

# **The history and the future of policyholder dividends in Japan from the viewpoint of policyholders' benefit<sup>1</sup>**

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## **[Abstract]**

In Japan's life insurance market, many companies have sold participating contracts for many years. Although the sale of nonparticipating contracts has been on the rise in recent years, participating contracts still dominate the market.

The practice of paying out dividends depends on the prevailing circumstances of the business. For example dividend payout rates which were very high during a high economic growth period have dropped sharply due to the burst of bubble economy. Recently many companies have begun raising dividend payout rates as a result of changes, such as the economic up-trend, recovery in companies' sales and an improvement on their solvency position.

I will introduce the history of policyholder dividends in Japan from the viewpoint of policyholders' benefit, and then examine how it should be practiced in the future.

## **1 . Introduction**

### **1 . 1 About the life insurance market in Japan and participating contracts**

In Japan's life insurance market, many companies were mutualized after the World War II, because of the forfeiture of a large amount of foreign assets, the increased expenses as a result of hyper-inflation and the fact that post-war compensation was terminated. In addition, due to the regulations that prevented foreign companies from entering the Japanese insurance market, mutual companies were the majority in the market.

Under the previous insurance business law, since rights and obligations which belonged to the policyholders of nonparticipating contracts of mutual

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<sup>1</sup> The content in this paper is the personal views of the author, and have no relation to Nippon Life Insurance Company.

companies, were not specified clearly, its interpretation caused problems and nonparticipating contracts of mutual companies were not popular. (Although the interpretation is still uncertain in part, since the dividends were stipulated also for stock companies by the revised of insurance business law<sup>2</sup>, most differences had disappeared.)

Amid the de-regulatory process with the revision of insurance business law in 1996, foreign life companies as well as the life subsidiaries of non-life insurers begun entering the life market and several bankrupt mutuals were also acquired by foreign firms and mutuals were demutualized, and this eventually resulted in stock life companies outnumbering mutual companies.

As a result, the number of companies which sell nonparticipating contracts increased, and the total number of nonparticipating contracts in force is increasing. However, in terms of sum insured participating contracts still represent the majority.

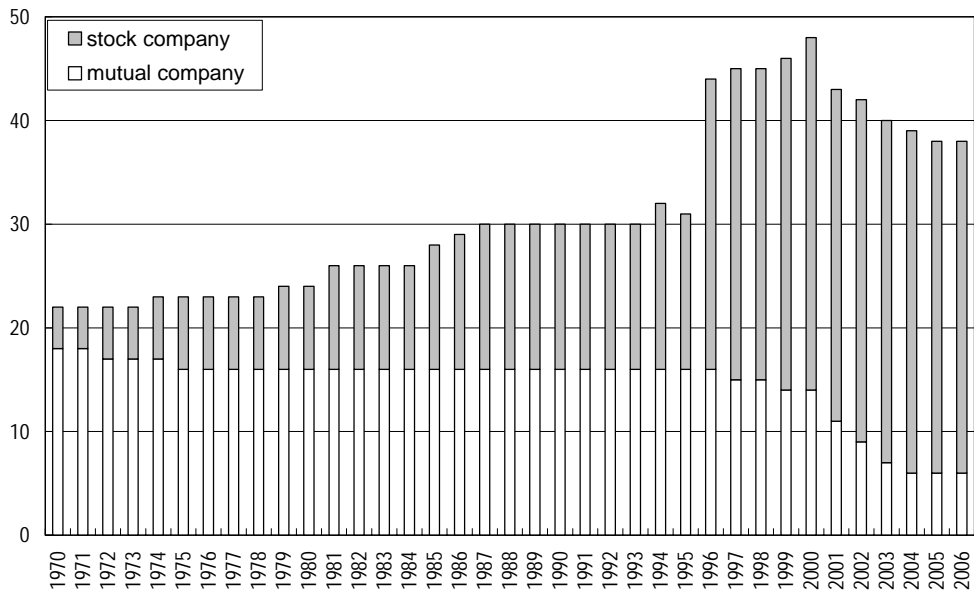
And in the past several years, each life insurance company which sells participating contracts has been increasing dividends to policyholders under the up-trend of economic conditions and its improvement of solvency status. In addition, contracts with high guaranteed interest rate, which were sold in the past prosperous period, began to mature or reach payout periods. However most of these contracts are not the ones whose dividend rates are increased, so the gap between actual amount of dividends and expected amount at inception became very wide. Consumers may therefore have more focus on the dividend increase in the near future.

I'll describe the history of policyholder dividends, and then consider ideal dividend policy in order to maximize policyholders' benefit.

