Part 1. Basic Concepts

1. Basic Concepts for Insurance Company Inspection

(1) Purpose and position of insurance inspection

Insurance companies are private companies and should basically be managed in accordance with the principle of self-responsibility. However, unlike ordinary companies, the main creditors of insurance companies are their policyholders, i.e., the general public. Steps must therefore be taken to appropriately protect the interests of the general public. Insurance plays an important role in that it secures against life and death of a person and various risks that arise in society and, when an accident occurs, it secures the continuity of economic life. The security function of insurance constitutes the basis of national economy and national life. These are the reasons why the state must take an interest in the sound and proper operation of insurance companies.

It is from this perspective that insurance companies are inspected by the regulatory authorities – “to ensure the sound and proper operations of insurance companies and to protect policyholders, etc.” (Insurance Business Law, Article 129, etc. The same is true with life insurance agents and non-life insurance agents.). The nature of inspections must be subject to constant review. Regulators must strive to make inspections adequate to the task of ensuring the sound and proper operation of insurance companies and protecting policyholders without inspecting into points that are not necessarily relevant from the perspective of “sound and proper operation.” Ensuring the sound and proper operation of insurance companies and protecting policyholders are the basic purposes of inspection, purposes that must be reconfirmed anew every time an inspection is performed.

However, sound and proper operation and the protection of policyholders shall not be ensured by inspection alone. The Insurance Business Law states that implementing this law shall be given to respect each insurance company’s own initiative with respect to the management of insurance business. The sound and proper operation of insurance companies and the protection of policyholders must, first and foremost, be achieved through rigorous adherence to the principle of self-responsibility and through reinforcement of market disciplines.

The board of directors of insurance companies must take the responsibility for ensuring that their operations are sound and proper and for protecting policyholders by enhancing their own internal control structure. An auditors take important responsibility for enhancing the internal control structure and they must fully discharge their duties of auditing the board of directors’ performance of their duties. The job of accounting auditors is to carry out rigorous external audits by which these internal control structures are accurately gasped, accomplishing with financial statements audits is independent of insurance company.. Having gone through this process, the insurance companies’ financial statements, business policies, and other relevant information must be widely disclosed, so that they can be monitored by investors through the markets (monitored by the market disciplines).

The public participation of the regulatory authority should be as a complement to the principle of self-responsibility and monitoring by the market disciplines, making up for areas in which they are inadequate to fully protecting policyholders, etc. Therefore, inspections by the authorities should assume that insurance companies have internal controls in place and that accounts are subject to external audit by accounting auditors. Inspections must maintain linkage and coordination with these systems, and must be conducted effectively, efficiently, and according to predetermined rules for the purpose of ensuring the sound and proper operation of insurance companies and the protection of policyholders.

(2) Basic principles of insurance company inspection

The concepts described above form the foundation for the basic concepts of inspection for insurance company discussed below.

Inspection for insurance company assumes internal controls by the insurance company itself based on the principle of self-responsibility and rigorous external audits by accounting auditors, and reinforces these systems (principle of reinforcement). Therefore, authorities must use inspections to strongly encourage insurance companies to establish proper internal controls and external audits based on the principle of self-responsibility. In addition, inspections should assume that these controls and audits are indeed being performed in an appropriate manner, and should emphasize "ex-post monitoring" type checking that focuses on "process checking" for the internal control and external audit systems. The onus is on the financial institution to explain whether internal controls are appropriate; the authorities are in the position of verifying this. It is neither possible nor necessary for financial inspection to inspect everything.

The resources available to the authorities and insurance companies are limited and must be utilized in an effective manner. Inspection for insurance company should therefore be fully linked and coordinated with auditing functions so that they are performed as efficiently and effectively as possible (the principle of efficiency). Inspections should seek to make greater use of auditing functions by coordinating with the work of auditors and accounting auditors. Furthermore, it should be assumed that insurance companies have their own controls in place.Inspection should be prioritized dynamically so that the frequency and scope of inspection reflects the degree to which insurance companies are actually accomplishing this.

