

# JAPAN'S HOUSE CONSTRUCTION WARRANTY AND ITS REINSURANCE SYSTEM

日本における住宅瑕疵担保責任保険と再保険制度

Proconsulting

Jean-François ESTIENNE

プロコンシュルティイング

ジャン-フランソワ・エスティエンヌ

Faculty of Safety Science,  
Kansai University

Katsuyuki KAMEI

関西大学 社会安全学部

亀井 克之

## 日本語要旨：

日本では「住宅品質確保法」によって新築住宅の10年間の補償が住宅事業者に義務付けられている。住宅に瑕疵（欠陥）が見つかった場合には、事業者は無料で修理する瑕疵担保責任を負う。2009年1月施行の「住宅瑕疵担保責任法」は、事業者が保証金を預けておいたり、住宅瑕疵担保責任保険（住宅かし保険）に加入することによって、倒産した場合でも、欠陥を修理するための資金を確保することを義務付けた。住宅瑕疵担保責任保険は国土交通省から指定された住宅専門の保険会社5社が引き受けを行い、損害保険会社が再保険を担う。住宅専門の保険会社は建築の各段階における検査を行う。こうした我が国固有の制度にはメリットとデメリットがある。

## SUMMARY

In Japan, housing suppliers' 10-year warranty<sup>[1]</sup> towards buyer is compulsory since 2000. Considering the possibility of suppliers' bankruptcy and insolvency, housing warranty has been designed by the Special Law on Fulfillment of Housing Warranty and Quality<sup>[2]</sup> voted on May 30<sup>th</sup> 2007 and implemented on October 1<sup>st</sup> 2009. Under this law, the seller/contractor can either make a deposit in a specific Government account or subscribe a Housing Warranty Insurance. This insurance cover is sold by MLIT<sup>[3]</sup> – approved Insurance Entities<sup>[4]</sup>, in charge of on-site inspections during the construction process. These entities reinsure themselves with the General Insurance Companies which are monitored by the independent Financial Services Agency (FSA<sup>[5]</sup>). The fact that some of the General Insurance Companies are shareholders of the Insurance Entities they reinsure and also the existence of a not-so-transparent but compulsory reinsurance pool where all the General Insurance Companies mutualize such reinsurance business may entice the effort to explore the particular merits and demerits of this rather unique Japanese insurance and reinsurance system.

## Key words

Housing warranty insurance, MLIT, insurance entity, on-site inspections, reinsurance, Risk Management

## INTRODUCTION

Construction is one of the most prominent economic sectors in any given economy, its dynamics being directly entangled with the whole economy's momentum. Accession to ownership through household savings is among the best indicators of a stable real economy, fueling domestic demand and use of local manpower. In most countries, the dwelling construction market is usually split between a league table of a small number of large construction companies and a very large number of middle size and tiny contractors, incorporators.

In addition to the technical risks<sup>[6]</sup> inherent to the construction process and the need to properly follow appropriate construction processes, may arise the risk of failure of contractors of any size. Such failure risk is indeed featuring high amongst the factors that may lead to a sharp loss for the contractors' client. Thousands of hopeful, hard saving, or borrowing households may instantly turn ruined and desperate. Thus the need for construction warranty insurance cover and its reinsurance.

In any given country, would arise one case of large scale failure of large construction company, or even worries among the public and/or the media for such event, the whole sector may prove under stringent hardship as regards public confidence. Sometimes to such extent, the authorities may have to intervene, taking proper, sometimes harsh, decisions and making them publicly known. The purpose being to avoid

political embarrassment, to restore confidence in the sector and thus, help the real economy keep some of its momentum. Putting at risk the legitimate wish of the hard working, hard saving middle-class households to turn themselves into owners of a brand new home is also of considerable political cost.

Japan, often depicted (or sometimes self-proclaimed) as a one-of-kind country, economy and society, is somehow a newcomer to such insurance and reinsurance model, the current system being, in 2012, less than 5 years old.

As it is most often the case in Japan, research, including knowledge and analysis of prominent foreign countries solutions has taken place before the selection of the design deemed the best for Japan's interest. Consecutive to the vote of the new law on May 30<sup>th</sup> 2007 and its inception on October 1<sup>st</sup> 2009, the new framework has been implemented, with the whole set of its main features: public sector supervision, risk management design, private stakeholders, on-site risk inspection, regulation and reinsurance.

### 1. ORIGIN OF THE CURRENT SYSTEM & TRANSITION TOWARD THE CURRENT ONE

The current Japanese wording of this Insurance is *Jûtaku Hanbai Kashi Tampo Sekinin Hoken* (住宅販売瑕疵担保責任保険), which means "Insurance for Responsibility in Case of Defect of Housing Sold". It is commonly called *Jûtaku Kashi Hoken* (住宅かし保険). The origin of the current insurance being the Japanese house warranty<sup>[7]</sup> (thus the old system<sup>[8]</sup>), dating back to the 1980, as

a voluntary insurance system.

Since Year 2000, builders has been legally compelled to give a 10-year warranty for new houses.

### 1.1 Transition between the old and the new system

#### (1) The Aneha Scandal, November 2005

Mr. Hidetsugu Aneha, a Japanese First Class architect, was convicted for falsifying data for 71 buildings out of the 208 he designed. The falsification concerned earthquake resistance, in order to reduce costs. The media and political impact of such scandal, in a matter mixing both safety (in particular against earthquake) and dwellings drew a crisis of confidence of the Japanese people towards the ability of the Japanese authorities to enforce safety and construction quality.

