

Impediments to Service Trade in the Insurance Sector

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6.1 Introduction

In the 1980s, during the course of the negotiations on the General Agreement on Trade in Services (GATS) of the Uruguay Round talks, the liberalization of insurance services began to draw attention as a key multilateral trade issue.

The non-life insurance sector had long been a political issue between Japan and the United States, in the context of the bilateral Structural Impediments Initiative talks which focused on structural barriers to trade¹.

On December 14, 1996, just before the deadline, the Japan-U.S. insurance talks were settled, after tough negotiations, with Japan pledging to push ahead with deregulation of its non-life insurance sector, including the liberalization of premium rates, and the United States preserving the vested interests of major American insurers who had a competitive edge (enjoying favorable treatment that is not accorded to Japanese insurers) in the third sector area².

As exemplified by the Japanese version of the "Big Bang" deregulation scheme, moves are under way toward a drastic reform of Japan's financial markets by eliminating restrictions on the entry into the market by all financial institutions including insurers.

This chapter examines problems in liberalizing trade in insurance services, and particularly in the life insurance business. First, it looks at the legal treatment of foreign-based insurers in the latest revision of the Insurance Business Law, and this is followed by a study on

¹ It is undeniable that the insurance talks have been turned into a major political issue because of the strong influence major U.S. insurance companies hold as supporters of the U.S. Clinton Administration.

² The third sector covers such insurance products as personal accident and medical and cancer policies that do not belong to the primary life or non-life sectors.

whether Japan's insurance services sector is really closed and difficult to penetrate. Then, in Section 6.3, we examine the question of whether a more restrictive regulatory system results in higher insurance value (in other words, a lower degree of efficiency) in the life insurance sector. This is done demonstratively through an international comparison of the relationship between insurance value and public regulations. This analysis takes into consideration the long-term nature of life insurance contracts, that are quite different from those of non-life insurance, which was the main point of contention in the recent Japan-U.S. insurance talks. Lastly, the conclusions of these examinations are summed up.

6.2 Revision of the Insurance Business Law and the Treatment of Foreign Insurers

In order to harmonize with international views, foreign insurers who do business in Japan by setting up branches should be treated in an equal manner with domestic insurers as much as practicable³. However, due to the fact that foreign insurers are established in foreign countries and thus their operations abroad are not effectively regulated by the Japanese authorities, they are treated somewhat differently from domestic insurance companies from the viewpoint of protecting insurance policyholders. This is the basic philosophy of latest revision of the Insurance Business Law.

Article 186 of the law provides for foreign insurers which do not have branches in Japan. The problem is that if a foreign insurer without a branch in Japan concludes a contract with a policyholder directly, through for instance a mail-order direct response method, it could evade Japan's insurance regulations, and either disrupt the insurance market through unfair

³ Comparing regulations on foreign insurers in Japan, the United States (New York State) and Europe, their regulations regarding foreign insurers have nearly the same characteristics.

First, entry into the market is basically permitted under the license system, though there are discrepancies regarding what kinds of business entities are authorized to enter. There are no regulations in terms of the equity capital (for a stock company) or fund (for a mutual company) which foreign insurers are required to set aside from deposits for the protection of policyholders. Furthermore, unlicensed foreign insurers are not permitted to provide direct insurance coverage from overseas.

competition or cause unexpected loss to the policyholder. For this reason, Paragraph 1 of the article in principle prohibits foreign insurers without any branches in Japan from concluding insurance contracts with any person who has a residence or an address in Japan or for a property that is located in Japan. In order to ensure the convenience of policyholders, however, Paragraph 2 of the same Article allows an applicant for insurance in Japan, with the permission of the Minister of Finance, to conclude an insurance contract with a foreign insurer without a branch in Japan. Paragraph 3 of the Article sets criteria under which the Minister of Finance may not give such permission.

In line with the national treatment principle, or the easing of regulations on foreign insurers, the revised law removed the regulation on Japanese yen-denominated holdings of liability reserve. Under Article 197 of the Insurance Business Law, foreign insurers are required to hold the equivalent of liability reserves “in Japan”, but foreign insurers are no longer forced to hold such “yen-denominated property” of the equivalent.

6.3 Is Japan's Insurance Market Closed?

6.3.1 Modes of Services Trade in Insurance Business

While the General Agreement on Tariffs and Trade (GATT) regulates trade in goods, trade in services is governed by the General Agreement on Trade in Services (GATS) in the Uruguay Round.

GATS assumes the following four modes for the form of supply of services across borders: cross-border supply (mode 1); consumption abroad (mode 2); commercial presence (mode 3); and presence of natural persons (mode 4).

Cross-border supply in insurance include reinsurance and providing directly insurance coverage from overseas. An example of consumption abroad is that a employee of Japanese company conclude an insurance policy with foreign insurers, when he goes and works abroad. However, the line between cross-border supply and consumption abroad is becoming increasingly blurred with advances in international telecommunications technology. For instance,

if a person concludes a policy with an foreign insurer via the Internet, it is little important to tell whether it was the supplier or the consumer that moved.

Providing services by establishing branches or local subsidiaries is the prevalent mode of insurance business. When the focus is placed on the establishment of business footholds, mode 1 means the "non-establishment-type" supply of services and mode 3 the "establishment-type" supply. From the standpoint of protecting policyholders, the Insurance Business Law assumes the "establishment-type" supply of services to be the normal mode, and as previously noted, the "non-establishment-type" supply of services comes under more restrictive supervision. It is difficult to assume the supply of services by the movement of a natural person as a normal mode of insurance services.

