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LIFE INSURANCE: THE OTHER DIMENSION TO JAPAN'S FINANCIAL CRISIS

The long period of deflation that followed the bursting of the financial bubble in 1990 has caught Japan's life insurance in a double bind: on the one hand asset values are falling, while on the other hand high returns to policy-holders are still being offered in an effort to stave off a collapse of new policy subscriptions. A vicious circle of insolvency then arises when liquidity constraints oblige these funds to liquidate depreciated assets. Bankruptcies multiply. These institutions are at the heart of Japan's economic model, but have now themselves become a source of uncertainty, leading to deflationary pressures. Reforms have been undertaken since 1997, but important changes remain to be made, if the sector is to be consolidated and the past mistakes of the banking crisis not to be repeated.

The bankruptcy of Nissan Mutual Life in May 1997 pushed the most protected sector of Japan's financial system into open crisis: of the eighteen life-insurance funds which have developed historically in Japan (see Box), six have gone into liquidation. In expectation of further bankruptcies, the Financial Services Authority got the Japanese Diet to revise substantially the Insurance Code and the Framework Law organising the restructuring of the financial system. Of the various modifications adopted, the most notable concerns State commitment to providing public funds for supporting the restructuring of the sector. This type of decision can only be justified economically if the social cost of bankruptcy is considerably greater than the direct costs borne by shareholders and creditors, and hence shows clearly the importance which Japanese authorities have given to these financial institutions in the economic stability of the country.

The Disastrous Management of the Financial Cycle

The deterioration of the financial health of Japanese life-insurance institutions is the direct consequence of their aggressive commercial policy implemented during the speculative bubble, and pursued for a further five years during the subsequent deflation.

Between 1985 and 1986, the 50% appreciation of the yen led to colossal portfolio losses in foreign currency holdings. In order to maintain the overall returns on assets, institutions were subsequently tempted to compensate for losses by participating in Japan's rising stock market euphoria. To increase the scope of their investments, and hence raise profits, the funds sought to attract more savings, through aggressive marketing. Returns of 6-7%, if not 10%, to clients were thus offered constantly. Given the long term nature of such savings, only continued rises in asset prices could support such payments[1].

Box - What is a Mutual Fund?

A mutual institution has no shareholders. It is a non-profit-making body, based on the principle of shared profits and losses by all contributing clients of insurance policies. Its clients are called members and elect the executive officers of the institution. This form of functioning makes hostile takeovers impossible and prevents outside shareholders imposing specific rates of return. At the same time, the absence of public equity does not preclude the mutual institutions from being subject to solvency standards and holding a reserves. The latter are mainly made up of provisions for asset depreciation and surplus finance not distributed to members. The only Japanese life-insurance institutions which are not mutuals are those created after the deregulation of the 1990s.

1. The life-insurance managers should have been dissuaded from adopting such a speculative approach by regulations which forbid returns on capitalisation products from being based on income other than interest income. In fact, permissive interpretations of the law and a lack of judgement by the supervisory authorities offered ample scope to circumvent such regulations.

But the bursting of the bubble in 1990, followed by the long period of financial deflation, put the life-insurance institutions in the position of having asset returns that have fallen below interest payment commitments to policy-holders. Their own reserves have been insufficient to absorb this shock: on the one hand, reserves were reduced to a minimum during the bubble (regulations on the use of capital gains and constraints on reserves were relaxed); on the other hand, market values have depreciated considerably since the euphoria has ended. Under these circumstances, the life-insurance funds had to reduce their guaranteed returns on new policies as soon as possible, for their financial position to be restored. But this revision did not take place until 1995, when the guaranteed rate went from 4.5% to 3.5%, the latter still being excessive given Japan's deflationary context. Thus, these institutions continued to sell policies likely to generate losses up until the second half of the decade.

