(Provisional translation)

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

1. Date and Time: November 18, 2019 (Monday) 4:00 p.m. to 5:50 p.m.

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

3. Members: At this meeting, the following persons participated as observers, in addition to the original Members and Observers.

AKIYAMA Yasuhiro (Prudential Holding of Japan, Inc.)

IZUMI Sachiko (MetLife Insurance K.K.)

HISHIKAWA Maki （Aflac Life Insurance Japan Ltd.）

4. Minutes: Following an introduction of the International Association of Insurance Supervisors (IAIS) press release, "IAIS adopts first global frameworks for supervision of internationally active insurance groups and mitigation of systemic risk in the insurance sector" and a presentation by the secretariat, the discussions were held as below.

- It is wonderful that international regulatory authorities agreed on ICS Version 2.0, which was put forward by the International Association of Insurance Supervisors (IAIS). We should take that seriously, reconfirm what Japan should do in response to this initiative, and incorporate it into discussions at this meeting.

- I would like to thank the secretariat for putting together a concise and comprehensive summary of our discussions thus far. The most important point of this material is on page 3, which touches upon i) the significance of forward-looking risk management through the use of economic value-based asset and liability assessment, ii) an incentive for better risk management through a regulatory framework that is more consistent with insurers' risks management, and iii) the need for a proper regulatory and competitive environment while protecting policyholders through ensuring medium- and long-term financial soundness. It is important to reconfirm that we introduce an economic value-based regulation because it is an effective approach, as we have discussed thus far.

- As for the schedule, the point is that the new framework should be introduced as soon as possible given its significance. We should make a decision to introduce it by 2025. ICS version 2.0 already sets a trajectory, including technical details, and we will not see any dramatic changes from here. It is crucial to prepare a working plan assuming the introduction in 2025, while considering the need for adjustments to factor in the characteristics of the Japanese market.

- Major Japanese insurers already utilize internal models, as do many of the peers in the other developed markets. As pointed out in the secretariat's material, it is vital that we take a positive stance toward the use of internal models, while paying attention to the issue of resource needs.

- Since the IAIS will not hold discussions on the MCR, it is an important point for discussion to be covered by the Council. Other key issues may include the treatment of climate risks under Pillars 2 and 3.

- In my view, there are three key points. First, everyone must clearly agree on introducing an economic value-based regulation. Second, a schedule needs to be established with a deadline for introduction. And the third point is resources. Over the next few years, both insurers and the authority have to assess the resourcing needs required for the new regulatory framework, and secure adequate human resources and budgets.

- The schedule for the introduction is important, and I fully understand the need to clarify the specific deadline (such as 2025), for steady preparation for the new framework. Meanwhile, even though the ICS is nearly finalized, it may ultimately not go as planned due to conditions in the US. In that case, insurers may need to allocate additional resources (including for IT systems), and/or realign their product and investment strategies that have been initially implemented. Even if the deadline for introduction is set to 2025, it will be desirable to reassess the situation 2-3 years prior to the introduction, taking into account the global developments and the results from the impact study by the IAIS.

- Insurers in the US may adopt the aggregation method, while European players will continue to implement Solvency II and claim its equivalence to the ICS. In light of this, we need to consider two different scenarios: the first is where the ICS is adopted as a uniform global standard, and the second whereby regulations in each country are loosely connected based on equivalence with the ICS. If we assume the former, we need to work on reflecting the elements that are necessary in the Japanese framework in the ICS as well, as IAIGs would like to avoid dealing with differences between international and domestic regulations. On the other hand, in the case of the latter scenario, domestic regulations in each jurisdiction will be permitted to some extent. Accordingly, we should develop a regulatory framework that properly reflects the characteristics of the Japanese market, within the range of equivalence with the ICS. Nonetheless, in either scenario, I agree that the domestic rule should be based on the MAV approach of the ICS and make necessary adjustments on top of it.

- I agree that the material by the secretariat is compelling. Page 3 of the material explains the significance of forward-looking management through the use of economic value-based asset and liability assessment. It cannot be stressed enough that we recognize the appropriateness of an economic value-based approach. Several compromises had to be made in the ICS during its negotiation process. In light of this, we should not simply mimic the decisions set out by the ICS, but always think about better alternatives.