6.3.2 "Market Access"

Under GATT, which governs goods trade, "tariffs" and "quantitative restrictions on exports and imports" are focused upon as trade barriers. In services trade, the issue of "non-tariff barriers" is more important. The crux of the issue is we can't still have common sense that how far non-tariff barriers should be removed. To put it forcibly, it could be argued that all kinds of regulation stand as impediments to services trade. However, it is obvious that regulations imposed to achieve social goals⁴, such as ensuring the public interest and safety of services, are justifiable, and that a total lack of regulations is not necessarily an ideal. The financial annex of GATS, which governs the financial services sector, excludes from the scope of liberalization regulations based on "prudential" reasons, such as measures for stabilizing the financial system as well as the need to protect investors and depositors.

"Necessary (appropriate) regulations" to achieve social goals must be maintained, even if they have the effect of restricting trade. Because of the differing stages of their development and differences in international competitiveness in the services trade, the obligations which all contracting countries to GATS should meet divides into two kinds of the obligation. One is like "most-favored-nation treatment" and "transparency," which all

⁴ Ito and Ishiguro (1993) argue that regulations for protection of the environment and protection of consumers and investors, along with police regulations, belong to the category of "social regulations" and

contracting countries should accept for all areas of services trade. Another is like "market access" and "national treatment," which contracting countries could selectively accept in certain services areas for which they have pledged to accept obligations, in accordance with their economic circumstances and international competitiveness.

"Most-favored-nation treatment," "transparency," and "national treatment" are all familiar terms. However, "market access" is a new concept introduced for the promotion of services trade.

This concept was devised to eliminate measures contracting countries may take to quantitatively or qualitatively restrict the market entry of foreign service providers through regulations such as qualifications and licensing procedures. In the initial stage of the Uruguay round, however, the definition of that concept was not completely clear. As a result of the negotiations, a distinction was made between "quantitative regulations" (such as limits on the number of businesses allowed) whose trade-restrictive effects can be measured objectively with relative ease, and "qualitative regulations" (such as standards and criteria businesses are required to comply with in their operations) that are more difficult to quantify in terms of trade-restrictive effects. Thus, the obligation of market access was set to apply to the former, "quantitative regulations."

It is of great significance that the market access has been limited to "quantitative regulations," as there are constant fears that the "market access" concept, backed by the argument for aggressive reciprocity, could be used, as seen in the Japan-U.S. insurance talks, as a tool to demand a sort of "reverse discrimination," or unduly favorable treatment of foreign new entrants at the expense of domestic firms⁵.

6.3.3 Assessment on the Japan Schedule of Specific Commitments

Contracting countries are obliged to offer market access and national treatment in services areas where they have made commitments. They may retain measures that are not consistent with these obligations even after the agreements take effect, but to do this, they must give

should be distinguished from "economic regulations," the subject of discussions regarding deregulation.

⁵ See Ito and Ishiguro (1993), pp. 147-150

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advance notifications of measures which restrict market access and national treatment, and enter them in a schedule of commitments which forms a part of GATS. The following table is Japan's schedule of commitments for the insurance sector.

As previously mentioned, the distinction between modes 1 and 2 of the services trade is unclear, and there are no internationally applicable common standards. In Japan, active marketing⁶ by a services provider makes the service mode 1 and the absence of such activity indicates mode 2.

Table 6-1 Commitments in the Insurance and Insurance-Related Services⁷

Modes of supply: (1)Cross-border supply (2)Consumption abroad (3)Commercial presence (4)Presence of natural persons

Limitations on market access	Limitations on national treatment
<p>7. FINANCIAL SERVICES</p> <p>In addition to Part of this Agreement and the Annex on Financial Services. Japan undertakes its specific commitments with respect to Financial Services under this Agreement in accordance with the Understanding on Commitments in Financial Services (hereinafter referred to as the “Understanding”, attached to this schedule. which forms an integral part of this schedule). Thus, the obligations under the Understanding are incurred in the sectors of Financial Services additionally to those covered by the provisions of Part of this Agreement and the Annex on Financial Services.</p> <p>For prudential reasons within the context of paragraph 2(a) of the Annex on Financial Services, Japan shall not be prevented from taking measures such as non-discriminatory limitations on juridical forms of a commercial presence. For the same reasons, Japan shall not be prevented from applying non-discriminatory limitations concerning admission to the market of new financial services which shall be consistent with regulatory framework aimed at achieving such prudential objectives. In this context, securities firms are allowed to deal in securities defined in the relevant Japanese law, and banks are not allowed to deal in those securities unless allowed in accordance with the said law.</p> <p>With respect to specific commitments in the sectors of Financial Services. services supplied in the territory of a Member other than Japan to the service consumer in Japan without any active marketing from the service supplier are considered as services supplied under paragraph 2(b) of Article I of this Agreement.</p>	
Specific commitments in the market access column with	

⁶ Active marketing is the act of encouraging a customer to make a purchase through newspaper advertisements and other means, in line with the provisions of the Securities and Exchange Law, etc.

⁷ “Liberalization by the end of June 1996” in Table 6-1 was completed by the revision of the Insurance Business Law. And, there were no entries in the column of "additional commitments" in the insurance sector.

