(Provisional translation)

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

1. Date and Time: August 28, 2019 (Wednesday) 3:00 p.m. to 4:40 p.m.

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

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

- An economic value-based valuation for risk management purposes could differ, according to insurers' capability and willingness for risk hedging and ALM. On the other hand, as uniformity and consistency are required for Pillar 1 (solvency regulation), it could deviate from insurers' internal risk management. It is therefore important to recognize that insurers' risk management should be addressed and reviewed under Pillar 2 (insurers' risk management and supervisory review).
- Pillar 1 may be moderated to some extent to mitigate unintended consequences, but the vectors of its sensitivities should be aligned with those in insurers' internal risk management, which should be based on economic value. In that sense, it might be acceptable to permit the use of the UFR and/or the addition of fixed spread to the discount rate within Pillar 1. In addition, I think there is little necessity to set strict eligibility criteria for hybrid capital instruments.
- To better align the regulatory framework with an economic value approach, the current regulation on real net assets may have a more substantial impact than the design of Pillar 1. If the rule is modified, it will signal that the authority is serious about the reform.
- In economic value-based risk management, risks could temporarily exceed capital when eventual recovery is expected. Nevertheless, the PDCA cycle should be implemented to assess the appropriateness of the forecast. This should be one of the

important checkpoints within Pillar 2.

- I do not agree with the opinion that the introduction of an economic value-based regulation under an ultra-low interest rate environment could potentially impair life insurers' ability to fulfill their insurance obligations and secure dividends for policyholders. The role of an economic value-based approach would be to prevent overly optimistic debt valuation and excessive dividends, which might cause problems in the future. It is doubtful whether an insurer can make a sound decision on the ability to fulfill obligations and the validity of dividends without utilizing economic value-based assessments.

- An economic value-based regulation could benefit policyholders through improving insurers' solvency. On the other hand, an excessive regulation may restrict insurers' investment strategies, which may then prevent them from accumulating necessary capital. It is critical to strike a balance between the two standpoints.

- Under J-GAAP and even under IFRS, which is close to a market-consistent valuation, such items as real estate and goodwill are not valued at market price. In addition, the future profit from insurance policies (CSM: contractual service margin) is valued using the lock-in valuation method under IFRS. Given that we do not have publicly disclosed figures that could be used as a basis for market-consistent valuation, it is important to ensure the appropriateness of calculation and internal validation processes. It is also necessary to keep in mind that there is a tradeoff between timeliness and the accuracy of information.

- In an economic value-based assessment, as valuation gains or losses are factored into capital, they fluctuate depending on the stock prices and interest rates. It is important to take this into consideration when developing a regulatory scheme. If insurers are never allowed to breach the regulatory minimum, a fire sale of stocks under a stressed circumstance may cause a further dip in the stock market, causing procyclicality. Another possibility is that insurers may refrain from investing in stock from the start in anticipation of such scenario.

- One way to mitigate procyclicality would be to make adjustment to the risk factors for equity exposures. The other would be to utilize all the three pillars, for instance by making some adjustments to the regulatory standard itself, and also utilizing the raw (stricter) assessments for other purposes. We should come up with multiple options regarding such grand design issues, and then see which one will work better under various risk scenarios.

- Economic-value based methodologies rely on a number of estimates. Given the breadth of those methodologies and their pros and cons, there seems to be no panacea. A combination of several approaches, rather than trying to solve everything using a single indicator, is a possibility.

- Regardless of whether an economic value-based approach is incorporated into the solvency regulation, insurers' management has to face the volatility caused by market movement. Market fluctuations affect insurers because they have exposures to such market risks. I see this as an advantage, rather than a disadvantage, of an economic value-based approach, in that it makes them aware of their position. It would be a dangerous idea to ignore the fact.

- I agree that it is difficult to solve all issues with a single economic value-based metric. What I mean here is that we should stick to the concept of economic value and utilize multiple approaches within its boundary, rather than relying on other approaches (that are NOT based on economic value). Pillar 2 will play a role in doing so.

- It is very difficult to assess whether and to what extent unintended consequences will arise with measures such as symmetric adjustment for equity risks. It could possibly vary depending on company or jurisdiction. It might be an idea to conduct a form of an impact study, to understand the implications from such measures.

- It seems challenging to clearly envisage a role of each of three pillars. While Pillar 1 appears critical in the Basel framework for banks, Pillar 2 may need to play a larger role in the case of insurance. If that is the case, we may need to allow room for some "looseness" within Pillar 1. As for Pillar 3, I think that disclosure should be fairly

granular, covering for instance valuation methodologies, parameters, exposures, durations and investment policies. We should also think about the roles of those who play a role of intermediaries, i.e. people who have the ability to digest granular information and can explain its implications to others (e.g. consumers).

- If one of the benefits of economic value-based solvency regulation is to provide a yardstick, then we need to come up with a more concrete image of it. By doing so, the level of commitment of the authority will be conveyed to the market participants and insurers.

- The purpose of solvency regulation would be to enhance management strategies of insurers. There will be no growth without some risk taking. As for the design of the new regulatory framework, we should send out a message that a strong commitment by the management is required. For example, if ESR falls below 100% every year, then it is not merely a matter of recovery actions, such as closing down offices. We also need to think about larger governance issues, such as the responsibility of the management.

- The average ESR for life insurers was 104% according to the field tests conducted in 2016. Interest rates have not risen since then, and it is now becoming a global trend. It is overly optimistic and risky to design a framework with an expectation that interest rates will rise in the future.

