StrategicRISK

ASIA RISK REPORT

THE TOP CONCERNS OF ASIAN RISK MANAGERS

2014 EDITION

JAPAN

IN ASSOCIATION WITH

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INTRODUCTION

SEAN MOONEY
Asia editor

A HOST OF ISSUES

Welcome to *StrategicRISK*'s 2014 Japan Risk Report, which looks at the major challenges to corporates operating in a country that faces enormous threats from natural catastrophes and its own demographics.

The *StrategicRISK* Japan Risk Management Roundtable held in Tokyo brought together risk and insurance professionals from some of Japan's biggest multinational corporations to discuss the country's risk landscape.

There was plenty to discuss in addition to human capital and nat cat issues, with money laundering and fraud, cyber risk, economic uncertainty, threats to supply chains, product recall and reputation risk all high on the agenda.

This report is produced with the support of Zurich, and with the assistance of the Pan-Asia Risk and Insurance Management Association (PARIMA).

PARIMA's aim is to strengthen and enhance the risk culture in the region through the creation of opportunities for education and dialogue within the risk management community.

It is a mission that sits comfortably with the aims of our publication and we will be working with PARIMA members in the future to bring you comprehensive coverage of Asia-Pacific's risk landscape.

Keep an eye out for future risk reports on countries such as China, South Korea and Taiwan and our pan-Asia risk report and interactive webinar towards the end of the year.

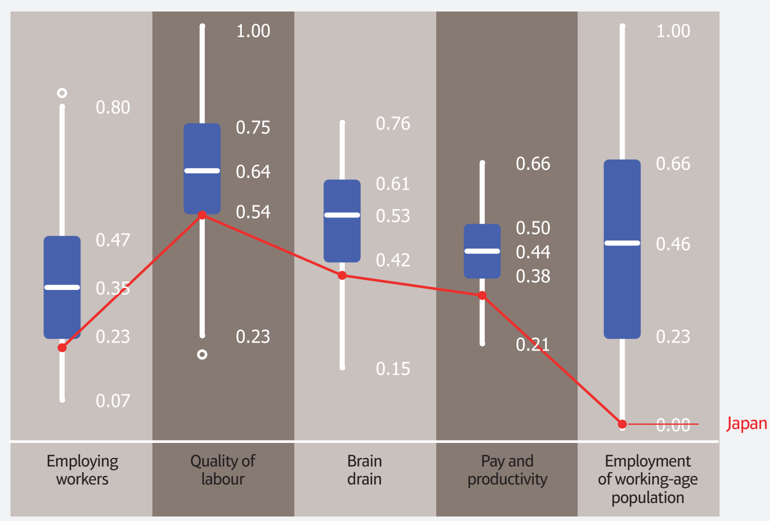
RISKS IN FOCUS

EMPLOYMENT AND POLITICAL INSTABILITY

Japan has a resilient labour market and a society that has long been stable, but it faces challenges from an ageing population and possible conflict with China

NOTE The risk bars indicate the world distribution of the particular risk, from the lowest scoring country to the highest. The lower the score, the lower the risk or exposure to the particular indicator (a lower score is always positive).

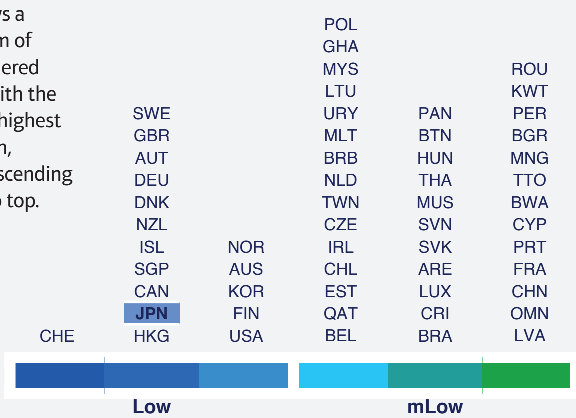
Employment



Buoyed by monetary easing and a weaker exchange rate, the labour market shows some healthy signs of resilience amid modest growth forecasts and weak consumer confidence. From a more long-term point of view, Japan's labour market has managed to cope with economic stagnation and the after-effects of the 'lost decade' from the mid-90s to early 2000s. There may, however, be equal-sized challenges ahead, of which a rapidly ageing population – and, by implication, shrinking workforce – might well be paramount.

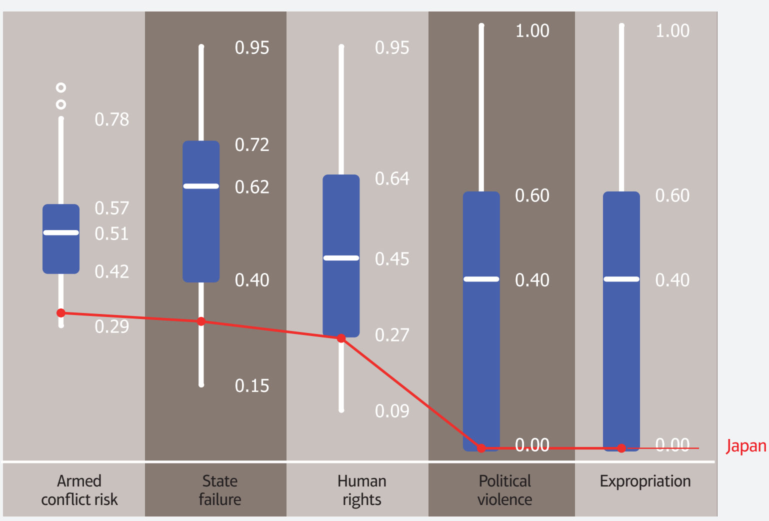
COUNTRY RISK STACKS

The Risk Stacks chart shows a nation-by-nation histogram of riskiness. Countries are ordered by ascending ZRR Metric with the lowest on the left and the highest on the right. Within one bin, countries are ordered by ascending ZRR Metric from bottom to top.