<p>respect to the supply of a service as prescribed in paragraph 2(a) and(b) of Article I of this Agreement are unbound except for obligations under paragraph 3 and 4 of the Understanding respectively which are incurred in this sector additionally to those covered by the provisions of Part of this Agreement and the Annex on Financial Services, subject to conditions and qualifications set out below.</p> <p>(1) Commercial presence is in principle required for insurance contracts on the following items and any liability arising therefrom</p> <p>(a) goods being transported within Japan; (b) ships and aircraft of Japanese registration.</p> <p>The cross-border insurance transactions for ships of Japanese registration which are used for international maritime transport and aircraft of Japanese registration will be liberalized by the end of June 1996.</p> <p>60 per cent of amounts of reinsurance on the compulsory automobile third party liability insurance is subject to the compulsory coverage by the Government.</p> <p>Insurance services are not allowed to be supplied through an intermediary in Japan.</p>	<p>(1) None</p>
<p>(2) Commercial presence is in principle required for insurance contracts on the following items and any liability arising therefrom</p> <p>(a) goods being transported within Japan; (b) ships and aircraft of Japanese registration.</p> <p>The cross-border insurance transactions for ships of Japanese registration which are used for international maritime transport and aircraft of Japanese registration will be liberalized by the end of June 1996.</p>	<p>(2) None</p>

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<p>60 per cent of amounts of reinsurance on the compulsory automobile third party liability insurance is subject to the compulsory coverage by the Government.</p> <p>Insurance services are not allowed to be supplied through an intermediary in Japan.</p> <p>(3) Establishment of commercial presence as insurance brokers is not allowed until the end of June 1996.</p> <p>60 per cent of amounts of reinsurance on the compulsory automobile third party liability insurance is subject to the compulsory coverage by the Government.</p> <p>Insurance intermediation services are not allowed to be supplied for insurance contracts made by an insurance service supplier who is not licensed in Japan.</p> <p>(4) Unbound except as indicated in HORIZONTAL COMMITMENTS</p>	<p>(3) Foreign life insurance companies are required to retain in yen currency an amount corresponding to their technical and claim reserves for yen-denominated insurance policies in Japan until the end of June 1996.</p> <p>As indicated in HORIZONTAL COMMITMENTS</p> <p>(4) Unbound except as indicated in HORIZONTAL COMMITMENTS</p>
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On the basis of the schedule of commitments submitted by members of the Asia-Pacific Economic Cooperation (APEC) forum, the Pacific Economic Cooperation Council(1995) calculated the measures of impediments to trade and investment in the services sector in the following way.

First, commitments were divided into three categories: "none," implying the absence of restrictions either on market access and national treatment for a given sector/mode of supply; "unbound," meaning no commitments was made for a given sector/mode of supply; and "other," implying that there are remaining restrictions for a sector/mode of supply that otherwise is bound by the GATS. For quantification purposes a 1 is allocated for "none," because it means progress in liberalization, while a 0 for "unbound," and for some of the ratios

a 0.5 for "other" regardless of the commitment.

The next step was to calculate the average of the above-mentioned ratings for the different service sectors. The average was then expressed as a percentage to indicate the degree of progress in liberalization, and this figure was subtracting from 100 to give the measure of the level of impediments. Impediments(1) is a stricter measure that did not count partial restrictions (0.5 was made equivalent to "none") in calculating the average, and Impediments(2) is an easier measure that counted in partial restrictions.

Table 6-2 Impediments to Trade and Investment in Insurance Sector

PECC (1995)

	Market Access				National Treatment			
	m1	m2	m3	m4	m1	m2	m3	m4
Life, accident and health insurance	0.5	0.5	0.5	0.5	1.0	1.0	0.5	0.5
Non-life insurance	0.5	0.5	0.5	0.5	1.0	1.0	0.5	0.5
Reinsurance and retrocession	0.5	0.5	0.5	0.5	1.0	1.0	0.5	0.5
Services auxiliary to insurance*	0.5	0.5	0.5	0.5	1.0	1.0	0.5	0.5

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	Market Access				National Treatment			
	m1	m2	m3	m4	m1	m2	m3	m4
Life, accident and health insurance	1.0	1.0	1.0	n.a.	1.0	1.0	1.0	n.a.
Non-life insurance	1.0	1.0	1.0	n.a.	1.0	1.0	1.0	n.a.
Reinsurance and retrocession	0.5	0.5	0.5	n.a.	1.0	1.0	1.0	n.a.
Services auxiliary to insurance*	0.5	0.5	0.5	n.a.	1.0	1.0	1.0	n.a.

Note1;* including brokerage and agency services

Note2;m1:Cross-border Supply, m2: Consumption abroad, m3: Commercial presence, m4: Presence of natural persons

The above are the PECC (1995) table and its modified version, and the two have the following three differences.

First, the column for the supply of services by the movement of a natural person is left blank in the modified table as this mode was considered quite unlikely in the insurance business.

The second difference has to do with the criteria for segmentation of the services sector. The insurance sector can be subdivided into four areas: life insurance, non-life insurance, reinsurance, and brokerage and other auxiliary services. The first two represent a classification by type of insurance, while the third is a form of an insurance transaction and the

last is an item concerning auxiliary services such as sales channels. Because these segmentation is not uniformed, there is the possibility that a specific measure may be doublecounted.

To avoid this, the modified table considers measures on the basis of their specific contents. For example, a measure providing for compulsory "reinsurance" of "compulsory automobile liability insurance" by government is a restriction on not non-life insurance but reinsurance.