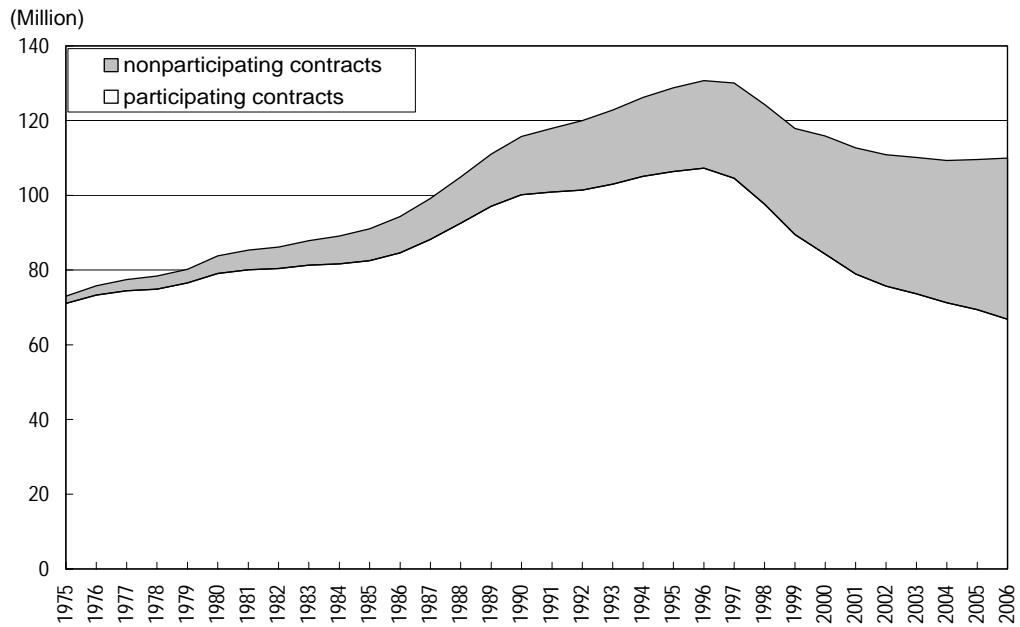
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<sup>2</sup> A new insurance business law took effect in April 1996.

**Figure1. Transition of the number of life insurers according to company form**

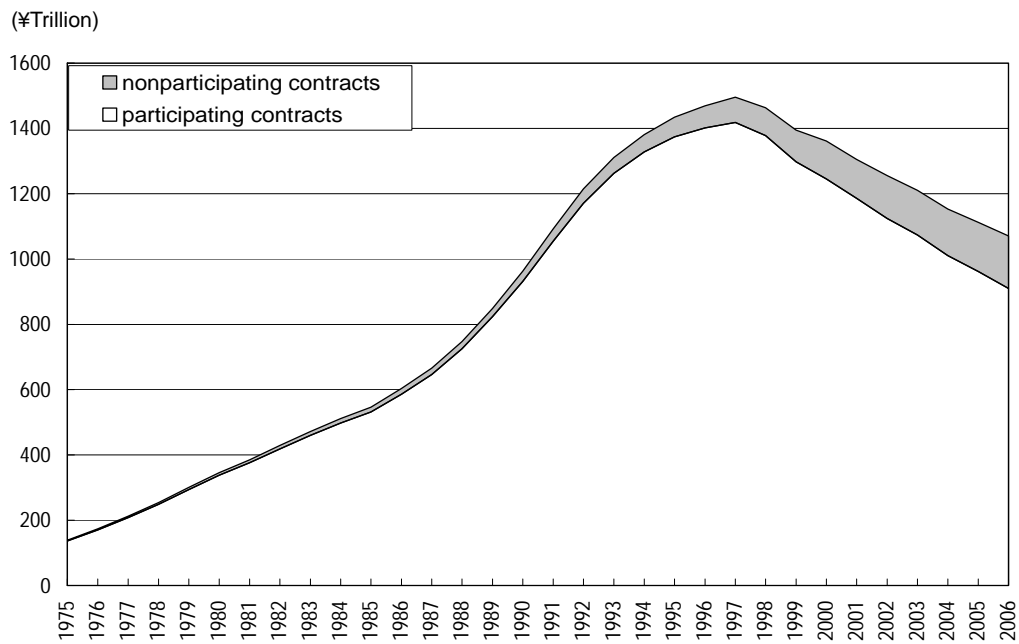


**Figure2. Transition of the individual insurance total number of policies in force <sup>3</sup>**



<sup>3</sup> Partly estimated by writer.

**Figure3. Transition of an individual insurance total amount of insurance in force <sup>3</sup>**



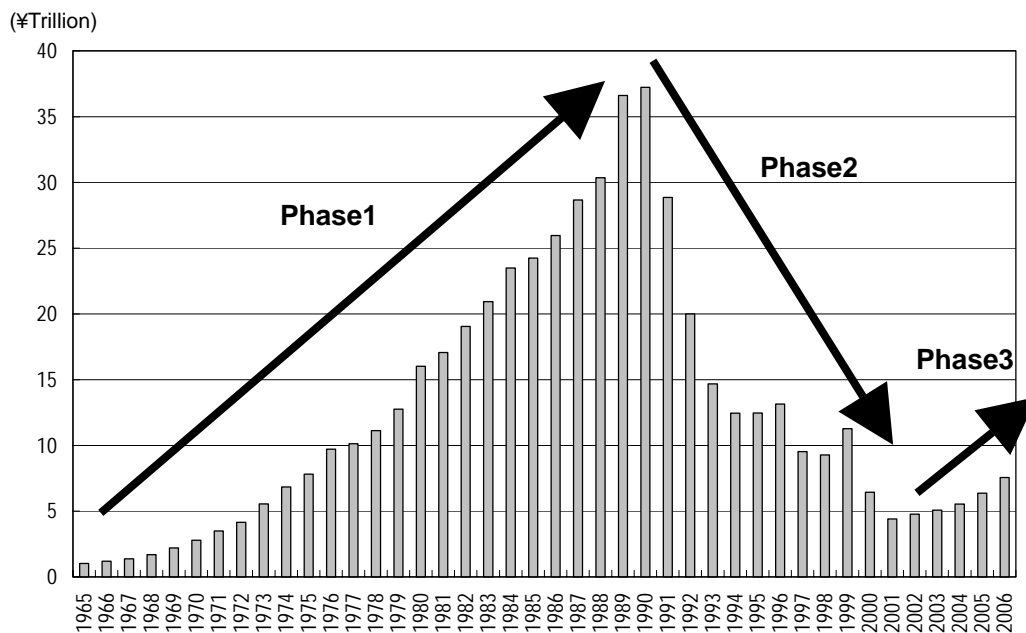
## 2 . The history of policyholder dividends

