(Provisional translation)

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

1. Date and Time: March 6, 2020 (Friday) 3:00 p.m. to 4:35 p.m.

2. Venue: Special Conference Room No. 1, 12th Floor, Central Government Building No. 7

3. Minutes: Following presentations by the secretariat and Member Tsujino, the discussions were held as below.

- The material prepared by the secretariat sums up the key points related to Pillar 2 very succinctly. As mentioned on Page 22 of Material 2, the UKPRA pointed out the importance of grasping how insurance companies generate capital. Under Pillar 2, it is important to look not only at the relationship between capital and risk but also at the relationship between capital, risk, and return.

- In relation to Page 10 of Material 1, I am afraid that the discussions related to the Pillar 2 might be held only between the FSA and insurance companies, and thus the status might remain unclear to the public. Of course, I assume that the FSA will appropriately manage the process, but even so, judgement concerning the requirements within on Pillar 2 may be overly influenced by the opinions of the industry. Therefore, it is necessary to listen to the voices of outside experts as appropriate. It is also important to make use of information available through the SFCR (Solvency and Financial Condition Report under Solvency II) described in Material 2.

- Regarding Pillar 3, it is very important to continue discussion from the user's point of view. On the other hand, when we think of reports intended for investors, discussion tends to focus on disclosure by joint stock companies. However, the SFCR is prepared not only for investors. If unlisted companies are allowed to disclose a limited amount of information, it could provide a perverse incentive for listed companies to seek delisting. We are looking forward to holding discussion from the perspective of the usefulness of information for a wide range of stakeholders, including investors and consumers.

- Regarding the discount rates mentioned on Page 8 of Material 1, it is pointed out that "when necessary, assessment should be conducted through methods other than the one prescribed in the regulation." The necessity should be emphasized by using a wording such as "assessment should be conducted using an appropriate estimation method in consideration of the current interest rate situation" instead of just saying "when necessary."
- It is appropriate that Page 8 of Material 1 refers to climate risk and cyber risk as elements that are difficult to be captured by Pillar 1 or to be quantified.
- In Page 16 of Material 1, the importance of dialogue between the FSA and insurance companies based on economic value-based information is emphasized. In relation to that, it is important for the FSA to develop its capacity and preparedness to hold more effective dialogue, given that much more sensitive information will become available and the supervision will shift from a rules-based approach to a risk-based approach.
- What impressed me strongly as I listened to Member Tsujino's presentation is that the method of disclosure differs significantly across insurers that are under the same Solvency II regime. In Europe, the standardization of information disclosure is an important challenge, and that is also the case in Japan. Nevertheless, I believe that it is possible to determine the desirable method of information disclosure and promote standardization.
- I agree with the view that it is necessary to continuously seek opinions from users regarding the discussions related to Pillar 3 going forward. As to the types of information to be disclosed and its modality, the FSA should make decisions after discussing details with stakeholders, including insurance companies, investors and consumers, taking into account their viewpoints. Going forward, discussion should be held on the points cited in Material 2, such as: whether or not it is possible to conduct standardization regarding insurance risk sensitivities in order to provide some degree

of clarity by using common scenarios (Page 8); whether or not it is possible to disclose the status of the asset-liability duration mismatch by insurance contract type in a comparable manner (Page 13); whether or not disclosure can be harmonized with respect to the breakdown of the difference between IFRS-based capital and economic value-based capital (Page 16); and whether or not there is a method that enables explicit disclosure of factors behind decrease in required capital under an internal model (page 18).

- Regarding the standardization of disclosure, the contents of the SFCR vary from company to company under Solvency II, so a standardized format has been proposed with respect to the sensitivities and movement analysis, on which insurance companies have been asked to provide comments. The EEV and the MCEV Principles have been formulated because a lack of consistency in insurance companies' approaches to the EV was impeding third parties’ efforts to conduct analysis from the perspective of a third-party. As Japanese companies disclosing the EV are now making disclosure under a somewhat standardized format, we should ensure that at least the same level of practice is maintained under the new economic value-based regulatory regime.

- The comparability of interest rate sensitivities may be undermined depending on factors such as the stress level, whether or not to assume only zero or positive interest rates in the negative interest rate environment, and whether or not the stress is applied to the UFR (Ultimate Forward Rate). Those points should also be discussed when finalizing the technical details at a later stage.

- Depending on how the surrounding environment will change in the future, cases may arise that are difficult or inappropriate to deal with through an existing set of standards. It is necessary to take into consideration the need to deal with such cases with some flexibility, regardless of whether they should be covered by Pillar 2 or Pillar 3.