The third difference relates to the description of the contents of measures. The clause that "Insurance intermediation services are not allowed to be supplied for insurance contracts made by an insurance service supplier who is not licensed in Japan" is said to refer to the parenthesized provisions of Paragraph 3, Article 275 of the Insurance Business Law⁸. The measure covers insurance products, which can be sold through brokers, provided by foreign insurers that do not have branches or agencies in Japan (all contracts for reinsurance and non-life insurance). Therefore, the measure is a restriction on brokerages and other services auxiliary to insurance.

A reassessment based on these factors causes 75 of the Impediments(1) in the PECC (1995) to fall as low as 25. In the case of the Impediments (2), the figure of 37.5 in the PECC (1995) falls to 12.5.

The common commitment on research and development subsidies ("HORIZONTAL COMMITMENTS") regarding national treatment for mode 3 is rated "1." Even when this is rated as "unbound=0" in a way stricter than the PECC (1995), the Impediments (1) still stands at 58 and Impediments (2) at 29.2.

Looking into the content of the Japan schedule of commitments, the remaining restrictions in Japan's insurance services sector involve specific types of non-life insurance and reinsurance as well as on brokering for non-life insurance provided by foreign insurance firms that do not have business footholds in Japan. Therefore, it can be concluded that in Japan's insurance services sector, legal trade barriers are not particularly high.

Of course, aside from legal aspects, the actual market conditions, including business

⁸ Thanks to Mr. Monbayashi of First International Organizations Division, Economic Affairs Bureau, the Ministry of Foreign Affairs.

practices, must be examined separately. Long-term corporate business relationships in Japan are often recognized as "keiretsu" in foreign countries and criticized as impediments to the entry into Japanese markets. To our regret, we don't deal with it because we don't have available data.

The PECC (1995) attempt to quantify impediments to trade and investment in the services sector is of great interest, but a host of problems will have to be sorted out before it can be adopted as an indicator for international comparison. They include how to segment specific areas of insurance services, whether it is really advisable to give a uniform rating of "0.5" ("other") to certain restrictions on market access and national treatment regardless of contents, and how to interpret common commitments applicable to all areas.

6.4 The Relationship between efficiency and public regulations in Life Insurance Business

As previously mentioned, Japan has been under mounting pressure from overseas to deregulate its insurance market. This section provides a demonstrative analysis of the relationship between efficiency and public regulations in the life insurance business in particular⁹, and offers suggestions regarding whether the foreign pressure is justified.

6.4.1 Method of Analysis

Life insurance companies invest and manage funds collected from a vast number of policyholders, and must, without fail, pay insurance claims for insured risk. The life insurance business thus has a high degree of public interest and plays a major role as national minimum.

For this reason, the life insurance industry worldwide is subject to public regulation and supervision from the viewpoints of supervising the management of insurance business, fostering a healthy insurance market and protecting the interests of policyholders. Authorities

⁹ In actuality, overseas calls for deregulation of the life insurance sector are not so strong at present, but are expected to intensify in the future.

determine which types of insurance can be underwritten by insurers , make stipulations on reserves or solvency margin, and have regulation to strengthen financial health. In addition, they take other measures to protect policyholders from fraudulent practices or from failures of insurers. In some cases, they regulate insurance value (premium rates and dividends that are components of insurance value) .

Regulatory authorities differ from country to country in their approaches to regulation. Generally speaking, there are about three types of supervision in the insurance business

The First approach allows policyholders to make judgments on the quality of management and financial health by having insurers disclose their business performance and other items of interest. Under the second approach, the authority sets forth a set of standards which insurance businesses are supposed to abide by, and oversees whether these standards are being adhered to. The method of the third approach provides for the continual supervision of a broad scope of developments in insurance business management.

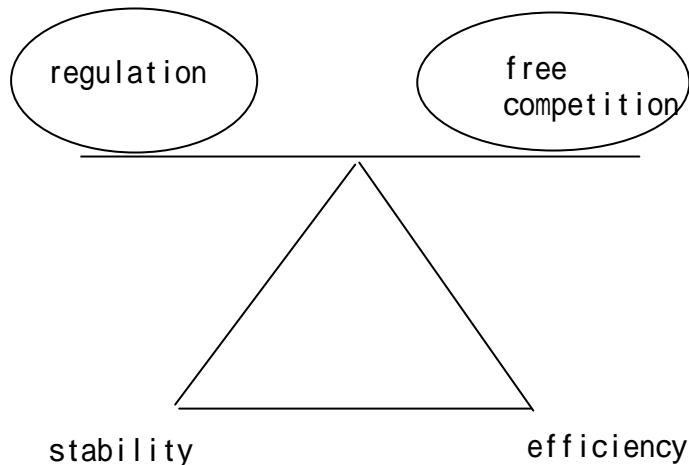
In England and Netherlands where laxer regulations are accompanied, consumers are left to make their own judgments about insurance value and contract terms, and this is accompanied by the belief that the solvency of insurers can be guaranteed by accumulating sufficient levels of liability reserves. It is believed that in an environment with moderate regulations, the merits of competition for lower insurance value and the variety of insurance policies among insurers benefit consumers.

