The insurer invited the board member from the Ministry of Finance mentioned earlier when Mr. B assumed the presidency.

(3) Fukoku Mutual Life Insurance

Fukoku Mutual Life mainly sold protection-based products via female sales employees to workers at government offices and large corporations. Its business model appears to have been as same as one adopted by major life insurers. However, under the policy of being independent, the company had been pursuing the goal of achieving a “net increase in policies in force” as its basic principle since the 1970s. While other insurers focused all their efforts on “how to win new contracts,” Fukoku Mutual Life didn’t force itself to market policies and instead devoted its efforts to acquiring high-quality contracts and offering follow-up services to policyholders after executing contracts. Its surrender and lapse rate (compared with policies in force at the beginning of the year) had been far lower than those of other insurers. It never faced a bad loan problem even after the bubble burst and had maintained financial soundness.

The company was different from other life insurers mainly in that (i) it didn’t turn to savings-based products and that (ii) it separated investment and sales activities. Moreover, (iii) the characteristics of its corporate culture were different from those of others.

(i) The company didn’t lean toward savings-based products

With its predecessor being a military service insurance company, Fukoku Mutual Life had mainly marketed savings policies until around 1970. However, the company shifted its focus to coverage products as its management agreed to the opinion of the budgeting department that the profitability of saving insurance was low. “It was not an easy task.

We chiefly marketed annual premium insurance to customers living in regional areas, but set up the department specializing in selling monthly-premium insurance in big cities and created an atmosphere suggesting that 'selling savings products is a sin,'" said a concerned party.

The management focused on earnings more than anything and set up a goal of attaining the level of policy reserves required under the net premium method (in 1962, the company became the first player in the industry that attained the level) and eliminating expense losses.

What differentiated Fukoku Mutual Life from other life insurers was that it aimed to improve its earnings by lowering its surrender and lapse rate as well as reducing costs, rather than seeking an increase in new contracts. The company judged that acquiring high-quality contracts and not losing existing contracts would be important if it aimed to achieve profitability as high as that of major insurers. "The Ministry of Finance called for life insurers to maintain a profit in each of the three profit sources. In order for Fukoku Mutual Life, a small-scale life insurer, to eliminate its expense losses, the management spearheaded an initiative to lower the company's cancellation and termination rate, which stood at 20% at that time, to zero," a concerned party revealed.

The sales department shifted its focus to the market serving employees of companies. The market enabled the insurer to visit customers effectively and maintain a high persistency rate, while helping the company eliminate its moral hazard risk. Thanks to efforts by sales people, the insurer was able to gradually tap into the market, a stronghold of major players. Fukoku Mutual Life especially strengthened its marketing efforts for the government and public sector market because shareholdings and loan, sales weapons of large insurers, were not effective in this particular market, allowing the company to evenly compete with those major players. Concerned parties said, "Being subject to severe penalties for contracts terminated or lapsed, sales employees turned to the market serving employees of companies because the surrender and lapse rate was lower compared to the household market" "We had some connections with major businesses, but such connections did not contribute to our sales. The market serving the workforce of companies was not introduced by our company, but sales employees exploited on their own."

Competition over total asset levels intensified in the late 1980s, putting Fukoku Mutual

Life at a disadvantage in terms of the scale of assets. However, Mr. E, then-President, didn't change the company's stance at all, saying, "It's fine as long as we are generating profits." Unlike other life insurers, Fukoku Mutual Life didn't see a surge in the number of contracts for single-premium endowment insurance and loan products offered in tie-ups with financial institutions (individual annuity insurance requiring policyholders to make an advance premium payment for all periods), because the actuarial and financial affairs departments raised their concerns soon after the launch of those products, prompting the management to order the sales department to halt sales of the policies. Under heavy pressure from the Ministry of Finance, the company developed a variable insurance product, but never marketed it. "Some people viewed that Fukoku Mutual Life was able to ensure soundness because they did nothing, but doing nothing was the most difficult thing in those days," says a party concerned. "It was tough to decide not to market variable insurance under the circumstance of that time. In the meantime, however, we made bold decisions to spend a relatively large amount of funds for the size of our company to construct a new head office building and establish a revenue base with tenant income," "stick to our own rules," Mr. G, then-President, told a press interview (according to Asahi Shimbun dated on August 29, 1998).

Being unable to increase its business scale, Fukoku Mutual Life saw its employees losing their motivation in the late 1980s. There were also growing calls on the company to "aim for profit expansion rather than a better balance in its three profit sources." However, the idea of being the highest quality company rather than the largest company was continuously upheld by the top management, and the company kept emphasizing opinions of experts such as actuaries and those in the investment department, while making fewer efforts to meet the complaint of sales people.

(ii)Separating investment and sales activities

In the life insurance industry, the sales department usually had a strong voice within their companies. The asset management department had a strong presence at Fukoku Mutual Life, however, and promising employees were assigned to the investment department. Many of its presidents also had experience in investment operations. The company had an established system of separating investment and sales activities, and hardly purchased stocks for the purpose of exploiting the market serving employees of companies.

The company had the experience of succeeding in stock investment and could attain the level of policy reserves required under the net premium method largely due to stock investment profits. Having a corporate culture of hating following other companies, however, Fukoku Mutual Life managed to avoid engaging in unreasonable investment during the bubble period. It took a dividend capture strategy and also invested in Nikkei-linked bonds as recommended by securities companies, but in the meantime, it had a culture of not doing things once hearing that "other companies did them as well." "The company's stock investment was based on a thought that following someone would bring no profit" "There was also a thought within the company that stock and land prices would always go up and down," said a concerned party.

(iii) Characteristics of the insurer's corporate culture

The common factor seen in (i) and (ii) is the culture where the top management places much value on management indexes and experts. None of its top management came from the sales department, and "people having a strong interest in the company's data took charge of running the business," according to a party concerned. Actuaries didn't gain a big promotion, but were highly valued as experts in the company. There appears to have been a culture where the management listened to what actuaries said. Moreover, the company had an established idea of emphasizing earnings on the bedrock of its business, and therefore it can be said that the company had rigorously done what it had to do.

The top management is said to have held strong power. Mr. E, the sixth president of the company, had served as president for 20 years until 1991. Mr. F, the next president, was the eldest son of a businessman called as the "leading figure who had rebuilt the company" (a prominent figure in the business circles serving as the third president of the insurer and also the first president of former Japan Development Bank) and joined the company on the premise that he would become president in the future. President G started his career at Fukoku Mutual Life, but he had a long experience of working as a secretary at the business office of the above-mentioned businessman. He served as head of the financial affairs department and held other prominent positions after returning to the insurer.

3. How were they different from failed life insurers?

Limits resulting from difficulties in looking for internal factors of existing companies cannot be denied, but our examination of the businesses of the three surviving midsize insurers has still revealed, in terms of differences from the businesses of failed life insurer, the following three points that the three companies had in common:

(i) All of the three companies grew, using unique business strategies different from those of major life insurers. They didn’t turn to single-premium savings-based products and drastically change their strategies either during the bubble period.

(ii) They didn’t lean toward high-risk investment during the bubble period or succeeded in reducing their risk at an early stage of the post-bubble period.

(iii) The management exercised leadership. They possessed their unique business model, managerial principle and investment philosophy. The companies’ management strategies were little affected by changes in external environments or moves taken by other insures, and they “seldom followed what other companies did.”

(iv) While the management meant sales for many life insurers, the management of the three surviving insurers distanced themselves from the sales department, or the surviving companies’ unique business models allowed the management to think of their sales and financial affairs departments in separate terms.

Looking at these things, we see that, as in the case of failed life insurers, the management played a significant role in the three midsize companies. Taiyo Life refined savings insurance that generated only a small profit and established its business base by developing a marketing method suited to its products and taking extensive cost-cutting measures. Daido Life exploited the coverage insurance market for small and midsize businesses untouched by major players, thereby establishing a solid business base. Fukoku Mutual Life entered into the market for government workers where it could evenly compete with major companies and secured profits by acquiring good-quality contracts and reducing its surrender and lapse rate. None of the three insurers followed what other major and midsize companies did. Instead, they followed their own unique strategies, succeeding in getting through times of radical changes in business environments from the late 1980s through the 1990s and thereafter.

At these three companies, the leadership of the management went in the right direction. To put it the other way around, however, these surviving companies employed an authoritarian management style. If the management had wandered from the right path, whether surrounding people could have expressed their opinions to the management remains to be unknown. Moreover, the centripetal force of the management was reduced at both Taiyo Life and Daido Life in around 1990 when managerial troubles were revealed. The three companies don’t appear to have been subject to greater internal and external checking functions than failed life insurers either. While the idea of ALM existed in Daido Life, Taiyo Life and Fukoku Mutual Life were scarcely aware of the need for implementing ALM.

Chapter 5
Was Japan an anomaly? – Comparison with failures overseas

This chapter will focus on the failure of life insurers overseas and look for points common to or different from instances of failure of midsize life insurers in Japan. Our purpose to make a comparison with overseas instances is to gain a deeper understanding of the factors leading to the failure of midsize life insurers in this country.

Many countries experienced the failure of life insurers. We took up cases of Equitable Life of the U.K. and Korea Life. With regard to Equitable Life, the Penrose report (mentioned in the Introduction) made a detailed analysis of the circumstances and explored the causes of the de facto bankruptcy. The author drew on the techniques used in the Penrose report. It would be worthwhile to compare the results of analysis in the Penrose report and my report. In this chapter we will describe the circumstances that led to the failure of Equitable Life and contributing factors in reference to the Penrose report and compare the case with similar instances in Japan.

We took up the failure of a Korean insurer because, historically, the South Korean insurance system was strongly influenced by the Japanese system and also because, as in the case of Japan, Korean life insurers failed on a large scale as their external business environment put them under great stress. We studied written materials and held interviews with many people in February 2006, including those of Korea's Financial Supervisory Service, which is the competent authority, Korea Deposit Insurance Corporation, which manages the safety net of insurance companies in South Korea, and think tanks such as the Korea Insurance Development Institute and the Korea Institute for International Economic Policy.