Finally, inspection for insurance company must be carried out effectively so that they serve to ensure the sound and proper operation of insurance companies and the protection of policyholders (the principle of effectiveness). Inspection departments should accurately communicate to insurance companies any problems found in their management or operation, and should maintain close coordination with the supervisory departments that are empowered to enact regulatory measures, thereby encouraging timely and appropriate correction of problems.

2. Basic Concepts Underlying the Insurance Company Inspection Manuals

(1) Self-management-style inspections

In light of the basic principles of inspection for insurance company described in the previous section, the Insurance company Inspection Manuals must provide further encouragement for the shift from authority-led-style to self-management(by insurance company)-style.

Specifically speaking, firstly, even though the manuals are essentially handbooks for the inspectors, they should be published as a means of encouraging insurance companies to operate under the principle of self-responsibility.

Likewise, manuals should wherever possible be in the form of checklists, which will be easier for insurance companies to use in their management.

Secondly, the focus of inspections should not just be on results whether scandals have taken place. Rather, they should be weighted towards process checking that verifies whether the insurance company has the proper structures of internal control and external audit in place to prevent scandals from occurring.

Thirdly, this manual should not be "convoy-style" lists of common check items for all insurance companies. If anything, they should actively include check items geared towards the most advanced insurance companies.

Finally, this manual should be aware of the roles and responsibilities of the board of directors, auditors, and accounting auditors within the internal control and external auditing structures, and should ask whether, from the perspective of the principle of self-responsibility, these roles are appropriate and where the locus of responsibility lies. In particular, inspection should endeavor to work "from the top down," by first confirming whether the board of directors and auditors are fully cognizant of the various risks to which their company is exposed, whether they make needed allocation of resources, and whether they are engaged in appropriate internal controls.

(2) Inspection with emphasis on risk management

In view of various situations surrounding insurance, this inspection manual should be weighted towards the risk management systems of insurance companies.

Due to changes in market environments and the diversification and advancement of investment methods, insurance companies are increasingly exposed to market risks, such as price fluctuation risks in securities investment and foreign exchange risks in investment in foreign currencies, in addition to credit risks. They have also come to be exposed to other risks, such as insurance underwriting risks and operational risks. Deregulation and liberalization of the economy is now being promoted through financial system reform in order to cope with the freer and globalized economy, the aging of the population, and changes in the environment surrounding the Japanese insurance business. The days of "convoy-style" regulation are over and a new period of business realignment is beginning in which insurance companies will be searching for new structures and businesses based on the principle of self-responsibility.

Amid the rapidly changing environment surrounding the insurance business, it has become increasingly important for insurance companies to accurately grasp and manage various risks on their own responsibility.

Furthermore, the international trend is to see risk management as the basis for operation. If the Japanese insurance industry is to make further development, then we must forcefully communicate the soundness of our risk management to both the domestic and the international publics.

Under the circumstances, inspection for insurance company should be performed from the perspective of ensuring proper risk management systems, although checks on the compliance with laws by insurance sales and the appraisal of assets from the perspective of ensuring the soundness of business of insurance companies are important factors in inspections.

3. Positions of the Insurance Inspection Manuals

The Insurance Company Inspection Manuals are essentially handbooks to be used by inspectors when they inspect insurance companies. It is expected that, as part of their efforts to ensure sound and proper operations and in accordance with the principle of self-responsibility, individual insurance companies will fully exercise their creativity and innovation to voluntarily create their own detailed manuals. These manuals should make note of the content of the Insurance Company Inspection Manuals and be adapted to the size and nature of the insurance company so that they will ensure sound and proper operation of insurance companies and protection of policyholders.

The check points in the Insurance Company Inspection Manuals represent standard to be used by inspectors in evaluating the risk management and compliance systems of insurance companies. They do not constitute direct statutory obligations to be achieved by insurance companies. Care must be taken that the Insurance Company Inspection Manuals are not adopted by rote and uniformly. If there may be cases in which the checklist description has not been fulfilled literally by insurance company, in the light of ensuring the soundness and appropriateness of its operations and protection of policyholders, only the time that measures by insurance company are equivalent in their effects to the descriptions for the check point or are sufficient given the size and nature of the insurance company these measures would not be deemed inappropriate. Inspectors will therefore need to fully dialogue relevant points with insurance companies during on-site inspections.