On the other hand, in countries like Germany and Japan which have strict regulations, the scope of supervision extends to the contents of insurance policies and their value. The objective is to protect the interests of policyholders by preventing excessive competition, or to prevent destructive price competition from damaging the solvency of insurers. It gives greater weight to market stability. As some point out, though, restrictive regulations make it difficult for newcomers to enter the insurance market, and tend to make the industry monopolistic.

The decision of how far deregulation should be pushed depends on how one considers the relative demerits of "inefficiency caused by restrictive regulations" and "greater instability stemming from the promotion of competition." When it comes to questioning the possible aspects of deregulation one always come back to what we would like to call the

magic triangle, stability -(de)regulation- efficiency in the life insurance industry (see Figure 6-1)¹⁰.

Figure 6-1 The magic triangle.



There are two approaches to solving this problem of the relationship between efficiency and public regulation.

One method is the estimation of frontier production functions with a parameter of efficiency, like the approach taken by Gardner and Grace (1993).

They used panel data of U.S. life insurance companies to estimate production functions, and examined the relationship between efficiency and public regulation or company form and so on. They came to the conclusion that insurers based in New York State, which has relatively strict regulations, have a high degree of efficiency¹¹.

The second approach is international comparison, using methods adopted by Fecher and Pestieau (1993) and Finsinger (1992).

The former estimated the efficiency of financial industries in the 11 member states of the Organization for Economic Cooperation and Development (OECD) with value added in gross national product (GNP) as the product. They concluded that in seven European

¹⁰ See Lutgart van den Berghe (1991), pp.213-215.

¹¹ Though, the quantitative degree of high efficiency is very small and the impact of reverse causality should also be taken into account, as insurers with high efficiency choose to do business in New York State.

countries, financial industry were more efficient in countries where competition was more intense and public regulations stricter.

On the other hand, Finsinger (1992) performed a regression to find real value (after adjustment for dividends) of term insurance in seven European countries by looking at the different intensity of regulation (dummy variable set at 0 for England and the Netherlands and 1 for the other countries), discrepancies in life expectancy, market yields on five-year government bonds and differences in distribution channels of life insurance. His conclusion was that insurance value was 73.6% higher in countries with a higher degree of regulations or that more inefficient in countries where public regulations was stricter.

These studies indicate that it is not certain whether a stricter public regulations serve to raise or lower the efficiency of insurance business. In this section, the latter method of international comparison is adopted to examine the relationship between public regulation and insurance value in Japan and other countries. Unlike the approach taken by Finsinger (1992), the intensity of regulations is not measured by the dummy variable of 0 or 1. And, given the long-term nature of life insurance, endowment policy with a 25-year maturity, instead of term insurance, is the subject of study.

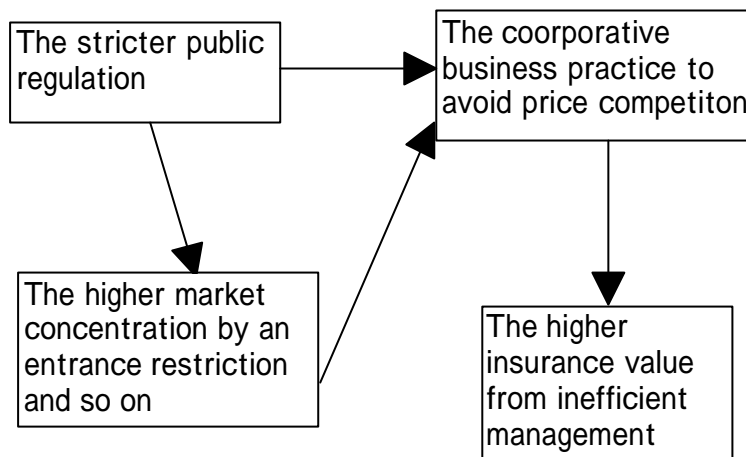
6.4.2 International Comparison of Industrial Structure

In discussions on industrial organization, the characteristics of an industry are described using the concepts of market structure, market conduct and market performance, with the basic causality assumed to be expressed in the direction of "market structure->market conduct->market performance."¹²

In international comparison of industrial organizations in the life insurance industry, this view could be expressed in Figure 6-2. It can be assumed that differences in the supervisory approaches of the different countries influence the market conduct of life insurers either directly or by making indirectly the market structure less competitive, and differences in the market conduct, in turn, has influence on the market performance of life insurance industries.

The hypothesis to be examined is whether policyholders are buying more expensive life insurance policies as a result of strict regulations which restrict market competition.

Figure 6-2 International Comparison of Industry Structure



First of all, we must define the value of life insurance policy. A life insurance policy is a very long-term contract, usually over 20 years, and has the peculiar characteristic that its value can be determined upon the maturity of the contract. The premiums paid each month or year are not the cost of a life insurance policy. In calculating the value of life insurance (VOL), it is necessary to subtract the matured endowment (S) and dividends (D) from the sum of insurance premiums paid in (P).

Thus, the value of life insurance is defined as follows¹³.

$$\text{VOL} = (P - S - D) / P = 1 - (S + D) / P$$

We can call $(S + D) / P$ "the rate of refund of premiums. The higher this rate, the cheaper the value of life insurance. (In the actual calculation of the rate of premium refund, P stands for annual premium payments rather than the sum of premiums paid in) For example, in Greece, the expected yield of assets is nearly 20%. If the expected yield of assets is not uniformed, the refund rate based on annual premium payments would so far to as high as 344.7 times. Therefore, in calculating the rate of refund of insurance premiums, the expected

¹² For example, see Tsutsui (1988), pp.110-127.