In front of the Japanese Diet, Mr. Aneha alleged being under pressure to save cost, from the one construction company, who represented 90% of his business. He also questioned the role played by safety inspectors who did not detect such defect that Mr. Aneha considered as easy to spot. The massive energy transmitted by an earthquake to any construction in Japan, requires particularly dire technical standards, resulting in the issuance of an average 300-page strong technical report. Detecting such a fraud may not be as easy as stated by Mr. Aneha (in particular when the inspectors are not aware they should spot *voluntary* defects in the report), but the cost and consequences were indeed tremendous.

One of the developers, also investigated during the scandal, rejected his own guilt, saying that he received inappropriate design from a crooked houses.

Finally, Mr. Aneha went to prison, flat owners had to leave ill-built dwellings, some hotels had to close and some real estate and construction companies went to bankruptcy.

Unfortunate clients lost everything and could not get any compensation from bankrupt dwellings providers. There was an obvious hole in the legal system, as to guarantee some protection to honest dwelling buyers left with nothing, when victims of architect's malpractice, including voluntary.

#### (2) Response from the Ministry of Land,

##### Infrastructure, Transport & Tourism<sup>[9]</sup>

The Japanese public opinion was truly shocked, since the Kobe earthquake occurred just 10 years before, with a fatality over 6,000. In Kobe, the aerial speedways supposed to be used for emergency service in such instances fell on the ground, due to substandard quality of material...

Response to the Aneha scandal had to be a public one, since Japanese the Japanese Diet took the matter into their hands, under tremendous scrutiny for the media.

Thus, for this purpose, and through the thrust of Japanese Parliament, -the Ministry of Land and Transport (MLIT) did propose a new legal frame, gathering a *kenkyūkai* (research committee) for reform. This Committee, as- it is usually done in such instance in Japan, did-congregate government experts, academics and representatives of

private sector's interested parties.

(3) The opinion of the regular General Insurers of Japan

Whilst all other interested parties from the private sector were linked whatsoever to an area under the scope of the Ministry of Construction, the regular insurers (meaning under the scope of the Financial Services Agency) were asked to contribute by expressing of their position. They indeed contributed through the General Insurance Association of Japan (GIAJ<sup>[11]</sup>), who provided a position paper<sup>[12]</sup>, dated July 18<sup>th</sup> 2006.

GIAJ was obviously not enthusiastic at all with the pool solution<sup>[13]</sup> and insisted on two main points: 1) each risk should be assessed by the insurers who will actually carry the risks (the General Insurer regulated by the FSA) and 2) the necessity to protect capacity.

The GIAJ position paper suggests, contrary to the pool system, that each individual contractor and project should get its own cover limits, based on each contractor's individual risk profile. In addition, GIAJ informed that they do not consider as proper that the entity<sup>[14]</sup> in charge of providing cover (the Housing Warranty Insurance Entities) be owned or being in any kind of connection with the inspection business.

The Research Committee (研究会 *kenkyūkai*) work led to a new legal framework, implemented as of October 1<sup>st</sup>. 2009.

## 2. DESCRIPTION OF THE CURRENT SYSTEM

### 2.1 CONSTRUCTION WARRANTY INSURANCE SYSTEM

#### (1) Current system

The current system has been implemented on October 1<sup>st</sup>. 2009, through the May 30<sup>th</sup> 2007 Law<sup>[15]</sup> and the related decrees.

The purpose is to provide a compulsory liability insurance cover, in order to back the home suppliers' own legal 10-year warranty<sup>[16]</sup>. The insured objects are dwellings, either detached house (usually a wooden structure (木造 *mokuzo*) in Japan, or flats in a residential building<sup>[17]</sup>.

Under the law, the seller/contractor has to provide a specific external warranty to the buyer, in case of defect. The seller/contractor can either make a deposit in a specific governmental account (this option is usually selected by large companies with large capital, able and willing to avoid the insurance cost) or provide with a specific insurance (which is the case for most small and mid-size sellers/contractors (conversely, for the opposite reasons). Which means that the insurance is compulsory only when a specific deposit has not been made.

The big builders are 1% of the total number of the builders (thus 99% are small and mid-size builders), whilst 46% of new house sales are protected through the warranted deposits (State) system, and 54% by the house warranty insurance<sup>[18]</sup>.

#### (2) Design

The Housing Warranty Insurance design

is shown on Figure 1:

The insurance cover is sold to seller/contractor (also called builder or housing supplier) by the MLIT-approved Housing Warranty Insurance Entities, also in charge of technical on-site inspections. These House Warranty Insurance Entities reinsure themselves (fully or almost fully) with General insurance companies<sup>[19]</sup>, who need to get a special license for entering such business.

(3) “Reinsurance” of entities by regular General Insurance Companies

On their turn, these regular insurance companies “reinsure” themselves with a Japanese domestic special-purpose pool, housed and managed by Toa Re. (See “Reinsurance”, *infra*).

(4) On-site inspection

The current system, in order to avoid repeating the criticism brought by the Aneha scandal provides the obligation of on-site inspections during the construction process.

Inspection are made by MLIT-approved House Warranty Insurance Entities themselves.

Such inspection process follows the rule exposed on Table 1 below:

For contractors who have applied for construction performance evaluation under the Housing Quality Assurance Law, the on-site inspection is only made once irrespective to the number of floor.