1. Inappropriate management – Failure of Equitable Life of the U.K.

(1) U.K. life insurance market

The U.K. life insurance market is the world's third largest after the U.S. and Japanese markets. Unlike in Japan, where traditional dividend-paying products such as death protection have a dominant position in the market, single-premium savings-type products (especially annuity products) form the core of the British market. These products are widespread among the people. "Insurance, pension" accounts for over 50% of all personal financial assets in Britain (less than 30% in Japan).

Products are classified into three groups—non-linked products (traditional dividend-paying products and non-dividend products), AWP, and linked products (whose dividend is linked to the actual investment return). AWP and linked products are more common types.

AWP is a scheme intermediate between the linked and the non-linked schemes and is a dividend-paying insurance plan in which each individual's share can be determined at any time. AWP came into being in the second half of the 1980s, when traditional dividend-paying products were losing out to linked products in the market. AWP became popular, particularly in 1988, when the government introduced tax-qualified personal pension plans. In Britain, unlike in Japan, pensions (before payment is started) and annuities (after payment is started) are treated as different products.

On the investment side, the high level of the stock weight to total assets is the most notable feature of British life insurance products. The percentage of stocks in total assets was over 30% in the 1980s and rose to 60% in the 1990s. No upper limits were placed on shareholdings. Unlike in the case of traditional dividend-paying products, the face amount or the maturity proceeds amount of AWP is not definitely fixed at the time of conclusion of a contract. Generally speaking, AWP does not put a heavy burden of guarantee on the insurer, making it easier for the insurer to invest in risky assets. With AWP, yearly investment returns are leveled out in the "smoothing" process before being paid as dividends. (With a linked product, the actual performance of investments is directly reflected in the contract value.)

(2) Corporate profile of Equitable Life

Equitable Life started business in 1762 as the "Society for Equitable Assurances on Lives and Survivorships." It used the death rates calculated from London's mortality statistics. Equitable Life was the world's first life insurance company that adopted the level premium rate for each age. It was a mutual company.

Equitable Life was a relatively small company until the first half of the 1970s. Most of its business concerned the FSSU (Federated Superannuation System for Universities, which was the pension system based on endowment insurance for university faculty members). When the pension tax system was revised in 1970, the company found it impossible to continue the FSSU business.

Table 5-1 Equitable Life's brief history

Year	Events
1762	Business launched.
1913	Starts selling annuity products.
1957	Launches sales of annuity rate-guaranteed pension (later called GAR).
1973	Terminal bonus introduced.
1975	Guaranteed yield raised from 4% to 7% (10.5% in real terms).
1988	Sales of dividend-paying retirement annuity product (GAR) discontinued.
1991	Roy Ranson becomes representative director (concurrently serving as an appointed actuary).
1993	Adopts the terminal bonus discrimination policy (reducing the terminal bonus payment to GAR annuity policyholders).
1994	Posts future profit when settling accounts.
1995	Negative spread emerges.
1997	Issues a subordinated bond. Ranson replaced by Alan Nash as representative director.
1998	Negative spread and the situation of dividend-paying contracts reported in the media.
1999	Takes out financial reinsurance. Wins a case in the first instance.
2000	Loses a case in the second instance and in the Court of Appeal. Stops offering to make new contracts (practically bankrupt).
2001	Sales network sold off. Contract terms changed.

Earlier, in 1957, the company developed a dividend-paying retirement annuity product with a guaranteed annuity rate. This did not grow into a leading product for some time. To cultivate a new market in place of the FSSU business, the company stepped up the sales of dividend-paying retirement annuity with a guaranteed annuity rate (GAR) to wealthy individuals as target customers. It expanded its own sales force and branch network, calling attention to the low cost and the high policyholder dividend that were made possible in a mutual company system.

Equitable Life also reviewed its product lineup. In 1971 customers were allowed the option of receiving part of the benefits in cash. The company raised the assumed interest rate in 1975 and enhanced the flexibility of switchover to an annuity contract in 1978. As a result of these efforts, the company gained a larger market share and grew into a second-tier company in the 1980s.

As it continued to pay high dividends while the interest rates were falling in the 1980s, the company became burdened with an "excess dividend" and its financial situation deteriorated. It discontinued sales of GAR annuity in 1988 and switched to individual annuity without a guaranteed rate.

Since the company used a single fund for management of both old and new products, the negative spread of GAR annuity affected other products which had no guaranteed rate.

(3) Developments leading to failure

The market interest rate turned up from around 1988 but began to decline in the early 1990s. In 1993, the market interest rate temporarily fell below the GAR (7%). This means that the guaranteed annuity rate fell into the state of "in the money" of option trading.

Equitable Life changed its dividend policy. According to its new policy, policyholders who received annuities at a guaranteed rate would receive a lower terminal bonus than those who chose to receive annuities at the market rate. As for accounting, new contract costs were subjected to quasi-Zillmer adjustment (that is, deferred) in the 1990s. At book closing for 1994, future profits were entered in the books. The company came to adopt accounting standards that were not conservative.

The long-term interest rate declined after rising in 1993. The guaranteed annuity rate was again in the state of "in the money" in 1995. The GAR-related liabilities became an increasing burden on the company. The negative spread was estimated at a maximum of 1.6 billion pounds a year, which was about half of the premium income at that time. The company issued a subordinated bond in 1997 to maintain the required solvency margin level. In 1998, the media began to report the company's situation and customer complaints about the discriminatory bonus payment policy. The HM Treasury got a grasp of the problem and warned the Financial Services Authority (FSA, which acquired the power of supervision in 1999) about Equitable Life's GAR problem.

Equitable Life maintained its measures to reduce the terminal bonus for GAR. Policyholders who did not like having their bonus amount reduced sued the company. In the first instance in 1999 the company won the case with a ruling that "Equitable Life has discretionary power to cut the bonus amount." In the second instance and the Court of Appeal (supreme court), the company lost the case with the ruling that "bonus cuts are illegal because policyholders had reasonable expectations for terminal bonus payments." To finance bonus payments, the company needed additional 1.5 billion pounds. It gave up reconstructing business on its own and offered itself up for sale, but found no buyer because, with the stock prices and the interest rates falling, the total amount of payment liabilities ballooned more than initially expected. At the end of 2000 the company was unable to pay guaranteed annuities to about one million policyholders (including about 90,000 GAR policyholders), stopped offering to make new contracts and ended up practically bankrupt.

(4) Cause of failure

The main and direct cause of the failure of Equitable Life was that the company, which had grown directly by selling GAR annuity products with a high-level and flexible guarantee option, became burdened with a negative spread as a result of decline in interest rates from the 1980s onward. In 2000 the court said no to the insurer's practice of cutting the terminal bonus amount to lessen the burden of the negative spread of GAR. This ruling drove the company to bankruptcy.

Let us first explain the mechanism of GAR annuity. GAR is the rate guaranteed when the policyholder shifts to an annuity contract. The policyholder has the option of choosing the market rate or GAR, whichever is higher. The policyholder is allowed to bring external funds to the annuity contract within the limits of the tax law (the guaranteed rate of GAR is applied to the funds). Moreover, the policyholder can flexibly choose the starting age for annuity payment. The significant point is that the power to exercise GAR right was held not by Equitable Life but by the policyholder.

Let us also explain the dividend (or bonus)-paying system. Under the GAR plan, the "ordinary dividend" is paid on the pension reserve contract and the "terminal dividend (bonus)" is paid when annuity payment is started. Terminal bonus is determined in the form of settlement of surplus remaining after the termination of the contract. Bonus payment is not guaranteed under the contract. When Equitable Life made a new contract, however, it presented the customer with the record of bonuses paid in the past. Further, every year the insurer informed policyholders how much they would receive in total (including bonuses) once the annuity payment was started. The court judged that these things had inspired policyholder's reasonable expectations and ruled that it was illegal to set the terminal bonus amount at different levels depending on whether the policyholder chose the GAR option or not.

The Penrose report lists the following 11 factors leading to the failure of Equitable Life. The report notes, among other things, that, "the most important factor among recognized failures lies in the heart of Equitable Life" and sees a problem in Equitable Life's corporate governance. The report also points out problems about the appointed actuary system and the audit corporation in addition to the 11 factors.

1) Adjustment of guarantee cost by using terminal bonus

As of 1983 the management had decided to adjust the guarantee cost by using the terminal bonus. This led to a "discriminatory terminal bonus policy" for which the company was sued later. This decision was not reported to the board of directors until 1993. The policyholders were left in the dark until 1995.

2) Dividend payment policy unchanged in 1988

When the company stopped selling GAR annuity in 1988, it did not adopt a new bonus policy but continued to indicate the same high bonus for a product that came after GAR annuity. The bonus resources for old and new contracts were combined and this resulted in a heavy burden of high guaranteed rates.

3) Reducing liabilities by increasing terminal bonus

From the 1980s onward the company raised the proportion of terminal bonus payments as against ordinary bonus payments. Equitable Life was not the only one to do so. In the British life insurance industry, the weight of stock investment increased and how to pass capital gains on to policyholders was a point of issue. There was a competition with unit-linked insurance. There was also a general view that "the terminal bonus is not guaranteed and does not need to be recognized as liability." The company interpreted this view in an extreme way to suit its own purpose and deliberately reduced the financial resource it should have saved for future benefit payments.

4) Excessive bonus from the second half of the 1980s onwards

Equitable Life was a mutual company and as such maintained the policy of rewarding policyholders with distributions of as much surplus money as possible and offered a high level of ordinary bonus payments as a means to win a larger market share. In the second half of the 1980s, weight was shifted to terminal bonus payments and, in the absence of a consistent bonus smoothing policy, bonus payments became excessive and undermined the financial condition of the company.

5) Artificially raising solvency margin

In the 1990s Equitable Life used a liability assessment method whose actuarial value was questionable and tried to improve the apparent solvency margin. It is pointed out, for example, that the company made quasi-Zillmer adjustment for single-premium contracts, underestimated its liabilities (the discount rate for liabilities was higher than the estimated bonus rate), postponed revising the mortality rates, used future profits, obtained a subordinated loan and used financial reinsurance (which led to inappropriate deduction of liabilities).

