

ASIA AND BEYOND - - MANAGING AND EXPLOITING NEW RISKS IN THE WORLD'S FASTEST GROWING MARKET FOR LIFE INSURANCE

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I. THE DIMENSIONS AND THE MOTIVATIONS OF PURCHASERS IN EMERGING MARKETS

A. Japan Has Led in Penetration But Domestic Carriers Struggle.

For calendar year 1998, the Japanese life insurance industry's share of world total premium stood at 28.6%, life insurance purchase on a per capita basis was US\$2,857 and the penetration rate measured in terms of aggregate premium value to gross domestic product was a remarkable 9.4%. This marked Japan as the world's largest life insurance industry by reference to national market size, and as of 1998 annual life premiums paid by Japan's residents represented 82.3% of the total for Asia. *See Mahdavi, Optimal Life Insurance Decisions and the Demand for Life Insurance: Case Study of Japan* (Abstract of Ph.D Thesis), www.aria.org. (2002 American Risk & Insurance Association Annual Meeting).

Japan encourages life insurance by permitting policies written by its domestic carriers to escape income tax on inside build-up, and there is no income tax payable in respect of death benefits paid on a domestic life insurance policy. The beneficiary receiving a death benefit on a matured domestic policy is, however, subject to Japan's inheritance tax on payouts in excess of a very modest exclusion which is determined by reference to the number of statutory heirs attributable to a decedent. Japan's top bracket

“basic” rate for inheritance tax is 70%. The impact of its progressive rate structure is somewhat mitigated by the separate calculation of the tax in respect of each heir, but there is a 20% surcharge added to the basic tax assessed upon any heir or legatee who is not a spouse, child or parent of the decedent.

Offshore policies receive less favorable treatment for Japanese income tax purposes but more favorable treatment for inheritance tax purposes. Residents of Japan are not permitted to acquire policies of life insurance from offshore carriers that have not been granted a license to do insurance business in Japan absent a permit from the Financial Service Agency, but published commentary indicates that this rule may be circumvented if the Japanese resident acquires a policy of life insurance from an offshore carrier through a foreign corporation (but not through a trust which is deemed transparent as a matter of Japanese law). *See* Otsuka and Nakatani, *Japan*; INTERNATIONAL LIFE INSURANCE (2002), 255-257.

In 2002 commentary questioned whether the advantages of an offshore policy in respect of inheritance tax are justified and suggested that Japan’s National Tax Agency might alter the Inheritance Tax Law Basic Circular to prevent future avoidance of inheritance tax by Japanese beneficiaries in respect of payments made on the life of a Japanese resident by an offshore carrier. *See* Otsuka and Nakatani, *Id.* Such questioning might prove predictive. The Tax Council which has ultimate authority in respect of Japanese tax policy is now investigating whether Japan can close loopholes in inheritance tax in order to shore up Japan’s fraying social safety net. *See Japan’s Top Business Lobby Urges Steep Sales Tax Increase*, BNA DAILY TAX REPORT (6/2/03) G-2.

Japan’s rapidly aging population, its evaporating savings and the solvency issues faced by certain of its domestic carriers has been the subject matter of considerable concern and media attention. *See* Belson, *Frugal Japanese Dig Into Savings*, N.Y. TIMES (National Edition, 5/31/03) p. A8; and Lacu, *Life Insurance: The Other Dimension to Japan’s Financial Crisis*, ’96 LA LETTRE DU CEPII (Dec. 2000)

[“. . . doubts concerning the solvency of mutual life insurance funds are leading to a general feeling of insecurity about the future, encouraging cautious behavior and a fall in consumption . . .”]. Swiss Re predicts nonetheless that demand for life insurance is likely to remain strong throughout Asia, including by implication Japan, due to rising household income and greater risk awareness on the part of an aging population looking for investment linked and pension products. *See Swiss Re, Insurance in Asia - Expanding Horizons*, www.swissray.com (1/20/03).

