The Importance of Insurance to Economic Growth and Security: An open invitation to dialogue

Fostering long-term, sustainable growth is a goal shared by government and industry alike. Much has been written about the various measures being taken and the reforms that at long last seem to be taking hold in the world's third largest economy. But insurance has received little attention. Herein we will look briefly at the role insurance can play in encouraging an environment of sustainable growth, touching on the domestic Japanese context and global insurance best practices. We will then propose three areas of focus for further discussion.

Our objective is to promote a constructive dialogue amongst regulators, policy influencers, and industry practitioners for the benefit of customers and Japanese society as a whole.

Why insurance?

To some, insurance is nothing more than a common utility. However, this assumption is both misleading and inaccurate as it does not consider the broader social and economic benefits of financial protection, public burden sharing, employment, and long-term capital investment that insurance fosters. Numerous studies over the years have repeatedly demonstrated the importance of insurance to economic development, starting with the findings of UNCTAD 1964[1] :

> "***A sound national insurance and reinsurance market is an essential characteristic of economic growth***".

We live in an increasingly connected world where risk can spread quickly and where reliance solely on public health and retirement schemes is becoming increasingly tenuous. By creating an environment of greater certainty, insurance fosters stable consumption, investment, and innovation, thereby promoting economic development by reducing the capital firms need to operate.

Insurance provides the peace of mind needed to confidently navigate the many facets of both opportunity and disruption in a global economy characterized by rapid social and demographic change and the emergence of new risks in areas such as political, climate, fiduciary, and cyber security. An increased awareness of risk management influences companies' investment decisions, protects value, and improves financial soundness.

Greater insurance penetration[2] de-risks governments, businesses and communities. It takes the financial burden of recovery off the taxpayer and boosts economic growth. Indeed, research shows that a 1% rise in insurance penetration translates into a 13% reduction in uninsured losses - a 22% reduction in taxpayers' contribution following a disaster. [3]

Japan insurance industry operating environment: A changing landscape

Japan has the second largest pool of insurance premium of any country in the world following the United States – both life and general insurance. Japan's corporate insurance market is the third largest in the world behind only that of the US and China and is estimated to be $36 billion in direct premiums written.[4]

Japan, however, ranks only 16th in overall insurance coverage relative to GDP[5], remaining under-insured compared to peers in advanced countries. This is due at least in part to the traditional style of business co-ownership amongst the larger companies. Since each company held shares in the others in its ecosystem, when something untoward happened to one company, all either pitched in to help or all struggled together. This approach to governance, which is based more on relationships and keiretsu links than on a clear understanding of risk management principles or an empowered Chief Risk Officer, has contributed to a general lack of risk sophistication.

One outgrowth of the traditional approach has been the creation of insurance intermediaries formed as subsidiaries of corporations and commonly referred to as 'case agents'. These case agents are given the responsibility for overseeing insurance placements for all the group's subsidiaries and relationship partners. Case agents are typically housed inside the logistics arm of the group and are managed as part of an administrative function, often with a focus more on generating commissions or maximizing business with group entities than on finding the best risk transfer or risk management options. Given the requirements of the role as traditionally defined, case agent staff often have not had, and indeed have not needed, formal risk management training to perform their assigned function. This is in contrast to the more globally prevalent risk advisory or brokerage model, wherein staff are typically seasoned, often certified, risk professionals focused on providing the proper type and amount of coverage. In Japan, however, the brokerage model represents less than 2% of distribution.

A clear example of problems stemming from this non-rigorous approach to risk management is severe corporate under-insurance as evidenced by the paucity of Natural Catastrophe, Business Interruption, and Contingent Business Interruption coverage bought in Japan. This lack of sufficient coverage became very apparent in 2011 following the disastrous events of the Great East Japan Earthquake where only approximately 17% – about US$35 billion – of the economic losses were recoverable through insurance. This meant that an estimated US$205 billion of the emergency relief reconstruction costs fell on taxpayers, slowing down the reconstruction of vital infrastructure and services, and impairing the ability of communities and businesses to get back on their feet, By contrast, economic losses from the Christchurch earthquakes in New Zealand were approximately NZ$40 billion, but were 75% covered by insurance, allowing the long, hard process of recovery to begin more quickly.

Major initiatives from the Japanese government looking to strengthen the economy and build a more sustainable international business environment are being put in place in response to increased demand for heightened risk awareness and more transparent corporate governance in the Japanese commercial marketplace. Investors and other stakeholders are giving greater scrutiny to the decision making processes and risk management philosophy espoused by each company. Landmark pieces of legislation and other initiatives are indicative of the realization of the need to improve on old models that are not in the best interest of the economy or society.

The Japan Revitalization Strategy approved by the Cabinet in June 2013 (and subsequently revised in 2014) laid the path to enhanced corporate governance that specifically addresses cross-shareholding issues and other concerns. It also has led to revisions to the Companies Act, which was passed in the Diet and became law in June 2014. Interest shown in the JPX Nikkei Index 400 index is an example of how better corporate governance – with a strengthened focus on ROE, long-term profitability, and the appointment of independent external directors – is of increased importance to the investment community. The Stewardship Code, though voluntary, is another initiative that has attracted considerable attention.

