

4. Topics in Life Insurance Industry

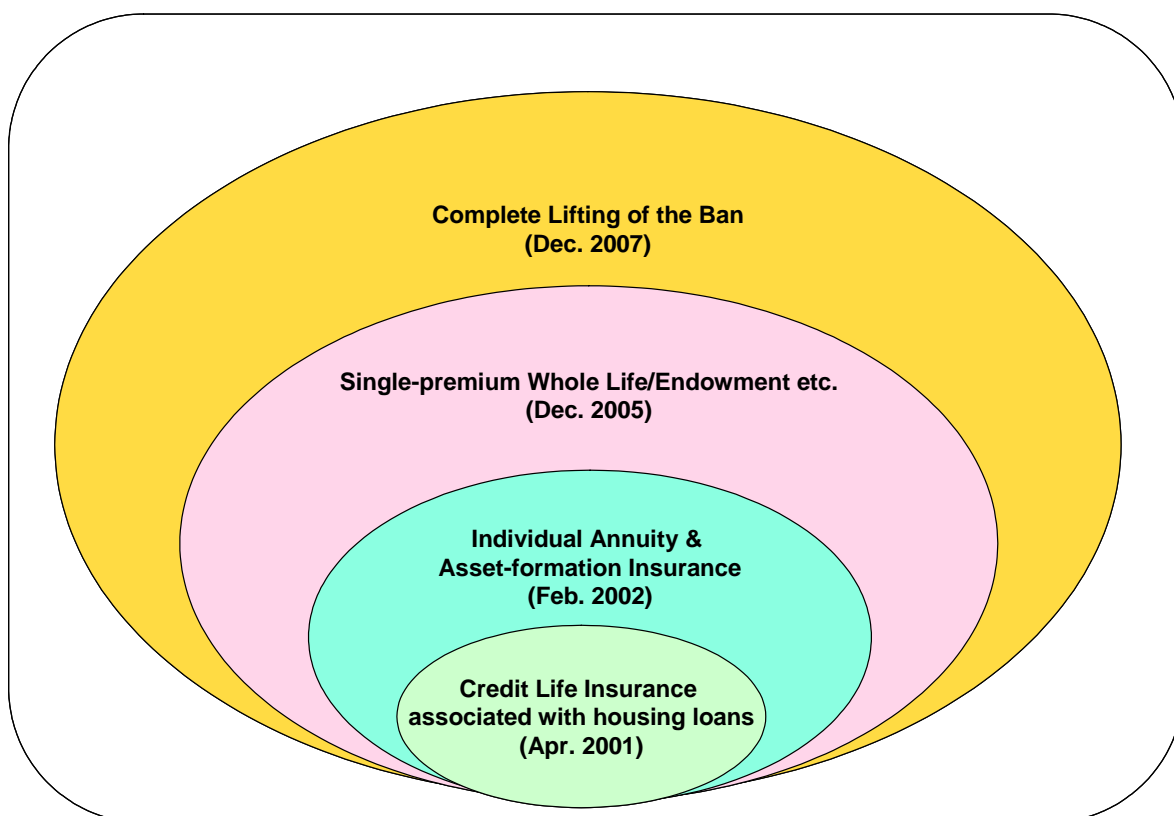
a) Bancassurance

Following the Report of Insurance Council in 1997 and the amendment of the Insurance Business Law in 2000, the ban on over-the-counter (OTC) sales by banks of long-term fire insurance, long-term income indemnity insurance and credit life insurance (all associated with housing loans) as well as overseas travelers' personal accident insurance, was lifted on 1 April 2001. However, the credit life insurance policies that might be distributed by banks were limited to those of the life insurers which were either a bank's subsidiary or an affiliated company. At that time, the bancassurance in Japan was still in its early stages of development.