- I understand that life insurers are put in an extremely difficult situation now, and it would be punitive to impose an extreme measure on them in a short period of time. However, the situation may become worse in the long run if we do not address the issue appropriately. In light of this, it might be realistic to moderate the discount rates used in Pillar 1, for instance through partially incorporating the premiums on the asset side. On the other hand, the relatively loose elements in Pillar 1, including UFR, could be addressed under Pillar 2 more rigorously. Another idea would be to put disclosure requirements to enable external stakeholders to assess insurers' conditions appropriately.

- Life insurers were not able to match the durations of assets and liabilities due to legacies from the past, which led to the current level of equity holdings. They would likely be in a better situation had the ultra-long term bond market been properly established 10 or 20 years earlier. Considering that interest rates have continued to fall in the past, I think it is too late to insist that a significant increase in bond investment may cause a negative market impact. The new regulatory regime should give insurers an incentive to focus on economic value and implement robust ERM, as least for newly written policies.

- Even in situations where the yield curve flattens out, the EV and ESR does not drop that far when the UFR is used, which may lead to a false sense of security. In the holistic review of Solvency II in the EU, there are opinions that the starting point for extrapolation (LLP: Last Liquid Point) should be adjusted from 20 to 30 years. We should recognize that these risks are noted in the EU as well.

- If a calculation methodology is clearly stipulated, particularly for liabilities, it will be easier for insurers to conduct calculations and explain the results to third parties. The existing EV principles do not specify concrete rules for calculation. I think that some type of guidelines will be required if an economic value-based framework is introduced as a regulation.

- There are two objectives to economic value solvency regulation. The first is risk management and the second is the protection of policyholders. Insurers try to improve corporate value while controlling the risks. Meanwhile, from a standpoint of policyholder protection, risks may come first and then assess the sufficiency of margin – in other words, an insurer might be seen as prudent even if its margin (net asset) is small, as long as the risks are sufficiently small and covered by the margin). It is important to strike a balance between the two different viewpoints.

- 100% will be a regulatory minimum to be maintained when ESR is introduced as a regulation. Meanwhile, it appears that around 200% in ESR is seen as a norm (by third parties) in the context of Solvency II. Such situation may result in capital inefficiency

due to overcapitalization.

- Under the Solvency II framework, the 100% is merely a point where insurers are required to submit and implement a recovery plan. Stricter supervisory intervention is triggered when the MCR (Minimum Capital Requirement) is breached, which corresponds to a lower level of capital. Perhaps we will be able to dodge "unintended consequences" pointed out by some, by clarifying the role and level of the MCR when designing the framework.

- Economic value-based regulations focus on quantifiable risks. However, qualitative components also play an important role in the corporate value and risks in a broad sense e.g. human resources, reputation, or business practices that are not centered on customers. Pillar 2 and 3 should incorporate such qualitative factors as well. Insurers need to thoroughly explain those areas that cannot be fully captured and economic value-based methodology. Without this, life insurers on the path to recovery may be drenched in unfounded reputational risks.

- Consumers may become worried if the solvency ratio suddenly drops when transitioned into an economic value-based regulation. Measures for a soft landing might be needed. In addition, we should take a holistic approach, for instance through forward-looking assessment of insurers likelihood of recovery, so that the consumers are not panicked by looking at the level of ESR. For those who play a role of an intermediary between insurers and consumers, it will be necessary to devise a way to provide easy-to-understand explanations on these issues.

- When choosing insurance products, rather than looking at the solvency margin ratio, consumers sometimes also look at other indicators, including real net assets, fundamental profit, and credit ratings. I think it is important to devise better ways to present various indicators so that consumers do not become overly anxious.

- It would be ideal to incorporate a PDCA-type of mechanism in Pillar 1 to incentivize insurers to enhance risk management, monitored and supported by the authority.

- Some insurers already calculate and disclose ESR based on their internal models. Once a regulatory standard formula for ESR is stipulated, a debate may arise as to which metrics should be prioritized. We should not force insurers to solely rely on a standard formula even in the context of their internal risk management. While a certain level of comparability and transparency is required in a regulatory framework, it would be desirable if such dilemma could be resolved within Pillar 1.

- Pillar 2 needs to incorporate elements that are difficult to quantify or evaluate, such as emerging risks, as well as risks that should not be measured against capital, such as liquidity risk. The role of Pillar 3 will be effective governance on various elements covered under Pillar 1 and 2 through the dialogues with market participants and the authority, for instance through reporting and disclosure requirements similar to those under Solvency II.

- The regime might have shifted from the world where interest rates actually existed. We need to recognize what can and cannot be done in such an environment. We need to think about whether it is possible or appropriate to try to meet current consumers' needs in the market environment prevailing now.

- I am not convinced that an economic value-based regulation may hurt insurers' ability to earn investment income – we will actually see a different picture when looked through the lens of economic value. It may not be prudent to continue to pay dividends on the basis of seemingly sound (accounting based) figures, if the real corporate value has eroded.

- It is important to assess the potential for recovery under a stressed condition. We should note that life insurers may be able to take a fairly long period of time for recovery. While I understand that a temporary breach of 100% is not completely unacceptable, it might be received differently by third parties. Such reputational issue may be mitigated if we show an ESR as one of the multiple metrics for financial soundness (including real net assets), and market participants understand its implication appropriately. This is easier said than done, as it is sometimes quite

challenging to convey the message appropriately even within our company, as the agenda is fairly technical and complex.

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