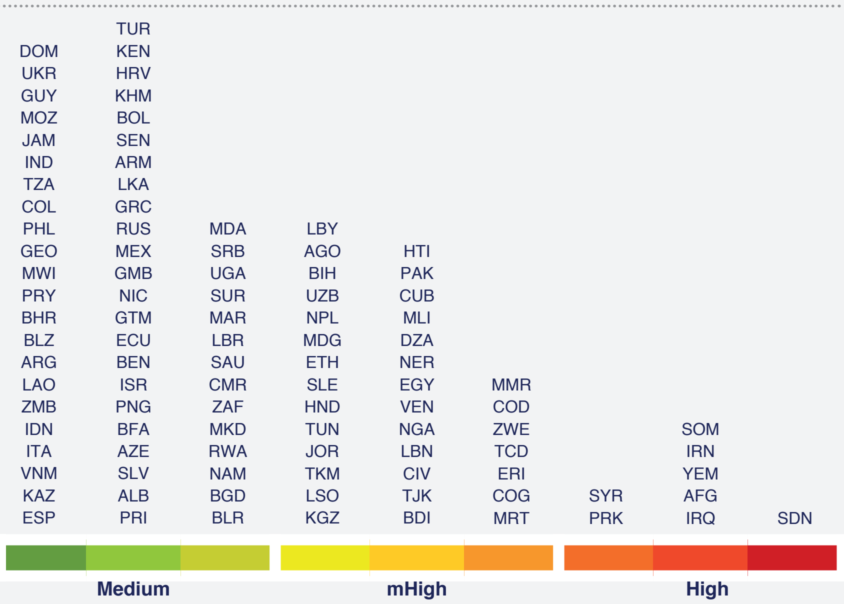
1.9% 1 year ahead GDP growth forecast	**2.6%** 1 year ahead inflation forecast	**3.7%** Annual inflation
-8.4% Fiscal balance (%GDP)	**4908.3** GDP, current USD (billions)	**1.1%** Real GPD growth, year on year

Political instability



Japan's finely tuned political institutions and well-developed judiciary system give rise to the belief that political stability can be maintained into the foreseeable future. The key downside risk to the positive outlook continues to be a potential heating up of lingering territorial disputes with China.

Source: Zurich Risk Room



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TOP RISKS

Caught in a quandary

Natural catastrophes are one thing, but in the face of dire demographic changes, a stagnant economy, inadequate cyber security and problems abroad, Japan has to raise its game

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When risk and insurance professionals from a select group of Japan-based organisations gathered in Tokyo for *StrategicRISK*'s risk management roundtable, first on the agenda was a poll listing the main challenges faced by Japanese corporations. Responses ranged from money laundering and fraud, through cyber risk, economic uncertainty and threats to supply chains, product recall, reputation risk and human capital issues. However, the undoubted top threat to corporations and society was named as natural catastrophe risk. This is no surprise, given the impact of the 2011 Tohoku earthquake and subsequent tsunami and Fukushima Daiichi nuclear disaster.

As Yasunori Araga, president of catastrophe modelling company RMS Japan, points out, the earthquake/tsunami proved that such an event can "seriously damage life, property, infrastructure and the economy in Japan, especially when it involves a nuclear power plant".

He adds: "Heavy rain and wind, with or without typhoon, is also a significant risk in Japan and flood, mudflow and [storm] surge look to be sharply increasing, perhaps because of global climate change." Interestingly, although the havoc wreaked by the earthquake was enormous, the Thai floods that same year had a much greater impact on many corporations and certainly on the Japanese insurance industry. (For more in-depth analysis of natural catastrophe risk in Japan, see 'Where the worst has already happened', on pp8-11.)

Another challenge highlighted was people risk. Japan is a country with "some extreme features", says Paolo Marini, global head of customer management, corporate life and pensions at Zurich. "If we take the demographic shifts, Japan is the country with the highest longevity in the world, where people who are born today are expected to live at least until 80 if they are males and at least to 86 if they are female. Also, if you take the median age of the entire population, which stands today at 44 years, it is also probably the oldest country in the world. To give you a measure of comparison, the US stands at about 37," he adds.

"Not only are people living longer, fertility is also declining. If you combine very long life with very low fertility, which is 1.41 children per woman in Japan, this is similar to what we see in many Western European democracies and it is well below the replacement factor, which is on average 2.1 births per woman." Marini points out that the population of Japan declined slightly in 2013 and is now "about 126-127 million and expected to decline even further", all things being equal. "So, in 20 years' time, we would expect the population to decrease to close to 100 million."

Head of Willis Japan Dean Enomoto says Japanese companies face risks with ageing staff and their retirement costs. "This isn't just about HR," he points out. "Many businesses will face strategic, financial and operational ramifications. They need to think more strategically about employee demographics, their interests and needs, and align the personnel strategy to align with the business strategy."

Lifetime employment

RMS's Araga says the majority of large Japanese corporations have "a tendency to cultivate generalists rather than specialists, with frequent job rotation". He adds: "This is mainly based on the Japanese lifetime employment and seniority system, and it may sometimes be difficult to find highly professional staff of mature age. On

The Great East Japan earthquake of 2011 damaged life, property, infrastructure and the economy, as seen here in the country's second largest prefecture, Iwate.

the other hand, many young people have difficulties to find an opportunity to develop their skills and behaviour as part of a permanent workforce. This is because of rapid deregulation and long depression; as a result, it is not so easy to find cultivated young staff." (For more in-depth analysis of people risk and demographic shifts in Japan, see 'The shrinking, ageing population conundrum', on pp12-13.)