(5) parts covered by the guarantee insurance

The insurance covers the parts shown on

Figure 2:

(6) Insurance premium

The insurance premium varies among the 5 entities, but the price setting is made out of those following basic parameters:

- a) type of residence: detached house or apartment,
- b) type of construction: wooden structure or not,
- c) insured capital: the legal basic amount insured is ¥20 million, but usually extra capital can be covered, for an extra fee
- d) area of the residence. A price schedule usually exists, starting from 40m<sup>2</sup> or less, up to 100m<sup>2</sup> or more, with various brackets for flats. The schedule starts from 100m<sup>2</sup> for houses.
- e) Inspection fee are always added to the insurance premium, with separate fee schedule,
- f) Insurance premium is tax free, whilst inspection fee are taxable,
- g) Number of inspections may vary according to the number of floors, the type of structure, other factors,
- h) Example of insurance premium, (Entity: J Anshin), in the case of a120 m<sup>2</sup> dwelling, in a wooden-structure residence building, limited to 2 stories, for a (basic) insured capital of ¥20 million.

Insurance premium:	¥49,170
+ Inspection fees:	<u>¥28,350</u>
Total:	¥77,520

(7) Cost covered:

- a) Repair
- b) Legal expenses, with prior consent of entity
- c) Investigation fee to decide proper repair work
- d) temporary accommodation and removal

(8) Insured capital:

Up to ¥20 million, for either a detached house or an apartment unit. (For insured capital above this amount: 30, 40 or ¥50 million, an optional contract is available, premium informed on demand. In which instance, the maximum payment for negligence or intentional act is up to ¥20 million).

(9) Investigation fee (example):

- for detached houses: the larger between 10% of repair cost or ¥100,000 per house, (up to ¥500,000 per event);
- for apartment units: the larger between 10% of repair cost or ¥100,000 per building, (up to ¥2,000,000 per event).

(10) Temporary Accommodation and Removal Expenses:

Either detached house or housing building unit: ¥500,000 (per house, or per unit).

(11) Claim settlement

This aspect is the one providing the benefit for the consumer, with reasonable limitations for protecting the insurer, reinsurer (regular non-life insurer and the reinsurance pool.

- a) Unitary basic insured capital is ¥20

million. (This amount is the one for the compulsory insurance. Optional, additional capital cover may be available, on a case-by-case basis).

- b) Maximum payment per housing supplier per fiscal year<sup>[20]</sup>: ¥2.5 billion.

This is to avoid a serial effect concerning a single supplier (as was the case in the Aneha scandal).

- c) Deductible: ¥100,000 (paid by housing supplier).

The purpose of deductible is to avoid small and numerous small claims, thus inducing the housing supplier to settle them<sup>[21]</sup>.

- d) Coverage ratio in case of bankruptcy of housing supplier: 100%, less deductible, all other cases: 80%, less deductible.

This feature confirms the original purpose of this insurance, which is to protect the consumer in case of failure of the supplier.

- e) Insurance payment formula: Insurance payment = (Amount of damage – Deductible) × Deducted Portion of Compensation

- f) Multiple beneficiaries and/or multiple insurers

For an apartment building, right to claim shall be exercised by the owner of each unit in the building.

In case were some housing unit (s) is (are) in the same apartment building are not covered by the same insurance, insurance payments will be

calculated based on the proportion of the area of insured units (insured through the same insurer) to that of the total number of units.

g) Exclusions:

- Natural disasters such as floods and typhoons or fires, lightning strikes, explosions or others “Acts of God”;
- Subsidence, upheaval, movement, oscillation or softening of land, landslide, outflow or inflow of soil or other defects caused by land formation works;
- Worm-eaten, wear and tear or deterioration not due to construction defects;
- Significantly improper use or maintenance of the house;
- Defects of the work or parts that have undergone expansion, remodeling or repair work;
- Burnout, loss, effluence or other damages caused by earthquakes, eruptions or tsunami.

h) Specific Relief Fund<sup>[22]</sup>

In case of gross negligence or aforethought, there is a specific Relief Fund, managed by the Association of Housing Warranty Liability Insurance (Housing Insurance Warranty Entities).

Only in case when a housing supplier (insured) is unable to carry his/her liability for certain period of time due to bankruptcy or other reasons, an accident resulting from “gross negligence or aforethought of a housing supplier, owner of the house, parties involved with construction work, design work, supervision of construction work, soil survey

or soil reinforcement work by contracts or persons who have a contract of employment with any of those parties can be insured. The payment will be made directly to the homeowner from the Relief Fund. This Fund is linked to the Association of Housing Warranty Liability Insurers (*entities*). This Fund is different from the Relief Fund in case of Earthquake.

(12) Serial losses

Serial losses caused by the same defect are treated as a single loss.

This feature is a stop-loss to avoid serial claims.

**2.2 THE REINSURANCE POOL SYSTEM**

No specific literature seems available about the pool system. It has been possible to meet persons in charge at General Insurance Companies that are pool members, but it has not been made possible to meet directly with people in charge of operating the pool itself.

The ELC (Expected Loss Cost) pool is administered by Toa Re, which seems to play the role of a custodian. The pure reinsurance function, with is the ultimate risk covering, of the pool seems to rest with the pool members, i.e. the General insurance companies. These insurance companies must have applied for and obtained a specific license<sup>[23]</sup> to operate in the House Warranty (*de facto*) reinsurance branch. Toa Re may also participate to the pool as one among the other members, possibly with a rather small share (again, nothing seems to have been published on the matter).



All information thus has been obtained from secondary sources. This situation comes from the fact that the pool system is not a part of the legal frame of the original law. The first ceding process, between the (MLIT-approved) Housing Warranty Insurance Entities and the regular, FSA-approved General Insurance Companies (which, in addition, must get a specific license to accept such risk) is called reinsurance, but basically means that such entities do not retain any risk, or very little. Therefore, it is not totally wrong to consider that the real risk carriers are the General Insurance companies, which “reinsure” the entities’ portfolios.