Global best practices: Risk management is integral to good corporate governance

Unlike in other developed countries where risk management is a regular item on management and board agendas, in Japan there is much room for improvement in placing risk at the forefront of management awareness. Best practice among largest multinational corporations outside Japan involves regular management and board discussions on the risks and rewards associated with particular business strategies. With the introduction of the new Corporate Governance Code in Japan and a significant increase in independent directors compared to a decade ago, there is a clear opportunity to inject more vigor and purpose into Japanese board meetings by establishing risk as a core standing agenda item.

Having board leadership that understands the roles and responsibilities of risk management does not come without its challenges in any jurisdiction. It takes time for mindsets to change. In the United States, the Securities and Exchange Commission released new disclosure rules in 2010 that require listed companies to disclose details about the boards' role in risk oversight. Although the rule only requires disclosure about current practices and does not require a specific framework, it indirectly promotes the adoption of best practices in risk management. Similar rules have been adopted across the European Union.

In the normal course of business insurers are exposed to a wide variety of global and domestic corporate clients and have the opportunity to gain insight into underlying practices as they review various risk structures. Companies that leverage risk management as a competitive advantage often incorporate some form of Enterprise Risk Management (ERM) into their top-level oversight functions.

Strong risk cultures are those that include operational, financial, strategic, and compliance risk across their ERM program. However, risk should not be seen as something to be avoided at all costs, but rather as something that can be managed and used by the corporation as a potential opportunity. Proactive risk identification and the discussion of mitigation plans need to be part of formal strategic planning processes in order for corporates to improve their risk management capabilities. Communications on risk assessments need to be methodically rolled up to risk committees and boards in order for top-level management to be aware of and have opportunities to assess, mitigate, and where appropriate leverage risk appropriately.

Ever increasing sophistication and rigor with advanced analytical techniques is required for corporate boards to catch up to and maintain best risk management practices in a rapidly changing global environment. Prediction is difficult. However, as risk management programs at Japanese corporations gain more maturity and experience, risk owners will increasingly be more knowledgeable and equipped to manage the unpredictable.

Global best practices: The role of brokers in international markets

An examination of the insurance brokerage model prevalent in developed economies can be instructive as an alternative approach to risk sophistication and customer-focused service. Brokers are legally obligated to act in the client's best interest, representing the client in the insurance buying process and acting independently in relation to insurers. They help clients with their insurance and risk management thinking by presenting them with alternative products and solutions from various sources, working at times with multiple companies to place coverage for their clients.

The professionalization of insurance intermediaries in overseas markets has been driven by increasingly complex business requirements as well as changing legislation, compliance, and product solutions. This has produced brokers with a broad knowledge of the insurance market, a high level of product and technical knowledge, and a professional understanding of insurance terms and conditions. This knowledge serves corporations well and also provides an important economic benefit in that their professional advice increases breadth of cover, improves access to markets, and reduces risk exposure and cost for clients thus enabling them to focus their efforts on better growing their business.

As professional intermediaries, brokers add value to insurance companies by saving time and developing effective solutions for customers. For larger clients, they may utilize several insurance carriers for placement of different lines of business or to spread risk where capacity is an issue. In addition to benefiting the client and the insurance companies involved, the increased efficiency also leads to cost reductions, benefiting the economy as a whole.

Time of Transition: FNLIA focus and invitation

In this time of transition and opportunity where interest in shifting to best practices in corporate governance and risk management is increasingly aligned, FNLIA is looking to promote constructive dialogue and appropriate collaboration amongst regulators, policy influencers, insurance practitioners, and clients for the benefit of the industry, customers, and Japanese society as a whole. We call for action focused in the following three areas:

Support Stronger Corporate Governance

- Promote efforts to support the enhancement of corporate governance activities in Japan
  a. Enhance Board involvement in crucial risk management decisions
  b. Increase transparency in decision making
  c. Balance relationships between customers, intermediaries, insurers, and regulators

Foster a culture of risk management

- Increase awareness of international risk management practices and help foster risk management skills among the industry participants and customers through educational seminars conducted by global experts
- Help expand educational and training opportunities for professionals by supporting risk management associations, internationally recognized certification programs, and the development of risk management study programs at universities

Leverage best industry practices

- Through industry dialog, share global insurance industry best practices in Enterprise Risk Management, distribution/channel management and solicitation oversight
- Work with the various insurance industry associations to support Japanese customers and society by providing more risk-matched coverage products
- Support innovation and entrepreneurial activities through need-specific risk consultation and mitigation
- Promote discussion around ways to enhance and support Japan's unique social healthcare and pension system via cooperation with the private insurance industry

We invite dialogue from all interested parties in moving forward with these important initiatives.

FNLIA
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[1] Proceeding of the United Nations Conference on Trade and Development, first act and report, p.55, Vol. I, annex A.IV.23
[2] Insurance penetration: the ratio of insurance premium underwritten in a given year to GDP
[3] Source: Lloyd's Global Underinsurance Report – published October 2012.
[4] Swiss Re January 2015 Japan's Commercial Insurance Market
[5] Based upon OECD data: overall insurance penetration for 2013