6) Malfunctioning board of directors

The board of directors lacked sufficient knowledge or skill and was incapable of raising an opposition to the management in important areas such as product development and liability assessment. Information passed to the board of directors was fragmentary, so board members were in no position to grasp the situation clearly. Most directors were unaware of the negative spread of GAR annuity until about the autumn of 1997.

7) Overdependence on appointed actuary

Supervision of business operations was heavily dependent on the appointed actuary. In the critical period from 1991 to 1997, the appointed actuary concurrently served as chief executive officer (CEO). Accordingly, the board of directors fully depended on the appointed actuary's information and advice to grasp the financial situation and determine the bonus payment level. The appointed actuary had the responsibility of giving technical and expert actuarial advice to the board of directors, but gave no warning, for example, about the risk of raising "policyholders' reasonable expectations" for terminal bonus payments.

8) Inappropriate solvency margin standards

The solvency margin standards laid down by the authorities were out of line with the industry trend. While the industry shifted its weight to terminal bonus payments and "policyholders' reasonable expectations" assumed greater importance, future liabilities necessitated by terminal bonus payments were left out of account on the financial statements. The aggregate value of all contracts reflecting the cumulative final bonus payments was greater than the available assets as of 1987 and remained so to the end. Even so, the authorities focused their attention on the legal solvency margin calculated on the assumption that no reserve was set aside for terminal bonus payments, so they failed to assess the company's actual financial situation correctly.

9) "Policyholders' reasonable expectations" as reflected in liabilities

In the 1990s the regulatory authorities understood what "policyholders' reasonable expectations" were, but failed to build a system that made it necessary to earmark money for cumulative final bonus payments in the future.

10) Use of financial reinsurance to inflate solvency margin

The regulatory authorities did not give full consideration to the fact that Equitable Life's solvency margin ratio was based on future profits. It is not clear, for example, on what grounds the company was allowed to deduct liabilities by using financial reinsurance.

11) General failure of supervision

The regulatory authorities and the Government Actuary's Department generally failed in doing a follow-up on problems that arose in the process of supervision over Equitable Life and giving it management guidance.

(5) Rating trends

The Penrose report states that the Department of Trade and Industry paid excessive attention to external ratings by S&P and others. According to S&P, Equitable Life was high rated at AA from 1993 to May 1999. The rating fell to A+ in May and remained unchanged until December 2000, when the company wanted to sell itself but found this difficult. At this point the rating slipped to BBB at once. It slipped further to BB when the company ceased to make new contracts. The rating changed quickly in a short time.

Moody's rating of Equitable Life came down from Aa3 (AA- according to a common rating system) to A1 (A+) in September 1999. It dipped further to Baa1 (BBB+) in July 2000, when the company lost the case in the Court of Appeal, and Baa3 (BBB-) in December 2000, when the company was ordered to stop making new contracts. There is no doubt that both rating agencies saw Equitable Life as a perfectly sound company in the 1990s.

In the second half of the 1990s S&P praised Equitable Life as "a leading company in pension products" and for its "low expense ratio" and the "high productivity of its sales unit" and saw nothing particularly wrong with its capital strength and bonus payment. In reality, the insurer had suffered a negative spread of GAR since the latter half of the 1980s and the situation got worse in the latter half of the 1990s when interest rates declined further. The chances are that during this period the rating agency either failed to grasp the problem or underestimated "policyholders' reasonable expectations." S&P did not take the GAR problem so seriously even in October 1998. Unfortunately, ratings played a very limited role in bringing the problem of the life insurance business to light.

(6) Comparison with failures in Japan

We have seen the case of failure of Equitable Life in reference to the Penrose report.

Finally, let us see in what respects the failure of Equitable Life is similar to or different from the failure of midsize life insurers in Japan.

A product like GAR annuity did not exist in Japan. It is unlikely, at least in Japan today, that insurers take account of "policyholders' reasonable expectations" and recognize the estimated amount of dividends to be paid in the future as liabilities. Some time ago, it was common practice to indicate the total amount of insurance the customer would receive in the future, including the estimated dividend amount, in the sales promotional materials. Japanese insurers have dropped this practice. In Britain until some time ago, insurance companies had far more discretionary power than their counterparts in Japan.

A notable difference between British and Japanese cases lies in external factors. In Japan, the life insurance business was no doubt affected much by the surge in stock prices in the second half of the 1980s and the drop in stock prices and interest rates in the 1990s. In contrast, the failure of Equitable Life was not preceded by an asset bubble to speak of. Britain was emerging from the economic stagnation that lasted until 1980 or so, and inflation was subsiding. The continued decline in the interest rate level was an unexpected change in the external environment for Equitable Life. Among leading and second-tier life insurance companies, Equitable Life was the only one that leaned toward GAR annuity and fell into a crisis. In Japan the external factors played such a big part in the failure of life insurers so that it was difficult to see what the problem really was. In the case of Equitable Life, external factors merely amplified the internal factors of the failed life insurer.

Failed Japanese and British life insurers had many things in common where internal factors were concerned. The reason Japan's midsize life insurers took an expansionary policy in the second half of the 1980s was that their past experience and business models built up over time influenced them to do so. In the case of Equitable Life, the termination of the FSSU business forced the insurer to drastically review its existing business model, and this led to the expanded sales of GAR annuity.

In both Britain and Japan, the management's judgment and behavior were largely responsible for the failure of the life insurance business, and internal and external checks and risk management measures did not function as they should have. Equitable Life also had difficulty reversing its expansionary policy even after it became financially troubled (it did not change its bonus payment policy even when discontinuing sales of

GAR in 1988). It superficially inflated the solvency margin ratio and made things worse later. Although the actuary was at the center of management, “the board of directors depended entirely on the appointed actuary’s information and advice when trying to grasp the financial situation and determining the dividend level” and “information that reached the board of directors was fragmentary and board members failed to grasp the situation clearly.” This situation bears a striking resemblance to the case of Kyoei Life in the 1990s.

Equitable Life was not a listed company, but a mutual company, and the regulatory authorities were the only ones that kept a watch over its management from the outside, just as in the case of midsize insurers in Japan. The solvency margin standards were out of line with reality and the authorities provided no appropriate guidance, either in Britain and Japan.

2. Undisciplined management proved fatal—Failure of South Korean life insurers

(1) South Korean life insurance market

Let us now study cases of failure of South Korean life insurers in the latter half of the 1990s.

The South Korean life insurance market is the world’s sixth largest and the second largest in Asia after Japan in terms of premium income. The penetration rate for households of life insurance has been rising rapidly, from around 40% in the latter half of the 1980s to 90% more recently. The ratio of the total insurance premiums to the GDP in South Korea is not as high as that of Japan or Britain but is higher than that of the U.S. and France. Life insurance is widespread in South Korea as it is in Japan.

For a long time after the Korean War, South Korea had six life insurance companies. After the Korea-U.S. insurance negotiations were successfully reached an agreement in 1986, the South Korean market was opened up to domestic and overseas insurers in the latter half of the 1980s. As a result, 33 life insurance companies were in operation at one time. The financial crisis that came at the end of 1997 drove 14 companies to bankruptcy. The Korean life insurance industry experienced a severe structural adjustment. As of 2007, 22 life insurance companies were doing business. Of these, the top three firms—Samsung Life, Kyobo Life and Korea Life—had a dominant share in the market, accounting for 60% of the premium income and 70% of the total assets. Foreign-owned life insurers have had a growing presence in recent years.

In South Korea until the mid-1990s, life insurance was almost equated with savings. Endowment insurance was the most popular product, and was sold mostly by saleswomen (called solicitors) in the same way as in Japan. During the reconstruction period following the Korean War, South Korea modeled its life insurance system after the system of its neighboring country, Japan. Mass hiring and mass staff turnover was a feature common to the life insurance industry in both countries. In South Korea the number of solicitors has decreased to some 100,000 after peaking at 350,000 in 1996. With sales of insurance by banks permitted in stages from 2003, sales channels have become diversified.

South Korea's insurance supervisory system preceding the financial crisis was largely modeled on Japan's three former insurance supervision laws. Just like Japan, South Korea adopted a convoy-like administrative approach. After the financial crisis, the nation began to adapt various Western systems. It integrated different sectors of financial administration (putting all financial institutions under the general supervision of the Financial Supervisory Commission and the Financial Supervisory Service), reviewed insurance accounting, introduced early correction measures and liberalized products and sales channels.

All South Korean life insurers (except branches of overseas insurers) have been joint stock companies and none of them has ever been listed. South Korea has regulations that permit an industrial capital including conglomerate to own an insurance company but not a bank.

(2) Structural adjustment

In South Korea one conglomerate after another went under from 1997 onward, leading to a serious financial crisis. This had a big impact on the life insurance industry, driving 14 life insurers, most of them midsize and smaller firms whose managerial base was weak from the beginning, to de facto bankruptcy and throwing some major insurers into a crisis. With the exception of Samsung Life whose group had a number of good-quality companies, and Heungkuk Life which received support from its parent firm, practically all life insurance companies were in trouble.

The financial crisis made a great impact on the South Korean economy. In 1998 the real GDP growth rate fell sharply, the unemployment rate rose to nearly 8% from the previous 2% range, and banks' nonperforming loans increased steeply. It was difficult to predict this rapid deterioration in the business environment and the failure of one life insurer after another was inevitable, say some people.

Even so, a review of failed life insurers reveals that factors that drove them into a crisis include the unchecked expansion of the scale of business, high-cost structure, investment in and loan to high-risk assets and inappropriate behavior of managers and that external factors alone cannot account for the crisis of life insurers.

We will review the cases of failed insurers, most of which were newcomer companies established in or after the latter half of the 1980s but which included Korea Life, one of the three major life insurers, and identify the managerial problems of these companies and their similarities to and differences from failed Japanese life insurers.