Instead, the pool is more a voluntary (or self-imposed) design, considered and recommended by *kenkyūkai* (Research Group) set up by the MLIT to design the then new law. The absence of retrocession and the *pro-rata* share of allocating risk taking and loss settlement, results in a functioning where General Insurance Companies pool members (to the number of 10-15 companies, according to some informant), mutualize their risk between themselves mirroring the one of a *de facto* syndication system. Such is the result of the situation when the subscription of each risk is made by one party (the Entity) that will not truly bear the risk (the General Insurance Company instead, will).

The risk the pool is carrying is indeed the reinsurance of the House Warranty Insurance Entities, within its compulsory design (the one above depicted, including the exclusion and the single loss feature).

The main features of the reinsurance pool are unfortunately not to be revealed to third parties, for lack of authorization from informant.

### 3. PLAYERS, STAKEHOLDERS AND ENVIRONMENT

#### 3.1 THE JAPANESE GOVERNMENT

##### (1) The Ministry of Land, Infrastructure and Tourism (MLIT)

The organization of the Ministry, as far as the Housing Warranty Insurance is concerned is shown on Figure 3.

##### (2) The Financial Services Agency

The FSA is involved as the monitoring authority providing the specific licensing allowing General insurers authorized in Japan, to get access to this specific line of insurance (indeed reinsurance of the portfolio the House Warranty Insurance Entities). Getting such license provides (imposes?) the membership of the reinsurance pool. FSA has not been on the list of the institutions to be visited, since the direct insurance entities are under the monitoring of the Ministry of Land, Infrastructure, Transport and Tourism (MLIT)

#### 3.2 THE HOUSE WARRANTY INSURANCE ENTITIES

These entities are represented by the Association of Housing Warranty Insurance.

This Association (created in December 2008) provides, among other things, a characterization of its MLIT-monitored members (the House Warranty Insurance Entities),



which is shown on Table 2:

### 3.3 THE GENERAL INSURANCE COMPANIES

Most of the most prominent of them are involved in this construction insurance modality as reinsurer of the entities (some of these General insurance companies may held some stakes in the capital of some entities), being then both shareholders and reinsurers at the same time). All prominent Japanese General insurance companies are known as pool members, such as, for instance, Tokio Marine, Aioi, Mitsui-Sumitono...

### 3.4 THE TOA RE AND THE REINSURANCE POOL

These are the great absentees of this report. Toa Re<sup>[24]</sup> is the sole Japanese reinsurer. A rather discreet company, they were unfortunately not available for providing information on the reinsurance pool of the Japanese construction warranty insurance.

### 3.5 GLOBAL PLAYERS IN INSURANCE AND REINSURANCE

Apart from Allianz (which bailed out in 2011) from the direct insurance side, there is no apparent interest in such market from abroad.

### 3.6 FACTORS OF ENVIRONMENT: LEGAL, AND OTHER ASPECTS.

#### (1) Legal

In the current design, the legal system in force is involving two ministries:

- a) the Ministry of Land, Infrastructure, Transport and Tourism, in charge of regulating the whole construction

industry, among which, the inspection companies, and the Housing Warranty Insurance Entities, which some, among the five in activity, are gotten both licenses.

- b) the FSA. Since the entities are not real insurance companies and are ceding almost all their risks to the General Insurance Companies, the real insurance business and legal monitoring, on a technical side, is resting with the FSA. Thus, the General Insurance Companies acting as reinsurers (the only role they can play since they cannot operate as insurers) must get a FSA ad hoc license in order to be authorized to accept MILT-licensed Housing Warranty Insurer's risk as reinsurers.

Getting such license from the FSA authorizes the licensed General Insurance insurer to become a member of the pool, in order to get retrocession and risk mitigation.

The pool does not seem to have any specific legal framework, so the pool certainly operates in some regular legal framework. In such case, there is a real difficulty to get public information.

#### (2) Environment

This is the dimension of the current system that is not limited to legal aspects. For instance, the current pooling system does exist, but is not a legal obligation. The General insurers can, even through the pool if

they so wish, get access to global reinsurers capacity (or access to Toa Re, would Toa Re play the role of a traditional reinsurer). This would be the situation where reinsurers wish to re-reinsure some of their risks towards third parties, usually other reinsurers. Such risk management strategy, called retrocession<sup>[25]</sup>, allow reinsurer to mitigate the risks between themselves, thus being less exposed to their own risks, while, at the same time, accepting to share some of the risks of their retrocession counterparts.

The situation is typical of the Japanese reinsurance market, where big local insurers enjoy quite huge capacities and thus may consider, rightly or not, that the recourse to global reinsurance is not so necessary. Thus the pooling system, which is a risk mitigation that the local players cannot refuse for being funneled to them on a reinsurance basis (with quasi non-existent retention) and redistribute between themselves on a proportional, syndication-type basis retrocession. Some players, anyhow, may show some open-minded attitude towards alternate reinsurance solutions, such as retrocession, when thinking about optimizing their risk management strategy and their risks exposure as reinsurers.

### (3) Loss ratio

So far, so good. The current loss ratio and the rather short track record for a very recent system, in particular when dealing with a 10-year warranty provides, rightly or not, the feeling (or the affirmation) that there is no need to improve a system where there are so few losses. This is what is said “in the

market”, but in the absence of transparency and public sources, it is impossible to confirm such information.

## 4. ANALYSIS: MERIT/DEMERIT/OBSTACLES/ OPPORTUNITIES

After reviewing in detail what is visible, and taking into account such limitation for a fair analysis, (since the Pool itself and Toa Re wish to be rather off-limits), one can try and make the following assessment.

