August 12, 2004

Ratings on Foundation Funds of Mutual Life Insurance Companies

1. Foundation Funds

Foundation funds are an institution unique to mutual companies. Under Article 6 of the Insurance Business Act, it is stipulated that an insurance company shall be either a joint-stock company or a mutual company with its capital or foundation funds (including accumulated redeemed foundation funds) totaling equal to or more than 1 billion yen as set under the relevant ordinance. Foundation funds can be characterized as inauguration expenses and business funds, and are equivalent to capital of a joint-stock company as indicated by the fact that they are recorded in the capital section of a balance sheet. On the other hand, foundation funds have a characteristic of liability. Being based on an agreement between a mutual company and a contributor of the foundation funds similar to a loan for consumption agreement, they are required to pay interest and be redeemed at a specified date under the foundation funds contribution agreement.

All of the mutual companies operating in Japan currently are the following 6 life insurance companies: Nippon Life Insurance Company, The Dai-ichi Mutual Life Insurance Company, Meiji Yasuda Life Insurance Company, Sumitomo Life Insurance Company, Asahi Mutual Life Insurance Company and Fukoku Mutual Life Insurance Company. While a mutual non-life insurance company can also exist, there exists no mutual non-life insurance company in Japan after demutualization of Kyoei Fire and Marine Insurance in April 2003.

2. Funds for Interest Payments and Redemption of Foundation Funds

Under Article 55 of the Insurance Business Act (see Article 55 frame below), interest payments and redemption (principal redemption) of foundation funds can be made within the limit of net assets on the balance sheet less total amount of foundation funds, reserve for future losses, accumulated redeemed foundation funds and other amounts as stipulated by the Cabinet Office ordinance. If this limit is short of the interest payments or redemption amount, the shortage is deferred based on the foundation funds contribution agreement. In redeeming foundation funds, it is necessary to set aside funds equal in amount to the redemption amount as accumulated redeemed foundation funds (Article 56 of the Insurance Business Act). Accumulated redeemed foundation funds were once limited in use only to appropriation for future losses. It was specified that even when the reserve was reduced for future losses, the amount was not allowed to be calculated into Article 55 frame. However, requirements for use of the reserve were eased in the revision in July last year of the Insurance Business Act. Accumulated redeemed foundation funds can now be reduced irrespective of use when endorsed by special resolution at a general meeting (Article 56-2 of the Insurance Business Act). In such a case, the reduced amount can be calculated into Article 55 frame funds.

Life insurance companies in practice set aside reserve for redemption of foundation funds as a general reserve to make it clear that funds for redemption of foundation funds are assured. Accumulation of reserve for redemption of foundation funds is made in general through transfer from the reserve for redemption of foundation funds to the accumulated redeemed foundation funds.

Article 55 Frame of The Dai-ichi Mutual Life Insurance Company Unit: ¥ million

(Capital)		
Foundation Funds	230,000	…(i)
Accumulated Redeemed Foundation Funds	70,000	…(ii)
Revaluation Reserve	248	
Surplus	327,958	
Reserve for Future Losses	3,700	…(iii)
General Reserve	225,881	
Reserve for Redemption of Foundation Funds	171,500	
Others	54,379	
Unappropriated Retained Earnings	98,377	
Reserve for Land Revaluation	5,816	…(iv)
Net Unrealized Gains on Securities, net of tax	833,856	…(v)
Total Capital	1,467,880	…(vi)

(Statements of Surplus)		
Unappropriated Net Surplus for the Year	98,377	
Transfer from General Reserve	2,988	
Appropriation of Unappropriated Net Surplus	101,366	
Reserve for Policyholder Dividends	70,076	
Net Surplus	31,289	
Reserve for Future Losses	300	…(vii)
Accumulated Redeemed Foundation Funds	-	
Interest Payment for Foundation Funds	4,120	…(viii)
General Reserve	26,869	
Reserve for Redemption of Foundation Funds	21,500	
Others	5,369	