- While it may be true that we should not proceed hastily with the introduction of the new regulation, we cannot move forward without having a concrete timeline. Given that we already envisage a direction to take, we need to establish a timeline for preparation and implementation.

- Page 13 of the material proposes to mainly concentrate on the prudential issues within our discussion on Pillar 2. However, it would not make sense if solvency is assessed on an economic value while other managerial decisions are based on completely different metrics. I think it is beneficial to discuss risk-based corporate management, not merely a solvency assessment, and to incorporate such perspective into Pillar 2.

- I am very much in agreement with the overall directions indicated in the material. However, from a practical standpoint, I think it needs to be decided early on whether we aim for introducing the pure ICS as a domestic regulation, or introduce a regulation that is equivalent to the ICS, as it may lead to a major rework. In addition, in the event that the ICS and domestic standard differ, insurers may face an excessive burden and operational inefficiency.

- There are three major issues that must be considered moving forward. The first is IT infrastructure and human resources. While there might be some differences across insurers, it will likely take around 2-3 years to carry out preparations. It is an issue that requires decision making at an early stage, including on the budgeting, planning on personnel and a governance system. The second is the response by small and medium-sized insurance companies. For instance, we need to recognize that internal models require substantial labor and manpower. The third is how to inform policyholders. Since ESR varies greatly with the current Solvency Margin Ratio (SMR), its interpretation could be challenging, which should be considered in our timeline. In any event, I recognize the importance of a timeline, to tackle various issues to achieve our ultimate goal.

- I am very much in agreement with the overall direction of the material, but would like to comment on some minute details. Page 3 of the material states that one goal is "to ensure consistency between the regulatory framework and insurers' risk management." Given that the level of risk management varies from company to company, I interpret this to mean "developing the framework while taking into account the consistency between the regulation and insurers' risk management." As for an incentive for insurers to enhance their risk management, insurers would need to develop a risk management framework which could respond to emerging risks, including climate change and terrorism, which should probably be covered under Pillar 2. On the other hand, the quantified amount of risks may increase if these risks are measured through internal models. We may need to think how to link this to insurers' incentives.

- To make progress on this project, it is critical to move forward along with a concrete timeline, and modify the direction as necessary.

- As ESR cannot be calculated based on J-GAAP-based financial statements, it is necessary to prepare separate economic value-based balance sheets, which could be burdensome for insurers. I believe there is leeway for reducing resources and workload by taking into consideration the further developments in accounting standards.

- The material explains that the MCR is equivalent to 0% in the SMR under the current regulatory system, while it corresponds to 25-45% of the PCR (SCR) under the Solvency II. I wonder if the MCR provides no buffer if the MCR is set at 0%.

- I believe that the purpose of Pillar 3 is to promote market discipline through disclosure. The frequency of disclosure is important from the viewpoint of workload and resources. As economic value-based indicators fluctuate reflecting the economic environment, it is the key for supervisors to have access to the timely information. On the other hand, it is also important to consider balance between the frequency of disclosures and the lead time required for disclosure.

- I am very satisfied with the material. I agree with the importance of spelling out a clear timeline. Page 6 of the material mentions the equal footing with other jurisdictions, but some of them, such as Europe and Australia, have already introduced an economic value-based regulation. Even if we have not yet done so, we need to ask ourselves whether it is appropriate for insurers to focus on long-term businesses, which is more challenging for ERM. From the viewpoint of those investing in Japanese insurance groups, it is important to ask if the situations in other jurisdictions could really be used as an excuse.

