(Provisional translation)

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

1. Date and Time: January 20, 2020 (Monday) 4:00 p.m. to 6:00 p.m.

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

3. Minutes: At the beginning, following a presentation by Member Morimoto, the discussions were held as below.

- I have no objection with requiring MOCE. I also understand this can be used as a source for dividends, as compensation for capital. However, opinions might be split over whether it is really appropriate to use the assumption that these are paid out entirely as a reason for recognizing MOCE as a liability and not deducting it from required capital. If there is no distributable profit, then voluntary or other surplus will be drawn down to create capital that can be distributed as dividends. Given that prudential regulations mainly aim for policyholder protection, it is questionable whether such a strong premise is required. Stronger reasoning is likely necessary to back this up.

- As mentioned on page 1 in Material 1, I believe the statement "MOCE is an essential line for insurance liabilities in a market consistent valuation" is correct. In addition, in the event that foreseen risks arise, an MOCE, not just a best estimate, will be required to fulfill the obligations of the insurance policy. This is essential from the standpoint of the exit value to transfer the policy. It is my understanding that ICS is based on this type of design concept. With that said, from the viewpoint of an insurance company, it is too strict as a capital regulation if a MOCE is required to fulfill the obligation of insurance policies even in a crisis situation. The opinion from the industry is that the portion covered by required capital and the portion covered by MOCE differ, and it is unnecessary to require MOCE in the context of capital regulation.

- The cost of capital method would also entail technical discussions, such as the possibility of circular calculation if MOCE is subtracted from capital. Although it may be a minor issue, I think it would be easier without such interdependencies from the standpoint of simplicity.

- During a previous crisis that hit Japanese life insurance companies, there was no buffer for transferring insurance liabilities (policies), making it difficult in practice to transfer them. We are discussing the design of a capital regulation, and I think that MOCE should be considered as a buffer when transferring insurance liabilities, which entail uncertainty. Various discussions have been carried out at the IAIS as well on MOCE, and it was decided that MOCE is calculated using the percentile method and included in liabilities. There are various opinions worldwide on the theoretical interpretation of MOCE, and I do not think we can reach consensus in this group either. What is important is the understanding in international arenas that MOCE is included in liabilities. This outcome should be supported from the viewpoint of regulatory practices as well.

- As I mentioned at the previous meeting, when looking at capital regulation as a going-concern basis, such as in the PCR, MOCE should be maintained until the next fiscal year. If risk (required capital) is adjusted for MOCE, it is possible to factor it in loss compensation for a single fiscal year. However, it may be difficult from a practical standpoint. In addition, when considering cases where adjustments for one fiscal year are made to reflect compensation for loss, given the loss experienced, the starting point from which risk is assessed is lowered. Therefore, when reevaluating MOCE, there is a possibility that the MOCE will be larger than the in the case of simple adjustment for one fiscal year. Especially when considering a multi-year policy, a requirement necessary for PCR is to require MOCE in full without adjustment. Discussions focusing on liquidation criteria that allow the elimination of MOCE is basically more related to the MCR.

- If an insurance company facing financial woes is to receive insurance policies transferred from another company, this does not mean that the MOCE portion is not necessary. Rather, MOCE is essential during times of management difficulties. In reality, when an insurance company is undergoing bankruptcy, there are certain difficulties when it comes to transferring policies without MOCE. If no consideration is given to MOCE, then an alternative needs to be devised. Even when some mitigation measures are permitted, it would be nothing more than an alternative to MOCE. At the very least, as a base for considering regulations, MOCE should be included in liabilities.

- Regarding its relation with MCR, when considering bankruptcy procedures that closely approach liquidation standards, a concern is whether an unnecessary additional burden will arise by not taking MOCE into consideration. I do not have a clear answer yet, but MOCE might also be necessary at MCR as well.

After that, following presentations by the secretariat and Observer Miyazaki, the discussions were held as below.

- The direction of this group has basically been determined, thanks to the discussions carried out thus far. The relation of domestic regulation with the ICS continues to be an issue. However, matters related to the ICS should be discussed at the IAIS.

- It is vital to reinforce the system for verifying the sufficiency of insurance liabilities when introducing an economic value-based regulation. We may be capable of preparing their own guidelines on the calculation of insurance liabilities. However, actuaries need to play a major role in determining how the guidelines are operated. In light of this, the professionalism, independence, and governance to ensure independence of actuaries are even more important. Accordingly, it is necessary to establish a framework for this purpose.

- I think the UFR of the ICS is too high given the current situation in Japan. Up to now, we have carried out discussions on the handling of UFR in Pillar 2, instead of Pillar 1. Rather than having companies make independent decisions under Pillar 2, the regulator should establish firm standards. It is vital to make Pillar 2 as solid as Pillar 1, so that each company will recognize a sufficient level of insurance liabilities.