(3) Structural adjustment of newly established companies

Most of South Korean life insurers that failed during the financial crisis were established after the market was opened up in the latter half of the 1980s, unlike their Japanese counterparts, which were mostly long-established midsize life insurers. South Korea's Financial Supervisory Commission ordered 18 life insurance companies to submit a "business normalization plan" in May 1998 and closed four life insurers (Kukje Life, BYC Life, Taeyang Life and Coryo Life) in August. It carried out a structural adjustment (liquidation) of one company in 1999, five in 2000 and four in and after 2001.

Incidentally, structural adjustment took the form of transfer or sale of contracts involving the use of public funds (such as capital infusion by the Korea Deposit Insurance Corporation and loss compensation for rescuing insurance companies). There was no reduction of policy reserves or change of contract terms as exercised by Japanese life insurers. Insurance contracts as well as bank deposits were fully protected. Insurance was equivalent to savings in South Korea, as mentioned earlier. The government dealt with banks and insurers collectively in order to overcome the financial crisis. "Since the nation was in an unusual situation (under a financial crisis), the public raised few objections," says a government official.

The failure of life insurers was triggered by the serious financial crisis, to be sure, but this was not only the cause. Newly established companies had various problems to deal with, such as the large number of competitors, nondescript management strategy, high-cost structure, and deterioration of group management. We will take a closer look at (1) nondescript management strategy, (2) high-cost structure and (3) tightened sound-business regulations.

1) Nondescript management strategy

In South Korea, newcomers entered the life insurance business one after another from the end of the 1980s and thereafter, as stated earlier. The number of life insurance companies leaped from six to over 30 in a country with a population of 47 million. Although the life insurance market was growing, sales competition became very intense.

The business model adopted by the newly established companies was largely the same as that of the six existing life insurers. An exception was Prudential Life Insurance Co. of Korea (established in 1989), which had a unique management strategy and hired highly educated men as consulting sales employees who offered security-type products. Most life insurance companies hired a large number of female sales employees and mobilized them to sell savings-type products whose appeal was maturity benefits. The penetration rate for households of insurance products like this was below 50% at that time. The biggest goal for a life insurer was to expand its business scale and win a large market share. In fact, the entry of newcomers into the market stimulated the industry and the penetration rate rose year by year.

While the existing life insurers mainly handled products with a short maturity, newcomers promoted sales of fixed-interest products with a longer-term (say, 10-year) maturity in order to gain a large market share. In South Korea the interest rate remained high and there was no cause for concern about asset management. Every company devoted its effort to selling products. They began to suffer a negative spread when the interest rate declined in the latter half of the 1990s. “Overemphasis on the ‘outward-form strategy’ was to blame. Insurance companies were intent on increasing their premium income and were too aggressive in sales. As a result, the persistence rate of contracts declined,” says a government official.

Their purpose of entering the life insurance business was to “make investments in and loans to group companies,” “launch the asset management business” and make the most of the life insurance business which they saw as a “money-growing tree.” Many managers are said to have been uninterested in the scheme of products they offered or the risk of the life insurance business.

2) High-cost structure

The life insurance business involves a high initial cost. “It generally takes about 10 years to reach a break-even point” in South Korea, according to an insurer-affiliated think tank. Newly established companies had a very low earning power due partly to excessive competition. They spent an enormous sum of operating expenses to expand the organization and secure personnel to win a market share. The amount of expenses became so large that there was no way to eliminate the expense loss and the policy reserve remained at a low level. “They failed to achieve economies of scale. From the beginning they were not making profit by underwriting insurance. They collapsed when the currency crisis eroded their investment returns,” says a government official. Newcomer life insurers “put more emphasis on scale than on profitability and resorted to the strategy of mobilizing a large workforce. Each company had a powerful sales division and kept on trying to get a market share even at great cost,” according to an insurer-affiliated think tank.

The high-cost structure of newcomer life insurers became even more pronounced because they had deferred assets. Under the system revised in the latter half of the 1980s, newcomers were allowed to record a maximum of 50% of the operating expenses as deferred assets until their fifth year from establishment. They needed to write off deferred assets over the next five years, but, thanks to these assets, they found it easier to use operating expenses and ended up developing a high-cost structure.

The shortage of the policy reserve was another problem. The net premium method was the rule in South Korea as in Japan. As of the end of the 1980s, Samsung Life, Kyobo Life (both major life insurers) and Heungkuk Life (then ranked fourth) were the only ones that attained the required level of policy reserve under the net premium method. Insurers that failed to attain the required level were permitted to adopt the seven-year surrender value method (provided that the K ratio [the ratio of the surrender value-based reserve to the net premium-based reserve] did not fall below the previous year’s K ratio).

3) Tightened sound-business regulations

Life insurers saw their business deteriorating amid the financial crisis. The fact that the sound-business regulations were tightened in a short period of time was a blow to newcomers.

As South Korea sought the financial support of the IMF (International Monetary Fund) when it was hit by the currency crisis, the nation was forced to carry out economic reforms in all fields of activity. Insurance was no exception and various systems were adopted to ensure the sound operation of the insurance business. For example, the solvency margin standard was introduced and the required capital was quadrupled from the previous level (the standard was introduced in stages in consideration for smaller firms). An insurance company whose solvency margin ratio fell below the required level received a warning or an order for business improvement. In and after 2000, South Korea adopted other systems including the standard policy reserve system and the CAMEL rating system (which was the U.S. Federal Deposit Insurance Corporation (FDIC)'s overall CAMEL rating as applied to insurance companies).

Troubled newcomer insurers were pressured to increase capital, but it was difficult to raise capital in a short time when the economy in general was under strong stress. Some gave up and closed business. Some established a joint venture with a foreign organization which, however, refused to put up additional capital in view of the uncertain future of the South Korean market.

(4) Structural adjustment of Korea Life

Korea Life is the third largest South Koran life insurance company in terms of asset size. Its business crisis came to the surface when the owner's suspected illegal loan was exposed in 1998. The company explored the possibility of concluding a tie-up with an outside partner such as MetLife of the U.S. Meanwhile, the company was found to have window-dressed its financial statements and concealed a huge amount of loss. It was declared bankrupt in August 1999 and received an infusion of public funds (and continued to do business as usual, unlike failed Japanese insurers).

Factors that led to the business crisis included the expansion of scale through sales of short-maturity products with low profitability, failure in investments and loans such as investing in the construction of the head office building and lending to group companies, and inappropriate management by the top executive.

Korea Life adopted basically the same business model as that of other major life insurers. Its business style was such that female sales employees were hired to sell savings-type products. In the 1980s, the company promoted sales of short-term (three-year) savings-type products and enjoyed a sharp increase in the premium income but was unable to eliminate the expense loss.

Governance or lack of it played a greater part in the business failure. Inappropriate management by the top executive, for example, was a cause of failure. Korea Life was a member of a midsize conglomerate called Shindonga Group. Chairman A made full use of Korea Life for the benefit of the group. He established a trading firm overseas and financed its operation with funds drawn from Korea Life. He also supported a group member firm that had no prospect of repaying its debt. In the 1980s he built "Korea Insurance Life 63 Building" (head office building), the tallest building in South Korea. The book value of this building was said to reach 400 billion won as against the company's total assets of less than 1 trillion won at that time. Excessive investments and loans to group members turned sour and depressed the company's finances. "The cause of failure was loose management by the top executive," says a government official.

Further, Chairman A misappropriated the company's money for his private use. He was a devout Christian and built a number of fine churches with Korea Life's funds. The funds flowed also into political circles.

The board of directors did not function properly. The atmosphere was such that anyone who spoke up would be fired. As a result, there were only quiet members left in the board of directors and they remained in the position for a long time. The company's regulations were in place but were easily ignored because the top executive had the power to shuffle personnel and no one dared to contradict him.

Korea Life was not a listed company and the regulatory authorities were the only one who checked the company's operations. Even the authorities failed to grasp what was really going on until Chairman A was arrested and the prosecutors raided the company in 1999. Before the financial crisis occurred, the government had a system for rating insurance companies and the ratings were publicly disclosed. The rating system did not function well, however, as shown by the fact that the high-rated Korea Life was put under state control. "The supervision of insurance companies was not as good as the supervision of banks and securities houses," says a former employee of a major Korean life insurer.

(5) Comparison with instances in Japan

There are important points of difference between cases of failure of Korean and Japanese life insurers. Most of the failed life insurers in South Korea were newcomers while failed life insurers in Japan were long-established midsize firms. Most of Korean life insurers struggled with the deteriorating business amid the serious financial crisis. In particular, newcomers with a weaker business base and lower profitability as compared with larger insurers were hit hard. In Japan, the number of newcomers began to increase in the mid-1990s, and the total number of life insurance companies doubled from around 20 to over 40, but none of the newcomers failed (some withdrew from the business).

The failure of Japanese life insurers was due largely to the rapid expansion of assets in the latter half of the 1980s and their tendency toward high-risk investments and loans. Newcomers got a boost in sales from the existence of their struggling rivals.

Another big difference lies in the existence of banks. In South Korea, financial capital and industrial capital are clearly separated from each other, and a conglomerate (industrial capital) is prohibited to own a bank. Banks and insurance companies do not hold each other's capital, so banks do not come to the rescue of a failing life insurer. In Japan, banks and life insurers came to hold each other's capital when financial institutions were losing their creditworthiness in the mid-1990s and after. This amplified the financial system uncertainty.

All the same, there are many background factors common to both Korean and Japanese insurers which brought on their crisis. Life insurers in both countries gave top priority to expanding their business scale and were intent on strengthening their sales unit. It did not occur to them that assets and liabilities should be managed in an integrated manner. Historically, life insurers were regarded as the financial source for industrial capital in both countries. Perhaps for this reason, it seems that they focused attention on "how to collect premiums" and gave scant weight to the interest rate risk of assets and liabilities (ALM risk).

It has become clear that managers' judgment and behavior played a big part in causing business failure in South Korea as it was in Japan. Newcomers were more interested in securing immediate funds and a market share than in stabilizing operations, and failed to put their life insurance business on track. In the case of Korea Life, we may say that the top executive’s loose management brought down the company.