- As for Pillar 3, the Solvency and Financial Condition Report (SFCR) in the Solvency II is very detailed. While I do not insist on having exactly the same requirements in Japan, investors will demand fairly detailed information, including sensitivities and a breakdown of risks, under an economic value-based regulation. Listed companies are already voluntarily disclosing ESR, EV, and other indicators. But investors are finding it difficult to utilize when they are not properly explained. Moreover, as an economic value-based regulation could be burdensome, many companies may stop disclosing EV reports under the new regulation, as has happened in Europe. If that is the case, insurers should also disclose under the new regime at least the information that is covered in EV disclosure, such as sensitivities and movements in the numerator and the denominator. By the way, page 14 of the material touches upon a potential burden of insurers related to disclosure. While I understand that consideration could be given to unlisted companies and branches/subsidiaries of foreign insurance groups, I would like to emphasize that disclosure is of the utmost importance for listed companies.

- Many mentioned the challenge in explaining ESR to policyholders, but I think this could not be an excuse to delay the implementation. We faced the same challenge when the current SMR was introduced. The current SMR could be misleading in some cases, and it does not adequately capture some of the important risks. Higher SMR does not automatically mean better, which should also be the same for ESR. I do not view challenges related to explanation to policyholders as a constraint for introducing an economic value-based regulation.

- I think it is vital to set a clear target date of 2025. It could be interpreted as a necessary period for transition and preparation, rather than the alignment with the schedule of the ICS.

- It appears that there was no getting around the discussion of the aggregation method in the US, as they have many small insurers. If our discussion is based on the ICS, we need to hear views from small and medium-sized insurers.

- Regarding the framework for validation of insurance liabilities, we need to decide how to clearly divide up the tasks ahead, for instance between this Council, the Institute of Actuaries of Japan, and various testing exercises going forward.

- Pillar 3 is not merely a disclosure requirement. Under the economic value-based framework, it will be necessary for companies to disclose the reality regarding risks and buffers, which will be beneficial for investors. In addition, consumers will not be able to select insurance products if these points are not clarified. There is a possibility that the details disclosed to stakeholders will be nearly the same as those submitted to regulatory authorities. However, it may not be comprehensible if such granular information is directly disclosed to consumers. There need to be parties that play a role of intermediary. Relatedly, consumer education is also an important issue.

- The material clarifies the significance and timeline for the economic value-based regulation, and contains several significant points. From the perspective of economic value-based risk management, the differences in the methods of risk control is an important issue. Risks can be controlled either through the loss absorption capacity of capital, or transferring or replicating the risk via hedging or ALM. Each insurer's style of risk management could differ, depending on which of the two is emphasized. For instance, it would not be appropriate to use an artificially generated yield curve, including UFR, if an insurer takes a hedge-based risk management strategy. It might be less problematic if an insurer's strategy emphasized capital rather than hedging.

- I assume that there will be some inconsistency between the internal models and the regulatory model---if all insurers completely align the internal model with the regulatory model, this will hinder the momentum of enhancing risk management. Thus, I view the discrepancy between the ICS, internal models and domestic regulation not as a huge problem, but something to be tolerated. In addition, the material states that supervisory measures at the PCR should not be excessive. If it is the case, it would be even more important to support the momentum of enhancing risk management and internal models at each company.

- I think the biggest concern for insurers is reputational risk due to the fluctuation of ESR, where the disclosure of ESR has started. If so, insurers need to carry out various preparations to improve their capability to control ESR. In that regard, a clear timeline would be key. While the development of IT infrastructure is important, the critical point here is to enhance their ALM and ERM to improve their capability to control ESR.

- Page 11 of the material explains the net real asset is an "indicator to assess whether the company has sufficient funds to offset cancellation refunds in preparation for policy cancellations when interest rates rise." In the past, not even half of policies were cancelled, even at defaulted insurers. In light of this, I think it is too strict to measure total assets against total refunds for policy cancellations. Also, the possibility of negative real net assets could be a concern when implementing internal risk management that focuses on hedging. In this case, simply disclosing the real net assets could trigger reputational risks and could potentially put the brakes on the enhancement of risk management.

- At present, in the US various system revisions are being undertaken in accounting standards and PBR (Principle Based Reserving). Taking this trend into account, the allocation of resources is also an issue for US insurance companies. Decision-making and internal management inevitably become more complex when a variety of yardsticks emerge. I am concerned that the lack of consistency between them may slow down the enhancement of internal management.