B. China, Taiwan and Hong Kong -- Remarkable Growth.

During the 1990s when average annual premium growth for the world was between 2 and 10%, premium revenue was growing at the rate of 18% in the region comprised of China, Hong Kong and Taiwan. *See Hwang and Greenford, An Examination of the Determinants of the Demand for Life Insurance in China, Hong Kong and Taiwan* (Abstract), www.aria.org (2002 Aria Annual Meeting). The China Insurance Regulatory Commission estimates an annual growth rate for the Chinese insurance industry in general of approximately 12% during the period of 2001 through 2005. *See Allison, Risks and Rewards in China's Insurance Market*, ASIA TIMES Online (2/16/01), www.atimes.com/report/CB16Ai01.html. Swiss Re singles out China and India as exceptions to the trend of consolidation and streamlining to improve profitability in Asian markets as a result of the Asian financial crisis. “China and India, both of which have recently opened their insurance sectors to competition, will continue to attract global and regional insurance companies. Being home to one-third of the world’s population and among the fastest growing economies, both offer huge untapped potential.” *See Swiss Re, Insurance in Asia --Expanding Horizons, supra*; and Mozumder, *India, China To See Fastest Growth in Life Insurance Biz in Asia: [Swiss Re] Study*, www.rediff.com/money/2001/sep/08_insur.htm.

Scholars, who have recently studied the determinants of demand in what they characterize as the “Chinese territories”, cite as distinguishing characteristics of the population, culture and economy of such territories the following:

- (1) The Chinese territories have a long history and contain the largest national population in the world as of the year 2000,
- (2) Chinese culture has been materially influenced by Confucianism which emphasizes family loyalty (a factor disposed to encouraging the protection of family members),
- (3) the religions and beliefs found in the territories provide a channel for spiritual improvement and uncertainty avoidance to escape human suffering (a driving force in the purchase of life insurance being risk aversion),
- (4) GDP annual growth in the territories was over 9% during the 1990s (Swiss Re notes that in the larger Asia region GDP growth slowed to 3.6% in 2001, but it advises that the outlook for emerging Asia continues to look good), and
- (5) life premium income in the Chinese territories has accelerated at a very rapid rate and life insurance markets have experienced unprecedented growth during the 1990s.

See Hwang and Greenford, supra.

Rapid growth of the insurance industry in China has not been problem-free. Reports indicate that most domestic life insurance companies in China have pay out obligations that are significantly greater than their current return on investments, and that shortages of actuaries and professional insurance management staff have produced poor business practices by insurance companies. *See Allison, supra.* The introduction of foreign competition into the insurance markets in China and Taiwan as a result of their

entries into the World Trade Organization a day apart in November 2001 are viewed as very positive factors. Joint ventures between domestic carriers and foreign carriers are becoming commonplace in China, and recent announcements portend expansion of domestic carriers' capital bases through the overseas sales of shares. *See* Forsythe, *China Life Insurance Co. Looks for Cash Abroad*, (1/14/03), www.iht.com/articles/83257.html; McMillan, *China Insurers Want to Sell Stock Abroad* (11/11/02), edition.cnn.com/2002/BUSINESS/asia/11/11/china.insurance/.

China's tax policy in respect of life insurance remains in its nascent stages, but it will undoubtedly evolve. Whether as some have predicted it will come to mirror the tax policy of Taiwan which has granted generous incentives to life insurance remains to be seen. At present, Taiwan levies neither an income tax nor an inheritance tax upon life insurance death benefits. The concessions granted to life insurance by Taiwanese tax law have been subjected to scrutiny and could be curtailed in the future, but the insurance industry in Taiwan works hard to protect the tax advantages of life insurance. *See* Chiu and Wu, *Explaining Taiwan's Trust and Related Tax Laws*, www.Asianbanker.com.sg.