### 4.1 MERIT

The current system definitely shows some merits:

#### (1) Institutional

The current pooling system respects the double dimension of the specific Housing Warranty Insurance, where the risk assessment (inspection) lies within the regulatory scope of the Ministry of Land, Infrastructure, Transport and Tourism and the risk taking lies within financial institutions, the General Insurance Companies. Such design does allow the MLIT to be in charge and provide a quasi sub-regulatory role to the Housing Warranty Insurance Entities, since that insurance line has become, quite rightly, a compulsory insurance<sup>[26]</sup>. Indeed, such compulsory aspect allows, to some extent, to enforce the MLIT standards to the construction sector, a very legitimate priority for the Japanese Government. This is exactly the response to the aftermath of the Aneha scandal, ensuring that the factors which created the situation which helped the emergence of such scandal

do not repeat themselves. With the new insurance system and, would some defect appear, a proper liability insurance system will provide the victims with relevant indemnity through the insurance system. (Or the State Fund will be put into action, in case the house supplier has selected such form of cover for its own liability towards the consumer).

In that respect, the current system, from the MLIT side, seems to plainly fulfill its objective and provide, when justified, the victims of housing construction defect with insurance money. And when the defect is the consequence of gross negligence of the constructor or is intentional, a proper Relief Fund, managed by the entities through their Association is available for providing an indemnity.

On the institutional point of view, the transfer of risk to FSA-regulated General Insurance Companies provides the correct regulatory frame for the management of this risk, like any other insurance risk. In addition, the imposition of a specific license, among the General Insurance Companies allowed to operate in Japan by the FSA, ensure that such Companies are truly able to provide both technical know-how and capacity for this specific line, thus comforting the Housing Warranty Insurance Entities' ability to provide insurance indemnity when necessary, for the benefit of the Japanese home buyer.

## (2) The State Fund option

It is important to remember that insurance is compulsory only when the

constructor has not opted for providing a deposit amount to the specific Government system. As a consequence, cash-rich huge construction companies select such deposit system, and thus avoid paying the Housing Warranty Insurance. There are, numerically, a limited number of construction companies using such deposit system.

## (3) Risk management

On the risk management side, it makes sense that the Housing Warranty Insurance Entities do not retain a significant part or no part at all of the risk they are supposed to insure and transfer almost all of their risk towards real General Insurance Companies. This provides the correct regulatory FSA frame for ensuring that the real risk takers, acting in such instance as reinsurers, show the correct risk governance and financial ratios enforce by the FSA, plus the technical know-how of excellent General Insurance Companies, huge and competent players.

The pooling system, providing risk mitigation, then proportional retrocession in a syndication style scheme, does allow sufficient capacity for reinsuring the Housing Warranty Insurance Entities and does mitigate the risk for each pool member, a necessity when considering that risk selection is out of reach for the General Insurance Companies.

## 4.2 DEMERIT

### (1) Housing Warranty Insurance Entities as true insurance underwriters

These entities enjoy an excellent technical level, and for sure, the MILT is totally dedicated to enforcing the correct construction standard, in the aftermath of the Aneha scandal and the Great Tohoku Earthquake. But if those entities are strong on the construction side, they are not such seasoned insurance suppliers.

Thus, it is of course wise to transfer most or the whole risk to real insurers, the FSA-monitored General Insurance Companies. But this situation of extremely minima or nil retention does not entice those entities to be discriminant on the risk taking side, since they are entitled, whatsoever, to get reinsurance from the General Insurance Companies. Of course, technical inspection is or should be (they did not detect the Aneha big problem...) a stringent process and the correct technical procedures definitely reduce the risk dramatically.

But technical inspection and insurance (and of course reinsurance) are rather different business, though they should contribute more separately to the same safe and proper result.

But the fact for the entities to be provided reinsurance coverage on a quasi-automatic basis from the General insurance companies does not necessarily ensure that the specific insurance-minded risk assessment will be made, and certainly will not prevail against technical inspection when the same entity is doing both.

### (2) General Insurance Companies

These companies have been invited to provide their opinions, during the process of creating the new Housing Warranty Insurance System created in urgency in the aftermath of the Aneha scandal. They clearly stated that the then envisaged (now current) system has some demerits. The first one comment made by the General Insurance sector refers to the division made between risk assessment (by the sole entities) and risk coverage (by the sole General Insurance Companies). Indeed, one has to remember the core activity of insurance is precisely underwriting. And underwriting can correctly function only in the case of the underwriter gets first-hand information and the final say on the decision to provide the insurance or reinsurance.

Taking into account this universally accepted definition of insurance or reinsurance underwriting, we prefer the wording "risk coverage" to qualify the situation in Japan of the General Insurance Company with Housing Warranty Insurance than "underwriting". The main feature of underwriting activity is for any insurance company to be presented with each risk separately and be able to assess them through the insurance company's freely defined underwriting process. This means, for instance, that it is the insurance company total decision and discretion to accept or to refuse any risk. This refusal should be possible irrespectively of the fact that the insurance line is compulsory or not. In the case of Housing Warranty Insurance in Japan, the reinsurance provided

by the General Insurance Companies, to be done in a proper and sound manner, needs to involve a technically full and relevant underwriting process, which indeed is the true core activity of the business. Unfortunately, in the case of Housing Warranty Insurance in Japan, reinsurance looks mandatory for the General Insurance Companies to accept, irrespective of any underwriting process.

The Ministry of Land, Infrastructure, Transport and Tourism is indeed in its full legitimacy for enforcing the much-needed inspection process and supporting the inspection companies. This is certainly a central feature to monitor the quality of building and to reduce risks, in particular with on-site inspections<sup>[27]</sup>.

But the technical construction inspection companies, certainly wishing to enforce the best level of construction standards, are not, in essence, true insurers.