- In relation to the standardization of disclosure, it will be unavoidable to draw a line somewhere when it comes to the level to which all companies, including both life and non-life insurance companies, are uniformly required to comply. On the other hand, one possible option is to encourage companies already disclosing the EV, such as listed companies, to proactively make additional disclosures. In fact, I assume that those companies are disclosing the EV because of the view that legally mandated disclosure is not sufficient to enable appropriate assessment of their businesses. I expect that voluntary disclosure will continue with respect to areas that cannot be captured by the standardized approach or IFRS, such as whether or not to include renewal of insurance contracts. Regarding those points, the regulatory regime should be so designed as to encourage voluntary disclosure on the premise that linkage with Pillar 2 should be secured to a certain degree.

- In relation to Page 12 of Material 1, the term "stakeholders" is difficult to understand in this context. There is the issue of how people other than investors and consumers should be treated, and there are also problems related to listed companies. Therefore, it would be better to use clearer wording so that it reflects the situation of Japan.

- Information disclosure is expected to become fairly professional in nature, but I am looking forward to some kind of new industry emerging as a result.

- Cyber risk is also important as an example of enhanced disclosure mentioned on Page 14 of Material 1, so it should also be cited as an example.

- The content of Material 2 is a very practical, and it is meaningful to publish a material like this as a document from this Council. With respect to figures for technical provisions and risk margins indicated on Page 10, it is desirable to explain what approach was used for calculation and how they might change depending on an approach used. As for the differences between the standard and internal models explained on Page 19 and after, it is necessary to show how the risk margin and the best estimate may be affected by the use of internal models. The level of information disclosure should be unified and a resourceful disclosure method should be devised to clarify why differences arise among insurance companies. Moreover, it is also desirable to indicate the size of the margin included in basic assumptions, such as the mortality rate. Information disclosure is a matter for the forthcoming discussion. Instead of this group holding a detailed discussion on it, it would be better for the FSA and insurance companies to create a forum of discussion among users of this sort of information in the future.

- Regarding the suggestion concerning Pillar 2 made on Page 6 of Material 1, I agree on the point that a shift to economic value-based approach should be made in order to ensure its consistency with Pillar 1. On the other hand, financial accounting-based figures will remain in use, and may still affect dividends and stock prices. In addition, such figures will also continue to be applied to various usages, such as delisting criteria and bankruptcy procedures. Therefore, I wonder if it is appropriate to shift fully to economic value-based supervisory reporting. From the perspective of policyholder protection, if there are different types of risks, all of them should be taken into consideration. Simplifying information gathering due to practical considerations is good in itself, but it may be necessary to take into consideration the possibility of gathering financial accounting-based data to an extent that fully covers risks under conceivable scenarios.

- For the early warning system to function effectively, the frequency of the reporting is also important. One possible option is to require disclosure of provisional figures on a quarterly basis and of firm figures corroborated by external verification on an annual basis, as in the case of the UK, while utilizing sensitivities in the meantime. Some insurance companies may not be prepared to report on a quarterly basis at present, so it is necessary to take into consideration the time necessary for the capacity development.

- If the details of Pillar 3 are to be discussed starting in 2022 and fixed in 2024, the development of IT systems may fail to keep pace with the schedule. As mentioned in Material 2, a very large set of and a great variety of figures will be required to be disclosed following the introduction of economic value-based regulation, so it is important to develop an IT system capable of processing all those data. According to the timeline indicated on Page 17 of Material 1, discussion on the rough outline of disclosure requirements should be completed by 2022, taking into account the status of discussion on Pillars 1 and 2. Once the rough outline has been discussed in reference to the SFCR, the development of IT systems will be easier and thus could be completed in accordance with the timeline. It is necessary to make clear that the details will be fixed after 2022, building upon the rough outline that will have been determined by then.

- With respect to the SFCR, I, as a person involved in preparing and checking disclosure, feel that the required level of disclosure may be excessive in some cases. As mentioned on Page 12 of Material 1, the viewpoint of the cost-benefit balance should be fully discussed with the involvement of insurance companies. It is necessary to discuss the appropriate level of information disclosure and ensure the balance between cost and benefit, while keeping in mind that different categories of stakeholders need different sets of information.

- A colleague member argued that the deadline of 2022 is too late if the system development is taken into consideration. One possible option is to hold stage-by-stage discussion starting with the field tests, while keeping in mind some kind of disclosure format.

- Insurance companies should not conduct both accounting-based risk management and economic value-based risk management at the same time. I have already pointed out the importance of promoting a shift to economic value-based assessment. If the current interest rate environment continues and if the existing accounting-based risk management is maintained, a dangerous situation may arise. If insurance companies try to make up for the negative spread under the existing accounting standards, interest risk control will inevitably be neglected. Therefore, it is necessary to abandon the approach to focus on interest income and negative spread. As I already mentioned, if it is difficult to abolish real net assets as an indicator, it might be an option to deduct policy reserve-matching bonds and the matching policy reserves from its definition.