- This study group should discuss whether to introduce an internal model for the regulation, on which I am positive, and if it does, it would be appropriate to take a gradual, step-by step approach while conducing dialogue between the regulator and the industry. As stated in the secretariat's materials, natural catastrophe risk should be the priority, and the scope should then be extended in stages to insurance and market risk assets. I think this proposal is feasible. What is important at that time is to establish a capacity and resources that allow the authority to monitor internal models. I think that prior examples, such as those in Europe, will be helpful. Furthermore, it is necessary to establish insurers' capacity and governance structure to verify the internal models. The difficulty is that actuaries and auditors work on compensation paid by the company. Therefore, there is a concern as to whether or not a full level of independence can be achieved. I therefore believe that the regulator plays a key role as the last stronghold in the validation of the internal models. If the internal model is allowed, discussions should be carried out on whether a floor (minimum value compared to the required capital of the standardized model) should be set. We need to consider whether or not to accept a model with a low capital requirement, about 50% or 60% of the standardized model.

- I agree with the direction for a step-by-step approach for the internal model framework. When using an internal model, the disclosure of its contents is very important. In addition to explanations by the insurance company to the regulator, there also should be disclosed information that can be understood by professionals, including in which categories the internal model is applied and how it differs from the standardized model.

- The timeline in Material 2 states 2022 as the deadline for "provisionally deciding on specifications." Regarding this, the details of discussions up to the previous meeting have been factored in, and I understand that this may not be limited to technical aspects. For example, as for the vision for 2025, in cases where the aggregation approach in the US and the Solvency II regime in Europe are loosely linked to the ICS, it may be necessary to consider regulations that are more suited to the Japanese market. In light of this, it is my understanding this is close to meaning that "another review will be conducted."

- The direction of gradually and carefully expanding the scope of the internal model is highly realistic. Thinking about the future, I think it is desirable to allow full internal models. But it is not likely that the ICS will adopt such a step-by-step approach. Insurance companies in Europe have already fully introduced internal models, and such a fair amount of human and system resources have thus already been injected. If internal models are approved under ICS, I think that European companies will call for the full internal model approach, given this advantage. Meanwhile, it is not easy for Japanese insurers to invest a large amount of capital to be able to compete against them in a short period. Considering this situation in Europe, we should carefully discuss internal models in the context of the ICS.

- I agree that it is necessary to conduct a certain degree of screening for the vendor model and proprietarily-developed model, as shown on page 11 in Material 2. In the field of accounting audits, when information on the market value of securities and other financial instruments is obtained from vendors, certain procedures will be required. In light of this, I believe, certain procedures should also be carried out for employing the vendor model, for the purpose of solvency regulation.

- When performing validation, in addition to the model governance, the underlying data governance is also important. When actually creating a model, a correct model cannot be developed if the data is not correct. I therefore think it is better to also include perspectives from data governance.

- Governance can be broadly divided into internal and external governance. Internal governance must be organized, including internal conflict of interest, and internal independence of management and actuaries. Otherwise, even if a company claims a governance system is in place, it is nothing more than a pie in the sky. The market plays a crucial and indispensable role in external governance. Disclosures are not only for market participants but also for customers. Discussions going forward should focus on how to convey to customers those matters that are difficult even for market participants to assess, including whether premiums are appropriate and the financial soundness of insurance companies.

- I agree that we should embark on the introduction of a framework for an internal model. However, we need to clarify at what level insurance companies will use a partial model. I think it is desirable for market participants, customers and the regulatory authority to be able to grasp this at a glance. I also think that insurance companies should indicate the level of standards they aim to achieve in the long term. I also think a deadline should be set for achieving these standards.

- Regarding the statistical quality test for the internal model on page 13 of Material 2, it is suggested that the authority performs a comparison (of calculation methods and calculation assumptions of each company). However, given that the internal model will be adopted because each company is in a different situation, I wonder if there is any meaning in performing such an exercise. Also, as was the case in the UK, it is doubtful whether each company can properly explain the differences between itself and other companies to the authorities without understanding the overall picture. For this reason, the authorities should not primarily focus on a side-by-side comparison of internal models, but rather a clear recognition and clarification of what timeline they are planning, where they are heading to and where they are currently located.

- If we go in the direction of introducing a full internal model, the authority is the final key as a checking function for the internal model. Insurance companies use an internal as well as external validation function, including auditing companies, to verify internal models. As long as the authority steps into the details where necessary, as they do in Europe, then sufficient discipline will be imposed to make the overall framework effective. Some of the insurance companies in Japan are also acquiring foreign subsidiaries. As such, thought must be given to how to employ the validation function for the entire group; otherwise, there will be inconsistencies within the group when the internal model is introduced.