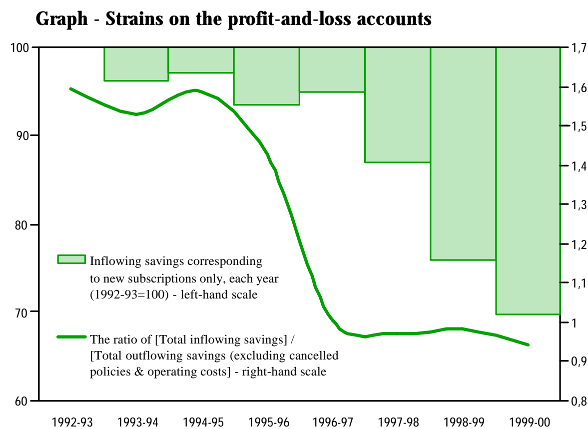
A Vicious Circle

The importance of these financial institutions led the Ministry of Finance, as well as the institutions themselves, to conceal the weaknesses of the sector while waiting for a recovery. As long as policies are not cancelled or do not mature, the opaque accounting system allowed losses to be covered up. But, as the deflation took hold such losses rose. Despite the level of returns offered, market saturation and economic recession led to a fall in new policies, as of 1992 (see graph). This in turn led to a persistent cut in the current resources available to the insurers. Reimbursing contracts reaching maturity by liquidating corresponding assets would lead to the forced revelation of losses. To prevent such a liquidation of assets, the insurers must therefore ensure that current resources are higher than those in use: hence they are forced to bid up returns to attract new investors. This has led to the development of Ponzi-style finance. Savings are attracted at a high cost and are meant to be invested, but in reality are used to mop-up losses on existing policies.

Financial charges rise as high yield policies reach maturity. From 1996 onwards, the losses associated with the returns gap were declared. The fall in stock market values and the levelling off of interest rates led to a collapse in investment incomes and latent capital gains. This double bind on the profit-and-loss account led to the failure of Nissan Mutual Life in May 1997, whose disastrous management triggered a slump in household confidence. The fall of new subscriptions has been aggravated by an explosion of policy cancellations[2] ; in short, there has been a run on the funds, though less violent than in a real banking crisis. The weak macroeconomic and financial situation of the late 1990s thus led to a self-fulfilling deterioration of solvency. To satisfy their rising liquidity constraints, the life insurers, which found it increasingly difficult to borrow, were led to liquidate depreciated assets in ever-increasing volumes.

Since 1997, each new bankruptcy announcement has reduced the credibility of the sector as a whole and intensified the crisis[3]. While all the institutions are not in the same situation, low accountancy standards tarnish all actors and reduce the solvency of the sector as a whole, thus becoming a self-fulfilling prophecy[4]. Official pronouncements by the authorities, as well as from the profession itself, have been that latent capital gains in life-insurance portfolios should make it possible to mop-up losses, a position which was previously applied to banks until their re-capitalisation in 1999. This argument is still faulty. On the one hand, latent capital gains (net of latent capital losses) have essentially been exhausted. On the other hand, cleaning up balance sheets by liquidating assets in the middle of a crisis actually nourishes the downward pressure on asset prices, reduces the solvency of asset owners and worsens the need for liquidity. This aggravates a vicious circle of financial deflation, from which life-insurance companies cannot escape by themselves. At the heart of the Japanese economy, these institutions have now become an important factor in worsening uncertainty and sustaining deflationary, macroeconomic pressures.

Graph - Strains on the profit-and-loss accounts



NB : Inflowing savings, added to investment incomes constitute the life institution's operating resources. Outflowing savings include interest payments, rents and reimbursements. Along with cancellations, these represent the operating expenses. Source: ***Life Insurance Association of Japan***

A Systemic Influence

As with the banks, Japanese life-insurance companies are "not just another financial services institution". They have a systemic[5] influence on the economy, which is directed through three major channels:

2. A particular characteristic of contracts offered by life institutions in Japan is the technical possibility to cancel them without suffering from dissuasive penalties, so that savings may be withdrawn on a massive scale.
3. The scale of losses is difficult to gauge, though it is sure that they are considerably higher than the ¥ 10 trillion (Euro 103 billion) put forward on a number of occasions.
4. This expression describes a situation in which an economic agent, seeking to protect him/herself, acts in such a way as to provoke the risk he/she wants to avoid, this being independent of the initial probability of the risk occurring.
5. Systemic risk is defined as "the possibility of situations arising in which the responses of agents to the risks they perceive will increase overall insecurity, rather than lead to a better spread of individual risks", M. Aglietta and P. Moutot, "Le risque de système et sa prévention", ***Cahier économique et monétaire***, n°41, 1993.