¹³ This averts the troublesome problem of foreign exchange rates in international comparison.

yield of assets is assumed to be 8% in every country. The mortality rate also needs to be adjusted, because life expectancies differ from country to country. Though, the influence of this factor is not as large as that of the expected yield of assets.

The following is a list of life insurance value, intensity of public regulation, market structure of the life insurance market and other factors in Japan and seven European countries.

Table 6-3 Indicators of Insurance Value, Etc.

	Japan	Denmark	France	Germany	Greece	Italy	Netherlands	England
VOL'	14.29	15.85	19.76	16.10	16.98	22.03	22.57	19.34
RI	2.35	1.66	2.15	2.35	1.92	2.00	1.28	1.40
MS1	44.2	58.1	29.3	24.3	38.1	39.5	40.7	26.9
MS2	9	8	18	40	10	12	9	50
DIST	100	50	58	81	59	56	13	38.5
FMS	1.61	2.35	2.05	3.31	23.47	1.49	7.96	5.19
P	30.69	27.26	35.70	32.84	29.86	30.75	34.72	43.88

Sources; Finsinger(1992), Andersen Consulting(1990) and so on

Note; VOL':the value of life insurance

RI:Intensity of public regulation

MS:Market Structure

DIST:Distribution Channels

FMS:the shre of foreign insurers

P:an annual premium for insured amount 1000

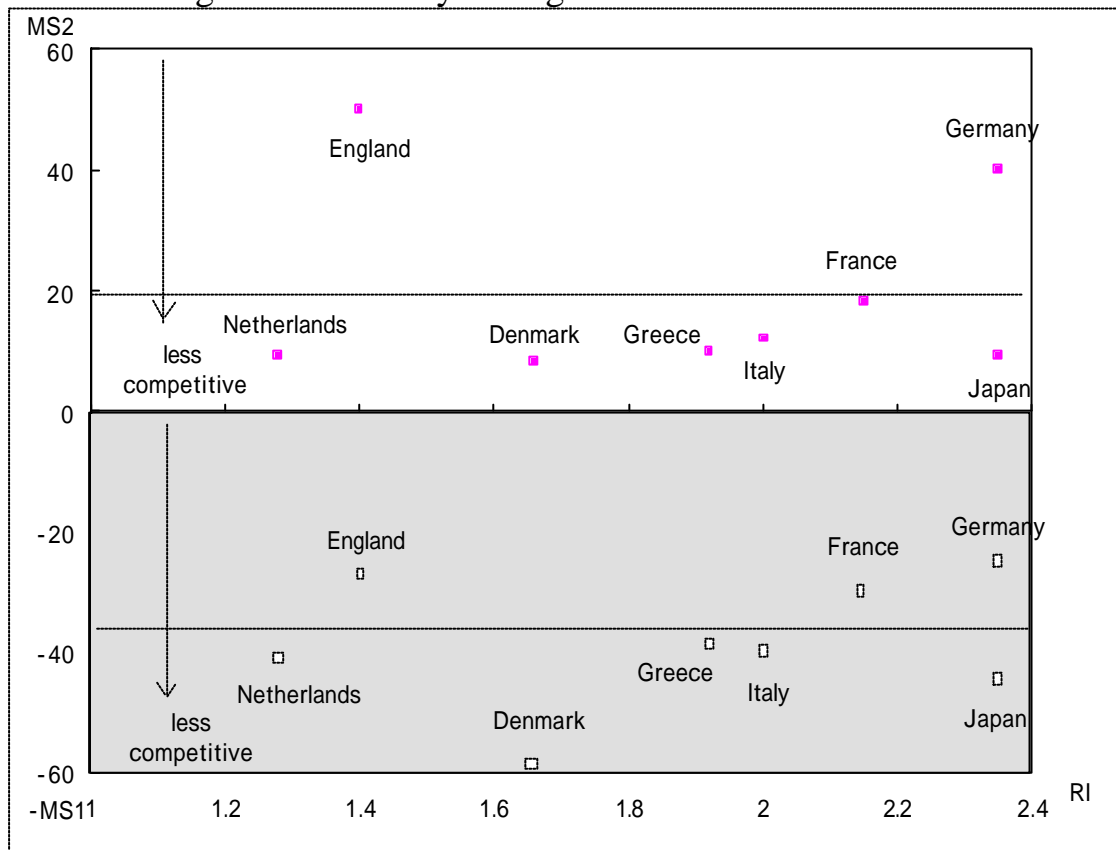
The proxy of insurance value (VOL*) is obtained by multiplying the reciprocal¹⁴ of the premium refund rate by 1,000 (a 35-year-old male taking out a 25-year endowment policy). The scheduled premium rate (P) is an annual premium for insured amount 1000 (a 35-year-old male taking out a 25-year endowment policy).The intensity of regulations (RI) is based on Table 27.3 of Finsinger (1992). Japan is assumed to have the same intensity of regulations as Germany¹⁵. For indicators of market structure, we use the concentration of premium revenues received by the top three insurers (MS1) and the number of insurers that have a combined share of 80% in premium revenues (MS2).

¹⁴ Since the price of insurance declines as the premium refund rate increases, the reciprocal of the refund rate was adopted as a modification.

¹⁵ The U.S. International Trade Commission (1991) listed Hong Kong, the United States, Britain and the Netherlands as countries and areas with easy regulations, and Japan and Germany as countries with stringent regulations.

