

Rating Methodology by Sector

Life Insurance

This rating methodology mainly applies to life insurance companies and life insurance groups in Japan. It also applies to mutual aid corporations that handle life mutual aid. For overseas life insurance companies and others, JCR applies this rating methodology after making necessary adjustments to the analytical indicators based on the laws, accounting systems, regulations, and financial administration, etc. in the country or region where those companies are located.

1. Business Foundation

(1) Industry Characteristics

(i) Market size and growth potential

The life insurance business handles insurance products for the survival or death of a person (the so-called first sector) and bodily injury or illness (the so-called third sector) in accordance with the Insurance Business Act.

The life insurance market is large and expanding moderately. Life insurance is based on the principle of mutual assistance and has a social mission to provide security throughout one's life. Japan's population is on a declining trend, and demographic changes due to the falling birthrate and aging population, as well as the diversification of lifestyles, such as the increase in nuclear families and single-person households, are expected to further develop. While needs for death benefits are declining, there is room for growth in third-sector products such as medical insurance that address the risk of longevity, and annuity insurance products to secure funds for retirement and to support retirement living. Although it is difficult to expect high growth in the life insurance market, JCR believes that the market is unlikely to shrink rapidly.

(ii) Competition

The life insurance business is licensed, and there are relatively high barriers to entry. On the other hand, the life insurance household participation rate is very high, and in addition to traditional domestic life insurance companies, there are many foreign and non-life insurance companies competing in this mature market. As for sales channels, the sales staff channel held by traditional life insurance companies continues to have a large presence, but they are diversifying and becoming more specialized, such as joint agencies (insurance shops), bancassurance, and direct (Internet) channels. Life insurers have little room for differentiation in their products, so it is not easy for them to secure a competitive advantage. Although there is a certain amount of competition in all sales channels, major life insurers have a reasonable share of the market, and the growing awareness of risk and return due to the prevalence of ERM (Enterprise Risk Management) is making excessive price competition less likely.

(iii) Transaction stability

Life insurance products are not patent subjects, and even if a company develops a product that captures customer needs, it is likely to be followed by competitors. In addition to being long-term contracts, life insurance products are unlikely to be cancelled or switched because premiums generally increase as the age of participation increases and there are surrender charges. The stability of transactions is also supported by the strong grip on customers by sales staff and the company's coping with the obsolescence of coverage through a conversion system. On the other hand, some savings-type products are susceptible to switching to more advantageous products due to changes in market conditions, such as rising interest rates and exchange rate fluctuations.

(iv) Protection and regulation

Life insurance companies are supervised by Financial Services Agency and are required to calculate a solvency margin (SM) ratio that indicates how much solvency margin they have against risks that exceed normal expectations. Under the current regulations, early corrective measures are triggered if the SM ratio falls below 200%.

In addition, life insurance companies are subject to bankruptcy resolution procedures under the Insurance Business Act and the Act on Special Measures for the Reorganization Proceedings of Financial Institutions. Policies of a failed life insurance company may be continued after its bankruptcy through transfer of policies by a bailout company, merger, share acquisition, etc. However, reduction of policy reserve may be implemented. In such cases, Life Insurance Policyholders Protection Corporation of Japan will, in principle, compensate up to 90% of the policy reserve at the time of bankruptcy, except for policies with a high assumed interest rate, in accordance with the Insurance Business Act and other regulations. In addition to reductions in policy reserve, policy terms and conditions may be changed, such as reductions in assumed interest rates.

On the other hand, financial system incorporates various measures (prudential policies) to maintain stability and efficiently function. The expected protection for insurance companies and insurance holding companies is weak compared to that of banks.

(2) Market Position and Competitiveness

The market position and competitiveness of life insurance companies are important for ensuring stable earnings over the medium to long term. The depth and characteristics of the customer base, diversity of sales channels and sales capabilities, uniqueness of product and management strategies, brand power, and high customer convenience through the use of digital and other means determine market position and competitiveness.

Regarding the customer base, JCR evaluates the number of customers (policyholders), characteristics of the customer segment, and the size and stability of in-force contracts. In order to build a stable customer base, it is important to secure stable contract performance. JCR evaluates the stability of in-force contracts not only in terms of size, but also in terms of the fact that in some cases the company has a presence in its own customer base, such as belonging to a particular corporate group.