Later, in October 2002, the range of such products was extended to include individual annuity, asset-formation insurance, individual annuity and accident insurance and asset-formation personal accident insurance. Also the restrictions on the credit life insurance (bank-subsidary rules) were removed. As a result, OTC sales by banks of life insurers' products practically started. On 22 December 2007, all restrictions on the sale of insurance products by banks were lifted. Accordingly, the following measures were introduced to prevent eventual negative effects of the deregulation:

- ✓ To stipulate a "split of work" rule between banks and insurers regarding after-sale activities (inquiries of policy contract, replies to claims and consultation services, etc.) and present it to customers
- ✓ To require banks to secure enough staff members to process the necessary work after selling insurance policies
- ✓ To make customers aware of the insurance solicitation guideline of banks through documents, oral explanations, in-store posters and notices, home pages and other means
- ✓ To assign staff with enough legal and practical knowledge of insurance business (about solicitation activities, policy contracts, etc.) in banks' internal audit departments
- ✓ To require banks engaged in this type of operations to comply with the "Comprehensive Guideline for Supervision of Insurance Companies" described in the "Concerning Unfair Business Practices following the Easing of the Regulation on Businesses of Financial Institutions and Expansion of Scope of Business Services" document

These regulations are to be re-examined in 2010 after being monitored by the FSA.



b) Insurance Contract Law

The bill on the new Insurance Contract Law was passed by the Diet on 30 May 2008 and promulgated on 6 June 2008. The rules of private law concerning insurance policy contracts, currently set forth in Chapter 10, Part 2 of the Commercial Code, will come into force as a special law on 1 April 2010.

The current rules and regulations related to insurance business were first established in 1899, when the Commercial Code was enacted, and partly amended in 1911. However, most of the said rules and regulations have remained with no particular change for almost a century. Accordingly, they did not only lack provisions concerning injury and/or illness-related insurance and liability insurance but constituted also somehow rigid rules based on old-fashioned theories.

As such, in several aspects, they were not suitable to modern insurance theories or current business practices. Recognition of these defects prompted the authorities to both, drastically review the basic civil laws regarding our economic activities, and amend the text of contract rules so that they may fit to current times and be easily understood by ordinary people. We have now this new Insurance Contract Law as a result.

The Insurance Contract Law provides the following measures to better protect insurance policyholders and maintain the soundness of the insurance system in Japan:

- a) Application of the Law to cooperative insurance: The Insurance Contract Law is now applicable to cooperative insurance policies to which provisions in the Commercial Code were applied *mutatis mutandis* previously.
- b) New regulations on injury and/or illness insurance-related contracts: The Insurance Contract Law stipulates provisions on not only life and non-life insurance contracts but also injury and/or illness insurance contracts, which were not specifically regulated by the Commercial Code.
- c) Unilaterally enforceable provisions clearly-stated: Most of provisions in the Commercial Code are understood as permissive rules that grant priority to the provisions of policy clauses. This Insurance Contract Law stipulates that, with respect to representation obligations, time of claims payment, rescissions due to a serious reason, and insurance reserve funds, among others, any unfavorable arrangement for policyholders should be declared void.

Provisions of the Insurance Contract Law exert a great impact on the business practice of the insurance industry. Newly-created or significantly-amended regulations are as follows:

- ✓ Solicitors' activities encouraging misrepresentations from customers
- ✓ Lien of the victim in liability insurance
- ✓ Changes of beneficiary based on testaments
- ✓ Continuation of life insurance policies based on beneficiary's own will
- ✓ Policy rescissions due to a serious reason
- ✓ Time of benefits payout

In principle, the Insurance Contract Law may not apply to insurance contracts concluded before the enforcement of this Law except for:

- ✓ Consent of the insured regarding the assignment of right of insurance claims
- ✓ Decrease of insurance risk
- ✓ Policy rescission due to a serious reason
- ✓ Effect of policy rescission
- ✓ Time of benefits payout for insured events occurring after the enforcement of this Law
- ✓ Exercise of the right of intervention by garnishers against policy rescissions after the enforcement of this Law

c) Solvency Margin Ratio

1) Existing Solvency Margin Ratio

Reserve of insurers will be able to respond to normal expected risks. However, unexpected events resulted from catastrophic disaster or significant fall of stock prices might happen. In order to determine whether the insurer has “margins of solvency” to be able to respond to such unexpected risks, solvency margin ratio was introduced as an index of administrative supervision.