In both countries, the regulatory authorities were the only ones that kept watch on the operations of life insurers. Failed life insurers were not listed companies and their information disclosure was insufficient. It was easy for the top executive to keep control over the management of such a company for a long time. The regulatory authorities may have not fully functioned as a form of external discipline. In Japan, the authorities inspected insurers in the same way as they inspected banks. In South Korea, the authorities were not competent enough and merely made perfunctory checks.

Conclusion
What did we learn from failures?—Lessons for the future

(1) What changed and what did not change after the failure of life insurers

Over seven years have passed since the failure of Tokyo Life in March 2001, and more than five years have already gone by since the management crisis of Asahi Mutual Life in around 2001 and 2002. The total number of policies in force has been on the decline, but the crisis of life insurers has become a thing of the past thanks to the end to the Bank of Japan's zero interest rate policy (quantitative easing policy) in 2006 as well as a stock market rally that began in 2003.

As we examined earlier, the self-discipline of failed midsize life insurers in the form of risk control and governance structures didn't function well. Moreover, measures taken by the government in the 1980s ended up exacerbating life insurers' risk, and the steps taken to cope with the crisis in the 1990s gave an impression that the government was rather too late addressing the problem. The market discipline didn't function well either. Business monitoring function from outside parties hardly existed at that time, and neither mutual companies' meetings of representatives nor stock companies' shareholders' meetings effectively had management oversight function.

How have these things been changed?

Learning from a series of bankruptcies of rival companies and their own deteriorating creditworthiness, life insurance companies tried to retain periodic profits as much as they could in the form of contingency reserves or reserves for price fluctuations of investments in securities in order to improve their abilities to meet insurance payment obligations. Mitsui Life, which converted itself from a mutual company into a stock company in 2004, drastically increased its capital through a third-party allocation of shares, while all four major life insurers additionally set aside massive policy reserves to cover negative spread. As a result, the credit standing of each insurer has improved with major companies receiving high ratings, from AA (the third-highest) to A-plus (the fifth-highest), from R&I. As I will mention later, however, I consider that the current risk management and ALM (asset liability management) structures of life insurers still have plenty of room for improvement. Insurers' unpaid claim scandal has also revealed defects in their internal control systems.

Table-Conclusion 1: Changes in ratings of major life insurers (R&I)

<table>
<tr><th></th><th>March 1998</th><th>March 1999</th><th>March 2000</th><th>March 2001</th><th>March 2002</th><th>March 2003</th><th>March 2004</th><th>March 2005</th><th>March 2006</th><th>March 2007</th><th>March 2008</th></tr>
<tr><td>Nippon Life</td><td>AAop</td><td>AAop</td><td>AAop</td><td>AAop</td><td>AAop</td><td>AA</td><td>AA</td><td>AA</td><td>AA</td><td>AA</td><td>AA</td></tr>
<tr><td>Daiichi Life</td><td>AAop</td><td>Aop</td><td>A+op</td><td>A+op</td><td>A+</td><td>A+</td><td>A+</td><td>A+</td><td>A+</td><td>A+</td><td>AA-</td></tr>
<tr><td>Meiji Life</td><td>AAop</td><td>Aop</td><td>Aop</td><td>Aop</td><td>Aop</td><td>Aop</td><td rowspan="2">A</td><td rowspan="2">A+</td><td rowspan="2">A+</td><td rowspan="2">A+</td><td rowspan="2">A+</td></tr>
<tr><td>Yasuda Mutual Life</td><td>AA-</td><td>AA-</td><td>A+</td><td>A+</td><td>A+</td><td>A</td></tr>
<tr><td>Sumitomo Life</td><td>A+</td><td>A+</td><td>A</td><td>A</td><td>A-</td><td>BBB+</td><td>BBB+</td><td>A-</td><td>A-</td><td>A</td><td>A</td></tr>
<tr><td>Taiyo Life</td><td>Aop</td><td>Aop</td><td>A</td><td>A</td><td>A</td><td>A</td><td>A+</td><td>A+</td><td>A+</td><td>A+</td><td>A+</td></tr>
<tr><td>Daido Life</td><td>AAop</td><td>AAop</td><td>AA-op</td><td>AA-op</td><td>AA-</td><td>AA-</td><td>A+</td><td>A+</td><td>A+</td><td>A+</td><td>A+</td></tr>
<tr><td>Fukoku Mutual Life</td><td>AA-</td><td>AA-</td><td>A+</td><td>A+</td><td>A+</td><td>A+</td><td>A+</td><td>A+</td><td>A+</td><td>A+</td><td>AA-</td></tr>
<tr><td>Mitsui Life</td><td>A-</td><td>A-</td><td>BBB+</td><td>BBB+</td><td>BBB-</td><td>BB</td><td>BB</td><td>BB</td><td>BBB-</td><td>BBB+</td><td>BBB+</td></tr>
<tr><td>Asahi Mutual Life</td><td>Aop</td><td>BBBop</td><td>BBB+</td><td>BBB+</td><td>BB-</td><td>B+</td><td>B+</td><td>B+</td><td>BB-</td><td>BB+</td><td>BBB-</td></tr>
</table>

*"op" represents unrequested ratings (the use of plus and minus signs began in March 2000). Ratings for March 1998 were granted by the former Japan Bond Research Institute (JBRI).
*Meiji Life and Yasuda Mutual Life merged into Meiji Yasuda Life insurance Co. in 2004.
(Data) compiled by the author

Even after 2001, the government was busy handling liquidation procedures of failed life insurers and rebuilding a safety net. In 2003, the revised Insurance Business Law finally took effect, enabling insurers to lower their assumed rates of return for existing policies. With concern about the financial system gradually easing, the financial authorities have been implementing a variety of rules to ensure the soundness of life insurers since then. They have just started reviewing the solvency margin standard, the "core" measure of financial health of life insurers.

(2) Efforts to strengthen governance

The most important internal factor revealed in research and analysis this time was "one concerning managers." That is, the inadequate corporate governance of failed life insurers is believed to have eventually increased their failure risk.

As I mentioned in Chapter 1, mutual companies have a structural weakness in governance. In the first place, policyholders are not much aware that they have a role of autonomously managing their company as one of its members, while representatives chosen among members don't always act in the interests of the entire company either. Therefore, managers tend to steer their business in the interests of themselves. However, unlike the times when most major and midsize life insurers were mutual companies, only six insurers have still taken the form of a mutual company (among such insurers, Dai-ichi Life has shown its intention to demutualize itself).

Even insurers in the form of a stock company may also choose “someone inappropriate for the top position,” “someone lacking a sense of management,” or “someone making a number of errors in judgment” as their top executive. The president has the power to shuffle personnel, and the management is required to have a leadership. In that case, isn’t it possible to create a system that reduces failure risk arising from internal factors associated with managers?

The first step necessary to be taken to strengthen governance is to review a business organization. As analyzed in Chapter 3, the number of internal factors classified into Category 3 (those regarding business organizations) was only one third of the total number of internal factors, well below the number of factors classified into Category 2 (those regarding managers). A large part of internal factors were classified into Category 2 probably because efforts to increase checking function and risk control structure within organizations wouldn’t work as long as managers have a problem. However, if insurers are able to reduce internal factors classified into Category 3, in other words, to create an organization where governance can work more easily, they may be able to reduce their failure risk associated with their managers.

For example, Category 3 has an item called “problem of information communication function.” At failed life insurers, the management’s failures to have a proper understanding of the financial standing of their companies often led to their misjudgments. Managers of that time only focused on measures of scale such as “insurance in force” and “premium income” and at best, profit or loss on three profit sources. Unfortunately, managers of some insurers also falsely recognized their companies’ financial standing based on these measures, failing to make appropriate management decisions. It may sound discriminatory, but if a manager is from the sales field and also doesn’t emphasize experts’ work, he wouldn’t have any chance of properly grasping the financial standing of his company.

This also relates to the issue of insurance accounting. Japan’s insurance accounting does not fully reflect the actual business conditions of life insurers, and grasping the life insurance management solely through accounting information was and still is almost impossible. For example, we cannot assess an insurer’s current financial results without looking at how much profit will be generated over future years from contracts acquired during the current year, other than changes in value of new insurance policies and premium income. It is also wrong to think that a negative spread problem is well addressed as long as a current loss arising from negative spread is covered by profits from any of its three profit sources. Rather we have to understand how the company's negative spread will weigh on its business over future years, which means we have to understand the company's effective amount of policy reserves under certain premises, which is different from the amount of policy reserves released in its financial statements. First of all, it is important to make the true business conditions of the life insurer visible and create an environment that enables managers to make proper judgments. Unfortunately, I still cannot say that these ideas have already fully penetrated into the life insurance management.

(3) Making management "transparent"

There is also a sign of change, though. Many life insurers, especially those in the form of a stock company, have recently been using and disclosing "embedded value (EV)." It is a measure of assessing the shareholder value and earnings of a life insurance business and calculated by adding "the adjusted net asset" and "the value of policies in force."

"The value of policies in force," one component of EV, refers to the present value obtained by subtracting certain capital costs from the future profits that the insurer's policies in force will likely generate and discounting the resulting figure by the rate that incorporates the risk premium of the life insurance business. To put it more boldly, the value is designed to make the insurer's business "transparent" beyond the framework of insurance accounting.

The calculation method of EV has plenty of room for improvement. However, it can still serve as an effective tool to change life insurers' management goals from just producing good results in terms of changes in insurance contracts and premium income, or simply pursuing profits in accounting perspective.

During my research on bankruptcies of midsize life insurers, many people I met said, "Despite concern raised from actuaries and other experts, the sales department had a strong say, and the management took no action." Things will surely change if actual business conditions are properly presented within the company, and business targets are given based upon such conditions. In other words, at midsize insurers of that time, "the scale" was the only measure recognized across the companies. Therefore, I assume, even though some experts had presented numerical values other than the scale measure, they couldn't persuade either the management or the sales department.