The roundtable heard that Japan was actively targeting growing markets overseas as its own population aged and declined in size. Takayuki Tanaka, general manager of the insurance consulting department of Mitsui's business engineering division, points out that this raises new risks. Directors' and officers' risk keeps getting more complicated since some countries or regions started to set laws and rules – such as the US Foreign Corrupt Practices Act and the UK Bribery Act 2010 to regulate directors and officers severely. Political risk might also bring a significant negative impact to us." Political risk is part and parcel of overseas expansion, of course, and Willis's Enomoto highlights the effects of current geopolitical crises in the Middle East and Russia and Ukraine. "Developments through 2014 have left Japanese global companies with growing concerns about supply chain disruption," he says.

> **'Corporates operating in Japan are facing physical, emotional and economic threats from outside'**
>
> **Yasunori Araga**, RMS Japan

Takuji Urisaka, who works in the logistics and insurance department of a large Japanese general trading company, believes effective management of political risk is important for global companies to deal with the "trends of globalisation".

Araga of RMS Japan says his country's primary geopolitical risks come from neighbouring countries such as South and North Korea and, particularly, China, which "Japan does not have a good relationship with". He explains: "This is mainly because of historical occurrences around World War II, but might partly depend on the attitude of the current leading politicians in each country. Hence, corporates operating in Japan are facing physical, emotional and economic threats from outside Japan." Indeed, for most multinational companies with international strategies, the state of the China market is both a current and future risk. (For more in-depth analysis of Japan's relationship with China, see 'The other China syndrome', on p10.)

Production chains

Regional tensions and disputes and political risk involving riots and strikes, have the potential to negatively affect the international expansion of Japanese corporations. The Asian Development Bank's (ADB) *Asian Economic Integration Monitor*, a semi-annual review of Asia's regional economic co-operation and integration, points out that Japan is the biggest foreign investor in South-East Asia and that its companies are increasingly shifting their production chains to the region.

Omar Hamid, head of Asia analysis and forecasting at IHS Country Risk, says increased investment in Laos is one example of Japan's plans to expand its economic and strategic influence in the Association of Southeast Asian Nations region. "The value of Japan's investment in Laos for 2013 reached US$405.7m – up almost 15% year on year from 2012," he says. "Although Japanese interest has traditionally focused on real estate and golf courses, there has now been increased investment in the manufacturing, services and agro-forestry sectors."

According to Motoyoshi Suzuki, economic adviser to the Japan International Co-operation Agency, the main reasons behind the increased investment flows to Laos in 2013 were rising labour costs in China's major cities, Thailand's floods in 2011 and political instability. These have led Japanese companies to shift part of their production bases from China and Thailand to Laos. Japanese investment in Vietnam has also soared, from US$169m in 2010 to US$4.45bn in 2013.

The increase in Japanese access to new emerging markets does not come without risk,

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of course, but Kazuhisa Otani, head of sales at Zurich Global Corporate Japan, worries that too many firms “expand their business outside of Japan, but don’t pay enough care to risks”. JLT’s Wada says one such risk is financially catastrophic supply chain disruption. “Japanese manufacturers appear to still be struggling with their development of adequate risk financing solutions for this risk,” he adds. Another area that troubles him is the general exposure to cyber risks. “The financing solutions available in the Japanese insurance market for this risk are far from adequate, especially for large corporations,” he says. Yusuke Tanaka, insurance manager at Japan’s largest oil and gas exploration and production company, Inpex, agrees. “Computer network-related risks are looming as potentially catastrophic,” he says.

Cyber crime

Stuart Poole-Robb, founder and chief executive of strategic intelligence, risk and security management firm KCS Group, says the Japanese government is scrambling to patch up the country’s “notoriously leaky” cyber security as it gears up to host the Olympics in 2020. “The country is understood to be drafting legislation that is set to reveal the true and terrifying scale of Japan’s losses to cyber crime,” he says. “Companies will be obliged by law to reveal the extent of their losses, reporting all incidents, irrespective of the resulting bad publicity.

“The National Information Security Center (NICS) will be named as the country’s primary cyber security co-ordinator. The NICS reports that only half of Japanese companies have any IT security in any shape or form. In common with their counterparts in many other developed countries, Japanese chief executives fail to grasp the level of cyber crime risk, with most believing cyber crime is something that happens to others.”

A key challenge for prime minister Shinzo Abe is the revival of Japan’s stagnant economy, partly through achieving long-term sustainable growth by promoting companies abroad, especially in the construction, agribusiness and transport sectors. He is also promoting the export prospects of technology companies to

> **‘Only half of Japanese companies have any IT security in any shape or form’**
> **Stuart Poole-Robb**, KCS Group

better enable Japan to tap into the expanding market for infrastructure development. Although opinions differ on the wisdom of devaluing the yen, it is generally agreed that this is helping to improve international competitiveness, at least in the short term. This was reflected in Japan’s jump in the world rankings in the IMD *World Competitiveness Yearbook*, which was published at the end of June and measures how well countries manage all their resources and competencies to increase their prosperity. Japan rose three positions to 21, helped by the weaker currency. More good news comes from a new Creative Productivity Index developed by the ADB and the Economist Intelligence Unit, which ranks Japan as one of the most efficient countries in the Asia-Pacific region at turning creative inputs into tangible innovation.

