(Provisional translation)

The Fourth Meeting of the "Advisory Council on the Economic Value-based Solvency Framework"

1. Date and Time: October 21, 2019 (Monday) 10:00 a.m. to 11:45 a.m.
2. Venue: Special Conference Room No. 1, 12th Floor, Central Government Building No. 7
3. Minutes: Following presentations by the secretariat and Observer Itaba, the discussions were held as below.

- Although the discussion in the IAIS focuses on the PCR, the MCR has a considerable impact on insurers. We need to discuss the roles of and distinction between PCR and MCR, as well as how to explain the difference between the two. The transitional period before the new regulation is enacted is another important topic to be discussed.

- I do not see the need to establish separate regulations for IAIGs and non-IAIGs, from the standpoint of a level playing field.

- Resources and preparedness on the authority's side are important issues. There will be a significant change in insurance supervision, in the face of the introduction of the ICS and the ComFrame, as well as the new supervisory approaches proposed by the JFSA. It will require supervisors to have capabilities and skill sets that are different from those in the past. The authority needs to start preparation as early as possible, in anticipation of these changes.

- Financial institutions cannot maintain financial soundness without sustainable growth. Thus the FSA, through engagement towards best practices, needs to discuss the future of financial institutions as a partner and support their sustainable growth. Such engagement will probably fall within supervisory review under Pillar 2. It is also necessary to consider how to link such an approach to the oversight on insurers' prudence.

- It might be an idea to introduce qualitative and/or quantitative stress testing on climate risk, as part of the FSA's "engagement towards best practices."

- Economic value-based calculations are complex. Data governance and resources could be a problem for small insurers, if the same level of governance is required of all the players. Consideration should be given to such practical issues when introducing a new regulation, including the time required for preparation, as well as the use of external resources.

- I understand that the authority monitors the conditions of insurers continuously and requires improvement as necessary under Pillar 2. If that is the case, a breach of the Pillar 1 requirement would mainly be triggered by market fluctuations. Other members mentioned a symmetric adjustment mechanism for equity risk charges and extension of recovery periods, to deal with a rapid deterioration in the economic environment. However, if both are implemented, the roles of the two mitigation measures might overlap. We need to consider whether they should be permanent measures or a temporary arrangement in a transitional phase.

- It is one idea to define the MCR by setting a different confidence level from the PCR, such as in Solvency II. Another approach would be to make an adjustment from the PCR via the recoverability assessment of deferred tax assets and valuation of intangible assets (e.g. goodwill).

- Practical challenges may be caused if we retain the current regulation on real net assets, as it may not be aligned with an economic value-based approach.

- I often hear that the existing regulations are preventing insurers from controlling and reducing risks properly. I agree that a reform in our solvency regime is an urgent issue.

- Perhaps real net assets will need to be valued based on economic value under the new regulation. Introducing a deposit floor is a possibility, as insurance liabilities could be valued at a negative figure in an economic value-based approach.

- Some members commented that the UFR is overly optimistic, but I think that we should distinguish between the issues of the level and the methodology itself. We need some assumptions to extrapolate the yield curve to the ultra long-term territory anyway, and the UFR is merely an option to do so. If the UFR is set at 3.5%, it may indeed look too optimistic given the current environment. However, the same level would look very conservative if the prevailing interest rate was around 10% under hyperinflation.

- Insurers bear a large burden in maintaining internal models in terms of both financial cost and human resources. Nevertheless, to strengthen risk management by taking account of the characteristics and business model of each insurer, there is no other way than to rely on internal models, given that the standard formula merely reflects the average of the entire industry. Insurers would be encouraged to do so if the required capital was reduced by using internal models (under Pillar 1), which I think is a necessary mechanism to provide an incentive to use internal models.

- Thus far, there has been an opinion that the introduction of an (economic value-based) regulation should be handled carefully, keeping in mind potential "unintended consequences" of the new regime. Others pointed out that we need to transition into a new regime as soon as possible, as the current rules (rather than the new economic value-based regulation) have had unintended consequences. We cannot continue to cover both sides forever. Some have raised concern on the fluctuations of economic value-based metrics caused by market movements, which I do not agree with. The fluctuation of ESR is a fact which we should not ignore. We should be clear on the perspective from which we use the term "unintended consequences," if we want to move our discussion forward.

- The secretariat raised a question as to the way to enhance insurers' risk management practices under a new economic value-based regulation. I think that statement should be transposed. Regardless of the regulatory regime, insurers' risk management should focus on economic value, and external stakeholders should also look at the soundness and sustainability of insurers from the perspective of economic value. We should focus on designing Pillar 1 and 3 in such a way that we can promote insurers and other stakeholders toward such direction.