I'll show the graph of the transition of the total amount of dividends in Japan.

It had increased steadily until 1990 under steady economic growth, such as postwar high economic growth and a bubble boom. Because of the long slump of the economy, accompanying the burst of bubble economy, the total amount of dividend decreased sharply. But in recent years, due to the up-trend of economic conditions, the amount is starting to increase gradually again.

In this section, I'll divide the period from the postwar to the latest into three phases, and consider meanings and problems of policyholder dividends in every phase.

**Figure4. Transition of the total amount of dividends**



**2 . 1 The period of economic growth which continued from the postwar period to the burst of bubble economy (Phase1)**

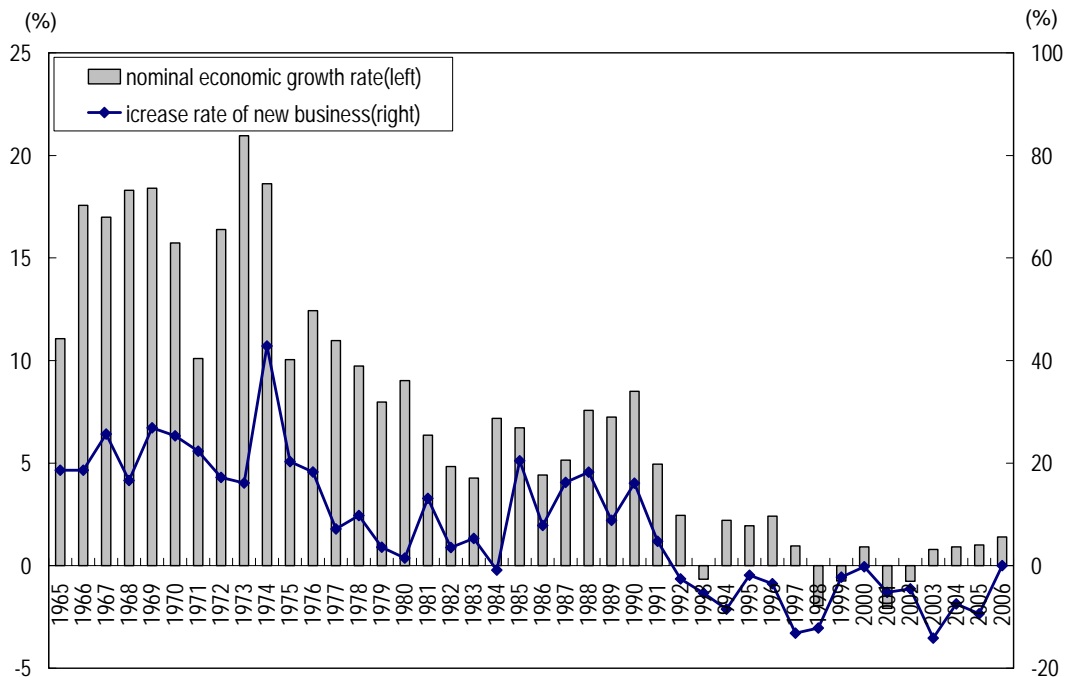
**【Economic conditions】**

Although Japanese economy has accomplished high growth after the World War II, which was globally rare, the economic growth rate was almost reduced by half due to the first oil crisis in 1973, and entered stable growth stage. Afterwards it traced steady growth basically in spite of an external shock such as the second oil crisis in 1979 and the appreciation of the yen by the Plaza Agreement in 1985. "The Heisei economy" from November 1986 became a long-term economic expansion, which is called "the Bubble Economy", accompanied with the extreme rise of stock and land prices.

**【The life insurance industry】**

The life insurance businesses of this phase was strongly influenced by business fluctuations, and an increase rate of the amount of new business stayed around 20% in Showa 40's(from 1965 to 1974), but it dropped to single figure in Showa 50's(from 1975 to 1984). It was sluggish in 1984 and 1985 when economy turned worse by the second oil crisis, and it became a minus in 1984. Then the increase rate became a large number again under the rise of the economy in Showa 60's(from 1985 to 1988).

**Figure5. Transition of the economic growth and the increase rate of new business**



**【Policyholder dividends】**

Japan's economy continued growing up basically, and as for policyholder dividends, a rate for calculating dividends<sup>4</sup> was set high (7%-8%) because of high investment yields of yearly average 7%-8% and the improvement of the mortality rate after the war.