However, as Bharat Kannan, director of Aon Japan, says, such innovation is a result of fierce competition, which can also “erode market share and potentially put the company out of business”. He adds: “Increased competition is considered as one of the major risks [in Japan] as it lowers market share and decrease profits.” This combines with a range of economic risks considered pressing by the professionals consulted by *StrategicRISK* – such as market risk, exchange rate fluctuations, credit risk and an increase in consumption tax – to create a difficult business environment in Japan.

“Economic slowdown/slow recovery is often cited as the risk that causes the greatest income loss,” says Kannan. “The underlying reasons for this being considered one of the major risks are uncertainty in the economies of the eurozone; slow growth in China; uncertainty in the fiscal direction of Japan; uncertainty in the fiscal direction of the US; and elevated unemployment figures around the world.” **SR**

Tokyo Tower overlooks the city's famous skyline – but is Tokyo ready for the next big earthquake?

THOUGHT LEADERSHIP

PAOLO MARINI
Global head of customer management, corporate life and pensions,
Zurich Insurance Company

HOW JAPAN CAN MEET ITS CHALLENGES

Japan is currently facing serious demographic challenges. Japanese men are expected to live to at least 80 on average; women until 86. This is the world's record and, combined with low fertility, saw the population of Japan actually decline slightly in 2013. Last, the number of retirees is increasing: in the 1960s, about 5% of the population was above 65 years of age; today, that figure is about 25%. Demographic decline not only affects household savings capacity but, just as importantly, presents a real threat to the country's innovation potential.

The effects of these demographic forces are compounded by other financial and social factors to create a worrying environment. These factors include very high public debt, a high average age of retirement, an aversion to using imported labour and heavy reliance on families to care for the elderly. So the overall picture is not always an easy one, but the Japanese government has realised this and, for example, is changing the investment philosophy of its national pension fund. This is a clear signal to Japanese corporations that are suffering the effects of these same demographic, financial and social issues.

Many corporations have been derisking their balance sheets in the past two decades of low growth. But now, many corporations are deleveraging their own balance sheets to achieve lower debt levels and better liquidity. This has resulted in an upturn in investment, especially non-domestic investment as Japanese firms increase their investment abroad.

It is impossible for corporations to alter demographic trends, but there are actions they can take to better cope with financial and social challenges. These include more flexible management of their pension assets, increasing holdings of (especially foreign) shares and reducing domestic bond holdings.

In the workplace, companies should look at reducing labour rigidity with initiatives that encourage more flexible working patterns and retirement-age rules aimed at retaining older employees, but not necessarily in full-time employment. This would allow firms to hire more younger people and potentially increase innovation.

CATASTROPHE RISK

Where the worst has already happened

As though the earthquake, tsunami and nuclear meltdown of 2011 were not enough, Japan is prone to landslides, typhoons and snowstorms. Fortunately, lessons learnt in the past three years are proving invaluable today

Although Japan occupies only a small percentage of the earth's land mass, it is affected by a disproportionate amount of risk from volcanoes, tsunami, earthquake and other natural disasters. The 2011 Tohoku earthquake and subsequent tsunami and Fukushima Daiichi nuclear disaster spring to mind, but typhoons, snowstorms and landslides are also common.

Yasunori Araga, president of RMS Japan, says torrential rain has led to an increase in landslides in recent years. "The most recent occurred in mid-August this year in Hiroshima and caused damage or flooding to more than 330 houses," he says. "Similarly, there have been significant losses from winter storms, mainly in the northern parts of Japan. The snowstorms in February of this year impacted central and eastern Japan, causing significant disruption to transport and industry, producing losses in excess of US$3bn."

Interestingly, Japan has experienced relatively low typhoon activity in the past decade. "The last typhoon with significant losses was Typhoon Songda in 2004, which at the time created insured losses of US$4.7bn," says Araga. "But very intense typhoons with winds of category 5 can happen, such as Typhoon Vera in 1959, which if it occurred today would create losses in the range US$14bn-18bn." The "primary risk", though, is earthquakes.

Some interesting approaches to natural catastrophe risk management were put forward at the *StrategicRISK* roundtable, including revision of communication procedures after both fixed and mobile phone networks proved useless during the 2011 magnitude 9.0 earthquake. Sourcing better information from private firms, rather than government agencies, regarding the probability of disasters was also seen as vital.

Randall Wada, head of JLT's Japan office, says such catastrophes can and will always happen in Japan. "From a corporate governance point of view, management can no longer ignore these risks or believe that their other contemporary peers are also not doing something to more adequately protect the balance sheet of the companies they lead," he says. "Contrary to what many Japanese corporations have been led to believe, viable risk financing options are available in the form of affordable insurance and other alternatives."

Takayuki Tanaka, general manager of the insurance consulting department of Mitsui's business engineering division, says that now his company "analyses and watches natural catastrophic risk periodically with hazard maps for a few years". He adds: "To judge if we should invest money in new business, we review and analyse the natural disaster risks of that investment in detail." A risk manager in a multinational corporation who wishes to remain anonymous puts it this way: "We learnt that science and engineering analysis cannot tell all. We have to prepare for the worst scenario."

> **'After the 2011 earthquake, production at major automotive manufacturers was halted for a month or six weeks'**
>
> **Bharat Kannan**, Aon Japan

Dean Enomoto, head of Willis Japan, says that although many companies already had business continuity plans (BCP) in place, the events of 2011 highlighted the importance of developing and enhancing them. "Companies increasingly think about natural catastrophe risk in other countries as well as their domestic risks in Japan, because of the effect on supply chains," he says. "The great east Japan earthquake and the Thai floods were major events that affected Japanese companies hard. The events caused huge losses on two fronts. First, companies with business facilities based in the disaster-affected areas took a direct hit, and second, those businesses based outside the physical scope of the disaster saw their supply chains disrupted or terminated. So, many companies realised that they should consider indirect losses and business interruption risk."