Therefore, one may challenge why it has been deemed necessary to turn the entities, competent in technical inspection of the construction process, into insurance companies. The Japanese Housing Warranty Insurance design scheme itself shows that the true underwriting process is supposed to be made by the General insurance companies, themselves under the supervision of the FSA.

### (3) What an improved underwriting process could be

In the globally accepted underwriting process, the inspection companies and the insurance companies definitely need to work together, but each of them in its own

capacity.

The generally accepted design is the one where the experienced General Insurance Companies (in the case of Japan, FSA-licensed) independently design and master their own underwriting process and request the specialized on-site construction inspection firms to provide field and technical reports, so that the General Insurance Companies can freely assess and underwrite the risk, which means, refuse the risk if they deem such decision necessary.

### (4) Housing Warranty Reinsurance Pool

Since the General Insurance Companies have to accept the risk ceded without real underwriting process the pooling system has been design with the effect of mutualizing and mitigating the risks between the pool members (the General Insurance Companies which have been granted the proper license by the FSA).

So the General Insurance Companies have to accept, through the pool design, risks brought by the competing follow pool members, without any pool members, either the accepting “reinsurer” or the other pool members, being able to neither implement nor enforce a real reinsurance underwriting process.

The pool closed-ended syndication design also does not allow individual pool members to the benefit of retrocession with global reinsurers.

Retrocession, if used by the Japanese General insurance companies, at least to some extent, would bring to these Japanese

insurers the expertise and the capacity of global reinsurance, and provide an additional tool for sound and proper risk management.

The current very low level of claims ratio<sup>[28]</sup> seems to justify the self-declared lack of appetite for global reinsurance.

General Insurance Companies may seem to currently enjoy a good business since they receive premiums and seems to get very few losses.

But they are in any way in a double-passive situation<sup>[29]</sup>, very rare for any insurance or reinsurance company, when the real risk taker cannot refuse a risk and have to collectively back the pool, thus backing the other pool members' voluntary or involuntary subscription.

The current design of the pool, being a non-transparent, closed-ended entity, without any known specific legal framework does not allow the participation of global reinsurers, since the participation to this reinsurance mechanism imposes to get a license of local direct General Insurer in Japan, plus the additional specific license to accept the Housing Warranty Insurance risk as a FSA-authorized General Insurer. This would probably mean that there would an obligation to admit direct insurance from entities, which is very unlikely in a scheme where true underwriting is denied.

Global reinsurance players will not only bring capacity (which may prove welcomed in case of the claims ratio getting into adverse territory<sup>[30]</sup>), they will bring expertise and their possibly stringent underwriting rule<sup>[31]</sup>. Which would in return possibly entice the

General Insurance Companies members of the pool to create and enforce reinsurance underwriting rules towards the Housing Warranty Insurance Entities. The latter would then may not get their reinsurance on an automatic basis, contrary to the current system.

## CONCLUSION

The current system does respond to the criterion of providing coverage to the consumer buying a new house or flat. But the current design, very recent, has not gotten enough time to confirm its efficiency in case of hardship.

The analysis of the current system, in particular its lack of transparency, the absence of true underwriting and the passive risk mutualisation may not create the perfect risk management.

The close-end design of the reinsurance pool does not provide the opportunity for the Japanese General Insurance Companies to benefit from the capacity, the expertise and the global risk mutualisation that the global reinsurance companies may provide.

In addition, one may get surprised when the Japanese Construction Warranty, now all stock companies, have among their shareholders some Japanese General Insurance companies, which could create some non optimal situation as regards possible conflicts of interests, in particular when the risk is accepted automatically and also automatically mitigated with the shareholders local competitors through the syndication style of the reinsurance pool.

In addition, one may get surprised when

discovering that among the shareholders of the 5 entities distributing the Japanese Construction Warranty, now all stock companies, are some Japanese General Insurance Companies. This could create some non-optimal situations.

For instance, a potential conflict of interest may arise when the same Japanese General Insurance Company, as a shareholder, may influence the said entity to accept a specific risk. This influence may take into account the interest of the said Japanese General Insurance Company, as the reinsurance body of the said entity. In other words, being both the shareholder and the reinsurer of an insurance entity is a specific situations that may lead to influence the risk selection of the ceding company, here the entity.

Another conflict of interest may arise from the pool effect: the same Japanese general insurance company can choose to operate its right for retention for the risk that may be considered as the best, whilst at the same time, decide to mutualize the less appealing ones in the pool, indeed sharing such less desirable risks with its competing Japanese general insurance companies.

Both non-optimal situations may be solved by bringing the risk, at least partly, to the global reinsurance market, where acceptance (or non-acceptance) of ceded risk is based on criteria which are not exposed to neither the shareholding of ceding entity, or mutualization with competitors that the pool system is creating. The pool being opaque, makes it difficult to confirm or exclude any bias. The

desire for transparency being of course, up to Japanese people, market and authorities.

The positive side is that Japanese General Insurance companies are among the World most advanced insurers in terms of risk management and may decided, sometime in the future to bring into action sound and proper underwriting. And possibly test what the global reinsurance market may bring in the field of capacity, expertise and global risk management.

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Nevertheless, the author, being totally free to organize his research and to write his conclusions, is obviously fully responsible for the content of the current paper.



