GUY CARPENTER

Guy Carpenter Views

Reprinted from www.guycarp.com

July 2003

Japan's Insurance and Reinsurance Markets

The Impact of Deregulation

Until recently, Japan, despite its rank as the second largest insurance market in the world, was insulated from the global market – and from competition. This is no longer the case.

Japan is the second-largest insurance market in the world. However, until recently, it was insulated from the global market – and from competition – by government regulations. All of this has now changed.

Guy Carpenter Views talks with James Nash, Managing Director of Guy Carpenter in the firm's Tokyo office, about developments in the Japanese market in the years since deregulation proceedings began.

In Part One of this interview, James provides an overview of the primary and the reinsurance markets both before and after regulatory changes were implemented. The focus of this section is on the impact of deregulation and other recent economic developments on Japan's insurance industry and its clients. The opportunities available to foreign companies are also discussed.

Part Two focuses on Japan's current risk management environment; the evolving need for new products and services; and how insurers, reinsurers, and brokers can help clients in Japan manage their evolving exposures.

■ Part One

The Japanese Market Before Deregulation

Guy Carpenter Views: Can you provide a brief overview of the structure of the Japanese insurance market before deregulation negotiations began?

James Nash: Before deregulation, Japan's insurance market operated under a tariff system and enjoyed steady growth and profitability. Premiums were fixed at the same rate for all companies, and product forms were generally undifferentiated.

Many of the larger commercial risks were controlled by the keiretsu system, under which representatives from all of the major industrial and financial sectors – including banks, suppliers, manufacturers, insurers, and so forth – joined together to form large corporate groups. Each member of the group was bound by tradition and cross-shareholding arrangements to conduct business only with other members of their keiretsu, which meant that an insurer within the group would write most of the keiretsu's insurance.

Where no corporate groupings existed, as was the case with many of the smaller commercial accounts, clients were still often financially connected to their insurers either through cross shareholdings or loan agreements.

In this undifferentiated market, domestic insurers did not need to be particularly innovative, nor did buyers need to be very sophisticated. A few foreign insurers were licensed in Japan, but their share of the non-life market has generally never been greater than 5 percent. Foreign insurers generated income primarily by creating niche areas within the market, particularly in the accident and health sector.

GCV: Was there much need for reinsurance? What types of reinsurance coverages were available? Were reinsurers willing to follow the fortunes of their clients?

JN: Because Japan's insurers were conservative in terms of capital and exposure to catastrophic loss and were shielded from outside competition, they did not need significant reinsurance. Much of the reinsurance that did exist was provided domestically – either through an exchange system, under which individual companies reinsured each other, or through industry-controlled pools.

Generally, reinsurers followed insurers' original coverages in a market that was dominated by pro rata treaties. When windstorm insurance became more widely available in the mid 1980s as an automatic coverage under fire policies, catastrophe excess of loss reinsurance expanded. This was particularly true following the devastating effects of Typhoon Mireille in 1991, which was Japan's single largest insured loss event and caused insured property losses of ¥497 billion (approximately US$3.8 billion).

The nature of the tariff system, combined with the prevalence of pro rata treaties, ensured that both insurers and reinsurers made money in this market.

GCV: What role, if any, did insurance and reinsurance brokers play in this market?

JN: The insurance brokers that have been operating in Japan generally have been servicing their multinational accounts and operating small agencies. Traditionally, all major commercial accounts have been handled directly by insurers through in-house or captive agents. Corporate policyholders would turn to brokers only for assistance with risks outside the country.

On the other hand, reinsurance brokers have been trading, mainly from London, in the Japanese reinsurance market for around 100 years and acting largely as a distribution channel to access the broader world reinsurance markets.

Overview of Market Changes

GCV: What was the objective of financial services deregulation? When did it begin? What were the most significant reforms that were introduced?

JN: Despite insurance industry profitability, Japan's overall economy was stagnant, asset markets were weak, and the government began looking for ways to stimulate growth. The specific aim of the Japanese "big bang" was to promote a fundamental reform of the Japanese financial market so that it would rank alongside other major world markets. The government hoped to enable Japanese companies to compete on a global scale and to encourage foreign investment in the country.