At this time, the regulation for valuation was changed. (A shift to net premium method from Zillmerized reserve.) However in the fiscal year 1970 many companies reached the limit of reserves under a net premium method.

In addition, from the viewpoint of policyholders' protection against high inflation and a surge of consumerism, it was necessary to give inflation protection to fixed amount insurance contracts.

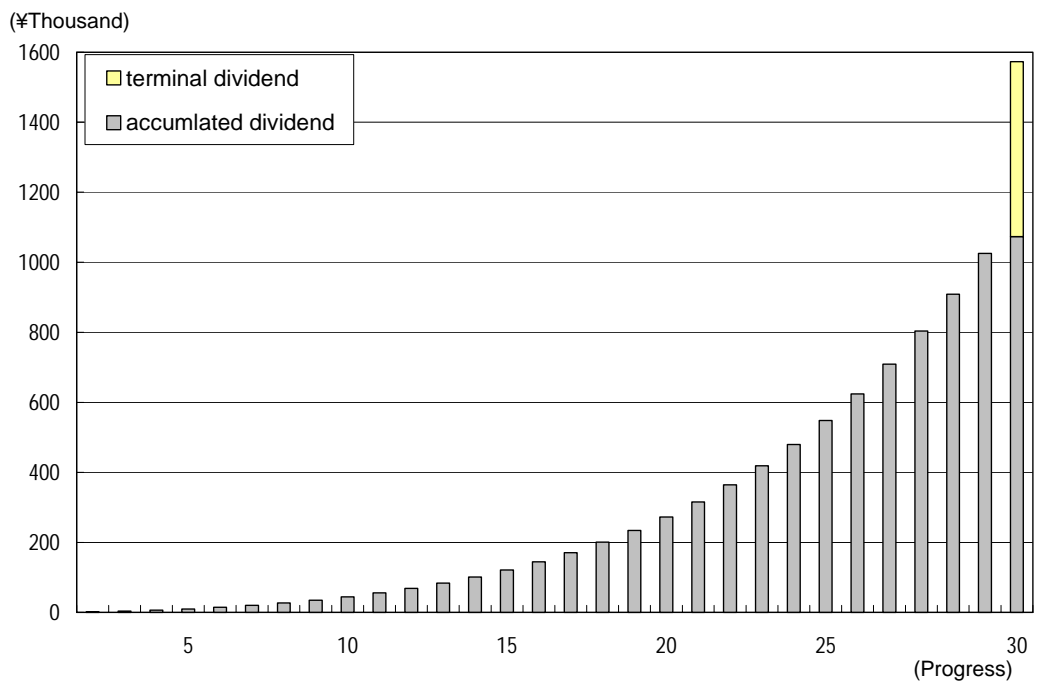
In response to these demands, terminal dividend was introduced in 1971, the dividend which are paid at the maturities for contracts with a certain length of insurance period. The terminal dividend, which had been 1% of maturity paid when introduced, increased. Afterwards the extent to which terminal dividend was paid, was extended to contracts which extinct by death or surrender. 65% of maturity paid was the highest paid for terminal dividend. In addition, because terminal dividend was paid in proportion to policy reserve, the

<sup>4</sup> In the case that if this rate exceeds guaranteed interest rate, interest profit dividend will be paid.

imbalance that it was not paid to term contracts including term riders occurred. Therefore terminal dividend paid in proportion to premium instead of policy reserve was introduced for these term contracts in the fiscal year 1986.

I'll show the illustration of the dividend of an endowment contract, which was settled in 1977 (insurance a million yen, insurance period 30 years). The amount of dividends was calculated according to the premise whose dividend rate<sup>5</sup> was set in the fiscal year 1976, the latest result at inception. This number was used for a proposal at that time to show the estimated total amount of dividend at maturity. (So it may be expected amount of dividends for policyholders at inception.) But because of a large reduction of dividends after the burst of bubble economy, the actual amount of dividend dropped sharply. ( The details are mentioned later. )

**Figure6. Expected amount of dividends at inception based on the dividend rate set in the fiscal year 1976**



<sup>5</sup> Based on the dividend rate of general mutual insurance companies at that time.