For the moment, there is in China what one commentator describes as a *de facto* tax-free environment for residents who purchase life insurance, and such commentator predicts that “. . . the tax-free situation on the life and annuity business will probably continue to last five to ten or even more years in China.” *See* Fong, *The Life and Annuity Insurance Taxation System of the People's Republic of China*, INTERNATIONAL LIFE INSURANCE (2002) 231-235. Professor Fong reasons that the tax-free situation for life insurance in China might actually serve to inhibit demand for offshore policies, but he concedes that wealthy individuals in China “. . . may consider diversifying their assets [through the purchase of offshore policies] in order to reduce risks once they accumulate a certain level of the amount of wealth.” *See* Fong, *Id.*

II. THE CHALLENGES TO MEASURING MORTALITY RISKS IN EMERGING MARKETS - THEIR IMPLICATIONS

A. Lack of An Actuarial Data Base - - Is Modern Science the Answer?

The assessment of risk inherent in the insurance of a life, taking into account the phenomenon of adverse selection, is enormously challenging and can become politically charged when the factors which drive willingness to underwrite at a particular price (or at all) are exposed to public scrutiny and sometimes sensationalism. Studies have demonstrated that purchases of life insurance do not occur in a vacuum, and that the demand of an individual for life insurance is a species of general portfolio hedging activity in which the insurance purchase decision and other portfolio decisions are interdependent.

Adverse selection is defined as “the observed phenomenon that under-average risks will be proffered more readily for insurance than above-average ones and that when an insured has an option in a policy he will tend to exercise it in the direction that is least favorable to the insurer.” *See Glossary of Terms*, Insurancetimes.co.uk. An insurer takes this phenomenon into account in choosing which risks to insure and on what terms with an eye to achieving a balanced portfolio of risk that benefits from the operations of the laws of large numbers. But what happens when the carrier asked to write a large policy of life insurance has neither the laws of large numbers nor sufficient mortality data for the region whose residents it seeks to insure?

Part of the answer to the problem of predictability is that mortality risk is the subject of increasing study and investigation even in jurisdictions which do not have well developed life insurance industries. *See e.g., Aalabaf-Sabaghi, Mortality Risk in Iran* (Abstract), www.aria.org (2002 Aria Annual Meeting). Part of the answer is that “life insurance” as it is packaged and sold outside of the United States will very frequently entail only modest mortality risk because the tax laws do not demand that policies identified as “life insurance” be mortality driven in order for the fund value to be tax

sheltered.” See Whelehan, *International Life Insurance: An Overview*, INTERNATIONAL LIFE INSURANCE (2002) 1, 3-4. Part of the answer lies not surprisingly in science.

Recently announced research conducted by Dr. Richard Cawthon and his colleagues at the University of Utah holds that initially healthy people under the age of 60 years with shorter telomeres, which are snippets of genetic material that cap chromosomes, are more likely to die than people of the same age who have longer caps at the end of their chromosomes. A blood test for telomeres could make longevity predictions more accurate, and it has already been speculated that this might revolutionize the life insurance and health industries. Those with shorter telomeres would pay higher rates or might even be denied coverage while those with longer telomeres would get lower rates. See *Telomere Length Indicates Mortality Risk* (1/31/03), www.futurepundit.com/archives/000925.html. Such speculation traces in part to Dr. Cawthon’s own analytically flawed socio-economic statement that “In the UK, nobody would deny you coverage because you have got the National Health Service . . . I wish it were like that here in the U.S. - life or health care insurers might ask you to take a telomere test before they would give you coverage.” See Arthur, *This Is Your Life: Blood Test That Reveals Your Destiny Reveals How Long It Will Last* (1/30/03), www.freerepublic.com/focus/news/832841/posts.

Notwithstanding that a measurement of telomeres might take some of the guesswork out of life insurance risk management in all jurisdictions, including those where accurate data bases are lacking, there will nonetheless remain other factors influencing mortality which are not uniform from one jurisdiction to the next.