Deregulation of the insurance industry began with the passage of the Insurance Business Law of 1996 and was influenced by the two Japan–US insurance agreements concluded in 1994 and 1996.

Efforts to liberalize the industry have resulted in the elimination of fixed rates; greater product differentiation; promotion of cross-sector entry of life and non-life insurers, banks, and securities houses; and the removal of most barriers to market entry. In terms of reinsurance the roles of both the domestic exchange system of reinsurance and industry reinsurance pools have diminished.

Impact of Reforms on Domestic Companies

GCV: What was the initial impact of market reforms on domestic insurers?

JN: On a macro level, a series of factors – including low interest rates, depressed equity markets and continuing bad loans – have created a difficult trading environment and an unprecedented period of economic stagnation.

As a result, growth has been modest. Although combined ratios have begun to stabilize, many companies are being forced to recognize losses due to declining asset values and, in some cases, to the September 11th terrorist attack.

GCV: How have Japanese insurers attempted to regain their competitiveness?

JN: Domestic insurance companies have been forced to develop new business strategies in order to meet the demands of post big bang Japan. These have included a series of mergers and management integrations, together with alliances between non-life and life insurance companies.

The focus of these changes has been to enhance efficiency by reducing expense ratios and to stimulate growth by generating new distribution channels through alliances with life insurers and other mechanism such as over-the-counter bank sales. In addition, non-life insurers have sought to take advantage of their new access to the so-called "third sector" of accident and health insurance by launching a series of new products.

GCV: Have companies moved away from the keiretsu system?

JN: Equity market declines have created a need to reduce the number of cross shareholdings, but many of the large industries are still tied financially and culturally to their historic corporate groupings.

Opportunities for Global Insurers and Reinsurers

GCV: Did opportunities develop right away for global insurers to enter this market? What obstacles have had to be overcome?

JN: Theoretically opportunities exist for global insurers to enter the market but practically and culturally the barriers to entry into the Japanese non-life insurance market remain high. This is particularly true in the industrial and commercial sector where penetration by insurance brokers remains extremely low. This in turn limits opportunities for new insurance entrants.

The distribution channel is critically important. So is the ability through that channel to educate the client base to the benefit of the products that insurers offer. Access to the distribution channel and education of both clients and agents is costly and difficult.

Since deregulation, we have actually seen a decline in the number of foreign insurers operating in the industrial commercial sector, but have witnessed some new entrants in niche areas such as automobile direct distribution.

GCV: You mentioned that the roles of industry reinsurance pools and domestic exchange systems of reinsurance have diminished. How have these changes affected opportunities for global reinsurers?

JN: The weakened roles of these two domestic reinsurance practices theoretically creates new opportunities for foreign reinsurers. Instead, these potential opportunities are offset by the fact that industry consolidation has created large and well-capitalized companies that are able to increase their retentions and, as a market, cede less business to reinsurers.

The abolition of the tariff market means that reinsurers must select their ceding company partners more carefully. At the same time, it is also important for insurers to make sure that their reinsurance placements are well spread rather than concentrated on a limited number of reinsurers.

The opportunities that have arisen have involved primarily two categories of reinsurers: those capable of providing support across all lines, and those that are willing to provide significant catastrophe cover to meet the demands of a changed environment for earthquake insurance.

Since 1996 we have also seen a growth in the number of cooperative insurers selling natural perils products and seeking to purchase reinsurance and, in particular, significant catastrophe limits.

■ Part Two

The Role Of Global Brokers

Guy Carpenter Views: How has the role of international brokers changed in the past few years? Do you expect that their role will expand as deregulation continues?

James Nash: One of the provisions of the Insurance Business Law of 1996 was to allow global insurance brokers into the market for the first time. Broker authorization, along with many other reforms outlined under the new regulations, will begin to drive change in the Japanese insurance marketplace.