Table-Conclusion 2: Embedded value of Taiyo Life and Daido Life

(in units of ¥100 million)

	Taiyo Life			Daido Life		
	March 2007	March 2008	Increase and decrease	March 2007	March 2008	Increase and decrease
EV (Embedded Value)	7,386	5,749	-1,637	12,630	9,907	-2,723
Adjusted net asset	5,749	4,847	-902	7,280	5,329	-1,951
Future value of existing policies	1,637	902	-735	5,349	4,577	-772
Portion of EV belonging to new policies	334	182	-152	552	462	-90

<Major factors responsible for changes in EV observed over the previous fiscal year>

	Taiyo Life	Daido Life
EV at the end of March 2007	7,386	12,630
Dividend to shareholders	-61	-99
Changes in preconditions of insurance	-165	-150
Estimated earnings	407	554
Differences in preconditions and actual results for the year ended March 2008	-32	-155
Differences in earnings from investment	-1,969	-3,324
EV for new policies acquired during the year ended March 2008	182	462
EV for the year ended March 2008	5,749	9,907

<Impact of changes in preconditions on EV>

		Changes in EV of the T&D Life Group
Sensitivity 1	0.5% increase in risk free rate	1,640
Sensitivity 2	0.5% decrease in risk free rate	-2,036
Sensitivity 3	10% fall in value of stocks and real estate	-1,570
Sensitivity 4	10% decrease in cancellation and termination rate	594
Sensitivity 5	10% reduction in expense ratio	418

(Data) compiled from materials used for T&D Holdings Inc.'s business results announcement

If the business conditions become "more transparent," the management of life insurers cannot help but change their goal to expanding their surplus and controlling its volatility. In this case, the term "surplus," if I am allowed to use the concept suggested by Professor Mitsuru Iwamura of the Graduate School of Asia-Pacific Studies, Waseda University, refers to the amount left by subtracting the gross basic rate (that neither reflects the credit risk of the company itself nor contains safety loading) and the replacement value of insurance policies calculated based on market interest rates from the market value of assets. That change, if it actually happens, will enable us to assess the competence of managers at earlier stages than we are currently able to do, thereby helping to prevent the top management and surrounding people from taking inappropriate actions.

(4) Upgrading the risk management system

I'll now discuss insurers' risk management system. As I explained in Chapter 1, major managerial risks of life insurance companies include insurance underwriting risk (insurance risk and interest risk of assets and liabilities), asset management risk (price volatility risk, credit risk and real estate risk), liquidity risk and operational risk. Of such risk, interest risk of assets and liabilities and asset management risk came up to the surface at failed midsize life insurers, with no exception, driving them into a management crisis.

Advanced technology as well as increased implementation of risk control measures has recently enabled insurers to carry out sophisticated ALM and integrated risk control. Things have changed drastically from the 1990s. Nevertheless, I think that life insurers' risk control structure still has plenty of room for improvement. For example, not a few companies consider the absolute amount of ability to meet insurance payment obligations as their management goal even now. Above all, insurers had to break the chain of bankruptcies before sophisticating their own risk control. Therefore, they first placed top priority on bolstering their abilities to meet insurance payment obligations.

A study group hosted by the Financial Services Agency (I also participated in the group as a member) referred to this point in its report titled "Regarding Solvency Margin Ratio Calculation Standard" released in 2007.

In the report, the group showed its sense of crisis over the current state of life insurance management, saying, "There is a concern that life insurers' efforts to bolster solvency have become solely dependent on the criteria required under regulations" "The management of life insurers themselves have to fully recognize the trend of solvency assessment and substantially raise awareness of efforts to make their risk control systems more sophisticated." Thus, group members encouraged life insurers' management to carry out reform.

Aside from the trend of regulations to ensure soundness, major insurance groups in the U.S. and Europe are preparing to establish highly sophisticated integrated risk control structures that are far beyond the levels required by regulations. Some of them have disclosed the details of their risk control structures in an effort to expand their corporate value in a stable manner by communicating with the market. I hope that the management of Japanese life insurers will reform their mentality.

By the way, it's not that midsize life insurers were not aware of "risk" at all in the late 1980s. For example, as far as interest risk was concerned, the financial affairs and actuarial departments of many companies questioned rapid expansion of high-cost funds, even though they didn't implement ALM. At Daihyaku Mutual Life and Kyoei Life, actuaries conducted future cashflow analysis at relatively early stages, and people in charge of actuarial work knew the risk associated with a drop in interest rate.

The problem is that such information was not used for running the companies. Chiyoda Mutual Life, which was saddled with massive bad loans, had implemented a rule concerning asset management risk and a checking function before the bubble period. However, people close to the president watered down the rule and made the checking function ineffective on the back of the president's authority. Moreover, a former employee of Toho Mutual Life reveals that the power to make final decisions was meaningless if the president said OK.

However perfectly structures are put in place and numerical values are calculated, risk control wouldn't work as long as such structures and values are not used for the management of companies. The instances of failed midsize life insurers suggest the importance of efforts to enhance the effectiveness of risk control. In order not to render risk control ineffective, the management are required to strengthen their own checking function and build a framework where discipline by the government or the market works as well as to boost their own awareness of risk control. This means governance is highly important.

Insurers will not be able to completely avoid risk associated with their insurance business because companies are required to take a risk. One thing I can say is that failure risk will likely increase if a company seeks rapid expansion or leans toward certain products too much. Nissan Mutual Life, for example, saw individual annuities rapidly increase in a short period of time to account for more than 50% of its policy reserves. Situations like this should be considered as a problem in terms of policyholder protection.

(5) Change in business environment

In the meantime, in a few years since a series of failures of life insurance companies, business environments surrounding life insurers drastically changed. The contraction of the death coverage market has continued with the values of new policies and policies in force for individual insurance plunging to one third and two thirds of the levels seen 10 years earlier, respectively. In addition to failed life insurers, many major and midsize life insurers with long business histories have continued relying on the business model of marketing large-scale package products mainly including death insurance coverage through frequent visits by a large female sales force called “sales lady.” However, such marketing methods have been showing their limits year by year. Therefore, insurers are shifting their focus to the third-sector products such as medical and nursing coverage, individual annuities and other promising sectors that offer “coverage during policyholders’ lifetime.”

Changes have also been seen in the aspect of sales. A ban on sales of insurance products by banks was fully lifted in December 2007, following the lifting of a ban on bank sales of individual annuities in October 2002. Japan Post Network Co. has started selling insurance policies other than Kampo, or postal life insurance, after privatization of postal services in October 2007. The number of shops marketing products to customers visiting their premises (so-called “insurance shops”) has also increased. These shops don’t specialize in products of one particular insurer, but rather handle products offered by several life insurers, thereby serving as a shared marketing channel.

In the wake of these changes, life insurance companies have started facing business risk that they were scarcely aware of before. For example, whole life medical insurance products to ensure hospitalization and other coverage for a policyholder’s entire life such as “Ever” offered by American Family Life Assurance Co. of Columbus and “Cure” of Orix Life Insurance Corp. have become core products among the third-sector insurance in Japan. However, it is more difficult to reasonably assess future risk in medical and nursing care fields than in the field of death coverage. Thanks to advances in medical technology, patients who would have died if having lived in older times could be cured with inpatient treatment, while an early diagnosis of cancer has become increasingly popular, both resulted in a surge in cancer insurance payouts. The risk of facing such unexpected events has emerged. Therefore, medical insurance that offers coverage for an extremely long period is not popular in the U.S. and Europe.

Sales of individual annuities have also surged since the lifting of the ban on bank sales in 2002, leading to the launch of life insurers specializing in offering individual annuity policies via financial institutions. Many of those policies are lump-sum variable individual annuity that guarantees minimum payouts to policyholders, forcing life insurers to make up for a loss when investment performance falls below expectations. Insurers have recently released products that allow policyholders to step-up the amount of guarantee from their initial amount of principal or lock in profits when investment performance reaches a predetermined level and other types of products that are deemed to require extremely complicated risk control.

Moreover, in bank branches and other shared marketing channels, life insurers face greater difficulty managing sales than in traditional specialized channels, as shared channels put life insurers in a position to be chosen by sales companies. Competition over fees or product development also tends to intensify in shared channel. However, in the case of failed Nissan Mutual Life, financial institutions (to be more precise, their agents) took the lead in sales, thereby making the company unable to control its sales, resulting in deterioration of the insurer's business conditions. Thus, it can be said that this is a new yet old problem.

At present, life insurance companies face these new kinds of risk, in addition to risk that was highlighted as a problem of failed life insurers such as price volatility risk, credit risk and risk of having negative spread resulting from mismatch between assets and liabilities. It is probably essential to step up restructuring of a business model that corresponds to changes in the insurance market and distribution. At the same time, life insurers also urgently need to upgrade their risk control structures, break away from existing management practices of pursuing scale expansion in the short term and develop their management into one aiming to steadily expand corporate value.

(6) Lack of transparency of policyholder dividends

I would like to also talk about the issue of policyholder dividends as an example of showing the inadequacy of governance.

Under the former Insurance Business Law, life insurers' financial buffers were achievement of the level of policy reserves required under the net premium method and latent stock profits. Life insurers, especially major ones where both of the buffers had been substantially built up, paid high levels of dividends to policyholders in the late

1980s. Many life insurers had been trapped into earnings structure depending on latent stock profits partly because the government called on life insurers to “reward their policyholders with dividend payouts rather than to accumulate internal reserves.” Due to differences in scale, customer basis, product strategy and others, profit or loss of failed midsize life insurers from three profit sources often looked inferior to that of major companies, and therefore failed insurers depended on “sales to lock in profits” more than major companies did to pay dividends.

Such management does not succeed unless stock prices keep on going higher. Midsize life insurers saw their latent stock profits depleted at early stages amid a stock market downturn in and after 1990, partly because stock acquisition prices were relatively high in the first place. They then turned to makeshift measures to get through their business results announcement such as “purchasing investment trusts to receive dividends,” “lowering the standards for setting aside policy reserves” and “using financial reinsurance,” which gradually weakened the financial strength of these insurers.