Takuji Urisaka, who works in the logistics and insurance department of a large Japanese general trading company, says many companies revised their BCPs to make them more practical. "In addition, we have learnt about natural catastrophe risk from a variety of sources, such as insurance companies, insurance brokers and consultant firms," he adds. "For example, we arranged comprehensive property insurance, including earthquake risk cover, last year."

Heavily affected

The concentration of supply chains of many Japanese companies – often seen as providing cost and operational benefits – was a major contributing factor to the impact of the Thai floods. Japanese production, especially for the automotive industry on the eastern seaboard of Thailand, was particularly heavily hit. The *World Development Report 2014 – Risk and Opportunity: Managing Risk for Development*, offers the following example: "In November 2012, for instance, Japanese automaker Honda cut the factory hours of its US auto assembly workers in Ohio because it could not get parts from Thailand, [which was] affected at the time by large floods." This illustrates Japan's unique risk profile as a highly industrialised manufacturing country in which lengthy supply chains should be viewed as more of a concern than physical damage.

Japanese prime minister Shinzo Abe visits Fukushima Nuclear Plant, Japan, September 2013

ZUMA/REX

Bharat Kannan, director of Aon Japan, says memories of the 2011 earthquake and floods are "still so fresh in the minds of many people". He agrees that the key lessons from these events relate to supply chain management. "Typically, manufacturers in Japan, particularly automotive manufacturers, operate on a 'just-in-time' basis, meaning that all the key suppliers and the suppliers' suppliers are set up in a small and concentrated area, so when a major natural catastrophe event [occurs], there are significant issues with the supply chain," he explains. "After the 2011 earthquake, production at major automotive manufacturers was halted for a month or six weeks. Once production could be resumed, however, it was significantly hampered by supply bottlenecks and the availability of critical parts, which not only affected production in Japan, but also in other countries."

The roundtable heard that Japanese corporations do not generally purchase earthquake insurance, but the majority of Japanese companies operating in Thailand had flood coverage. Furthermore, the Japanese insurers who wrote most of this insurance ceded the majority of it back to their head offices, rather than the international reinsurance market. In general, they offered non-admitted, unlimited coverage for floods in Thailand, thereby leaving themselves open to unlimited losses. Aon's Kannan says the majority of insurance policies issued by Japanese insurers did not contain Contingent Business Interruption (CBI) coverage. This indemnifies the firm against the loss of sales/gross profit caused by covered perils that damage the facility of the customers or suppliers. "Many companies suffered loss of sales after the earthquake or flood owing to the damage at the customers'/suppliers' facilities, but there were no recoveries because the policies excluded CBI cover," he says. "During the claim adjustment process after the Thailand flood, it was discovered that the majority of the insured failed to properly declare the sum insured for business interruption and effectively were 'underinsured'; that is, the sum insured was lower than the sum at risk. In cases of underinsurance, the claims were adjusted downward according to the ratio of sum insured divided by sum at risk – meaning that the amount of recovery was lower than the calculated loss amount, often significantly."

Information analysis

The good news is that many of the lessons learnt are being put to good use. For example, 'Learning from Megadisasters' (a knowledge-sharing project sponsored by the Japanese government and the World Bank) collects and analyses information, data and evaluations on the 2011 earthquake, with the aim of sharing Japan's knowledge on disaster risk management and post-disaster reconstruction with other countries. RMS Japan's Araga says a Phase 1 update to the Japan EQ model was undertaken after the earthquake. "A Phase 2 update is in the pipeline to incorporate 2014 hazard updates by the Japan Headquarters for Earthquake Research Promotion," he says. "As part of the Phase 2 update, a probabilistic tsunami model will be made available." Araga says that research into flood defences in Japan indicated that the country is at greater risk from flood losses than previously understood. "A significant percentage of the population lives below sea level and is therefore tenuously protected," he says.

THE 'OTHER' CHINA SYNDROME

It is often said that Japan and China have a "politically cool, but economically hot" relationship. But when asked if Japan's often strained relationship with China posed a risk to business, the answer from the risk and insurance professionals consulted by *StrategicRISK* for this report was an unequivocal 'yes'.

Naohiko Aizawa, general manager of the risk management office at Hitachi's strategy support division, believes the top risk for Japanese businesses is the "progress of various reformation activities by the Chinese government and the relationship between Japan and China". A risk manager in a multinational corporation who wishes to remain anonymous says issues such as confiscation of assets in China and unfavourable customs treatment concern him. Takuji Urisaka, who works in the logistics and insurance department of a large Japanese general trading company, agrees: "It poses a direct threat in the security and safety of business operations in China and an indirect threat brought by changing laws and regulations applied to Japanese companies that have business relations with Chinese ones – for example, imposing a ban on cargo from Japan."

President of RMS Japan, Yasunori Araga, says if a trade embargo, antitrust crackdown or consumer boycott against Japanese goods occur in China, political motivations are immediately suspected. "We cannot tell if it is true or not, but another problem is that these are unforeseeable, unavoidable and sometimes non-negotiable to solve the problem," he says. Head of Willis Japan, Dean Enomoto, cites the example of the recent seizure by China of a Japanese cargo ship over a pre-war debt. He adds that overcapacity and overproduction in China has created an increase in commercial risk and the threat of disruption in Asian markets. "This creates more risk for Japanese businesses looking to invest there, meaning that companies are trying to get more government involvement for big-scale projects," he says.