Since the fiscal year ending in March 1998, life insurers in Japan have been disclosing their solvency margin ratio. It is calculated as follows:

$$\text{Solvency Margin Ratio (\%)} = \frac{\text{Total Amount of Solvency Margin}^a}{1/2 \times \text{Sum Total of Risks}^b} \times 100$$

^a The “Total Amount of Solvency Margin” (numerator) is the total of the following:

= Total Capital + Price Fluctuation Reserve + Contingency Reserve + General Bad Debt Reserve + 90% of Variance of the Estimate of Other Securities* + 85% of Unrealized Gain or Loss on Real Estate* + Debt Capital Instruments + Deductible Items, and others.

* If these values are negative, 100% of the value is applied instead of 90% or 85%.

^b The “Sum Total of Risks” (denominator) is calculated as follows:

$$= \sqrt{(R_1 + R_8)^2 + (R_2 + R_3 + R_7)^2} + R_4$$

R₁: *Underwriting Risk* – Risk of massive insurance payouts following a disaster or catastrophe

R₈: *Underwriting Risk of third-sector insurance* – Risk of massive third-sector insurance payouts such as health insurance and cancer insurance

R₂: *Assumed Interest Rate Risk* – Risk that investment return falls below the assumed interest rate

R₃: *Asset Management Risk* – Risk of a drastic devaluation of assets because of a crash in stock prices or sharp fluctuation in the currency market, and risk of a sharp increase in irrecoverable loans due to failures of borrowing companies

R₄: *Business Management Risk* – Business risk in excess of normal expectations

R₇: *Minimum Guarantee Risk* – Risk related to the minimum guarantee for benefits of variable insurance and variable annuity products

2) Early Warning Measures

Early warning measures were introduced by the FSA for the purpose of ensuring appropriate business operation of life insurers and protecting policyholders.

➤ Summary of early warning measures for life insurers

Category	Solvency Margin Ratio	Measures
None	200% and over	None
Category 1	100% to less than 200%	Submission and implementation of a business improvement plan
Category 2	0% to less than 100%	a. Submission and implementation of a plan for adequate solvency of insurers b. Prohibition or limitation of dividends c. Prohibition or limitation of policy dividends or distribution of surplus to policyholders d. Change in calculation method of premium for policies to be newly underwritten e. Prohibition or limitation of directors' bonuses, limitation of other operating costs, etc.
Category 3	Less than 0%	Partial or total suspension of operation for a limited period

- Even if the solvency margin ratio is less than 0%, a company may be classified as category 2 if real net assets (= assets - liabilities - price fluctuation reserve - contingency reserve, etc.) are positive.

- Even if the solvency margin ratio exceeds 0%, a company may be classified as category 3 if real net assets are negative.

3) Revision of Solvency Margin Ratio

The method for calculating the solvency margin ratio has been revised as the need arises. In December 2004, the FSA announced the “Program for Further Financial Reform” that includes a review of the solvency margin. Then, in November 2006, the FSA set up a team to deliberate on the calculation standard of the solvency margin ratio. The team held a total of 11 meetings and published a report entitled “Regarding Solvency Margin Ratio Calculation Standards.” This report made the following comments on the solvency margin ratio:

- ✓ Insurance companies are required to raise their solvency margin ratio to improve their financial position. On the other hand, other financial indicators, such as profit margins, must be used together with the solvency margin ratio in order to assess the financial soundness of insurance companies.
- ✓ If the insurers’ solvency ratio falls below the 200% line, “early warning measures” have to be taken depending on the level of the ratio. When revising the calculation method, it is necessary to improve the credibility of the solvency margin ratio by making it adequately reflect the actual situation of the financial market as well as enhancing the confidence level. Insurers also have to strengthen their financial control systems and improve their financial positions.
- ✓ Currently policy reserves are calculated based on the assumed rates by using a lock-in method, while risk amounts for the solvency margin are calculated based on a risk-factor approach. As a mid-term revision, the solvency valuation based on economic value should be realized to recognize the volatility of the net assets (the difference between the value of assets and the value of liabilities on an economic value basis) as the risk amount, and to manage the volatility appropriately. This is particularly important from the viewpoint of stakeholders who look at the corporate value index.