- US insurance companies mainly invest in corporate bonds. Noisy market prices of those assets was a problem under extreme market events, such as in the Great Financial Crisis. Keeping this in mind, there is still room for debate on the appropriateness of economic value-based regulations for insurers.

- We need to take a stance on whether we should proceed with our own methodology, even if it means inconsistency with the ICS, or work with the IAIS to make corrections to those areas that do not fully incorporate the characteristics of Japan's insurance industry. Specifically, from a technical viewpoint, some of the risk factors for insurance risks issued by the IAIS are excessive. For instance, we need to check whether the parameters for lapse and expense risks are appropriately reflecting the reality of the Japanese market.

- Once an economic value-based framework is put in place, it will be necessary to take into consideration how the rating agencies would react, from the perspective of providing information not only to investors but also consumers. The IAIS has decided to conduct an impact study from 2023 to 2024. I believe the focus and timing for a similar exercise in Japan is a topic of discussion.

- When calibrating risk factors unique to the Japanese market, the volume of products could be substantially different from company to company, for example in the case of the third-sector insurance market. We may need to come up with a methodology to factor in the characteristics of an individual company, for instance through some form of weighting.

- I fully agree with the opinion that Japan should move forward with an economic value-based regulation, regardless of how the IAIS proceeds with ICS. Meanwhile, the IAIS plans an impact study before the adoption of the ICS as PCR, while US regulatory authorities are not likely to require IAIG members to submit ICS data during the monitoring period as long as the aggregation method is approved. Under these circumstances, I think that we should carefully move forward with the timeline, while taking into account the developments related to the ICS during the monitoring period.

- It appears that many important points are taken under consideration for the discussion of supervisory measures on the material. However, in cases where a recovery within a specified period is required, its length should be a reasonable one, using Solvency II and other international frameworks as a reference.

- It is often argued in the US that insurance oversight is not just a quantitative requirement such as capital requirement. For instance, nearly all of 300 pages of the ComFrame focus on qualitative oversight. In light of this, Pillar 2 and 3 might be more important than Pillar 1.

- The aggregation method has been discussed in the US, owing to the wide base of the US insurance industry. There are over 2,500 non-life insurers and over 800 life and annuity insurers, including both large and small companies, and global and local companies in each category. They compete against each other to meet their own consumers' needs within each state. My impression is that they tend to see the ICS as a one-size-fits-all set of regulations, which may negatively affect the competitive environment in each state.

- In the US and Europe, the capital regulation is sometimes viewed as part of the wider public policy framework, for instance from the standpoint of the insurers' ability to meet consumers' needs, and the global competitive environment. Similar perspectives could be important in the domestic context as well.

- Even if the net real assets were excluded from solvency regulation, statutory policy reserves would likely be retained as is. The framework is not likely to be effective unless a certain degree of consideration is given to accounting-based matters.

- At present in Europe, a review on the disclosure framework of Solvency II is being conducted. One of the proposals is to make a distinction between the policyholder section and the non-policyholder section. This is based on experiences in Europe, which we might be able to use as a reference.

- There are various discussions being carried out ahead of the review of Solvency II in 2020. When the new regulations are in put in place in Japan, it might be reasonable to put some review point after the implementation in 2025, based on the experiences up until that point.

- Under the new framework, it is important to maintain a multi-faceted supervisory framework that does not rely solely on economic value-based indicators. I think the real net asset could be used as one of the tools in doing so. Even if the net real asset regulation is abolished, we should secure a multi-faceted supervisory framework, including a standard policy reserve and a product licensing system, so that judgments do not solely rely on economic value-based indicators. While some of the other members pointed out that the current regulation is lax, which is indeed true (compared with economic value-based ones) given the low interest rate environment. However, as interest rates rise, economic value-based indicators will become more optimistic. We cannot rule out the possibility that insurers will not be able to secure the surrender value for their policyholders under such circumstances.

- I have no objection as long as an appropriate timeline is set, factoring in the opinions of various stakeholders. However, given that there are cases that have shaken the trust of policyholders, we need to carefully convey the information and message to policyholders.