- Some may think that economic value-based indicators reflect fair market value. However, I think it is vital to note that it should also properly reflect the condition of an insurance company. From this viewpoint, the internal model is useful in terms of expressing the expert judgement being implemented by each company. It is essential to take into account the resources of both insurance companies and the regulatory authority. However, I think it is important that those companies that wish to use an internal model receive as much support as possible.

- There are difficult aspects in the actual operation related to validation. They might face challenges in cases where values change substantially due to a change in assumptions for calculating insurance liabilities. These points are difficult to identify through external verifications. In light of this, it is important to figure out an approach to perform an internal verification based on a PDCA cycle.
- There are limitations to calculating an economic value. Because of this, I think that discussions must be held with the authority prior to or when PCR or MCR are breached. Without this, I think the regulatory framework will not function properly.
- One of the issues to consider when introducing an economic value-based regulation is whether current rules will go against it or become restrictive, and if so, what actions should be taken.
- It is very difficult to acquire the skill to control ESR, in addition to its calculation itself. The systematic and step-by-step alignment of an economic value-based regulation with fundamental profit and net real asset regulation will serve as practical training for the capacity to control ESR. I think plans should be made during the upcoming preparation period.
- Page 6 of Material 1 presents an opinion on the calculation of the discount rate, which was stated at the previous meeting of the Council—"stocks can be liquidated in conjunction with liability cash flow." However, a large transaction on individual shares could be difficult. In addition to the large impact on the market, it takes a considerable amount of time to execute sales requested to a broker-dealer. Consequently, it is better not to assume that the individual shares held by an insurance company could be liquidated easily to match liabilities. Also, if the holding of stock affects the discount rates, it can trigger regulatory arbitrage.
- When considering the use of an internal model, we should secure comparability so that Pillar 3 will function effectively to offer adequate market discipline. We should handle it

carefully, especially for an internal model for highly common risk categories. As stated on page 11 of Material 1, it is reasonable that market risks is the last area in which to introduce an internal model.

- Adopting UFR impairs the natural dynamics of the yield curve. Even if the most outstanding vendor ESG (Economic Scenario Generator) is employed, there is always the possibility of a synthetic error if these are used in combination. Conversely, not using UFR could potentially be a benchmark for the approval of an internal model for market risks. This also aligns with the direction for enhancing economic value-based risk management. In such a case, the issue is how to provide an incentive to enhance internal management. But, internal management should be enhanced by each company independently of a regulatory framework. The essential advancement of risk management cannot be expected if an insurance company is merely interested in reducing regulatory capital requirements and saving development costs. An internal model that does not use UFR will shift risk management from a "capital-oriented" approach, which is assumed for the standard model, to a "hedge-oriented" approach, which is more challenging from a technical standpoint. This is consistent with the direction of enhancing capital efficiency and ESR control capabilities. Such incentives can only be expected from Pillar 2 and Pillar 3. The use of an internal model for market risk as offered in Pillar 1 can become an incentive if the model is received as a type of status symbol.

- Introducing an internal model to improve risk management is a positive step. Nonetheless, depending on the method of disclosure that is employed, it is possible that consumers will interpret this incorrectly as an insurance company using an incomprehensible model introduced from outside the company. Consequently, when introducing an internal model, it is desirable to disclose what areas this model will enhance and what types of management and a proper system of checks is adopted.

- As others have commented, instead of using an internal model to lower regulatory hurdles (by reducing required capital), it should aim at enhancing risk management. Management should first recognize that this is for the benefit of the company, and the authority should provide support. At this meeting, it is important to confirm the direction, including the significance and the objective of introducing the framework for internal models. As pointed out by other members, another key issue would be the timeline for implementation. If this is something that Japan should introduce, then it should be decided what needs to be accomplished by 2025. The establishment of capacity will be important when carrying this out, and the authority should embark on it as soon as possible.

- I believe that the internal model can be approved to a certain extent from the perspective of understanding the view on risks held by each company. However, I think it will be very difficult to conduct a cross-sectional comparison, including fully realizing technical consistency. In that respect, I think it is also a possibility to manage internal models under Pillar 2 while relying on the standardized model Under Pillar 1. First of all, the standardized model will likely serve as the greatest common divisor. The model will be prepared by reflecting the calibration by insurance company (based on historical data). Areas that are lacking in Pillar 2 will be covered by the internal model in Pillar 2, based on dialogue with insurance companies. Also, there should also be a mechanism for feedback on the best practices and other information obtained from dialogue on the standardized model on a regular basis.
- For example, the design of dynamic policy surrender models differs across life insurers. Ideas about areas other than the internal model differ by company and are not always consistent.

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