Director of Aon Japan, Bharat Kannan, says one of the major risks faced by Japanese firms is slow growth in the Chinese economy. Ikuo Homma, head of enterprise risk management at NEC Capital Solutions, agrees. "Everybody goes to China pursuing cheaper labour cost and a rapidly growing market, [but] before we are aware, we seem to have fallen into concentration status, risk-wise," he says. Takayuki Tanaka, general manager of the insurance consulting department of Mitsui's business engineering division, worries about riots and/or violence at Japanese-owned facilities in China.

Then, there is malicious damage of a different nature. The founder and chief executive of strategic intelligence, risk and security management firm KCS Group, Stuart Poole-Robb, says Japanese companies are facing a mounting barrage of cyber attacks, which have doubled in frequency since 2010. "Targets have included the lower house of parliament, defence contractor Mitsubishi Heavy Industries and a nuclear power research institution," he notes. "According to industry sources, most of these targeted attacks are coming from China and are taking place on a similar scale to those that occurred in the US and prompted that country to accuse China of state-sponsored industrial espionage." The cyber risk factor in China is likely to continue to grow, Poole-Robb adds, unless "Japanese executives wake up to the true scale of the threat and start to train a new generation of cyber engineers to fill the country's shortfall of 80,000 information security engineers".

Araga points out the events of 2011 highlight the increasing significance of tsunami risk. "We are currently investigating several tsunami scenarios that affect Japan locally and several others originating in Japan have basin-wide impacts," he says.

Sabrina Schoenholzer, earthquake specialist at Swiss Re, explains that prior to the 2011 earthquake, efforts were focused on building more detailed and sophisticated earthquake models, while tsunami risk was analysed with very simple approaches. "However, with an estimated 20%-30% of the insured losses from the Tohoku earthquake being caused by the subsequent tsunami alone, it suddenly became clear that this 'secondary' peril needed more attention and proper, tailor-made modelling solutions," she says "The realisation that tsunami was essentially an unmodelled peril and that the premium rates for earthquake insurance were not truly reflecting the potential combined losses finally spread throughout the insurance industry."

> **'Realisation spread that tsunami was an unmodelled peril and that premiums for earthquake insurance were not reflecting potential combined losses'**
>
> **Sabrina Schoenholzer**, Swiss Re

Although the earthquake and resulting tsunami were the obvious causes of the damage to the power plant, the Fukushima Nuclear Accident Independent Investigation Commission concluded that the disaster was "man-made". Both the regulators and plant operator were aware of the potential risk of a power outage in the event of a tsunami reaching the plant – and of the need for structural reinforcement of the plant – but they failed to act, it concluded.

Nuclear disaster

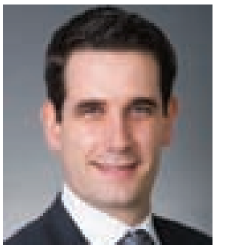
As the *World Development Report 2014* (*WDR2014*) points out, lack of flexibility and poor co-ordination proved especially problematic in managing the response. Local authorities were unprepared for a nuclear disaster coupled with a natural hazard, and plant technicians were initially isolated because of transport and communication failures.

"Both situations highlight the need to build capacity to respond flexibly to unexpected events," it states.

Establishing the chains of authority and means of co-ordination to be deployed in the event of a crisis and putting in place disaster co-ordination teams are important, says the *WDR2014* team – a fact that was highlighted by the 5.6 magnitude earthquake that struck 44km north-northeast of Tokyo in September.

Operators of the Fukushima Daiichi plant reported no additional damage to the facility. However, soon afterwards, the eruption of Japan's second highest volcano, Mount Ontake, further highlighted the risks facing its nuclear industry. Japan's Nuclear Regulation Authority had only recently approved the restart of a nuclear power station in the country's south-west. This was seen as the first step to reopening an industry that had been dormant since 2011. However, the Ontake eruption raised concerns that such a move could place the country in danger, as the plant is in a region with several active volcanic sites. These recent events serve as a reminder that Japan's nat cat threat is real and that the nuclear power issue should remain front of mind. **SR**

THOUGHT LEADERSHIP



SEAN WELSCH
Head of captive management and business development, Zurich Insurance Company, Asia Pacific

CAPTIVES ON THE RISE

Captive insurance companies, or captives, are sophisticated risk management and risk financing tools. They enable a corporation to better analyse and manage risk and insure uninsurable or not-yet-insured interests. They do so in an economic and stable manner across various classes of insurance to create a balanced portfolio.

Although there can be tax benefits from utilising a captive, these are more circumstantial. The main driver is the potential to realise profits that emanate from an increased focus on risk management. Generally, this increased attention to the ownership of risk throughout an organisation will lead to an improved loss history and claims experience.

Japan is one of the largest insurance markets in the world, but is very much underweight in its utilisation of captives, with only about 100 Japanese-owned captives in operation. There are many large Japanese multinationals with diverse portfolios in terms of geographical spread of assets and liabilities and industry type that could reap the rewards that are being achieved by similar corporations around the world. Utilising a captive as a risk financing vehicle would put Japanese companies on the same footing as their global peers and provide for better control, a deeper insight into these organisations' risk profiles and a more strategic and effective way to finance insurable risk.

However, the situation is changing and more Japanese companies are definitely showing interest in utilising captives, particularly to address their overseas risk exposures in a more structured way. Realisation is growing that captives take risk management off the balance sheet of the parent company and give it its own balance sheet, which allows the parent to have much more oversight and control.