JCR evaluates how well the new customers are being acquired by the sales channel's sales force and product appeal. For the sales channel, JCR confirms whether the company is accurately capturing diversifying customer needs. In the sales staff channel, JCR evaluates the sales force based on the age group and job classification of sales staff, as well as the state of recruitment and training, and sales efficiency. In the agency channel, JCR qualitatively evaluates business relationship between the life insurance company and its agents and strength of ties between them. In terms of product strategy, in addition to the fullness of product lineup, key point is whether the company is able to quickly and flexibly respond to changes in customer needs. It is not easy to differentiate its products from those of other companies, and merchantability (ease of understanding), marketing ingenuity, and skillful promotion are related to the differentiation.

(3) Management Strategy and Governance

Management strategy and governance are factors that affect the direction of business foundation, and also financial foundation. With regard to management strategy, JCR evaluates whether the company is able to formulate and execute a management strategy that takes into account changes in the business environment. JCR also focuses on the direction of risk appetite and the extent to which the ERM culture has penetrated within the company. With regard to governance, JCR checks whether a check-and-balance function adequately is functioning through the corporate governance system, such as the board of directors, management control system, risk management and internal control such as compliance, while taking into account the size of the organization. In the event of misconduct, risk of damage to the business foundation due to loss of reputation will become apparent. Therefore, JCR checks whether a system is in place to prevent misconduct from occurring, and whether a system will be in place to prevent similar incidents from recurring in the future when such misconduct has occurred.

2. Financial Foundation

(1) Earnings Power

In evaluating earnings power, JCR focuses primarily on economic value-based indicators. In particular, JCR checks trends in the value of new business, a component of Embedded Value (EV), which represents corporate value based on economic value. In addition, trends in financial accounting-based earnings, including core profit, are referenced. To ensure stable new business value and core profit, it is essential to analyze trends in contract performance.

For economic value-based indicators, emphasis is placed on the accumulation of "the amount of increase in EV associated with the results of sales activities," such as the value of new business, but it should be noted that the assumptions made differ from company to company. Since third-sector products have relatively high profitability in terms of economic value, JCR confirms whether the product portfolio is optimized to accumulate the value of new business, based on the diversification of products. The level of new business margin and control of sensitivity to market fluctuations such as interest rates and stock prices are also key points. At the same time, JCR also analyzes profitability by product, centered on core products.

Earnings power on a financial accounting basis is evaluated based on trends in core profit. With regard to insurance-related profit/loss of the core profit, JCR focuses on the balance between premium revenue and insurance claims/benefits payments or operating expenses. Regarding mortality gains/losses, while traditional mortality insurance is likely to easily have a profit outlook based on historical data, JCR pays attention to the possibility that the actual incidence rate for medical and nursing care insurance may deviate from the projected incidence rate based on data against the backdrop of advances in medical technology and system changes related to medical care and nursing care. In addition, since a decline in contract performance can lead to a reduction in the cost burden of new policies and other expenses, and core profit can swing upward in the short term, JCR does not view increases or decreases in core profit as a straightforward indication of trends in earnings power.

JCR evaluate trends in contract performance, which is the source of earnings power. Particular attention is paid to annualized new business premiums, which are a flow-based indicator. In addition to the acquisition of new policies, JCR checks the composition ratio of protection products and savings products, as well as the composition ratio of third-sector products. As for annualized premiums in-force, which are a stock-based indicator, JCR confirms whether the company is maintaining a reasonable policy size. For insurers that emphasize the provision of death benefits, it may be appropriate to check the trends of amount of new policies and the amount of in-force policies as indicators.

Key financial indicators

- New business value, new business margin
- EV
- Core profit (interest gains (losses), mortality gains (losses), and expense gains (losses))
- Annualized premiums (new business, policies in-force)

(2) Asset Quality (Asset Management)

ALM is extremely important in the asset management of a life insurance company, and JCR confirms whether the company has built an asset portfolio that is consistent with the characteristics of the insurance liabilities. If asset management is not consistent with the characteristics of insurance liabilities, negative spread on long-term life insurance products may put pressure on profitability. Since the risk-return approach to asset management differs depending on the asset management policy of each company, it should be noted that the composition of securities, real estate, loans, and other assets, which account for the majority of assets held, differs. Based on the composition of investment assets, JCR checks the risk of each individual asset and the diversification effect of the assets as a whole. It is important to secure investment income in order to maintain profits for financial accounting purposes. Based on the recognition of the basic risk-taking policy, JCR evaluates the appropriateness of the investment stance, adequacy of personnel and systems for asset management, and status of securing returns.