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- [ 1 ] 住宅瑕疵担保保険 *jūtaku kashitampo hoken*
- [ 2 ] 特別住宅瑕疵担保責任の履行の確保等に関する法律 (平成 19 年 5 月 30 日法律 66 号) *tokubetsu jūtaku kashitampo sekinin no rikōno kakuhotei ni kansuru hōritsu (heisei 19nen 30nichi hōritsu dai 66 gō)*
- [ 3 ] Ministry of Land, Infrastructure, Tourism and Transport 国土交通省 *kokudo kōtsū shō*
- [ 4 ] 国土交通大臣指定の住宅瑕疵担保責任保険法人 *kokudokōtsūdaiji shitei no jūtaku kashitampo sekinin hoken hōjin. Legal entities of home warranty insurance designated by the Minister of Land, Infrastructure, Transport and Tourism.*
- [ 5 ] 金融庁 *kinyūchō*
- [ 6 ] With an additional challenge in Japan when one considers that this Archipelago encompasses the whole gamut of natural catastrophes, from earthquake to typhoons, as well as floods, volcanoes. Construction insurance can obviously exclude such risks as regards the definition of the insurance cover, but nevertheless, the occurrence of such events always brings indirect hardship to the construction sector and its clients.
- [ 7 ] 住宅品質保証 *jūtaku hinshitsu hoshō* Quality Guarantee for Dwellings.
- [ 8 ] The old insurance system was a voluntary one. During its last year of existence, it covered only 13,9% of the then 1,285,246 new housing (split between a 33% coverage of the then 500,100 new detached houses and a meager 1,7% of the then 785,146 condo/apartment units).
- [ 9 ] 国土交通省 *kokudokōtsūshō*
- [ 10 ] 住宅瑕疵担保責任研究会 *jūtaku kashi tampo sekinin kenkyūkai*
- [ 11 ] 日本損害保険協会 *nihon sompo hoken kyōkai*
- [ 12 ] [www.mlit.go.jp/jutakukentiku/jutaku-kentiku.files/kashitampo/dai4/sonposiryō4.pdf](http://www.mlit.go.jp/jutakukentiku/jutaku-kentiku.files/kashitampo/dai4/sonposiryō4.pdf) (last viewed October 14, 2012)
- [ 13 ] see, *infra*, the current design, with the creation of a reinsurance pool.
- [ 14 ] In the current system, insurance cover is distributed by the 5 dedicated “House Warranty Insurance Entities”, 住宅瑕疵担保保険法人 *jūtaku kashi tampo hoken hōjin* monitored by the Ministry of Construction, not by the Financial Services Agency (FSA). Those entities are also in charge of on-site inspection during the construction process.
- [ 15 ] 特定住宅瑕疵担保責任の履行の確保等に関する法律 *tokutei jūtaku kashitampo sekinin no rikō no kakuhotō ni kansuru hōritsu* Special law on the fulfillment of housing warranty and quality.(平成 19 年 5 月 30 日法律 66 号).
- [ 16 ] The suppliers’ 10-year warranty towards the buyer has been itself made compulsory in year 2000.
- [ 17 ] For insured parts, see diagram *infra*.
- [ 18 ] Source: Association of House Warranty Insurance Entities 一般社団法人 住宅瑕疵担保責任保険協会 *ippan shadan hōjin jūtaku kashitampo hoken kyōkai*
- [ 19 ] Members of GIAJ (General Insurance Association of Japan), monitored by the Financial Services Agency. 金融庁 *kinyūchō*
- [ 20 ] Fiscal year in Japan: from April 1<sup>st</sup> to March 31<sup>st</sup>.
- [ 21 ] The deductible is also an incentive to the insured party (the housing supplier) to pursue its efforts for quality. For such quality insurance, insurers always try to avoid a misuse of insurance, when insured party may understand insurance to cover for a drop in quality standards. The deductible is meant to avoid such possible temptation.
- [ 22 ] 補助金 *hojokin* is the relief indemnity. 住宅保証基金 *jūtaku hosho kikin*, is the Housing Guarantee Fund, and 財団法人 住宅保証機構 *zaidan hōjin jūtaku hosho kikō* is the Housing Warranty Organization Foundation, managing the Fund.
- [ 23 ] Such license is provided by the FSA, see III. A/2), *infra*.
- [ 24 ] トーア再保険株式会社 *Tōa saihoken kabushikigaisha*

- [25] 再々保険 *saisaihoken* in Japanese
- [26] Compulsory for the housing suppliers which do not wish or do not afford to contribute to the State fund.
- [27] Even though such inspection companies were not able to blow the whistle (or where not listened to) during the improper process which later led to the Aneha scandal.
- [28] Or so far alleged, since no data seems available.
- [29] Once when receiving risks from the entities, second sharing the risks within the pool.
- [30] a possibility that no one may exclude, in particular when, apparently no simulation has been made as regards such possible evolution in the future, though competent local players do not lie to themselves and know that risk will increase with time, and not on a linear basis...
- [31] by all means definitely more stringent than the “no-underwriting rules” current situation.
- (原稿受付日：2012年12月24日)  
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### JAPAN HOUSING WARRANTY INSURANCE DESIGN

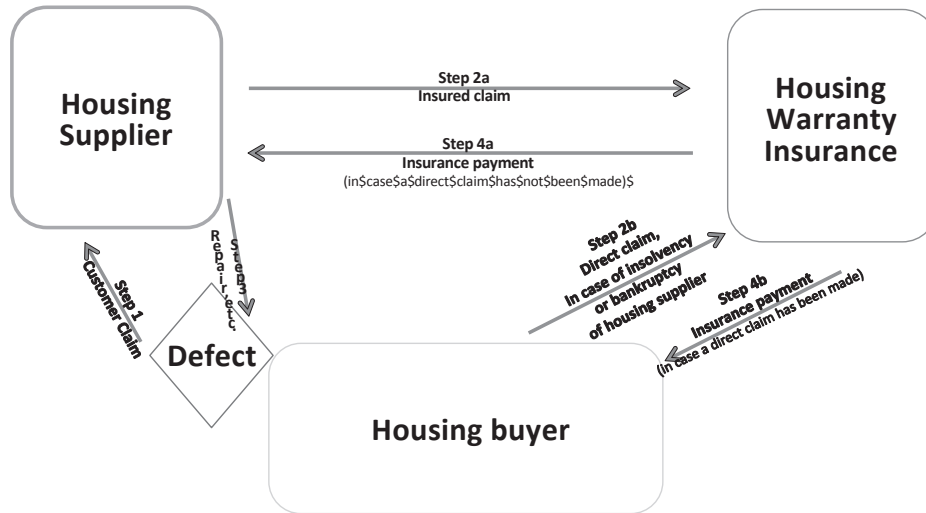


Figure 1: Housing Warranty Insurance design in Japan

Source: <http://kashihoken.or.jp/insurance/reform/> (last viewed on January 18 2013)