B. War and Terrorism -- A Question of Insurability.

Some life insurance companies did experience enhanced sales activity in the early aftermath of the events of September 11, 2001 which has been attributed to an awakening in individuals who had previously ignored the value of insurance, disability insurance and

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estate planning. See Leimberg and Gibbons, *Life Insurance: Decision-Making After September 11th* and EGTRRA, 29 *Insurance Trends and Topics* 36 (January 2002). The phenomenon of adverse selection should begin to evidence that some of those who are now most interested in the life insurance will be persons who are in fact more likely to be in harm's way by reason of their residences or business travel habits. How will the life insurance industry respond?

Although terror exclusion clauses have become commonplace in non-life policies subsequent to the events of September 11, 2001, they have not so far become a staple of life insurance policies. Carriers have, however, begun to review with greater care the applications of U.S. citizens traveling abroad and the projected lengths of their stays, the places they will visit, etc. Reluctance to insure persons relocating to a high risk zone has recently been manifested by the refusal of several life insurance companies in the wake of terrorist attacks which occurred in early May of 2003 to cover persons moving to Saudi Arabia. See *Insurance Cover for Saudi Arabia Dries Up* (5/19/03), www.inetimes.co.uk/news/articleDetail.asp?id=25816.

Terrorism presents an acute challenge to the insurance industry because the prospect of widespread loss might be too great for the insurer to accept absent some species of government back-up. In the aftermath of the events of September 11, 2001, which have been characterized by one commentator as "100 minutes of terror that changed the global insurance industry forever", the United States has wrestled with the issue of government guarantees for the inducement of the issuance of terrorism coverage. On November 26, 2002 the Terrorism Risk Insurance Act of 2002 became law, but such law which expires on December 31, 2005 is limited to property and casualty insurance, albeit the Act does mandate a Treasury Department study of the impact of terrorism risk on group life insurers.

Other countries which had previously created government backed terrorism insurance plans that were studied by the U.S. in the preparation of its own legislation

include the U.K., Spain, South Africa, Israel, Northern Ireland, Sri Lanka, France and Germany. See GAO, *Terrorism Insurance; Alternative Programs for Protecting Insurance Consumers*, Statement of T.S. McCool (10/24/01), GAO-02-199T; and see Hartwig, *September 11, 2001: The First Year; One Hundred Minutes of Terror That Changed the Global Insurance Industry Forever*, Exhibit 6. Hartwig notes that the September 11 attacks produced catastrophic losses in lines of insurance that had never before experienced catastrophes including life insurance, workers compensation and disability insurance. The focus of such government sponsored insurance as has been enacted to date has, however, remained on property and casualty losses. This suggests the conclusion that exclusion clauses rather than government guarantees will become the norm for life insurance.

C. Kidnapping and Ransom -- Whose Insurable Interest?

Terrorism manifests itself not just in bombs and explosions but also in the form of kidnapping, an action motivated by either commercial interest, ideology or a mix of the two. Kidnapping became such a problem for certain businesses such as Colombia's largest newspaper, EL TIEMPO, that it could no longer obtain life insurance for either its owners or its employees. See Marcus, *Dispatches From a Forgotten Front Colombia The Drug Dealers' New Tactic*, COLUMBIA JOURNALISM REVIEW (May/June 1991), www.cjr.org/year/91/3/colombia.asp. A recent NEW YORK TIMES business article characterizes kidnapping as a business expense for the ethnic Chinese business executives living in Manila, Philippines, and, while noting that kidnapping is not as common in the Philippines as it is in Colombia and Mexico, concludes with the troubling quote from a Philippine congressman whose children had been kidnapped: "Nobody is safe in the Philippines." See Arnold and Conde, *In Manila, Kidnapping Is a Business Expense*, NY TIMES (National Edition 1/28/03) C1.