➤ Major Revisions since FY 2001

Date	Major Revisions
30 March 2001	Reflection of valuation gains and losses on securities holdings (including unlisted securities) Risk amount calculation based on market value Introduction of price fluctuation risk of domestic bonds Restriction of “future profits” (from 100% to 50%) Negation of double-gearing with banks, etc. falling under the category of subsidies
22 October 2004	Creation of risk equivalent amounts corresponding to minimum guarantee risk
28 April 2006	Introduction of a stress test for risk assessment of third sector insurance products

Based on the aforementioned report, the FSA published an “Outline of Revisions to the Solvency Margin Ratio (Draft)” in February 2008 in order to obtain public comments on the following issues:

- ✓ Revising risk coefficients based on the most recent data available
- ✓ Considering the method to calculate diversified investment effects based on asset composition (ratio) for each insurance company
- ✓ Raising the confidence level of risk coefficients from 90% to 95%
- ✓ Deliberating the way to adequately include deferred tax asset

The FSA also conducted further reviews in the light of Yamato Life’s failure in October 2008, lessons learnt from the financial crisis and opinions on the proposed outline, and published the proposed revised outline in October 2009. Public comments are sought on the following items:

- ✓ Tightening of inclusion in margin (capital)
- ✓ Tightening of risk measurement
- ✓ Ensuring adequacy of solvency margin ratio

d) Life Insurance Policyholder Protection Scheme

The Life Insurance Policyholders Protection Corporation of Japan (PPCJ) is a corporate entity that was established on 1 December 1998 based on the Insurance Business Law. All life insurers operating in Japan automatically become members of the Corporation.

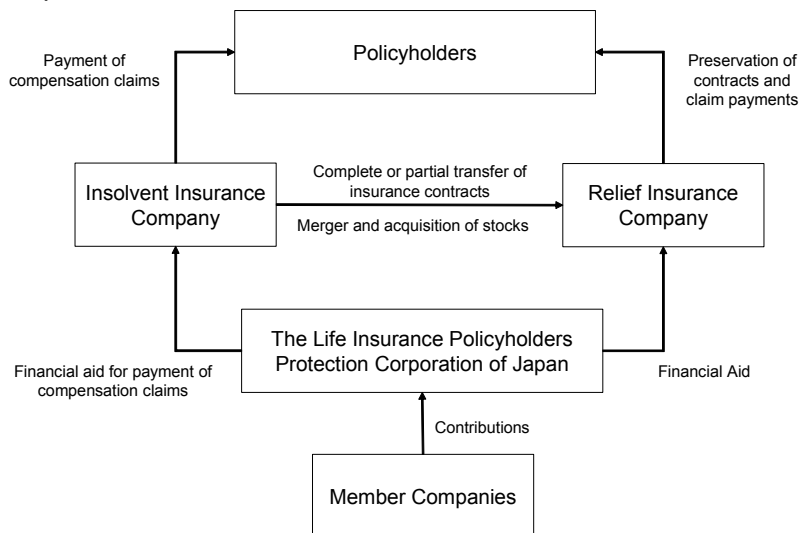
The PPCJ's mission is to provide financial aid when policies are transferred from an insolvent insurer or when payment of compensation claims is necessary, as a mutual assistance system for the benefit of policyholders of life insurers.

Also, the PPCJ acts on behalf of policyholders in following a life insurer's rehabilitation procedures, which includes all actions such as voting by proxy at stakeholders' meetings that discuss the proposed reorganization plan developed by the reorganization trustee.

