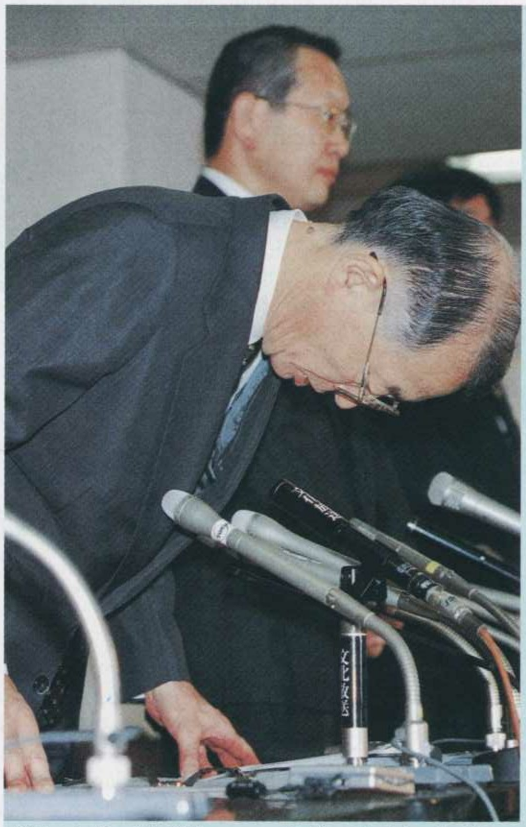
A Few Thoughts on Financial Safety Nets

By Hamano Takayoshi

In October 2000, Chiyoda Mutual Life Insurance Co., a medium-sized insurance firm, went under and filed for court protection from creditors after languishing for years under financial difficulties caused by reckless real estate and stock market investments as well as the marketing of high-yield insurance products during the late 1980s asset-inflated bubble economy. Chiyoda's collapse triggered the bankruptcy of Kyoei Life Insurance Co. two weeks later in a chain reaction after restless policyholders rushed to cancel their contracts. Kyoei similarly sought court protection. Chiyoda and Kyoei were the fifth and sixth life insurance companies to go bankrupt since 1997. They followed Nissan Mutual Life Insurance Co., the first life insurer to collapse in postwar Japan, Toho Mutual Life Insurance Co., Daihyaku Mutual Life Insurance Co., and Taisho Life Insurance Co.

The successive collapses of life insurers have made policyholders jittery about the future of their contracts. To deal with the situation, the building of a financial safety net in a broad sense is becoming an urgent task.

This may be high time to compare the Japanese financial safety net, including insurance system, with the one in the U.S., a leader in the insurance business.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Chiyoda President Yoneyama Reiji apologizing for the company's failure at a press conference on October 9, 2000

The case of the collapse of life insurance companies

Insurance companies, as well as banks, in Japan had long been protected by a Finance Ministry policy of keeping all financial institutions afloat irrespective of their competitiveness. This policy, compared to a convoy of ships limiting the speed of navigation to the slowest of all vessels, was aptly called the "convoy system."

Life insurance companies, thus, were immune to bankruptcy. But, as the failures of the six life insurance companies showed, the Finance Ministry's "convoy system" policy no longer worked. Neither did the traditional mechanism under which influential main banks were supposed to support them.

The current ultra-low interest rates only added to their woes. During the bubble period, life insurers marketed individual pensions with high prospective yields of 5% to 6% and endowment insurance with lump sum payments. In these low-interest times, however, 2% is the highest yield on investment they can produce.

In Japan, life insurance companies are not permitted to alter the prospective returns on individual contracts during the term of a contract. This has caused investment returns for many insurers to fall below the prospective yields promised to customers. Insurers thus find themselves hard-pressed to maintain contracts with high returns and see their financial health gradually weaken.

Those which overreached themselves during the bubble period are particularly in dire straits and are being forced to court foreign suitors. Otherwise, they will seek court protection under a special corporate rehabilitation law that allows collapsed financial institutions to receive fast-track assistance for rehabilitation. Under the law, insurance companies are allowed to lower prospective returns even during a term of contract and settle the issue of negative yields.

The Life Insurance Policyholders Protection Corp. of Japan, established by the life insurance sector in December 1998, to prevent business failures of life insurers, is empowered to take over, manage or deal with the contracts of failed insurance companies even if nobody comes to their rescue. The corporation replaced the former Life Insurance Policyholders Protection Fund to provide stronger protection for policyholders.

