Tentative decisions on the fundamental elements of the economic value-based solvency regulation

June 30, 2022

The Financial Services Agency of Japan (JFSA) has been conducting studies to introduce new economic value-based solvency regulation in FY2025. In June 2022, the JFSA released a report on the tentative decisions and basic directions with regard to fundamental elements of the new regulation (the framework of the standard method in particular). Its key elements are summarized in this note.

1. Introduction

- The JFSA introduced solvency margin ratio (SMR) regulation in 1996. However, as issues and limitations arising from the locked-in method of valuation of insurance liabilities and a simple factor-based risk measurement were pointed out, the Study Team on Solvency Margin Standard proposed a transition to economic value-based solvency regulation in 2007 over the medium term.

- The Economic value-based solvency regulation is a framework designed to capture the financial condition of insurance companies through the economic value-based valuation of assets and liabilities in a forward-looking manner, which would contribute to the sophistication of risk management in insurance companies.

- Based on the 2007 proposal, the JFSA has conducted several field testings (FTs) on economic value-based valuation and supervision since 2010 to understand and analyze practical issues faced by insurance companies and quantitative impacts on them. In the meantime, insurance companies have made steps toward introducing an economic value-based approach into risk management, while there have also been international developments, including those related to the Insurance Capital Standard (ICS) of the International Association of Insurance Supervisors (IAIS).

- Based on such developments, studies and deliberations on the direction of domestic solvency regulation including external experts started anew in 2019 and resulted in the publication of a report titled “The Advisory Council on the Economic Value-based Solvency Framework” in June 2020.

- For the introduction of new economic value-based solvency regulation, the report presented the timeline for the finalization of its standards in around the spring of 2024 and enforcement of them effective in April 2025. It was proposed that the basic content of the regime (the concept of the standard method in particular) should be tentatively determined in around 2022 as a milestone, based on analyses making use of FTs and also taking into account the international developments.

- The JFSA published tentative decisions and basic directions of the fundamental elements of the new regulation in June 2022, based on an analysis of findings from FTs conducted by 2021, dialogues with insurance companies and other stakeholders and international developments. Its key elements are summarized in this note.

- The purpose of the tentative decisions is to encourage insurance companies to improve their operational structure, including IT system investment before the introduction of the new regulation. From this perspective, the main contents of the tentative decisions are the basic structure of the standard method in Pillar1 and the validation framework of the economic value-based solvency ratio (ESR).

- With regard to arguments pertaining to supervisory measures and Pillars 2 and 3, the directions of arguments and examinations expected at this point are shown. Further considerations will be required for a smooth transition to the new regime.

2. Framework of regime for Pillar 1

○ Timeline for introduction of the new regulation

- Based on the timeline shown in the advisory council report, the JFSA and insurance companies have been steadily advancing preparations and examinations for a smooth transition to the new regime. No particular change has been made to the work plan of the ICS since 2020 when the advisory council report was published.

- Based on this the JFSA plans to continue steady preparations and examinations on the new regulation, aiming at the introduction of the regime in 2025 as originally planned.

○ Relationship between the new regulation and the ICS

- The basic structure of the standard method of the new domestic regulation will be consistent with that of the ICS.

- However, Japan's new regulation will be applicable to all insurance companies, including small and medium-sized insurers, while the ICS covers Internationally Active Insurance Groups (IAIGs). It is therefore considered appropriate to make modifications from the ICS as necessary, if there is rationale for such changes, for instance in light of risk characteristics of Japanese insurance companies, including small and medium-sized insurers.

○ Practical approach based on materiality

- In the application of the proportionality principle[1] stipulated in the ICS, a certain degree of discretion of individual insurance companies, based on their status, may be allowed with regard to such issues as whether or not to apply a proportional approach and the methods for simplifications. In this case, there should be a mechanism to ensure the appropriateness of their judgment from multiple perspectives such as independent validation, reports to the supervisory authority and disclosure.

- The JFSA will continue examinations to achieve an institutional design for appropriate applications, keeping in mind the timeline of showing a specific direction in around 2023.

3. Standard method (overview)

- The basic structure of the standard method of the new regulation will be consistent with that of the ICS, but deliberations are underway on the following points from the standpoints of making it appropriate as a domestic regulation.

  ✓To reflect risk characteristics and other factors of Japanese insurance companies including small and medium-sized insurers.

  ✓Issues when applying the approach of the ICS not only on a consolidated but also on a solo basis.

  ✓Clarification of treatment and calculation based on practical points of view as the domestic regulation concerning issues for which the ICS does not stipulate detailed methods.

- The JFSA will continue to consider the following issues through FTs and dialogues with stakeholders after the tentative decisions.

  ✓Issues that have limited impacts on insurance companies' development of IT systems and improvement of operational structure, such as risk factors and other parameters and technical adjustment and clarification.

  ✓Issues subject to continued examinations on the ICS

[1] Proportionality principle: When the IAIG can demonstrate that taking into account a specific factor/rule in their calculation or valuation would lead to a significant increase in complexity, without material improvement to the quality of the figure produced or to the assessment of risk linked to this figure, then this factor or rule can be ignored or simplified.