In Figure 6-3, the horizontal line shows the intensity of regulations and the vertical axis indicates the number of insurers with a combined share of 80% in premium revenue (upward) and the concentration of premium revenues by the top three insurers (downward). Each horizontal dotted line shows the mean of MS1 and MS2.

Figure 6-3 Intensity of Regulation and Market Structure



At first sight, in terms of the relationship between intensity of regulation and market structure, we did not discern a tendency for stricter regulations to make the market more monopolistic or less competitive. In other words, as far as indicators such as the degree of market concentration and number of dominant companies are concerned, it seems inadvisable to jump to the conclusion that strict regulations generate a restrictive market structure.

However, the fact that the number of companies which together account for 80% of premium revenue is large can signify two completely different things. One is that restrictions on new entries are relatively loose, while the other is that insurer-friendly supervision has allowed

inefficient companies to survive.

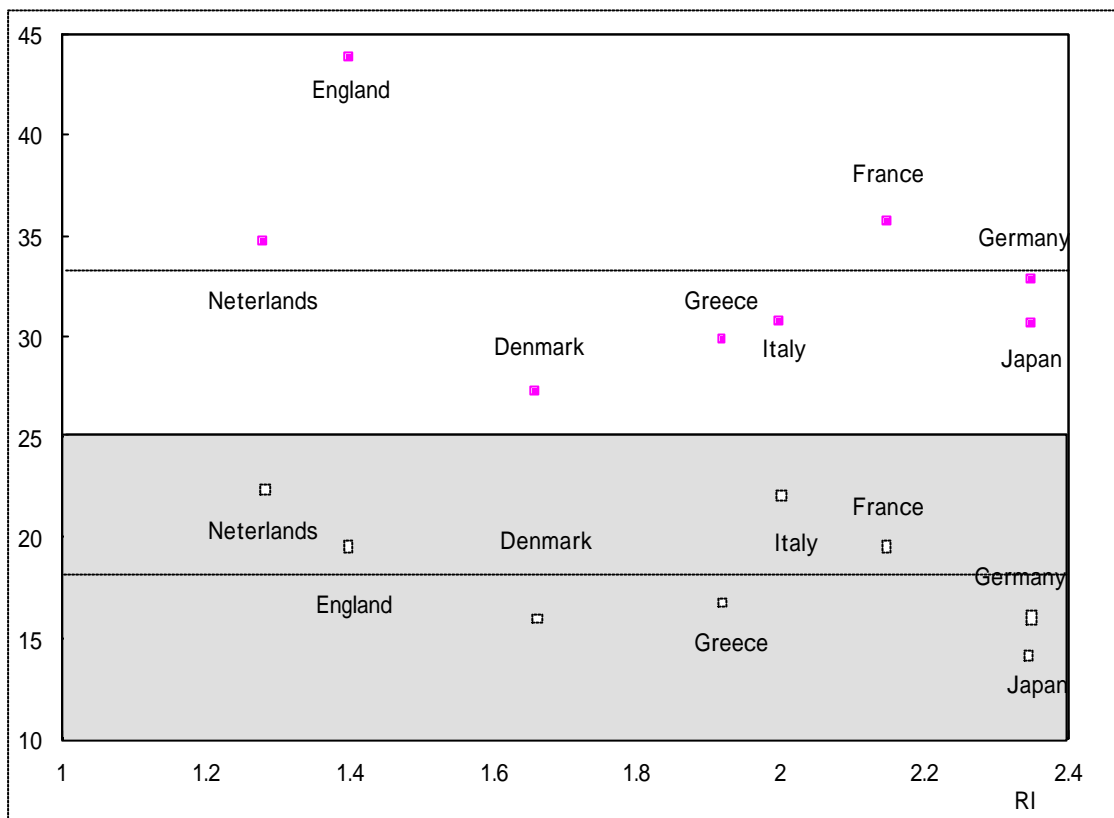
Moreover, life insurers sell a wide variety of products, ranging from life insurance and annuities to accident and health insurance, and pursue a business strategy of offering differentiated products in such policies¹⁶. Therefore, it is also necessary to analyze the market structure by taking note of the segmentation of the life insurance market.

A great deal of caution should be exercised to avoid making simplistic assessments of the relationship between public regulations and insurance market structures.

Figure 6-4, on the relationship between intensity of regulation and market performance, shows the relationship between scheduled premium rates (P) / life insurance value (VOL*) and the intensity of regulation. The horizontal line shows the intensity of regulations and the vertical axis indicates the scheduled premium rates (P) (upward) and life insurance value (VOL*) (downward). Each horizontal dotted line shows the mean of P and VOL*.

Figure 6-4 Intensity of Regulation and Life Insurance Value or Premium

¹⁶ For example, whole life policies with term insurance have high shares for the eight upper-tier life insurers in Japan (Nippon, Dai-ichi, Sumitomo, Meiji, Asahi, Mitsui, Yasuda and Chiyoda), while among the eight lower-tier insurers (Taiyo, Toho, Kyoei, Nippon Dantai, Daido, Dai-hyaku, Fukoku and Nissan), some have diversified into products other than whole life insurance, with Daido focusing on term insurance and Taiyo on short-maturity endowment insurance. Other smaller insurers (many foreign-affiliated firms included) have high shares in variable insurance, and some are putting particular emphasis on accident and health insurance policies.