- Insurers are likely to deploy various models and approaches regarding the valuation of insurance liabilities. Thus, the guidance cannot focus on a single approach. It would be counterproductive if the guidance hindered insurer's efforts and the PDCA cycle to enhance their approaches. We need to establish a framework that could reflect the characteristics of each insurer. Meanwhile, some insurers may struggle in preparing a validation report of insurance liabilities (which is being prepared as a part of the recent field tests) without detailed instructions, and it would make sense to provide some support for them.

- I think it is important to set a timeline to carry out more in-depth discussions and to proceed with preparations. Product development, investment strategies and insurance portfolios could be among important issues, in addition to the capability to calculate the figures, from a standpoint of insurers' preparation. In doing so, it would be counterproductive if some of the existing rules were pointing in the opposite direction to the ESR. On the other hand, assuming that the current accounting framework will continue to be employed, we also need to examine what the necessary rules in terms of accounting are.

- The calculation of the ICS covers material entities within a group, rather than all the subsidiaries. If all the entities need to be covered, just as with the current consolidated SMR calculation, the benefits might be too small compared with the burden regarding the actuarial operation and resources required.

- I think it is a very good idea to conduct necessary adjustments to domestic regulations based on the MAV approach of the ICS. The treatment of the overseas subsidiaries might be one of the topics in doing so.

- During the life insurance crisis around the year 2000, small and medium-sized insurers, regardless of whether their management was sound, experienced a large volume of cancellations simply because of their size. Thus, reputational risk associated with a volatile ESR is one of the psychological brakes for insurance companies. Under Pillar 3, one of the ideas is to promote the expansion of voluntary disclosures. Meanwhile, the resilience to come back from a crisis is an essential point to be disclosed and explained. Also, insurers need to disclose to their stakeholders how they assess and mitigate catastrophic risk during normal times, as well as the number of years it will take to resume a healthy level after undergoing a crisis. I believe that these efforts will be effective in mitigating reputational risk.

- The material suggests that Pillar 2 mainly focuses on the prudential issues. However, governance and corporate strategies are largely tied in with the emergence of risks, as in an increase in complaints, or conduct risk. For instance, picking strategic run-offs, such as those performed by Generali in Europe, as a key point, I think management decisions that are not compatible with policyholder interests can be avoided.

- The timeline for the future will change, depending on whether the ICS will be used in Japan as it is or whether some overlay will be introduced. As the risk factors for third-sector products in the ICS were revised as a result of data submission by Japanese insurers to the IAIS, I think it is important to understand how the data can impact methodologies going forward. IAIGs need to deal with multiple standards, such as the domestic regulation, the ICS and their internal risk management. In light of this, we need to think of what Japan needs to do to ensure consistency between them. Going forward, I believe it is important for Japanese insurers to work on the IAIS to get them to improve their methodology.

- The IAIS plans to release the results of its economic impact study in 2024. Should a major issue be uncovered and revision be implemented, we will need to change the direction we are taking for preparations for introduction in 2025. This will entail substantial cost and time. I think this timeline should be taken into consideration.

- The goal of the introduction of an economic value-based regulation is forward-looking corporate management through the use of economic value-based assessment and the elimination of obstacles hindering the enhancement of insurers' risk management and ALM. I do not think that the timeline is necessary if we have already reached an adequate level, including with ORSA, and there are no concerns in Pillar 2. However, my impression is that the insurers are still struggling with in-depth utilization of an economic value-based approach in a managerial context. One of the reasons behind it is likely the introduction of economic value-based regulation, which has been on the table for a while but has not yet been finalized. If there is a sense that things are moving somewhat slowly, then it is essential to clarify a timeline. While we should not move forward hastily, I think it is okay to be high-spirited and try to lead the way in global discourse, as long as we agree on an overall direction. I believe the authority have the sufficient resources and power to provide direction, not only Pillar 1, but also in Pillars 2 and 3, to carry the discussions forward.

- It has been clearly decided that the MAV approach will be adopted in the ICS. I think it is important to decide which direction Japan wants to take. We recognize the significance and objectives of the economic value-based framework. I believe it should be clearly stated that we aim for an early introduction, in other words, the introduction of regulations in 2025.

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