✓Issues related to measures aiming at certain policy objectives and transitional measures

○ Scope of consolidation

- The current consolidated SMR includes financial subsidiaries in the scope of consolidation in principle, even when they are excluded from the scope of consolidation for accounting purpose under the materiality principle, from the viewpoint of capturing risks in an exhaustive manner, given the lessons from the financial crisis.

- For the purpose of the ESR, consolidated subsidiaries are basically treated in accordance with accounting standards. However, if certain financial subsidiaries are deemed important in terms of their impact on the ESR, they should be included in the scope of consolidation.

○ Accounting-based balance sheet as starting point of ESR

- Under the new regulation, not only J-GAAP balance sheets but also IFRS balance sheets can be used as the starting point of the ESR.

- Specific treatments will be studied further, taking into consideration the differences between the IFRS and the ESR.

○ Economic value-based valuation approach (Current Estimate)

- To complement basic factors pertaining to the valuation and validation of insurance liabilities defined by the regulations, guidelines will be set to ensure the appropriateness of figures and certain comparability while respecting voluntary efforts of each company based on its circumstances.

- Discussions with stakeholders are needed on relationships and the division of specific roles concerning “basic elements defined by the regulations” , “guidelines” and “guidance to be jointly examined by the JFSA and the Institute of Actuaries of Japan”.

○ Discount rate

- There are various points of discussion on the discount rates for insurance liabilities, such as the methodologies for extrapolation to the longer time horizons in which there is no observable market interest rates and the need and approach for spread adjustment to risk-free interest rates. Their importance is particularly pronounced for life insurance companies, as they could have substantive impacts on their ESR due to the existence of long-term insurance liabilities.

- The ICS has adopted such measures as the “Ultimate Forward Rate (UFR)” and “the spread adjustment based on the Three-Bucket Approach”. The measures have been adopted considering insurance companies’ views that excessive volatilities of the ESR should be reduced and their investment strategies should be taken into account properly, while maintaining the basic concept of economic value-based approach. It is considered practical to apply them to the standard method in Pillar 1.

- In light of the foregoing, the framework of discount rates in the ICS will be applied to the standard method in Pillar 1 under the new regulation as a tentative decision. The JFSA will continue to study technical issues mentioned below, taking into account the results of FTs and the discussion of discount rates within the ICS.

  ✓ Whether the Last Observed Term (LOT, 30 years), the last maturity for which market information can be observed, which is applied to the Japanese yen under the current specifications, is relevant in light of the actual status of the Japanese government bond market.

  ✓ Whether the Middle Bucket criteria should be the same as those of the ICS.

  ✓ Adjustments related to “overshooting” or an increase in capital as a result of spread adjustments when market spreads widen.

○ Margin over Current Estimate (MOCE)

- Under the percentile approach adopted by the ICS to measure MOCE, differences in the duration of insurance liabilities may not be accurately reflected and the relationship between risk, return and capital might be blurred. Therefore, the cost of capital approach will be adopted in the new regulation.

- While the cost of capital ratio in the new regulation will be around 3% as a benchmark for the present, further examinations will be made through FTs and other steps.

○ Life and non-life insurance risks

- The ICS risk factors, calibrated based mainly on data from IAIGs, may not stand at appropriate levels for some of Japanese insurance companies depending on the scale of the insurance companies and characteristics of their insurance products.

- The JFSA carried out calibrations using the data collected through the domestic FTs, finding that the suggested risk factors are generally higher than the ICS risk factors. This could be attributed to the fact that the ICS covers IAIGs (which generally have large-scale business operations), while the JFSA's calibration included small and medium-sized insurers, which tend to suggest higher risk factors.

- From the viewpoint of examining specifications based on the scale and characteristics of Japanese insurance companies, the JFSA will continue to collect and examine the data toward the finalization of the risk factors. Studies will also be conducted on risk factors specific to insurers (Undertaking-Specific Parameters).

○ Catastrophe risk

- Given the need of achieving consistency with insurance companies' risk management and reflecting the nature of their risk profiles, the use of their natural catastrophe models is to be permitted. In this case, the criteria for supervisory review and approval, the processed and other elements will need to be examined thoroughly.

- When natural catastrophe models are used for the calculation of required capital, the JFSA will need to examine the model. After the 2022 FT, self-assessment by insurance companies and reviews by the JFSA will be conducted in line with the proposed criteria. Initial and formal review will be conducted after the criteria are finalized.

- Given that there could be cases where developing and/or utilizing sophisticated models are challenging, standard measurement methods will be adopted for earthquake, windstorm and flood risks in Japan. Technical studies will be conducted on details of such methods.

○ Market risks

Although the adoption of the same specifications as the ICS, with some exceptions, is a tentative decision, examinations will continue as the following points of discussion have been raised.

- Interest rate risk
  - ✓ For insurance companies that do not adopt the UFR for their own risk management, hedges against interest rate risk based on their internal models may result in over-hedging against the ICS interest rate risk.