## 2 . 2 The Heisei recession period with the burst of bubble economy (phase2)

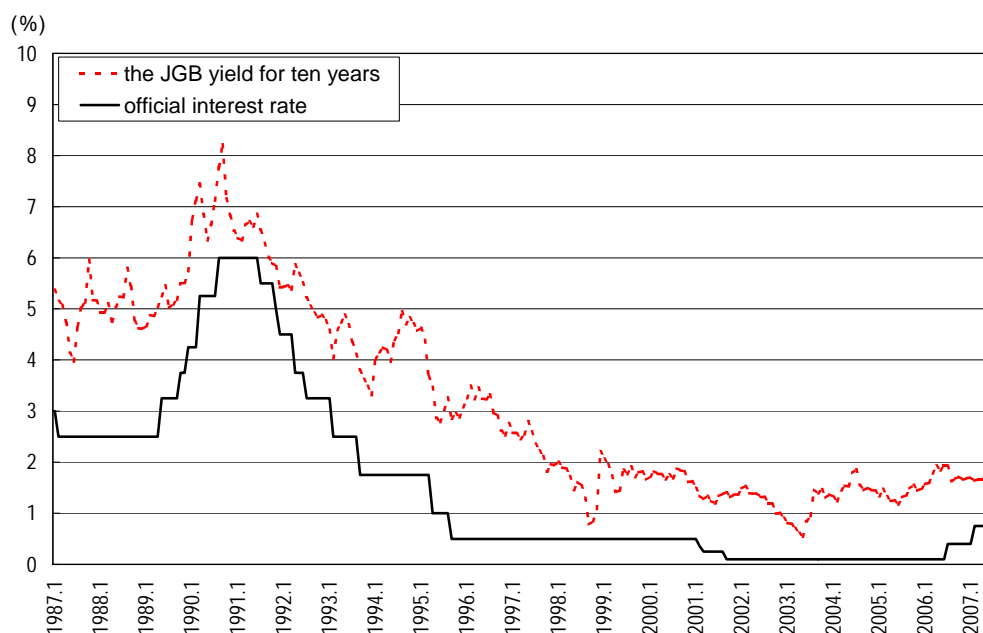
### 【Economic conditions】

The rapid economic expansion from November 1986 turned to recession period in April 1991. This economic recession was long and large, because of too enough plants and equipments in the Heisei economy and the aggravation of balance sheet by the fall of assets price. Bankruptcies of financial institutions occurred successively by a protracted economic slump after 1997. Also, by the reduction of official interest rates, ultra-low interest environment continued.

### 【The life insurance industry】

As life insurer's investment yields was by far less than guaranteed interest rates of contracts under ultra-low interest rates, so-called "negative spread" problem got worsen. By the aggravation of economic environment for a long term, bankruptcies of life insurers occurred successively. These bankruptcies increased uneasiness toward life insurers, and in 1997 the total amount of insurance in force was decreased for the first time after the war. Because some life insurers cannot endure a negative spread after 2000, life insurers went bankrupt one after another.

**Figure7. Transition of interest rate**



### **【Policyholder dividends】**

Expected mortality rates and expected expense rates have been reduced steadily because of the improvement in business efficiency and death rate. Though expected interest rates were set high at the time of past prosperity, it was reduced repeatedly due to the severe investment environment where low interest rates continued by the influence of economy slump after the burst of bubble economy. But for contracts with high guaranteed interest rates, the so-called "negative spread" problem, that investment yields were by far less than guaranteed interest rates became serious, and in fact it interrupted fair dividend allocation to policyholders. (Going to extremes, it was in a situation that the profits earned from contracts with low guaranteed interest rates, might be used to fill negative spread for contracts with high guaranteed interest rates.)

In this situation, to provide dividend depending on the contribution of each contract in a limited source of profits, we introduced new dividend systems, such as deduction for negative spread<sup>6</sup>, various rate for calculating dividends<sup>7</sup>, offset of dividends between main contracts and rider contracts<sup>8</sup> and adjustment for loading profit dividends and mortality profit dividends<sup>9</sup>.

In this way under a severer management situation, where stock prices and interest rates dropped after the burst of bubble economy, many companies reduced the amount of dividends largely to satisfy solvency.

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<sup>6</sup> In Japan if we have negative spread, the loss will be covered by other sources of profit (such as mortality profit dividend, loading profit dividend).

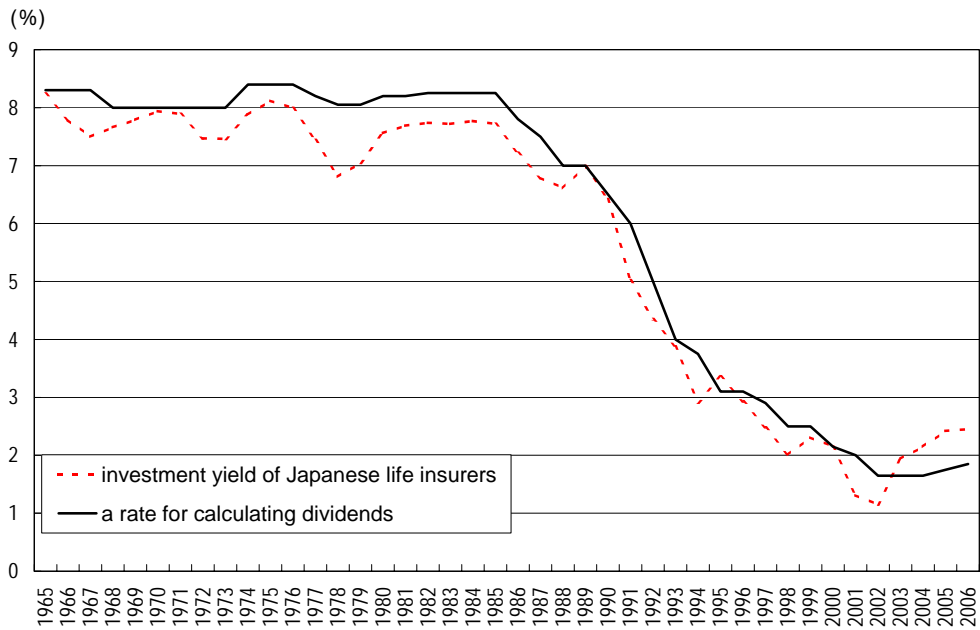
<sup>7</sup> Generally the rate for calculating dividends of contracts with high guaranteed interest rate is set lower than that of low guaranteed interest rate contract's to reflect the risk difference.

