June 22, 2022

Market Segment Outlook: Japan Life Insurance

Our outlook is revised from Negative to Stable in light of a budding recovery of overall business conditions for life insurers

AM Best is revising its outlook of the Japan life insurance segment from Negative to Stable, as the operating conditions for life market players appear to have improved. Key factors that support the revision of the outlook include the following:

- Continued positive momentum in top line recovery
- Possibility of further foreign interest rate hikes
- Bottoming out of domestic interest rates

AM Best anticipates that the operating environment currently has a neutral influence (as opposed to a negative influence) over the short-term operating performance metrics of Japanese life insurers for the remainder of fiscal year 2022/2023.

In our view, most Japanese life insurance companies maintain very strong capital positions, and are likely to be able to withstand the potential impacts on capital changes that may result from global financial market volatility. Several long-term and persistent challenges remain, including ageing demographics and a shrinking working population, stagnant wages, and evolving consumer needs. Over the near term however, we expect insurers' operating performances to benefit from some tailwind factors, such as the positive momentum in top line recovery, the possibility of further foreign interest rate increases, as well as a bottoming out of domestic interest rates.

Continued positive momentum in top line recovery

Efforts to embrace digital transformation prior to the pandemic were sporadic as most life insurers in Japan continued to rely heavily on face-to-face sales distribution. Thus, the outbreak of COVID-19 adversely affected life insurance sales given social distancing measures and restrictions on face-to-face sales activities. Although the sales performances of most life companies have yet to recover to pre-pandemic levels, we view that the situation is likely to continue improving with further loosening and removal of COVID-19 restrictions in the country, aided by an acceleration of digital transformation and new product launches.

Over the past two years, as face-to-face sales activities were curtailed due to the pandemic, most Japanese life insurers have sought to strengthen their sales activities that require less face-to-face interaction. This included implementing virtual sales methods, which make it possible to conduct sales even with limited or even no face-to-face interaction; this helped to make up for some of the shortfall from reduced face-to-face sales activities.

The pick-up in digitalisation efforts over the past two years has also opened up new sales channels and allowed for a wider range of products and services to be offered by life companies – both of which are likely to restore momentum in top line sales to reach pre-COVID-19 levels. As the number of infections in Japan has stabilised and more people are vaccinated, the government will increasingly shift its focus to economic recovery. As such,

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we believe that sales activities of most Japanese life insurers will continue to recover as business activities return to normality following the removal of COVID-19 restrictions.

Possibility of further foreign interest hikes

Foreign interest rate movements typically have a considerable influence on the operating performance of Japanese life insurers. Since early 2020, fears of a global recession owing to the economic fallout from the COVID-19 pandemic had led to most central banks cutting their interest rates. Steep reductions in interest rates overseas not only eroded the appeal of foreign-currency denominated single premium insurance policies (from the policyholders' perspective), but also the risk-adjusted returns of foreign interest-bearing securities (from the insurers' perspective).

Earlier in June, the US Federal Reserve raised its benchmark overnight lending rate for the third time in 2022; the increase of 75 basis points is the largest hike in the rate since 1994. AM Best notes that this has turned the tide on demand for foreign-currency denominated products, which used to be quite popular for several years prior to 2020, when interest rate differentials were wide. Should Japan's central bank continue to maintain its current low interest rates while market expectations are that foreign interest rates remain considerably higher than domestic interest rates, this may spur more current or prospective saving-type policyholders to consider higher-yielding foreign-currency denominated products over yen-denominated products or investments. Hence, AM Best expects that prospective sales of foreign currency-denominated products are likely to increase in tandem with foreign interest rate increases over the coming quarters.

In terms of investment, AM Best is of the view that continued hikes in global interest rates will bode well for life insurance companies in Japan. This is because the prospective investment climate is likely to become easier for insurers to manage risk-adjusted returns and re-investment risk, albeit with higher costs of hedging in general.