(Article 55 Frame)		
Article 55-1 Amount (Limit of Interest Payment for Foundation Funds)	324,508	…(vi) - (i+ii+iii+iv+v)
Article 55-2 Amount (Limit of Redemption of Foundation Funds)	320,088	…(vi) - (i+ii+iii+iv+v+vii+viii)

Source: The Dai-ichi Mutual Life Insurance Company

3. Handling Foundation Funds in Case of Bankruptcy

When a life insurance mutual company goes bankrupt, institutions that can be applied in practice are the following two: administrative procedures based on the Insurance Business Act and corporate reorganization proceedings based on the Act on Special Treatment of Corporate Reorganization Proceedings and Other Insolvency Proceedings of Financial Institutions. In both cases, proceedings including transfer of insurance contracts are made.

In liquidation of mutual companies under Article 181 of the Insurance Business Act, refund of foundation funds is not allowed to be made before reimbursement of debts. Debts owed by foundation funds are subordinated to insurance payment obligations and general obligations. This is also considered relevant when the Act on Special Treatment of Corporate Reorganization Proceedings and Other Insolvency Proceedings of Financial Institutions is applied. Liens are attached on insurance claims against life insurers (Article 117-2 of the Insurance Business Act).

When the Insurance Business Act was revised in July last year, changes in insurance contract terms (such as cutback on assumed rate of interest) were set out to allow insurance companies to ease their burdens while avoiding legal bankruptcies. When the assumed rate of interest under insurance contracts is lowered, an insurance amount scheduled to be paid out in the future will be reduced and the payout based on the original contracts will not be enforced, although the accumulated liability reserve will be maintained in full. When the contract terms are to be changed, contributors to foundation funds will also be required to shoulder burdens (Administrative Guideline, 2nd Volume Concerning Insurance

Companies, 1-7-3). Despite avoidance of bankruptcy of a life insurance company, therefore, when this system is applied, both the insured and contributors to foundation funds will fall into a situation of being unable to get fulfillment of obligations as contracted. In such a case, priority between insurance payment obligations and foundation funds obligations is difficult to define.

JCR announced its view on May 23, 2003 that when contract terms are changed by an insurance company, its ability to pay insurance claims will be rated as D.

4. Views on Rating on Foundation Funds

In rating foundation funds, JCR evaluates the assuredness of interest and principal payments being made in full without deferment. Therefore, when an insurance company goes bankrupt, JCR will regard its foundation funds as a case of default. And when payment of interest or principal is deferred, it will also be considered default even though the deferment is made under the foundation funds contribution agreement.

While lien is attached on insurance claims, refund of foundation funds is made only after reimbursement of other obligations in case of bankruptcy involving an insurance company. Subordination of foundation funds is clear in terms of debt recovery upon bankruptcy. Accordingly, the rating on foundation funds ought to be lower than that on ability to pay insurance claims. The notching should vary with the degree of bankruptcy risk of each insurance company. However, it should be noted that the establishment of a system for changes in contract terms under the revised Insurance Business Act has somewhat blurred the subordination of foundation funds to insurance payout.

On the other hand, even when an insurance company is not bankrupt and insurance payments are made normally, deferral of principal and interest payment for foundation funds is considered default. Risk of deferral of principal and interest payments for foundation funds should be taken into account in considering rating criteria for foundation funds. This risk is analyzed by looking into the balance between unredeemed foundation funds and funds for redemption (the current Article 55 frame plus the future retained earnings).

JCR considers that the rating on foundation founds should be equal to or more than one notch lower than that on insurance claims, taking into account the difference in subordination in recovery and probability of default. When the rating on the ability to pay insurance claims is high and bankruptcy risk is low and when there is enough room in the balance between unredeemed foundation funds and funds for redemption, JCR considers that the gap in notching should be limited to one notch. When the rating on the ability to pay insurance claims is low and there is not enough room in the balance between unredeemed foundation funds and funds for redemption, JCR considers that the notching should vary with each situation.