*The PPCJ's system of voting by proxy was established to ensure that rehabilitation procedures are smoothly followed, and does not prohibit voting by the policyholder.

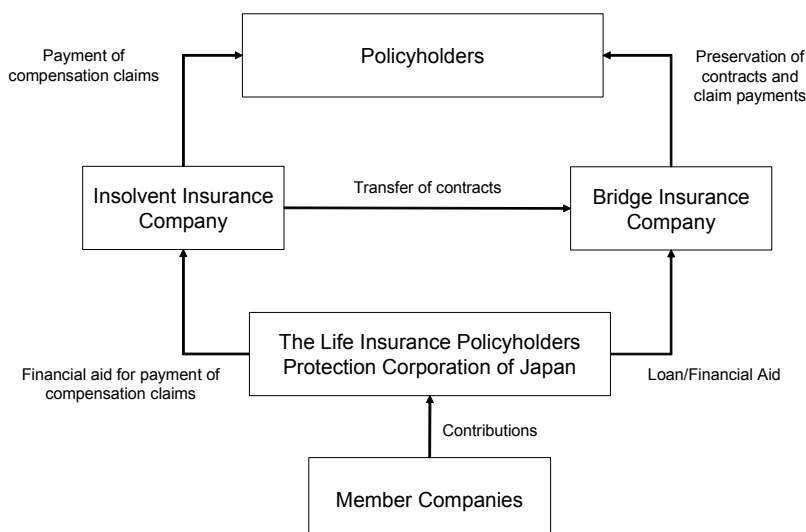
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- When a relief company, to which the insurance contracts of an insolvent insurance company are to be transferred, steps forward

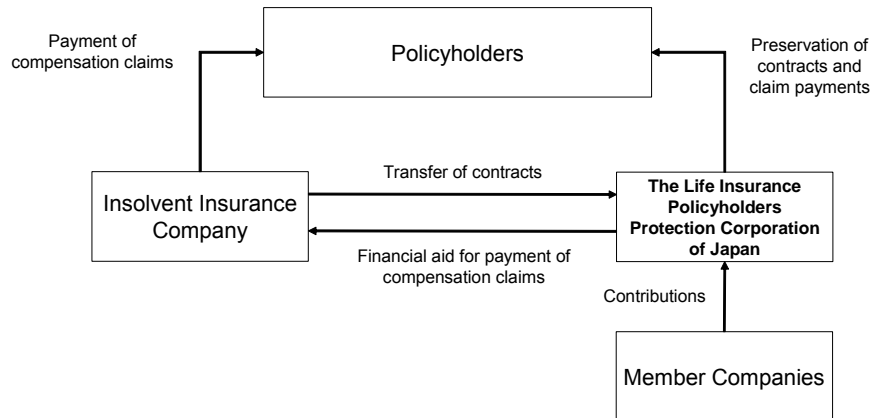


- When a relief company, to which the insurance contracts of an insolvent insurance company are to be transferred, does not step forward

1. Transfer of contracts to a “bridge insurance company”



2. Contracts undertaken by the PPCJ



Compensation Coverage

- Insurance contracts of life insurers operating in Japan (excluding the special accounts of investment-linked insurance policies)

Compensation Range

- 90% of policy reserves (excluding policies with high expected interest)
- The compensation ratio for policies with high expected interest is as follows:
 $90\% - [\text{sum of (each expected interest in the past 5 years – the base rate)}] / 2]$

Funding Scheme

Industry contributions ¥460 billion	+	In case the amount of financial assistance exceeds the ceiling on industry contributions, government aid is available*
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* Government aid becomes available when all of the following conditions are met: 1) the financial aid exceeds the industry contributions, 2) it becomes difficult to maintain the credibility of the insurance industry as a result of deterioration of a member's financial condition, and 3) there is a risk of serious impact on people's lives and financial markets. This is available until the end of March 2012.