- Look-through approach for equity risk

✓ The application of the look-through approach causes concerns about the possibility of inconsistency with risk management and an increase in workload.

▪ Measures for equity risk

✓ There were calls from the life insurance industry to introduce the "symmetric adjustment mechanism related to equity risks" and "reduction of risk factors related to infrastructure and long-term investment", both of which are adopted in the Solvency II framework in the EU.

✓ It is considered appropriate to conduct detailed studies on those measures together with discussions on transitional measures and supervisory measures.

○ Tax effect

▪ An upper limit of 20% by insurance capital requirement, which applies to the tax effect on capital requirement will apply to insurance capital requirement in the current specifications as in the case of the ICS.

▪ The JFSA will continue studies to determine appropriate treatment, taking into account the effective statutory tax rate of around 28% in Japan .

4. Validation framework related to ESR

○ Overall view of internal validation structure

▪ In the valuation of insurance liabilities and the use of internal models to calculate the ESR, insurance companies are often required to make judgments and estimates on their own. Furthermore, given that a significant number of items need to be calculated, a mechanism to ensure the appropriateness of overall ESR calculations is needed in order to assure the reliability and robustness of the ESR regime.

▪ The basic direction is to establish such mechanism to ensure the appropriateness of entire ESRs and components in which judgment and estimation play large roles.

○ Actuarial function

▪ The roles of the actuarial function, which is one of the control functions insurance companies should be equipped with, need to be studied, focusing on such issues as the roles of appointed actuaries under the new regulation and enhancing economic value-based risk management at insurers.

- Expected roles of the actuarial function could include, for instance: establishing policies and providing oversights, advices and internal reports on actuarial matters; the assessment of regulatory capital adequacy; and the assessment of other business operations that involve actuarial matters.

○ Validation by external experts

- In introducing validation by external experts, it is important to pave the way for dealing with the issue from the following standpoint:
  - (i) To complement the internal governance structure with the characteristics of the ESR in mind;
  - (ii) To ensure the reliability of ESR-related information for users of such information;
  - (iii) The appropriate level of reliability of information that is needed for Japan's solvency regulation; and
  - (iv) Effectiveness and efficiency of validation by the supervisory authority and information users

- The JFSA will continue further studies, while maintaining the introduction of validation by external experts as a basic direction.

5. Internal models

- With regard to the use of internal models in Pillar 1 of the new regulation, the JFSA will continue further studies while maintaining the following point as a basic direction:

  ✓ The priority until around 2024 will be the studies and dialogues with insurance companies toward the finalization of criteria for supervisory review and approval and the start of preliminary assessment on natural catastrophe risk models.

  ✓ The treatment of risks other than those of natural catastrophe under the new regulation will be presented after 2023. In so doing, attention will be paid to preparations by insurance companies and the JFSA for the review and approval of natural catastrophe models, studies related to the standard method (including those on the Undertaking-Specific Parameters) and the discussion on internal models in the context of the ICS and so forth.

6. ESR-based supervisory measures and Pillars 2 and 3

○ ESR-based supervisory measures

- To ensure the effectiveness of prudential policy framework, it is important to enable the supervisory authority to take supervisory measures, based on insurance companies' prudential indicators in a timely and appropriate manner.

- The Insurance Core Principles (ICP) offer two definitions -- the Prescribed Capital Requirement (PCR) which is the starting point of supervisory measures based on the level of capital and the Minimum Capital Requirement (MCR) which permits the invocation of the strongest supervisory measures such as business suspension. Studies will be conducted on a framework of prompt corrective measures under the new regulation.

○ Pillar 2

- The purpose of Pillar 2 is to address risks that are not fully covered under Pillar 1, and assess insurance companies' risk management and facilitate further sophistication of it. Initiatives currently undertaken by the JFSA, such as the accumulation and analysis of various supervisory information (e.g. accounting-based information and risk information, Own Risk and Solvency Assessment (ORSA) reports), the early warning system and supervisory dialogues could be seen as tools for Pillar 2 under the new regulation as well.

- Many insurance companies have already engaged in economic value-based Enterprise Risk Management (ERM) and ORSA. To introduce an ESR-based Pillar 1, it is considered important to further sophisticate them while recognizing the significance of such engagement.

- The JFSA will validate insurance companies' engagement through dialogues with them. To give insurers incentives to further sophisticate their economic value-based risk management, the JFSA will study the desired forms of supervisory framework.

○ Pillar 3

- Pillar 3 is aimed at improving the governance and discipline for insurance companies. In studies on Pillar 3, it is important to discuss items of disclosures to facilitate dialogues with external stakeholders, and disclosure framework that enables comparability across insurance companies.

- It is important that the usefulness and workload of disclosure should be balanced from the viewpoint of ensuring feasibility and preventing disclosure from losing substance, as the expansion and improvement of disclosure, accompanied by the introduction of the new regulation, could cause insurance companies' additional burdens.

- Detailed studies will be conducted on the overall disclosure framework and its key components .