Key financial indicator

- Composition ratio of asset portfolio

(3) Capital Adequacy

Regarding the financial foundation, JCR places the greatest emphasis on capital adequacy from a quantitative perspective, evaluating capital adequacy in terms of economic value, which is a market value assessment of assets and liabilities as a whole. This is in line with the ongoing trend in Japan to introduce solvency regulations based on economic value (new regulations).

As an indicator, JCR pays particular attention to ESR (Economic value-based Solvency Ratio). Since ESR is a numerical value based on internal management-based risk management and differs in terms of assumptions, JCR evaluates ESR by paying attention to trends in regulations and changes in calculation standards both in Japan and overseas. While internal management-based ESR, which represents the characteristics of each company, is the main target of the evaluation, JCR will also incorporate regulatory-based ESR into the evaluation from the viewpoint of comparability, as assumptions and other factors will be standardized after the introduction of the new regulations. Although the SM ratio under the current regulations is also used as a reference, JCR checks the ratio on a basis that includes adjustments for gains/losses on valuation of securities, taking into account the differences between mutual companies and joint-stock companies.

The effective components of capital, assuming the current regulations, include capital stock and capital surplus (joint-stock companies), reserve for redemption of funds (mutual companies), as well as various reserves such as price fluctuation reserve, contingency reserve, and policy reserve in excess of surrender values. Hybrid securities, which have characteristics of both equity and liabilities, are factored into the evaluation, regardless of whether they are subject to current or new regulations, in consideration of their equity content.

Many life insurance companies hold long-term insurance policies and thus have long liability durations. Therefore, they are exposed to interest rate risk arising from the duration gap between assets and liabilities, which varies from company to company. It is important to reduce the amount of interest rate risk through duration matching (shortening the duration gap), cash flow matching, and other measures and control sensitivity to changes in economic assumptions. In addition to appropriately controlling the amount of risk, including other asset management risks, JCR confirms whether the company has stabilized the level of ESR by building up capital through measures such as securing the value of new business.

Key financial indicators

- ESR
- Solvency margin ratio
- Capital adequacy ratio

(4) Liquidity

Regarding liquidity, JCR confirms that the company possesses highly liquid assets that enable it to respond

quickly in times of stress, such as a sharp increase in insurance claims/benefit payments or cash surrender values. JCR confirms that liquidity risk management is in place to enable reliable payment even if market risk or credit risk materializes during a financial crisis. A sharp increase in claims and benefit payments happens when a large-scale disaster occurs, a covered disease or other event becomes prevalent and morbidity and mortality rates are much higher than assumed at the time of product design. A sharp increase in cash surrender values for savings-type products could be assumed in cases of dynamic cancellations, where cancellations increase due to switching to more advantageous products when the market fluctuates, or in cases where the reputation of the life insurance company is severely damaged due to a deterioration in the business conditions.

Key financial indicator

- Liquid assets (cash, deposits, government bonds, etc.)

(5) Risk Management System

JCR focuses on the integrated management system of earnings and capital based on risk management, and checks the status of ERM development and progress in upgrading it. While excellent risk management is unlikely to be a positive factor in the evaluation, it can be a negative factor if it is considered that there is room for improvement in risk management. JCR mainly evaluates whether the company has incorporated an economic value-based approach into its management strategy and has secured an appropriate balance between risk and return. JCR also confirms whether the company comprehensively and accurately assesses various types of risks, identifies risks that have a significant impact on management, and can appropriately allocate capital accordingly. For effective risk management, it is necessary to elaborate and upgrade the risk management system.

In the life insurance business, there is a risk that the increasing frequency of payment events for third-sector products due to advances in medical technology and changes in the system will put pressure on profits. JCR takes the evaluation based on management conditions, such as payment trends of insurance claims and benefits and monitoring of morbidity rates, into consideration. In addition, JCR also confirms whether major life insurers have a global and group-wide ERM system in place, given the trend toward an increase in the number of group companies in Japan and overseas. The “Own Risk and Solvency Assessment (‘ORSA’) reports” are a useful tool for understanding the status of ERM and risk management systems.



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