<sup>8</sup> The negative spread of main contracts is covered with the profit of rider contracts.

<sup>9</sup> The loading profit dividend rate of contracts, whose amount of insurance is high, is set higher to reflect the loading income in proportion to the amount of insurance and the cost in proportion to contract numbers.

The mortality profit dividend rate of contracts, whose progress from inception is short, is set higher to reflect the effect of selection.

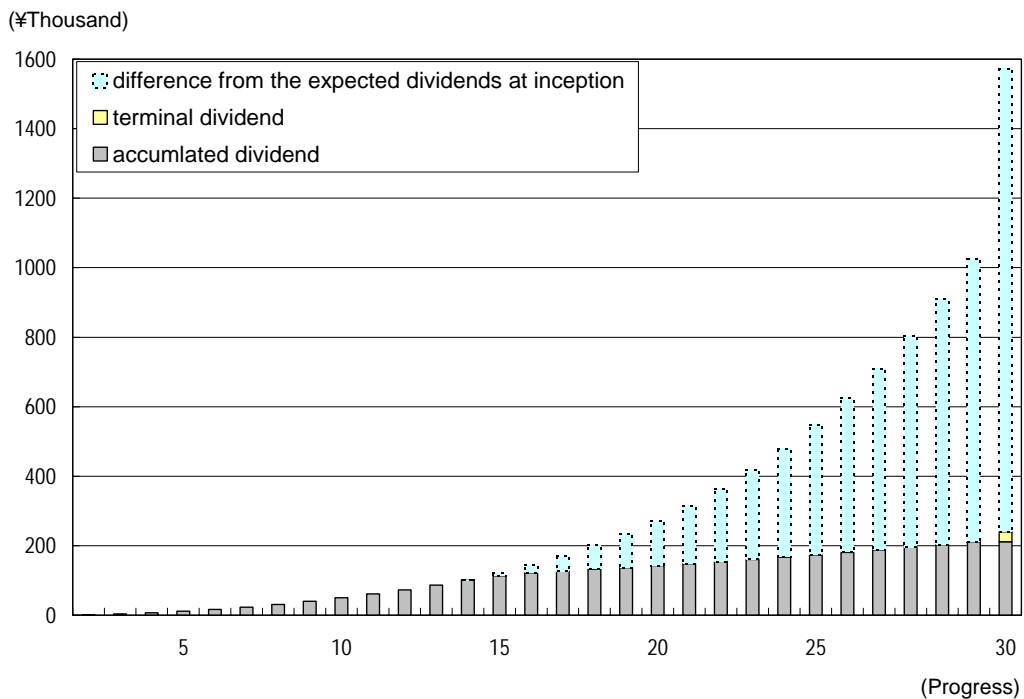
**Figure8. Transition of investment yield and a rate for calculating dividends<sup>10</sup>**



In the following figure 9, I'll show the actual amount of dividends of the endowment contract introduced in part 2.1 (Figure6). As a result of reduction in every year, the actual amount of dividends received at maturity decreased to around 200,000 yen, though the expected dividend at inception was 1,600,000 yen. These cases caused contractors' complaints and loss of trust about policyholder dividends.

<sup>10</sup> Based on the press announcement documents of companies.

**Figure9.Actual amount of dividends**



### 2 . 3 The increasing dividends phase backed by economic recovery (phase3)

#### 【Economic conditions】

Backed by steady economic recovery, up-trends, such as release from deflation and cancellation of zero-interest-rate policy on July 13, 2006, brought a large increase in profits to many domestic companies. In the domestic stock market, Nikkei averages rose to 18,000 yen, which had been less than 8,000 yen at the end of 2002, and the JGB yield for ten years also rose from 0.5% to nearly 2%.