Bottoming out of domestic interest rates

The ultra-low interest rate environment in Japan has always posed a challenge for Japanese life insurers, as reflected in various embedded-value metrics including new business profit margins, value of new business, and operating return on embedded value. However, there have been recent expectations that the Japan's central bank may consider normalising its monetary easing measures over the short to medium term as most major central banks around the world begin or continue to tighten credit. Over recent quarters, particularly since the first quarter of 2022, yields on medium- and long-term Japanese government bonds (JGB) have been on a general rising trend, mainly reflective of the developments in US interest rates. Between March 2021 and March 2022, there was a broad-based increase in JGB yields along the yield curve, which is generally favourable to most Japanese life insurers, as seen in their embedded-value metrics.

Nonetheless, the Bank of Japan will need to achieve a balance between maintaining an ultra-easy monetary policy that may subject the economy to import inflation, and raising interest rates to stem further weakening of the yen, which could also be detrimental to businesses. While it is difficult to anticipate precisely the future development path of domestic interest rates, at a minimum, AM Best notes that it is unlikely that the prospective yield curve would shift down significantly from the current level.

Should domestic interest rates hold up (at least close to current levels), this could imply that the worst, in terms of negative yields on medium-term JGBs, is behind us. This would provide additional support to the positive momentum in Japanese life insurers' operating performance metrics over the near term.

Based on the current trends, persistent upward pressure on superlong-dated JGBs, would also make the overall cost of accumulating more superlong-dated JGBs (to cope with an economic value-based solvency regulation that is expected to be introduced in 2025) lower than otherwise. This is most applicable to domestic life insurers with considerable duration mismatch.

Long-term and persistent challenges remain

Although AM Best anticipates a more favourable operating environment for Japanese life insurers over the next 12 months (compared to earlier stages of the COVID-19 pandemic), there remain several long-term and persistent challenges including changing demographics, evolving consumer needs and behavior and growing economic uncertainty stemming from ongoing supply chain issues.

Notwithstanding these potential headwinds, AM Best is of the view that most life insurers will continue to generate a stable level of core profits—a profitability indicator for the principal business of life insurance companies. In general, we still expect mortality and morbidity margins—the life insurance segment's bread and butter—to remain large and stable, which will help to support the steady emergence of core profit. In addition, the regulatory push to an economic value-based solvency framework is expected to facilitate the enhancement of risk management across the industry. By fostering all life insurers to prudently take into account the balance between risk, return, and capital in their strategic planning, we expect that this will help enhance market discipline and keep competitive pressures within the life insurance sector under control.

In terms of capital positions, AM Best remains confident that most Japanese life insurers' will be able to maintain at least very strong levels of risk-adjusted capitalisation. The amount of excess solvency margin held by most domestic insurance companies is also sizable relative to the value of equities and foreign bond holdings, which suggest that there is a significant amount of excess capital available to cushion against market volatility.

We will continue to monitor the trends in these major headwind factors and assess the corresponding implications on insurers' financial strength, should some of these long-term or emerging headwinds start to exert growing and significant pressure on the operating environment of Japanese life insurers.

GUIDE TO BEST'S MARKET SEGMENT OUTLOOKS

Our market segment outlooks examine the impact of current trends on companies operating in particular segments of the insurance industry over the next 12 months. Typical factors we would consider include current and forecast economic conditions; the regulatory environment and potential changes; emerging product developments; and competitive issues that could impact the success of these companies. Best's ratings take into account the manner in which companies manage these factors and trends.

A Best's Market Segment Outlook, like a Best's Credit Rating Outlook for a company, can be Positive, Negative, or Stable.

Best's Market Segment Outlook	
Positive	A Positive market segment outlook indicates that AM Best expects market trends to have a positive influence on companies operating in the market over the next 12 months. However, a Positive outlook for a particular market segment does not mean that the outlook for all the companies operating in that market segment will be Positive.
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Stable	A Stable market segment outlook indicates that AM Best expects market trends to have a neutral influence on companies operating in that market segment over the next 12 months.

We update our market segment outlooks annually, but may revisit them at any time during the year if regulatory, financial, or market conditions warrant.

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BEST'S MARKET SEGMENT REPORT

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