"Kidnapping insurance" has been created as an industry response to the problems of Colombia, Mexico, the Philippines and numerous other jurisdictions thus begging the

question whether this is not a perverse means of granting an “insurable interest” to the very parties who would put an individual’s life at risk. Recognizing the conundrum in which they work, carriers offering kidnapping insurance do not aggressively market the product because “. . . knowledge that a person is covered by insurance could trigger more kidnappings.” *See Philam Offers Kidnapping Insurance*, PHILIPPINE HEADLINE NEWS ONLINE (7/12/01), www.newsflash.org/2001/07/hl/hl013955.htm. On account of the potential that a kidnapping policy holds for giving incentive to the evil deed of kidnapping, carriers often provide that once such a policy has been written, the disclosure of information in any form, public or private, regarding the existence of the policy by the insured may be grounds for rescission of the policy, a condition which seems likely to prove a fruitful source of future legal controversy. *See Hollywood Highlights Insurance Needs; “Proof of Life” Causes Kidnapping Policies to be Considered, According to Insurance Information Institute*, RISK WORLD (1/22/01), www.riskworld.com/pressrel/2001/01q1/PR01a020.htm.

D. Disease - Fear of the Unknown in a Less Known Place

The recent spread of a new disease known as severe acute respiratory syndrome (“SARS”) with fatal consequences for many, particularly those over the age of 60 years, who contract the disease has been characterized as a “classic insurers’ nightmare”. *See Insurers Run for Cover on SARS Crisis*, THE GUARDIAN (4/26/03), www.money.guardian.co.uk. Some insurance companies have denied life insurance to Canadians who travel to Asia because of fears in respect of the SARS epidemic. A spokesperson for Clarica Insurance, when asked why it would deny policies to new applicants traveling to Asia but would not deny coverage to applicants who live in or visit Toronto (also materially impacted by SARS), reportedly responded “. . . South Korea is a concern because it is in Asia.” *See Life Insurance Denied to Canadians Traveling to Asia*, CBC NEWS (5/16/03), www.cbc.ca.

The China Insurance Regulatory Commission, astutely perceiving the adverse implications for its burgeoning domestic life insurance industry if claims in respect of persons whose deaths are attributable to SARS should be denied, promptly issued notice on April 17, 2003 “. . . Requiring all insurance companies to deal with cases relating to SARS promptly, practically and effectively and to defend the benefits of SARS sufferers and their relatives. No reason would be acceptable to refuse or delay compensation . . . any insurance companies found attempting to evade their responsibilities in cases of SARS compensation would be punished severely.” *See Beijing Settles First SARS Insurance Claim*, PEOPLE’S REPUBLIC DAILY (5/14/03), www.English.peopledaily.com.cn. Sensing commercial opportunity in what might be termed a “false positive” in respect of the phenomenon of adverse selection, China Pacific Life Insurance Company became the first to issue insurance policies focusing exclusively on SARS.

E. If Risk to Life Cannot Be Managed: What Implications for Globalism?

International life insurance has so often come to be thought of in terms of a tax sheltering mechanism (entailing only very modest mortality risk) that it can be forgotten that in a troubled world individuals might increasingly seek life insurance for the reason implicit in the product’s name. It is true that individuals of wealth possess financial resources which are adequate to support surviving family members without need of life insurance, but as noted in scholarly studies buttressed by inscrutable mathematical formulae, an individual’s demand for insurance is also a special case of general portfolio hedging activity which is a mix of many elements including concern (often unspoken) about the mortality of the insured.

To the extent purchases of life insurance become mortality driven not simply because of arcane tax law provisions designed to prevent excessive tax sheltering but also because of human response to a perception of enhanced risk, there is both opportunity and challenge for carriers with implications that reverberate well beyond the boundaries of the insurance industry. If business persons will not travel to, and wealthy individuals

will not continue to live in, large areas of the world including parts of the Middle East, South America and Asia because they cannot hedge their fear of heightened risk of mortality with life insurance, the world economy is harmed and economic integration and advancement are put to risk.

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