Savings and consumption behaviour by households

Pensions in Japan are mainly financed by capitalisation. Within this system, the life-insurance institutions manage the major share of individual, long term savings, as well as a substantial share of the savings collected by pension funds. Overall, the financial holdings of the eighteen mutual funds are drawn from 96% of households and account for more than one quarter of their savings. Confidence by savers in these institutions is vital to the stability of behaviour and the long term equilibria of the economy. Conversely, doubts concerning the solvency of mutual life-insurance funds are leading to a general feeling of insecurity about the future, encouraging cautious behaviour and a fall in consumption, which in turn is feeding deflationary pressures. The last two bankruptcies have affected 3.5 million savers, and may cause them to lose part of their long term savings.

Long term financing

As an integral part of Japan's large financial and industrial groups (the ***keiretsu***), mutual life-insurance funds play a structural role in the organisation of finance and industry (Table). They are sleeping shareholders and providers of stable finance. During the 1970s and 1980s, their long term liabilities along with the continued growth of their markets ensured that they did not suffer from liquidity constraints. They were protected from competition by being organised in a cartel, and any from shareholder pressure by their status as mutuals. Thus, they are bound little by the obligations of short term profitability, by transparency rules or the need to build up equity resources. Above all, they are protected from hostile takeover, which makes them very stable core players in the financial cross-holdings of Japan's large groups, and in particular in their cross-holdings with banks[6].

When the life-insurance institutions weakened, the solidity of the whole financial system came under threat. As stable funds became rarer, the expectations horizon of numerous economic agents shortened. Debt reduction and the build up of equity have become priorities over investment projects, while the downgrading of the latter stifles economic growth and future profits. Since the first bankruptcy in the sector in 1997, the solidarity and links between life insurers and their partners have been called into question, clouding the outlook for painless restructuring of the ***keiretsu*** and the whole of Japan's marketable sector.

The financial markets channel

Lastly, the most powerful and visible channel for propagating tensions is that of the financial markets. The concurrence of significant financial weight[7], high concentration and homogenous behaviour in terms of portfolio investments gives the mutual life institutions particular power. Under these circumstances, the worsening of their financial situation is likely to provoke highly sensitive market movements, that could weigh down on the liquidity and solvency of all investors, especially the banks.

Table - Main banks and life-insurance institutions belonging to the *Keiretsu*

Keiretsu	Member Financial Institutions:	
	Main banks	*Life-insurance*
MITSUBISHI	BoTM Mitsubishi T & B Nippon T & B	Meiji Life
MISUI	Sakura bank Mitsui T & B	Mitsui Life
SUMITOMO	Sumitomo bank Sumitomo T & B	Sumitomo Life
FUYO	Fuji bank Yasuda T & B	Yasuda Life
DKB	Daiichi Kangiyo bank	Asafi Life Fukoku Life
SANWA	Sanwa bank Toyo T & B	Nippon Life Daido Life
TOKAI	Tokai bank Chuo T & B	Chiyoda Life

NB: before the wave of mergers whichs has occured since 1999.

How is the Crisis to be Resolved?

Since the collapse of Nissan Mutual Life has revealed the absence of a framework for managing bankruptcies in the sector, significant progress has been made, with respect to guaranteeing saving-insurance contracts, accounting rules and prudential policy. However, problems still persist, necessitating substantial progress.

The Life sector's Policies Protection Fund was set up in 1995, and reformed in March 2000. Henceforth, it has become an essential tool for restructuring the industry. Its present capital stands at ¥ 460 billion, but is set to rise by a further ¥ 100 billion contributed by the industry itself between now and 2003, plus ¥ 400 billion in the form of government loans. The fund may also borrow in the markets, with the state underwriting such borrowing. The fund will thus guarantee life-insurance policies through to 2003, in the case of bankruptcy. But the terms under which such guarantees are met has led to harmful uncertainties. In effect, the measure stipulates that if bankruptcy procedures go ahead, then the returns on policies already sold may be revised, retroactively. This amounts to the ending of obligatory liabilities for policy-holders. Thus, it is already clear that some households holding policies with Chiyoda

6. Until the crisis broke out in 1997, these advantages were used abusively by banks and the major groups to transfer some of their insolvency to the life sector. These mutual institutions thus picked up substantial amounts of subordinated debts and low-performing stocks, in order to ensure the survival of banks and the stability of the capitalistic relationships within the keiretsu, at their own financial expense.