The management dependent on latent profits was not an exclusive feature of life insurance companies, but was rather adopted by a variety of Japanese businesses. However, the structure where the amount of financial buffers largely swings according to changes in stock prices is not much favorable for corporate management even if there are enough buffers to cover stock holding risk at present. Do policyholders really expect insurance companies from which they have bought their policies to provide returns (in other words, policyholder dividends) while holding a great degree of price volatility risk (in other words, allocating a large amount of capital to stock investment)? Furthermore, it would be acceptable if insurers adopt a performance-based dividend policy, but they may not be able to gain understanding of policyholders if they maintain the unclear dividend policies currently taken.

In the meantime, “products offering interest dividends every five years,” which, in principle, provide no expense dividends and mortality dividends, have become the mainstream of insurance contracts since the late 1990s, and the primary characteristic of dividend payouts, that is, post-settlement of insurance premiums, has substantially faded away. Insurers say that they can reduce insurance premiums for such products because the level of dividend payouts for such policies is low, but these policies return no income other than one coming from investment performance to policyholders, in principle. It especially puzzles me that mutual companies consider these policies as their mainstay products.

At any rate, payouts of policyholder dividends currently depend too heavily on discretion of top managers. It cannot be ruled out that insurers may fall back into management fully dependent on latent profits again. They also may not be able to gain policyholders' understanding if they continue charging a high amount of insurance premiums just to ensure safety and return their surplus, if any, to shareholders (or simply retain them). Some companies are now touting their levels of policyholder dividends, while the soundness of life insurers is getting on a recovery track and latent stock profits are gradually increasing. They should be aware of dividend payouts as a potential risk factor, however.

(7) Actuary's role

Bolstering internal and external business monitoring functions is essential for strengthening the governance of life insurers. It is insurance actuaries who play an important role as an internal checking function. In the first place, life insurance operations cannot be performed without actuaries, experts in actuarial science.

However, at failed midsize life insurers, opinions of those engaged in actuarial work and actuaries were not necessarily valued by the management, and voices from the sales department tended to be heard more. As I said earlier, managers from the sales department would not be able to make proper management decisions without receiving support from experts, but such management was still possible probably because the economy kept growing until the 1980s and the management meant sales. Fostering the culture of valuing experts is essential for future management, which also holds true in other Japanese companies. To do so, insurers need personnel- and salary-related measures.

On the other hand, Daihyaku Mutual Life and Kyoei Life placed relatively high value on those engaged in actuarial work, and actuaries often participated in management as board members. However, in the case of Kyoei Life, actuaries failed to disclose accurate managerial information to the management, while the company was facing a managerial vacuum, causing the company's executives to make various errors in judgment.

Confirmation work of policy reserves and others as an insurance actuary sometimes conflicts with judgment as a manager. In the case of Equitable Life Assurance Society of the U.K., an adverse effect was generated when an appointed actuary also served as CEO, effectively becoming one of the causes for the life insurer's failure. It can be said that actuarial work has certain limits because insurance actuaries are, after all, employees of the life insurer. In the meantime, they are able to conduct an accurate analysis based on ample in-house data, which is also a big merit for the company. Insurers have to clarify the status and responsibility of insurance actuaries within their companies and at least avoid having them serve also as executive managers.

(8) Administrative discipline

External checking functions for life insurance management didn't exist very much, not just at failed companies, but also at life insurers as a whole. A mutual company's meeting of representatives was like a "ceremony" or an "opportunity to entertain important customers." Labor unions, for the most part, didn't have a strong presence either. Auditing firms gained access to internal information of life insurers, but they only exerted a strong presence at final stages (of instances at Toho Mutual Life, Daihyaku Mutual Life and Kyoei Life). Under such circumstances, the regulatory agencies existed as the only body to supervise the management of life insurers and played a certain role. The Ministry of Finance had extremely strong authorities at that time, and many people said that "the managers of life insurers were the Ministry of Finance."

However, having looked at the instances of failed life insurers, I don't think the Ministry properly directed life insurers as their administrative authorities. For example, on-site inspections by the Ministry were conducted as an extension of inspections to banks and designed to assess the asset management risk (especially, credit risk) of insurers and confirm their ways of running operations. No checks are believed to have been conducted for risk unique to life insurance companies, except methods for building policy reserves. Regarding policy reserves, the Ministry apparently only focused on whether the level of policy reserves required under the net premium method had been achieved.

The insurance regulatory authorities didn't have any actuaries until recently, and this fact suggests the authorities didn't emphasize earnings and risk structures unique to life insurers. Administrators showing their concern over the risk of having negative spread are said to have existed from time to time, but they couldn't create a big trend due to a short rotation period. With many companies falling into a management crisis in the mid-1990s and thereafter, the authorities were unable to expedite the establishment of a safety net and had no choice but to place top priority on helping insurers get through upcoming business results announcement for the time being.

While the administrative body for the life insurance industry shifted from the Ministry of Finance to the Financial Supervisory Agency and then to the Financial Services Agency, the position and methods of the administration have drastically changed. The administrative authorities traditionally adopted an actual oversight approach (the method where the administrative authorities hold power and specifically oversee the overall business of life insurers), but appear to be gradually shifting to a rule-based approach (the method where the administrative authorities set certain rules and only oversee whether insurers have violated these rules). Nevertheless, the authorities should still take on a great role. With few personnel appearing to be well versed in the insurance field, concern remains over whether they will be able to perform their expected role by just sticking to the current personnel rotation system.

Regarding a framework to ensure the soundness of insurance companies, discussions are underway toward introducing economic value-based solvency margin standards in light of the report released in 2007 called “Solvency Margin Ratio Calculation Standard,” which was described earlier. I’m looking forward to ongoing efforts to ensure the soundness of life insurers, hoping that new regulations will fully reflect the earnings and risk structures unique to insurance companies.

(9) Role of disclosure

As already discussed, it is not too much to say that checking functions from outside parties other than the administrative authorities little worked at the instances of failed midsize life insurers. Life insurers’ disclosure of that time was extremely inadequate, as confirmed in Chapter 1, with no listed companies operating, only a limited number of people were using disclosed information. As a complement for disclosure, rating has been playing the role of maintaining the soundness of life insurance management via market discipline, but it was not until the late 1990s that domestic and foreign rating agencies started the full-fledged service of assigning ratings to Japanese life insurers.

In the wake of bankruptcies of many midsize insureres, life insurers’ disclosure has improved in terms of both quality and quantity. Toho Mutual Life of that time excluded most of its foreign and other securities holdings from the scope of market-price valuation, but such disclosure would never be allowed now. The improvement in disclosure has enabled experts to carry out detailed analysis on the quality of an insurer's ability to meet insurance payment obligations and asset investment risk. Insurers' disclosure can be said to have reached adequate levels to respond to a managerial crisis caused by asset deterioration, thanks partly to their efforts to bolster self-assessment.

Analyzing the assets and solvency margins of life insurers, however, is not enough to grasp their managerial conditions. Existing policies held by insurers will generate profit (or loss) over future years, and therefore we wouldn't be able to grasp the true conditions if we fail to assess their existing policies.

I will discuss some indicators related to existing policies that have been currently disclosed. Core operating profit and the amount of negative spread have been released as the industry's common indicators since fiscal 2000, while some companies, especially major insurers, have been disclosing the breakdown for profit or loss of their three profit sources since fiscal 2006.

Core operating profit and profit or loss of three profit sources mostly come from existing policies because life insurers' new policies do not immediately contribute to their profits. If we look at such data in chronological order, we will be able to broadly grasp the recent profitability of insurance. Substantial revisions to core operating profit are required to grasp the profitability of existing policies, however, because the figure is substantially lifted by mortality profit from group insurance, interest profit from group annuities, investment in foreign bonds, investment trusts and others.

Furthermore, on the back of the shrinking death coverage market and growing concern over social insurance, companies have been increasingly focusing on the third-sector products such as medical and nursing care insurance since the 1990s. Annualized premiums on the third sector products have been disclosed since fiscal 2004, and claim incidence rates on earned premiums have been announced publicly since fiscal 2007. However, the amount of data is still insufficient to estimate the third sector's contribution to insurers' profits.

Regarding policy reserves, insurers have started disclosing the balance of reserves by the contract year (the total amount of reserves for individual insurance and individual annuity insurance), in addition to data that once caught market attention including the way of building up reserves such as the Zillmer method and net premium method and the rate of reserve funding. The disclosed data suggest that policies acquired during the period from the 1980s through the mid-1990s with high assumed rates of return still account for a large part of insurers' policy reserves. Without any clue to the remaining periods of insurance contracts, however, we cannot tell how long the impact of high-return policies will last.

Having looked at disclosure concerning existing policies, we now know that adequate data have yet to be disclosed.

(10) Disclosure beyond the framework of insurance accounting

As described earlier, that the current insurance accounting does not fully reflect the managerial conditions of life insurers should be partly blamed for inadequate disclosure of existing policies and insurers' overall businesses. Not surprisingly, there are limits to grasping the life insurance management from information disclosure based on such insurance accounting.

The insurance accounting currently adopted in Japan is a halfway standard that combines supervisory accounting with financial accounting. The supervisory accounting of insurance companies is essentially designed to maintain soundness of life insurers, but some rules are apparently contrary to this objective. For example, one rule allows insurers to choose book value in assessing their stock holdings, while another has introduced deferred tax accounting (allowing insurers to book deferred tax assets). On the other hand, the first objective of financial accounting is to offer information to investors. However, financial accounting tends to generate a case where profits are squeezed when the number of new policies is growing and profits improve when the number of new policies is slow to grow because insurance premiums are recognized on a cash basis, while expenses are recognized on an accrual basis, resulting in a gap in the timing of reporting income and expenses.