Table 1: Inspection process by House Warranty Insurance Entities

Number of Stories*	Number of Inspections	Timing
3 or less	2	Step 1. Upon completion of the foundation structure. Step 2. Upon completion of the structure (i.e. roof for wooden structure houses).
4 or more	3 or more	Step 1. Upon completion of the foundation structure. Step 2. Upon completion of the floor structure of the intermediate floors** (reinforced concrete installation for reinforced concrete structure). Step 3. Upon completion of roof sealing.

\* including basement; \*\* intermediate floors are 2nd and 10 floor from the ground;

Source of comments: Association of House Warranty Insurance Entities.

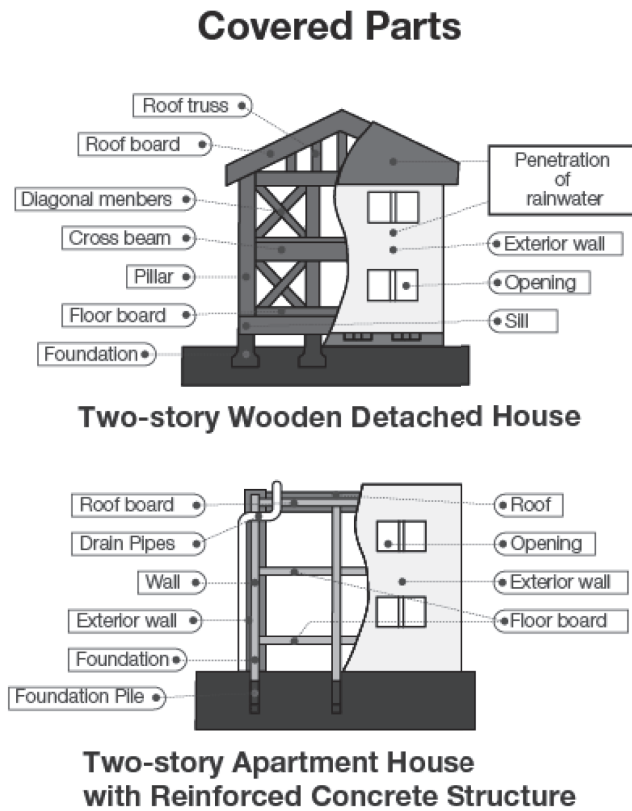


Figure 2: Insurance covers in House Warranty Insurance  
 Source: <http://kashihoken.or.jp/kashihoken/> (last viewed January 18 2013)

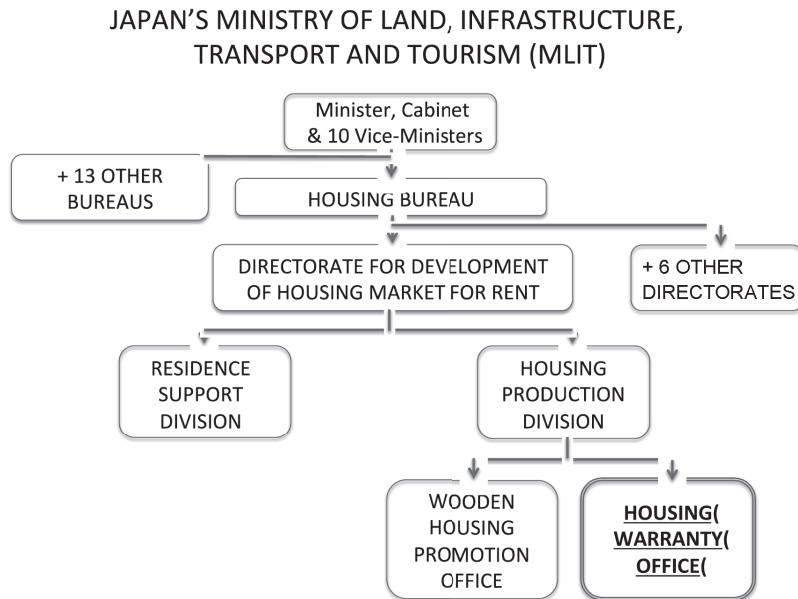


Figure 3: Organization of the Ministry concerning Housing Warranty Insurance is concerned  
 Source of comments: Association of House Warranty Insurance Entities.

Table 2: Housing Warranty Insurance Entities

Association of Housing Warranty Insurance Entities*	Characteristics
K.K. Jūtaku Anshin	<i>Backed up by a trading house which sells building material to builders</i>
Organization for Housing Warranty K.K.	<i>Longest experience in the housing insurance business</i>
K.K. JIO Corporation	<i>Has its own branches of housing inspectors nationwide and emphasizes giving guidance on quality works</i>
House G-Men Co., Ltd.	<i>Providing financial services for local builders through its group network</i>
Houseplus Corporation	<i>Known to be a top-class housing performance evaluation service.</i>

Source of comments: Association of House Warranty Insurance Entities.