These marketplace changes, coupled with the broader financial, accounting, and economic reforms being introduced in Japan, will begin to transform the risk management needs of Japanese insurers.

Consequently, the importance of a reinsurance broker's perspective will increase. Whether insurers are looking for captives, for quantitative services, or for catastrophe modeling, international reinsurance brokers have the experience to bring these products of the global marketplace to their Japanese clients.

Product Trends And Pricing

GCV: What types of reinsurance products are most in demand?

JN: The Japanese insurance market has been dominated by pro rata reinsurance, which was well suited to a tariff market environment because every company was normally profitable. As the market liberalizes, pro rata products become a more restrictive and less viable method of reinsurance. Consequently, there is now a movement towards excess of loss reinsurance.

GCV: What about alternative risk transfer (ART) mechanisms? Has there been any interest in these products?

JN: Japanese insurers have embraced certain ART products much more than have insurers in many other markets. In fact, Japan accounts for a relatively large number of the securitization deals that have been done over the past few years. Most recently, Tokio Marine arranged a state-of-the-art catastrophe swap with State Farm that broke new ground in the reinsurance and capital management arena.

I think Japanese insurers are certainly as sophisticated with regard to securitizations as are their counterparts in other parts of the world. I would not say the same about balance sheet-smoothing products, however, largely because of the lack of clear accounting guidance.

I believe that over the next few years, the market will become much more interested in utilizing mechanisms such as aggregate stop-loss products. This is because these products assist in the efficient utilization of capital and provide consistently high levels of protection.

GCV: What do you think will be the overall impact of pricing freedom on competition in the marketplace?

JN: Greater freedom in pricing will provide a competitive advantage to those companies operating on a lower cost base and to those companies that are able to select their risks with greater freedom.

In the short term, as the market adjusts to the new reforms and as expertise is developed, it is possible that market competition will lead to a deterioration of results in a number of sectors. This in turn could place a greater emphasis on efficient reinsurance structures.

The Role Of Guy Carpenter

GCV: What is Guy Carpenter's role in this market?

JN: Guy Carpenter has transacted reinsurance business in Japan since1906, originally via C.T. Bowring and Sedgwick. However, in Japan's heavily controlled insurance marketplace, until recently our role was predominantly that of a distribution channel for reinsurance business and a window to world markets.

Our role in designing programs, setting retentions, and developing and implementing sophisticated analytical tools had little practical application.

Now, however, all of this is changing. There is an increasing realization that these types of services can be of key assistance.

GCV: What areas are of concern to your clients?

JN: Our Japanese insurance clients as they enter the new deregulated environment are addressing many of the same issues faced by our client base in the United States and Europe.

We are increasingly involved in risk assessment and in dynamic financial analyses for our clients. Using our state-of the-art modeling tools, we believe we can help clients review their reinsurance decision making, particularly the strategic impact on their bottom line and capital structures of the many different types of reinsurance programs—pro rata, stop loss, excess of loss, finite, securitization. We can also extend this approach to programs that are not commercially available but that could be designed to fit an insurer's unique risk profile.

In the past, Japanese insurers tended to do all of their own analyses, program design, and retention setting. They then gave the results to the brokers, who would place the reinsurance coverage. However, the rapid pace at which the world reinsurance market is changing—particularly with regard to the more sophisticated analytical and modeling work—coupled with a desire to reduce costs may drive a change in attitude among reinsurance buyers.

Guy Carpenter's aim is to work in close partnership with our Japanese clients to understand and quantify their specific needs and to provide an effective, professional, and cost-effective service. In certain instances, this may involve the outsourcing of various functions where our years of experience in world markets can be of significant benefit to our clients.

The Future

GCV: Are you optimistic about the future of the reinsurance market in Japan? How is Guy Carpenter preparing for the future?

JN: As the Japanese market changes and evolves, so will the needs of our clients.

We strongly believe in the future of the Japanese non-life insurance industry and are committed to strengthening our partnerships with our clients and to fully understanding their needs in the changing environment. We hope that this understanding in turn will allow us to effectively bring the full range of our global resources and specialty services to Japan.