In addition, under insurance accounting adopted in Japan and many other countries, policy reserves are calculated based on the interest rate at the time of contract execution (a lock-in method), and the impact of changes in market interest rates that happened after the contract execution is only reflected as changes in interest profits or losses for the period. Assets (securities) are assessed at fair value, and therefore managerial conditions improve at a company holding massive long-term bonds when interest rates are rising. Nevertheless, assuming an extreme case, the company may still show a negative net worth in an accounting perspective.

To overcome these problems, efforts to disclose information beyond the framework of insurance accounting, as represented by the move to disclose EV mentioned earlier, have recently begun. There is a time lag between acquisition of a new policy and recognition of profits in an accounting perspective under the current insurance accounting, but in the case of using EV, contribution to future profits is recognized at the time of acquisition of a new policy. Thus, by disclosing EV, insurers can reinforce their financial information based on insurance accounting. EV is information originally designed to help grasp potential shareholder value, but it can also be used to determine an insurer's ability to meet insurance payment obligations in future and its probability of fluctuation. Insurers have disclosed not only EV but also the preconditions for calculation, revisions to the preconditions, and the impact on EV when the preconditions are revised, and such information can serve as an important clue.

Yet, looking at EV actually disclosed by each company, we also see that a big problem still remains. For example, EV is drastically changed when an investment yield and other preconditions are revised, and it is hard to tell such changes from an increase or decrease in EV caused by insurance operations. Risk is only incorporated into the discount rate, leading to a calculation problem in which EV increases as an insurer takes a greater risk in asset management. Moreover, it's difficult to make a comparison among companies because preconditions set by each company differ.

A review of insurance accounting itself is also in progress. The International Accounting Standards Board (IASB) is considering applying international accounting standards to insurance policies. Since the IASC, the predecessor of the IASB, took up the issue in 1997, discussions have been underway toward assessing insurance liabilities (policy reserves) at fair value. The review has been dragging on with the Life Insurance Association of Japan and others showing their objections. The IASB issued its discussion paper in 2007, aiming to complete creating a framework in 2009 or thereafter.

(11) What to learn from instances of failure

We have reviewed lessons learned from a series of bankruptcies of life insurers, ensuing improvements in governance and risk control structures of the life insurance industry and changes in external discipline including insurance administration and disclosure. Top executives appear to still have clear memories of the life insurance crisis and be more aware of risk and abilities to meet insurance payment obligations than they were before the crisis.

However, looking at the current life insurance management, I feel that the issue of corporate governance, which was highlighted as the most important internal factor that increased failure risk in our review on instances of failure, still remains as a relevant challenge. The recent scandal over benefit nonpayment cases and companies' responses to the problem also imply life insurers' strong inward-looking orientation rather than their willingness to carry out management reform. Their attitude of management information disclosure too shows no signs of their effort to improve governance. The disclosed information suggests insurers' intention to make their information look good as much as possible, or to avoid disclosing information that may be misleading, rather than their determination to convey information accurately.

Yet, a change in governance structure is expected to occur through a change in the form of business at some companies including Dai-ichi Life, which has officially announced its plan to turn itself into a stock company in March 2008. Review of solvency margin standards has also just begun. Maybe instead we'll see life insurers' changes from now.

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Chronological Table of Life Insurance Company Failures

Year	Month	Life insurance business	Financial business in general
1975	Apr.		Official discount rate lowered from 9.0% to 8.5%.
	June	The Insurance Council's report "Insurance business as it should be in the future."	
1976	Mar.	Assumed interest rate raised from 4.0% to 5.5/5.0%.	
1978	Mar.		Official discount rate lowered from 4.25% to 3.5% (rock-bottom during this period).
1979	Jan.		Second oil crisis.
	Apr.		Official discount rate raised from 3.5% to 4.25%.
1980	Mar.		Official discount rate raised from 7.25% to 9.0% (peak during this period).
	Apr.		The price of government bond with a 6.1% yield plunges.
	Aug.		Official discount rate lowered from 9.0% to 8.25%.
1981	Apr.	Assumed interest rate raised from 5.5/5.0% to 6.0/5.5%.	
1984	Jan.		Nikkei Stock Average tops 10,000 yen for the first time.
1985	Mar.	Domestic life insurers allowed to sell insurance products combined with deposits.	
	Apr.	Assumed interest rate raised from 6.0/5.5% to 6.25/6.0/5.5%.	
	Sept.		Plaza Accord.
1986	Mar.	Life insurers allowed to give greater weight to foreign securities in the investment portfolio.	Dollar hits 174 yen at one time (all-time high at that time).
	Oct.	Twelve life insurers start selling variable insurance.	
	Nov.	Nissan Mutual Life starts selling individual annuity with a bank-affiliated loan.	
1987	Jan.		Nikkei Stock Average tops 20,000 yen.
	Feb.		Official discount rate lowered from 3.0% to 2.5% (rock-bottom at that time)
	Oct.		Black Monday.
	Dec.		Dollar hits 120 yen range.
1988	Apr.	Life insurers start selling Japanese government bonds at their branch counters.	
	Dec.		Nikkei Stock Average tops 30,000 yen.
1989	May		Official discount rate raised from 2.5% to 3.25%.
	June	Life insurers' combined total assets surpass 100 trillion yen.	
	Dec.		Nikkei Stock Average hits 38,915 yen (historic high) at the final session of the year.
1990	Mar.		Nikkei Stock Average falls below 30,000 yen.
	Apr.	Assumed interest rate lowered from 6.25/6.0/5.5% to 5.75/5.5%.	
	Aug.		Official discount rate raised from 5.25% to 6.0% (peak during this period).
	Oct.		Nikkei Stock Average falls below 20,000 yen at one time.

1991	June		Securities houses found to have compensated customers for loss.
	July		Official discount rate lowered from 6.0% to 5.5%.
	Dec.		The Soviet Union's disintegration (end of the cold war).
1992	Mar.		Official land prices for 1991 (national average) fall for the first time in 17 years.
	June	The Insurance Council's report "New insurance business as it should be."	
	Sept.		The Ministry of Finance announces the amount of bad loans at 21 major banks.
1993	Feb.		Official discount rate lowered from 3.25% to 2.5% (same as historic low).
	Apr.	Assumed interest rate lowered from 5.75/5.5% to 4.75%.	
1994	Apr.	Assumed interest rate lowered from 4.75% to 3.75%.	
	June		Dollar hits 100 yen for the first time.
1995	Jan.		Great Hanshin-Awaji Earthquake.
	Apr.	Cost method adopted to assess domestic listed bonds.	Emergency measures to control yen's rise and stimulate the economy. Official discount rate lowered to 1.0%.
	June	Seven life insurers suffer current loss in fiscal 1994.	
	Aug.		Hyogo Bank liquidated.
	Sept.		Official discount rate lowered from 1.0% to 0.5%. Daiwa Bank's scandal in New York.
	Dec.		Plan for liquidation of Jusen housing loan firms approved by the Cabinet.
1996	Jan.	S&P announces ratings of eight life insurers.	
	Apr.	Revised Insurance Business Law put in force. Assumed interest rate lowered from 3.75% to 2.75%.	
	June		Act on Special Measures Concerning Promotion of Disposal of Claims and Debts of Specific Jusen Companies established.
	Oct.	Life and non-life insurers start entering each other's field.	
	Nov.		"Japanese Big Bang" in planning stage.
	Dec.	Japan-U.S. insurance negotiations concluded.	
1997	Apr.	**Nissan Mutual Life ordered to suspend business (the first case of life insurance business failure after World War II).**	
	May	S&P announces ratings of 13 life insurers.	
	June	Liquidation of Nissan Mutual Life decided (with policyholders bearing some of the burden).	
	Nov.		Sanyo Securities, Hokkaido Takushoku Bank and Yamaichi Securities failed.
1998	Mar.	Toho Mutual Life forms a tie-up with GE Capital (with old and new contracts separated).	Public funds injected into major banks.
	Apr.	Cost method adopted to assess domestic listed stocks.	
	June	Solvency margin ratios announced.	The Financial Supervisory Agency launched.
	Oct.		Long-Term Credit Bank of Japan put under special public control.

	Dec.	Life Insurance Policyholders Protection Corporation of Japan (with compulsory membership) established.	The Financial Reconstruction Commission started. Nippon Credit Bank put under special public control.
1999	Feb.		The Bank of Japan adopts zero-interest policy.
	Mar.		Public funds injected into 15 major banks.
	Apr.	Assumed interest rate lowered from 2.75% to 2.00%.	
	June	**Toho Mutual Life ordered to suspend business.**	
	Aug.		Plan to integrate three banks into "Mizuho" bank announced.
	Oct.		Tokai and Asahi banks announce business integration plans. Sumitomo and Sakura banks announce merger plans.
	Nov.	AXA of France acquires Nippon Dantai Life.	
2000	Mar.	Toho Mutual Life contracts transferred in block to GE Edison Life.	Sanwa, Tokai and Asahi banks announce business integration plans (Asahi withdraws in June).
	May	**Daihyaku Mutual Life ordered to suspend business.**	
	July		The Financial Services Agency launched.
	Aug.	**Taisho Life ordered to suspend business.**	
	Oct.	**Chiyoda Mutual Life and Kyoei Life apply for protection under the Act on Special Treatment of Corporate Reorganization Proceedings and Other Insolvency Proceedings of Financial Institutions.**	
2001	Jan.		The Financial Reconstruction Commission dissolved.
	Mar.	**Tokyo Life applies for protection under the Act on Special Treatment of Corporate Reorganization Proceedings and Other Insolvency Proceedings of Financial Institutions.** **Taisho Life contracts transferred in block to Azami Life (Yamato Life).**	The Bank of Japan decides on quantitative easing.
	Apr.	Daihyaku Mutual Life contracts transferred in block to Manulife Century Life. Chiyoda Mutual Life makes a fresh start as AIG Star Life under AIG of the U.S. Kyoei Life makes a fresh start as Gibraltar Life under Prudential of America.	
	June	The Financial System Council allows life insurers to change contract terms.	
	Sept.		Terrorists attack on the U.S. Nikkei Stock Average falls below 10,000 yen at one time.

About the author

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He was born in 1967.
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