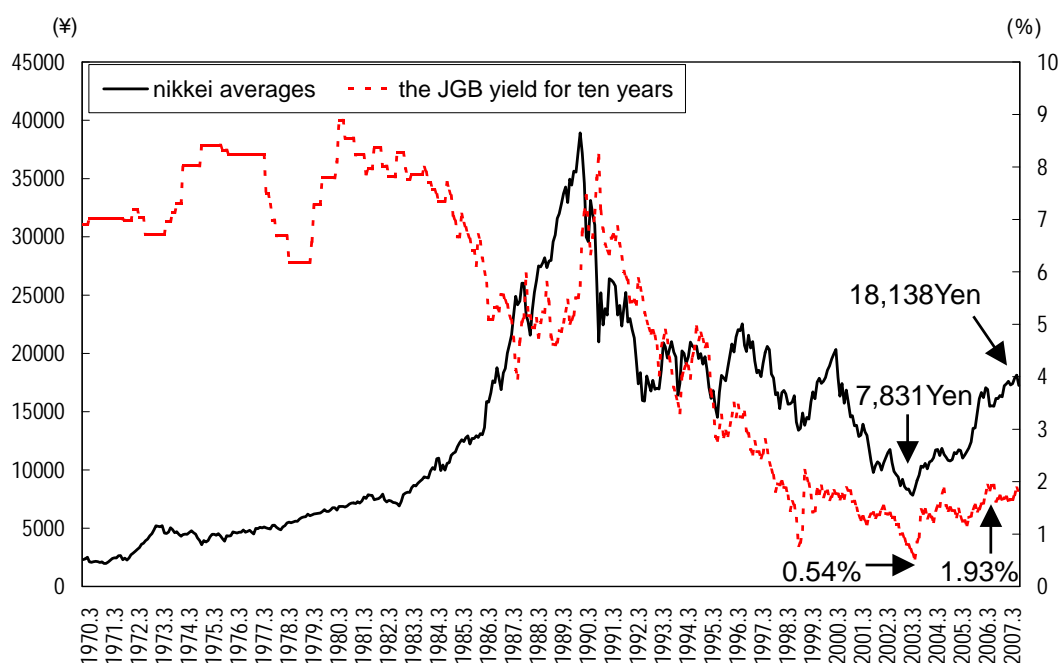
#### 【The life insurance industry】

Due to the changes of contractors' needs for life insurances, a tendency to decrease the amount of insurance in force doesn't seem to stop. On the other hand, both the number of contracts and the amount of premium income (for policies both in force and new business) show a tendency toward improvement a little. In addition, the profitability and the soundness of companies improved largely because of the large increase of investment income based on brisk market environment.

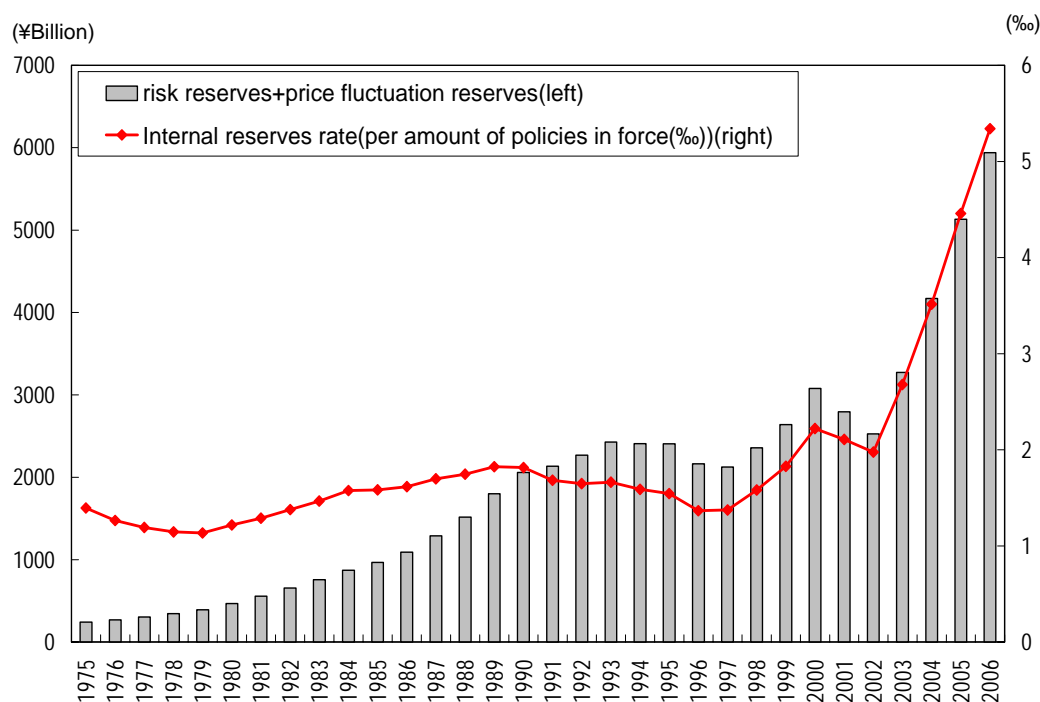
### 【Policyholder dividends】

Because economic environment improved and many companies satisfied solvency, they began to increase policyholder dividends. However, the negative spread issue has not been solved completely, and dividend rates are still lower than those at the times before the burst of bubble economy. Even though the tendency to increase policyholder dividends continues in future, a problem is how to divide the limited source of profits, depending on contribution to profit of policies.

**Figure10. Transition of Nikkei averages and the JGB yield for ten years**



**Figure11. Transition of internal reserves rate<sup>11</sup>**



### 3 . The dividend policy based on the policyholders' benefit

As I explained above, features of dividend policies depend on the circumstance of business. Due to the improvement of economic environment and the satisfaction of solvency, many companies began to increase policyholder dividends. In such a situation, I'll finally consider the dividend policy in order to maximize policyholders' benefit, under the standards for appointed actuaries of life insurance companies about policyholder dividends.

#### 3 . 1 A legal requirement for policyholder dividends

Article 55-2 of Insurance Business Law requires that "allocation of dividends to policyholders should be based on the principles for fairness and equitability." And appointed actuaries have the role to confirm fair and equitable dividend policy by a rule of Article 121 of Insurance Business Law. The concrete method must be followed to the standards for appointed actuaries of life insurance companies, which is published by the Instituted of Actuaries of Japan and is inspected by JFSA. According to this, fair and equitable dividend policy must satisfy the following matters.