Chiyoda and Kyoei were the first and second companies to apply for protection under the special law. Chiyoda had 1.3 million policyholders and its liabilities exceeded 2.9 trillion yen.

Kyoei, with 6 million customers, had much bigger liabilities at 4.5 trillion yen, the largest bankruptcy ever in the Japanese life insurance business.

Under the protection of the law, the two insurers will be able to start rehabilitation processes earlier than the other life insurance companies which went bust previously. Insurance business analysts expect policyholders' losses to be limited. Under a special administrative measure, death insurance claims and hospital charge benefits will be paid in full through March 31 2001, but payment is not guaranteed after that period. The payouts at maturity of savings insurance, such as endowment insurance and individual pension insurance, as well as pension benefits will be less than the amount promised. The existing system, however, prevents policyholders from canceling their contracts outright.

The unprecedented string of collapses of life insurers has made Japanese people increasingly distrustful of life insurance companies as they were of the banking sector several years ago following the bankruptcies of several banks. Is there any remedy for cutting the chain of people's distrust of the financial sector?

Financial safety net in the U.S.

While different people have slightly different ideas about a financial safety net, here I wish to discuss the safety net as viewed by insurance policyholders, depositors and amateur investors. How is the financial safety net built in the U.S.? How different is the American system from Japan's?

The biggest difference is that the U.S. safety net boasts carefully drawn rules which are strictly enforced. We tend to think that deregulation is the order of the day in the U.S. and that restrictions hardly exist there. But, in the financial sector, that is not necessarily the case. While it is true that there are hardly any restrictions on competition, the U.S. has many restrictions aimed at preventing unfair deals, perhaps more than Japan.

In the stock market, basic rules on deals are strictly laid out, with some 2,000 officials of the U.S. Securities and Exchange Commission (SEC) keeping constant watch. Strict controls voluntarily undertaken by neutral organizations, including the securities industry itself, are another feature of the financial supervision in the U.S. Such voluntary restrictions by the securities industry have yet to be developed in Japan.

Cooperating with the SEC is the National Association of Securities Dealers (NASD) which voluntarily watches over the operations of 5,600 securities companies. NASD computer terminals get readouts of listed issues 90 seconds after trading, and as soon as extraordinary moves in trading are noticed, the NASD launches an investigation. The system helps prevent insider trading or market manipulations.

Furthermore, in order to optimize the system, at least one compliance officer is posted at each securities company. Some major securities companies receive as many as 100 such officers. These officers see to it that procedures are strictly followed. They also handle grievances from investors. Moreover, for the smooth operation of corporate pension schemes, there is legislation in the U.S., known as the Employee Retirement Income Security Act (ERISA), which sets out basic rules clarifying fund managers' responsibilities.

Another thing I would like to point out in regard to the protection of investors is that American investors are not protected by rules alone.

Competition as a safety net

Competition has expanded investors' choices in the U.S. and made investments less risk-prone. There was a time when bank savings boomed in the U.S. But as there was a ceiling on deposit rates, bank deposits drained into more profitable investments when inflation gained momentum in the 1970s. Mutual funds, which began to hit the financial market around that time, changed the way people manage their assets. Mutual funds do not guarantee the principal, and so they are not totally safe. Yet, mutual funds caught investors' interest for they brought higher payouts than bank deposits even when they were managed with safe investments such as short-term government bonds.

Competition has enabled even individual investors to widen their investment portfolios in asset management. Now, investors, regardless of their social status, have a wide choice of investments, and put their money in long-term corporate debentures and the like. Participants in 401(K)-style pension plans, which are defined as contribution corporate pension schemes, popular in the U.S., could suffer losses, depending on the way the funds are managed.

In Britain some time ago, a large number of people who were sweet-talked by salesmen into buying similar pension plans suffered losses. However, 401(K) funds in the U.S. are invested in various fields, allowing investors to choose schemes with less risk and higher safety. This is why 401(K) plans are so popular in the U.S.

If we are to learn from the U.S., we might as well ease regulations and remove barriers to the market to encourage competition, while building a carefully planned mechanism which provides a safety network for amateur investors. Such a safety network should be a mechanism in which the government, the judiciary, neutral organizations including the private sector, and even individuals can play their respective roles.

In a time of rapid change, including technological innovation and reform of systems, we must constantly be prepared to refurbish the safety net to keep in step with the changing times. Japan faces gigantic tasks in building its financial safety net. JJTI

(This is the last article in this series.)

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