The majority of organisations that have already established captives only utilise them for one or two classes of insurance. They would do well to consider including additional risks within their captive programme – some of which they already assume on the parent company balance sheet. Supply chain risk and cyber risk are two good examples. A captive can provide a more effective structure to deal with these risks rather than just assuming them on the balance sheet.

The validity of using captives as a risk management tool has been proven by several recent successes in Japan. You might say that captives are on the rise in terms of strategic importance for Japanese companies.

PEOPLE RISK

The shrinking, ageing population conundrum

On the face of it, Japan's demographic issues seem worrying. Add in decades of economic underperformance, an inflexible labour market, mind-boggling debt and limited immigration and they start to look horrific

A major risk to business in Japan is its declining population. Japan is the sole non-European nation in the top 20 highest risk countries in Maplecroft's Working Age Population Trends Index, which lists nations with particularly slow-growing or shrinking working-age populations. The forecast is that more than a quarter of the Japanese be over 65 by 2030, with the figure rising to 38% by 2055.

Japan's working-age population is 62%, according to the World Bank, which is at the lower end of average. However, the bulk of the non-working-age population is 65 and over, with children aged 14 and under comprising a mere 13% of the population. This dramatic demographic shift means the total population of Japan is expected to shrink by almost 25%, from 128 million to 95 million, in the half-century to 2050, leaving a substantial debt burden (about 240% of GDP) to be shouldered by fewer people. In short, Japan's ever-shrinking workforce must support a growing non-working population in the midst of an increasingly sensitive global economy.

Ikuo Homma, head of enterprise risk management at NEC Capital Solutions, says he is "extremely nervous" about Japan's demographic challenges. "Even large companies will not survive without changing their own profile against changing markets and demography," he warns. "No young people think that they can pursue a stable life at one company [any more]."

Indeed, as the head of Willis Japan, Dean Enomoto, explains, the long stretch of economic stagnation – often called the 'two lost decades' – that followed the collapse of the Japanese bubble in the early 1990s irrevocably altered Japan's employment landscape. "Previously, a Japanese worker at one of the big well-known corporations could expect a lifetime of employment," he says. "That system hasn't completely disappeared but it has been shaken. These days, many low-skill jobs are taken by temporary workers because Japanese law is quite protective of full-time workers." Enomoto says the other effect of the 'lost decades' is that college graduates struggled to find a role at the traditional companies and were instead absorbed by different industries, often related to gaming or IT, which have much shorter-term business models. "This has created greater liquidity of talent, so that makes the retention and acquisition of talent more of a risk," he adds.

Since the framework of the typical Japanese firm is – to quote Randall Wada, head of JLT's Japan office – "based upon a male-dominated and homogeneous professional population", a significantly more diverse workforce will require fundamental changes to basic organisational culture. "The alternative would be to simply lose competitiveness to organisations willing and able to make drastic change," he says. "If one takes any senior-level meeting, be it a board or management meeting, 20 years from now, it will be an extreme challenge to recreate the same meeting with the same level of capability, gender and homogeneity."

Social tension

Paolo Marini, global head of customer management, corporate life and pensions at Zurich, says there is a danger that innovation will be stifled by "having a very old average workforce and the reluctance to accept interference from abroad". He says: "Wages in Japan tend to rise with age rather than with ability or merit and employers tend not to want to retain staff beyond retirement age. But at the same time, it's hard to dismiss people – the labour market is relatively rigid. This can create social tension when you expect younger generations to take care of the elderly, but at the same time, the elderly to a certain extent are reluctant to leave their occupation because of need. These trends are hard to reverse as almost none of these are in the hands of individuals or companies."

Marini says Japan's resistance to immigration, coupled with a reliance on family, rather than employed help, to care for elderly or sick people, creates particular risks. "It comes with financial consequences, such as a tax to fund long-term care, which everybody who is above 40 needs to pay," he says. "One thing, though, that we don't see much in Japan is the reliance on help from immigration of young

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> **Paolo Marini**, Zurich

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Problematic labour shortages are affecting Japan – especially in the construction industry – but filling these with workers from overseas is proving hard to sell to the Japanese public. Willis's Enomoto explains: "The Tohoku earthquake and the suite of fiscal stimuli brought by 'Abenomics' created a sudden demand for construction workers that simply could not be met. A similar situation was seen in the nursing and care industry. The lack of supply in these roles is expected to continue, forcing the government to consider allowing foreign workers to take them."

Tackling the workplace

It is almost impossible for companies to act on demographics, Marini concedes, although he says they can address related financial and social issues. "There is a more flexible management of their pension assets, increasing holdings of shares, especially foreign shares, reducing domestic bonds – this will certainly deal with some of the financial constraints," he says.

"Something also has to be done in the workplace – more flexible working patterns, flexibility of the retirement age, retaining people but not necessarily in full-time employment, and flexible working hours. People can still have an income but not necessarily as costly to the employer as normal full-time employment, and it also enables [firms] to hire younger people. This might even increase innovation, as long as it is coupled with a more meritocratic approach rather than an age approach. A better gender and nationality mix could also help."

It seems that some companies are already heading in this direction. Takayuki Tanaka, general manager of the insurance consulting department of Mitsui's business engineering division, says his company has "started recruiting capable personnel regardless of nationality, educational background or gender". He adds: "Our HR division is arranging various types of training to groom new employees."

For Takuji Urisaka, who works in the logistics and insurance department of a large Japanese general trading company, the solution lies in "a combination of good salary, right person to right place and promotion to higher position". SR

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INSURANCE AND RISK MANAGEMENT


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Mount Fuji and Tokyo, Japan

So, what is the problem with the Japanese insurance industry?