<sup>11</sup> Partly estimated by writer.

To calculate the amount of dividends under the situation where policy reserve is accumulated appropriately enough to maintain the soundness of companies

To allot and distribute dividends depending on the contribution of individual contract

To calculate, allot and distribute dividends based on reasonable actuarial mathematics and standard of generally accepted corporate accounting, conforming to laws, rules of notifications and terms of contract of insurance article

To allot and distribute dividends considering policyholders' expectation from the viewpoint of the trend of the death rate of the nation and the trend of market interest rates

There should be various interpretations about "the policyholders' expectation". I want to show one interpretation for it as follows and then consider ideal dividend policy in order to maximize policyholders' benefit.

### **3 . 2 To maximize policyholders' benefit**

#### **The balance between satisfying solvency and policyholder dividends**

"Expectation of policyholders" should be to receive insurance coverage with as low premium as possible, primarily. But it would be a great problem for a company to go bankrupt if premium were too low and they couldn't satisfy solvency. Because of the features of life insurances, transferring to other company may become impossible due to the problem of the state of health at the time of re-participation. In addition, life insurance plays a role to supplement social security and some contractors design future life including life insurance. Therefore to satisfy the solvency is the first concern of the standards for appointed actuaries to satisfy fair and equitable dividend.

But even though it's important to satisfy solvency, policyholders wouldn't allow a company to accumulate internal reserves endlessly. It became the most important how to keep the balance between to satisfy solvency and policyholder dividend. No matter what happens, we must accomplish insurance coverage with as low premium as possible, which maximizes policyholders' benefit.

Therefore it is necessary to grasp how much risk there is in companies and how much solvency we need to cover the risk. Also we must provide persuasive explanations for policyholders and get their understanding in order to maximize their benefit.

### **The reason why policyholders do not choose non-participating contracts but participating ones**

The reason why policyholders do not choose non-participating contracts, whose premiums at inception were lower without dividends, but participating contracts, whose premiums at inception were higher with dividends, is the outcome of policyholders' expectation that an actual premium adjusted by dividend might become lower than that of non-participating insurances.

Actually, various payment conditions exist and efficiency depends on companies, so it may be difficult to compare simply. The setting of dividend rates that considered the premium of non-participating contracts is expected from the viewpoint of considering the expectation of policyholders that the standards for appointed actuaries require.

### **Possibility of explanation to policyholders**

The dividend system depending on contribution may be the other side of concise dividend system. And the more equitableness for dividends pursued, the more complicated dividend system needed. It is undesirable that dividend system is too complicated due to pursuing equitableness to explain to policyholders. Dividend system that an actuary would regard fair, but a sales person, who is in charge of explaining to policyholders, couldn't explain is self-satisfaction of an actuary.

As stated above, dividend system has become complicated to divide for policyholders whose contribution degree is large from the limited source of profits. It is a fact that the conciseness of dividend system has been discarded in that process. In the example of above-mentioned figure 9, not explaining properly to policyholders the difference between assumption at recruitment time and actual influence may cause recent policyholders' complaint for dividend.

In other words, it is very important to draw up dividend policy from the viewpoint of concise dividend system and explanation possibility to policyholders.

### **The terminal dividend**

As well as a purpose to make up for the loss of value by inflation, which I mentioned above, terminal dividends have another side such as the final

adjustment of retained earnings. On the other hand, early payments of dividends will be demanded considering policyholders' needs. From the viewpoint of the fact that the actual profit will not be settled until the time of expiration, that the first duty is to accomplish long-term coverage surely and that low interest and negative spread have continued in latest years, it's natural to be careful about early payments. Since we can't request additional premiums in general, setting dividend rates that do not depend on earnings of each year but on those during a certain period of time, controlling dividends and filling up terminal dividends at expiration days when accumulated earnings become clear, will meet policyholders' benefit. In addition, as a matter of course, the appropriate management of retained earnings of each contract group is important, and intelligible explanation of the dividend policy of life insurers at inception will promote policyholders' understanding.

Setting terminal dividend rates, a problem is which model to choose, the revolving fund model, to return all of policyholders' shares, or the entity capital model, to retain some part of policyholders' shares to continue companies. It may be necessary to reserve some to disperse a risk between generations. But, reservation standard must be based on the reasonable estimate of risks in the future, and it will be necessary to get policyholders' understanding about it.

#### **Equitableness between generations**

As mentioned above, profits earned from contracts with high guaranteed interest rate may be used to cover negative spreads and to satisfy solvency. So it's very difficult to realize the equitableness between generations.

Therefore the profit, which should be allocated if there was no negative spread, can not be allocated to contracts with low guaranteed interest rates. The amount of contribution must be managed strictly, and it's important to pay dividends to these contracts (whose guaranteed interest rates is low) with precedence if earnings will improve in the future. And we must try to achieve accountability for policyholders.

### **3 . 3 Concluding Remarks**

Even though policyholders don't expect as much dividend as before after the sharp drop in the past, it is an undeniable fact that actual premium (including a dividend) is an important factor to choose a product.

Therefore, in order to maximize their benefit, it is our responsibility to give

**persuasive explanation to them as well as fix the level of dividends and ensure profit so that we could return dividend through entire period, considering their expectations.**