7. Assets held by life-insurance funds are mainly made up of securities. These mutuals are very present in the money market: they also hold about 10% of the Tokyo' stock market's capital, with all financial institutions taken together holding 40%. As a comparison, it may be noted that life insurance assets are only equivalent to 25% of bank assets. This ratio rises to 75% when only portfolio securities and other transferable securities are taken into account, rather than the total value of assets.

Life will see their assets depreciate by at least 10%. These measures have a strongly negative impact on private consumption behaviour. They may also worsen the instability of the insurance sector, by accelerating the pace of contract cancellation.

The debate surrounding a satisfactory resolution of the crisis thus remains open. The governing Liberal Democratic Party (LDP) has put forward a proposition which would allow mutual life-insurance institutions to modify the guaranteed rates of return on existing policies. This proposal is being supported by the largest institutions. They are less vulnerable to savings flight than the smaller institutions because of their renown, and they hope to capitalise on this at the expense of the rest of the sector. But the proposition does not provide a way out of the crisis. On the contrary, it risks provoking a macroeconomic shock and aggravating the crisis of confidence faced by the whole life-insurance industry. Just as with the banks before 1999, the life-insurance mutuals are refusing to adopt thorough protection of savings contracts, backed by taxpayers' money, because of its political repercussions, namely pressure by the authorities for institutions to restructure. Yet this is the only possible and first step to real reform. The guarantee of policies must be total, systematic and extended over a period of time beyond March 2003. Above all, it must be stated clearly, so as to reassure households and prevent the drain of savings out of life-insurance accounts.

The second step to reform, in corollary to the first, is to inject public funds into the system. The way the guarantee fund is financed has to be reformed to ensure the effective protection of savings contracts. It can no longer rest on contributions by the mutual life-insurance institutions which are now highly fragile. Yet, declared bankruptcies are likely to exhaust very rapidly the ¥ 900 billion at the disposal of the fund[8]. Furthermore, providing funding in case of bankruptcy is not all that needs to be done. The errors which occurred during the banking crisis should not be repeated. By liquidating depreciated capital assets to meet obligations, the life institutions have weakened themselves day-by-day. These institutions need to be re-capitalised by an injection of public funding, as finally happened with the banks.

This leads on to the third step in the required reforms which relates to prudential policy and accounting standards. To avoid generating moral hazard, taxpayers' money must be given under strict prudential conditions. Again, as in the case of the banks, the main problem lies in evaluating the needs of the life-insurance institutions. In other words, an acceptable standard of solvency needs to be defined, on which early measures of prevention may be based[9]. The supervisory agency, the FSA, has already carried out several encouraging changes along these lines. Nevertheless, the approach adopted raises certain questions as the introduction of a new, more reliable accounting system has been pushed back from 2001 to 2003, due to "fears of brutal consequences for existing accounts". Yet, the implementation of transparent accounting should go ahead as soon as the first two steps of reform have been accepted. Despite the numerous encouraging signs described above, doubts still surround the Government's determination to undertake a profound consolidation of the sector.

Lastly, in the view of the author, one major lesson needs to be learnt from the Japanese crisis, namely that any institutional investor raises systemic risk by intervening in the financial markets. All such investors must therefore be subject to supervisory rules and strict prudential standards. This has been common knowledge concerning banks for a long time. It is a lesson learnt with respect to American hedge fund crisis in 1998, and it is beginning to be learnt for pension funds and lastly for the Japanese life-insurance industry.

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8. The closure of Chiyoda Life alone will lead to cumulated losses of at least ¥ 500 billion.
9. The present ratio, copied from the American model, is applied in an unrealistic manner. Its definition needs to be reassessed (Chiyoda Life went into bankruptcy even though its solvency ratio was greater than the required minimum), as must the accounting standards used to gauge the value of its components.
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