- Regarding Page 9 of Material 1, while the status of stress tests is grasped through the ORSA report at present, how to make stress tests more effective is very important. Top managers in general—not only those in the insurance industry—tend to not take the results of stress tests seriously. However, in the case of banks, they were required to prepare a living will (a resolution plan) in relation to stress tests following the introduction of Basel III. I have heard that it was at that point that top managers of banks began to take the results of stress tests seriously. This is an important lesson for us.

- When we speak of an "internal model," that means two things. One is an internal model for the purpose of the PCR calculation and the other is an internal model in a true sense, that is to say, an internal model for the purpose of risk management. These two things are different and should be distinguished. The internal model in a true sense is a model used as a management tool regardless of the design of the PCR. Given that it is inevitable to set relatively loose criteria under Pillar 1, how to promote the development of internal models in a true sense is a challenge. For example, one effective option is to check why the main assumptions of models under Pillar 2 have been selected and what challenges exist in relation to them.

- It is desirable to set relatively strict criteria for approval with respect to internal models on market risks for the purpose of the PCR calculation. Even if the ESR figure under an internal model is unfavorable compared with the standardized model, it would be desirable for the company's approach to be appreciated for using an internal model (i.e. the company can obtain a good reputation for superior risk management) under Pillar 3.

- How to change the ORSA report through economic value-based assessment is one point of discussion. While risk measurement for regulatory purposes is based on a closed block approach, risk management for the purpose of ORSA could also use an open-block approach. In other words, the ORSA report could be used as a separate tool to examine whether continuing existing product and investment policies is really appropriate.

- Material 2 is very useful and instructive. What struck me was that insurance risk is the greatest risk for one of the companies mentioned, which means that it is an insurance company in a true sense. I assume that market risk is the greatest for most of the other Japanese life insurers. In the case of those insurance companies (for which market risk is the greatest risk and insurance risk is the second), we should examine why they consider their own risk profile to be optimal and how they intend to change their risk profile in the future under Pillar 2.

- As mentioned by a colleague member, it takes time to calculate economic value-based figures even with advanced computing technology. If various calculations have to be made in order to meet disclosure requirements, a large amount of resources will be required. Therefore, it is important to consider the balance between cost and benefit for insurance companies, as mentioned on Page 12 of Material 1. In addition, it should make some room for insurers' voluntary disclosure depending their size, rather than standardizing disclosure by converging each company's methodologies, as was the case in Europe.

- With respect to disclosure for consumers, the Life Insurance Association of Japan has formulated "Disclosure by Life Insurance Companies—Collection of Tips," which uses graphs to explain how policy reserves are built up by insurance category, as well as the details of the SMR calculation method. Of course, individual companies should make efforts to disclose figures in an easy-to-understand manner when the economic value based regulation is introduced, but I understand that the insurance industry as a whole should use creative ideas to ensure better understanding by policyholders.

- If the existing accounting standards coexist with economic value-based regulation in the future, various misunderstandings could arise. My view is that we should proceed with a resolution to change the accounting standards if necessary. In that case, it will become necessary to examine figures other than accounting data looking at the financial situation of insurance companies. Therefore, the Institute of Actuaries of Japan should develop an environment that enables a wider audience to access reference materials and receive education and training.

- Rather than reading the whole of disclosure materials, consumers use a digest and user-friendly information. As various indicators become more and more complex and sophisticated as a result of the introduction of economic value-based regulation, consumers will need simplified, user-friendly materials. Preparing such disclosure will require creative ideas to facilitate consumers' understanding. "Disclosure by Life Insurance Companies—Collection of Tips" by the Life Insurance Association of Japan is user-friendly and is popular among consumers. I hope that this will continue to serve as a useful reference material under the new regulatory regime as well.

- After the introduction of economic value-based regulation, actuaries will have to assume larger roles in many more places. Therefore, it is important for the Institute of Actuaries of Japan to develop infrastructure that enables individual actuaries to fully exercise their capabilities.

- Regarding disclosure, the presence of clearly defined calculation formulas has prevented numerical inconsistencies from arising so far. On the other hand, as assumptions may change in various ways under an economic value-based framework, companies will find it difficult to improve disclosure if they are constrained by past practices. Therefore, the FSA and external parties who look at disclosed information should have tolerance for changes where necessary.

- In relation to Page 14 of Material 1, I expect that, like their European counterparts, Japanese insurance companies will consider developing investment-type products in order to provide attractive returns for consumers, so how to manage conduct risk as something inseparable from that trend. It should also be included as a point of discussion.

- I totally agree with a colleague member's argument that stress tests should be made more effective. It is important for insurance companies not only to examine the results of stress tests but also to show to consumers how they intend to achieve recovery after stress events and execute their missions.

END