Japan's insurance market is the second largest in the world, so why doesn't it operate like its international counterparts? To answer that, first we need to talk about *Keiretsu*

The Japanese insurance market is one of the most mature in the world, according to the head of JLT's Japan office Randall Wada, and has seen some "surprising developments" in the past 10 to 15 years. These include a consolidation of the industry, resulting in the establishment of three 'mega' insurance groups that dominate the market with an estimated combined market share of 80%-90%.

"Although this market can be characterised as large (the second largest in the world) mature and highly sophisticated in the way business is conducted," says Wada, "it often does not function at the expected global standard levels. Suffice to say that a number of obstacles prohibit or retard the introduction of global standard risk solutions."

During the *StrategicRISK* roundtable, it was suggested that most Japanese corporates still choose their insurance company through the *Keiretsu* system (a grouping of companies with interlocking business relationships and shareholdings) that in Japan is extremely common. One participant suggested that even if middle management suggests a change of insurance company to solve specific problems in a firm's insurance programme, the board will often decide to remain with the "friendly" insurance company. As a risk manager in a

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> **Adam Garrard**, Willis

multinational corporation who wishes to remain anonymous puts it: "[The Japanese insurance market] is too closed to the international market and this damages the risk management of Japanese companies. The current situation should be changed from the perspective of strengthening the competitiveness of Japanese companies."

Another important factor, Wada says, is that owing to the prolonged lack of economic growth of the economy, Japanese insurers have had to look internationally to expand their business and improve profitability. "This appears to be a costly and challenging strategy to implement and it is still not clear if their efforts in this area will be a sustainable success," he says.

Yasunori Araga, president of RMS Japan, points out that Japan's declining population precludes market expansion. "Insurance for cargo and construction looks good in the short term because of 'Abenomics'. However, its future growth depends on sustainable economic strength," he adds. "Under these circumstances, major insurance companies look keen to expand their business outside Japan, and M&A strategy or underwriting skill and ability will be key drivers of success."

Takayuki Tanaka, general manager of the insurance consulting department of Mitsui's business engineering division, says Japanese insurance carriers have huge capacity for basic property and casualty risk. "However, as to non-traditional or new types of risks like directors' and officers', reputational risk, cyber risk and political risk, they do not have enough expertise, frankly speaking," he says. "I hope we can reach globally standardised insurance and coverage more easily and speedily in Japan."

Dean Enomoto, head of Willis Japan, says that for property insurance, earthquake premium has become a "critical issue". He adds: "Three years after the Tohoku earthquake, it is said that another large earthquake will occur in the Tokyo area. Japanese insurers increased earthquake premium for commercial and industrial risks by 15%-20% in July, in view of an increased risk of a large earthquake. They would also like to set up an earthquake reserve in preparation for the next one."

Adam Garrard, head of Asia at Willis, says that from a broking perspective, the big opportunity in Asia is penetration into Japan. "It's the biggest market in Asia by a country mile, but we're hardly touching it," he says.

"The retail broker plays a small part in that economy at the moment; we would like to play a much larger part. We are investing in Japan because we don't want to wake up 30 years from now and realise that we've missed the boat."

Pointing out that large domestic insurance companies dominate the Japanese landscape on a direct basis, he says brokers can help companies approach insurance differently. "The companies that we work with are the pioneering companies," he says. "They are interested in the full risk spectrum of 'identify, analyse, control and transfer'; they are breaking out of the traditional Japanese way of insurance purchasing." **SR**

TIME TO TELL IT TO THE BOARD

When it comes to enterprise risk management (ERM), the roundtable heard, Japanese companies are generally 'behind the curve' compared to Western companies. It was suggested that wisely run Japanese concerns need to put risk firmly on the board agenda, even those risks that board members are least likely to appreciate hearing about. Furthermore, acknowledging that every board member understands things in a different way is a vital step for an effective risk professional, so they can go on to employ a variety of methods to educate and change perceptions of risk in the C-suite.

Director of Aon Japan Bharat Kannan says that the boards of publicly traded Japanese companies were these days "under pressure from various stakeholders and/or required by law to maintain effective oversight of risk management discipline and results within their organisations". Yasunori Araga, president of RMS Japan, adds that many organisations are addressing board engagement to avoid fatal damage arising from misconduct or scandal, "but it seems unclear if strengthening of risk management has been successfully achieved in most of these organisations and is working efficiently".

Randall Wada, head of JLT's Japan, office agrees that corporate governance is high on most executives' priority lists. "As the Japanese corporate boards are made to include more external independent board members, this should provide additional impetus on corporate governance," he says. However, he adds, known catastrophic risks are often "left unfinanced and basically ignored" and even directors' and officers' insurance coverage can be "woefully narrow and inadequate compared to their global competitors' coverage". "Part of the problem is likely to be structural," Wada explains. "There is an absence of an HQ-based risk management function with the authority and mandate to manage and control risk. The vast majority of the largest companies in Japan manage their insurance and their insurer relationships through a wholly owned subsidiary in-house agent. The responsibility of insurance purchase rarely falls on the corporate treasury, finance or accounting divisions. Instead, it typically falls under general affairs and is often a part of its management of important shareholder relations."

So, is there a strengthening of risk management on the back of stronger engagement from the boards of Japanese organisations? Takayuki Tanaka, general manager of the insurance consulting department of Mitsui's business engineering division, thinks there has been a measurable improvement, as "most listed companies have started to focus on ERM and compliance in recent years, including risk management". He adds: "But from the standpoint of pure risk management, we also see that managerial members or boards are sometimes inclined/keen to just tighten the rules and guidelines to stand on the safe side as an organisation."