In England, scheduled premium rates are high, but insurance value is low. In Italy, on the other hand, scheduled premium rates are low, while insurance value is high. When assessed by scheduled premium rates alone, Italy seems to have more favorable market performance in the life insurance industry than England. However, because we must look at market performance using the previously noted yardstick of insurance value, England can be said to have a slightly better performance than Italy's. Generally speaking, consumers tend to pay closer attention to the levels of scheduled premium rates, but this way of thinking can lead to mistaken conclusions.

Neither scheduled premium rates or insurance value are correlated, either positively or negatively, to the intensity of regulation. In particular, it seems highly likely that the levels of insurance value in the different countries are totally unrelated to the intensity of regulation.

6.4.3 What determines life insurance value?

A regression analysis of life insurance value (VOL*) is made, with the intensity of regulation

(RI), shares of exclusive sales channels (tied-agents¹⁷ and sales via banks) (DIST), and shares occupied by branches and agencies of foreign insurers (FMS) as explanatory variables¹⁸.

If the hypothesis of market structure-market performance as noted in Figure 6-1 is true, strict regulations should result in high life insurance value, and the hypothesis can be verified by seeing whether the coefficient of the intensity of regulation is positive.

Exclusive sales channels only provide information about products offered by a single specific insurer, and cannot offer independent advice on the choice of insurers. Therefore, a high share of exclusive sales channels makes it hard for consumers to obtain comparable information and can raise life insurance value by restricting price competition. However, the kind of influence it can have is not clear a priori. On the other hand, the cost of sales through exclusive sales channels is low relative to that of independent sales channels (brokers and multiple-agents) and therefore this distribution system tends to lower the value of life insurance.

The use of the share of branches and agencies of foreign insurance firms (FMS) as an explanatory variable is designed to shed light on the relationship between market access and life insurance value.

Table 6-4 Determination of the life insurance value.

Estimation 1:

explanatory variables	coefficients	t-value
Ordinate	15.11	3.20
RI	7.78	1.87
DIST	0.20	3.08

Explained variables: VOL*, R^2 adjusted:0.66

Estimation 2:

explanatory variables	coefficients	t-value
Ordinate	15.89	3.50
RI	7.56	1.69

¹⁷ A tied-agent is a sales person exclusively retained by an insurer. A multiple-agent, on the other hand, has contracts with more than one insurer and his function is close to that of a broker. There also is a direct marketing system, which has a high share in the insurance market in Denmark and the Netherlands.

¹⁸ An indicator of the market structure has been excluded as an explanatory variable partly because its relationship with public regulation is not necessarily evident. An estimation was also made taking account of the different death rates according to country, but as a whole, the results of those estimates were not satisfactory.

DIST	0.20	2.87
FMS	0.06	0.61

Explained variables:VOL*, R^2 adjusted:0.61

The conclusions obtained by the estimates are as follows¹⁹.

First of all, the hypothesis of market structure-market performance has to be discarded. While coincident conditions are satisfied, t value is low. This indicates that there is no recognizable relationship in which strict regulations impose a burden on policyholders by pushing up the value of insurance.

The cost-saving effect of exclusive sales channels are recognizable. The U.S. International Trade Commission (1991) argued that the introduction of insurance brokers and new products will be a driving force for the promotion of cross-border competition, but the results of the estimates show that the value of insurance is higher in countries where more insurance sales are done via brokers.

Furthermore, the degree of market access does not affect insurance value levels. It is only natural that the new entry of foreign insurers, even when they are accorded full national treatment, will not bring benefits to policyholders as long as they are subjected to the regulations of the countries concerned.

6.5 Summary of Conclusions

Our international comparison of public regulation and efficiency failed to demonstrate that a policyholder in a country with strict public regulation must purchase a life insurance policy at a higher value. This conclusion is not necessarily consistent with the generally accepted idea that deregulation enhances the efficiency and as a result contributes to the benefits of policyholders.

What seems to be important in understanding this outcome is the long-term nature of life insurance products. Life insurance has a very long contract period, of 20 to 30 years, and

¹⁹ It must be noted that the limited availability of data, from only eight countries, kept the flexibility low, and the conclusions were obtained on the basis of extremely limited conditions.

this nature always raises possibilities of market failures since the market mechanism cannot be expected to fully function or a policyholder cannot be expected to show a completely reasonable expectation. Hence, the necessity of regulations by relevant authorities. In addition, one should take importantly the characteristics of life insurance business under which public regulations ultimately help enhance the interests of policyholders by ensuring the stability of the business, thus enabling insurers to pay out higher dividends to policyholders. In the case of life insurance business, its stability is of crucial importance.

For example, whether the promotion of price competition through deregulation of premium rates will immediately lead to the improved efficiency of the life insurance industry is not evident. Even when scheduled premium rates decline in the short run, due caution must be paid to preventing low premiums from prompting risky investment behaviors in asset management, with a resultant long-term decline in the rate of dividends (and failure to pay insurance claims under the worst-case scenario), to the detriment of policyholders.

This does not, however, imply that all types of regulations are justified. Deregulation of the life insurance industry is necessary. In discussing how to proceed with deregulation of the life insurance market, it is vitally important to not lose sight of keeping a good balance between the short-term benefits of the promotion of competition and its long-term performance. In other words, the main problem which we need to discuss is in Japanese life insurance industry, how far should regulation be maintained, in what respect is deregulation necessary, and how far can the free market and its competitive game be tolerated.