- In Solvency II, if an internal model is used for Pillar 1, insurers are required to prepare a validation report separately from ORSA, to verify that their internal models are properly used.
- I think there are two major obstacles to implementing economic value-based risk management. One is the existing regulation on real net assets, and the other is the psychological bias associated with the level of interest rates. If Pillar 1 transitions into an economic value-based one, it will be necessary to abolish or at least revise the existing real net assets regulation. To address the latter problem of the psychological bias, it could be effective to check and verify insurers' interest rate forecasts and investment strategies under Pillar 2, using a PDCA cycle.
- ICS is being developed as standards for IAIGs. If it is also applied to non-IAIGs, additional considerations should be given, including transitional measures.
- The current real net assets serve as an indicator of whether an insurer is in possession of a market-valued asset that exceeds the surrender value or a Zillmerized standard policy reserve for the entire period. Thus it has its own distinctive purpose that is different from the evaluation of interest rate risk, and plays an important part in the existing standard policy reserve system. I think it should be retained in some way, even though a certain revision could be made if necessary.
- Assuming ICS morphs into something not entirely satisfactory for us, we need to consider making necessary adjustments when designing a domestic regulation, from the standpoint of domestic policyholder protection. However, discrepancies between the ICS and the domestic regulation will pose difficulties for potential IAIGs. It will ultimately depend on the details of the ICS.
- Economic value-based risk management is becoming a global consensus. Meanwhile, we acknowledge that discussions are still underway as to economic value-based capital regulations. In addition to discussions on concrete design of the domestic regulation, we also need to think about whether the regulation to be adopted is indeed appropriate in the Japanese context.

- I have a concern that approval processes of internal models (in Pillar 1) may entail a considerable amount of time and cost. Given that some European players are already using internal models (for Pillar 1 purposes), Japanese insurers may be put to a competitive disadvantage.

- I agree that we should develop a domestic regulation based on the ICS. On the other hand, the ICS may ultimately become a relatively loose framework that includes such elements as the Aggregation Method, given what has been going on in the US. It is not clear if we should automatically transition into a new regime even if the ICS is not agreed upon as a uniform standard.

- The symmetric adjustment mechanism for equity risk and the volatility adjustment for discount rates should be considered in the future discussions on the ICS. If these mechanisms are deemed necessary in the Japanese context, Japan may need to work to have them reflected in the ICS as well.

- There could be substantial variability of the results if internal models are used for the calculation of ESR. For instance, in the case of treatment of interest rate risk, the design of a downside stress scenario or a correlation matrix may have a significant impact. Thus the design of internal models needs to be monitored continuously, and some guidance on internal models should also be developed.

- The existing regulation on real net assets does not provide insurers with an incentive to close duration mismatches between assets and liabilities. I have an impression that that is sometimes used as an excuse by insurers to explain why it is undesirable to invest more in long-term assets. Given this, modifying the rule will not be sufficient – my view is that the real net asset regulation should be abolished entirely.

- ICS is designed as a group-based standard for IAIGs. If we choose to adopt it for solo regulation for Japanese insurers, we may need some fine-tuning, including the treatment of intra-group reinsurance transactions

- The role of Pillar 3 is not limited to mere disclosure requirements – the corporate governance is of ultimate importance. Disclosure is necessary to enhance discipline on (insurers) from stakeholders and markets. This should also be a basis for Pillar 1 and 2.

- Considering the recent natural and economic environments, perhaps we should consider incorporating into Pillar 1 the elements that have been traditionally covered in Pillar 2, including natural catastrophe risks and geopolitical risks.

- If insurers continue to provide long-term coverage that exceeds their capabilities, it means they will pass on the risks to future policyholders. We first need to understand such problem of transferring risks between generations, then build a system to derive products that will truly address consumers' needs.

- There is already a trend to introduce an economic value-based regulation. The timing of the introduction should be clearly presented here. Regardless of the position of the US, it is already clear that the ICS as an economic value-based solvency standard will be available in 2025. We should not wait for another five or ten years after 2025. The transitional period should be limited to the minimum that is necessary for preparation. Both insurers and the authority will carry out preparation in the monitoring period over the next five years, and ICS-based regulation should be introduced promptly after that.

- Addressing consumers' needs and focusing on economic value perhaps can coexist, although they might appear to conflict at first glance. I think it is important to continue with efforts to find a balance between those different perspectives.

- Regarding group-based regulation, we need to design a group-based standard that is suitable for Japanese insurers with affiliated entities located overseas.

- Existing regulations and economic value-based risk management sometimes point to opposite directions. It should be considered whether to maintain current regulations as they are, while working toward implementing economic value-based regulation.

- In my view, real net assets can sometimes be useful as supplemental information when looking at the (J-GAAP-based) balance sheet.

- Insurers may have been forced to bear unnecessary risks and costs because of the co-existence of a variety of different standards. Points for future discussion will include whether we should use the same formula for the PCR and the MCR, whether to maintain real net asset regulation even under the economic value-based regime, and the relationship between the solo- and group-based standard, and the rules for IAIGs and non-IAIGs. We need to keep in mind that huge costs could be incurred if insurers are forced to deal with multiple standards.

- It will be beneficial if the regulation serves as an incentive to promote better risk management. Pillar 1 and 2 should be designed from such perspective.

- While we support the adoption of ICS-based domestic regulation, the ICS itself may change during the monitoring period. We need to take into account the developments in the US and Europe during the period.

- Given that each jurisdiction has its own context and characteristics, it is not clear if a uniform standard will function in a satisfactory manner in all the jurisdictions. I believe that this is the reasoning behind the Aggregation Method currently developed in the US.

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