Financial Services Agency

(Provisional translation)

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

1. Date and Time: February 13, 2020 (Thursday) 10:00 a.m. to 12:00 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.

KISHIMOTO Iwao (Lifenet Insurance Co.)

MOMOSE Yumiko (Anicom Insurance Inc.)

4. Minutes: Following presentations by the secretariat and Observer Miyamoto, the discussions were held as below.

- Drawing a line at 2022 in the timeline on page 9 of Material 1 clarified action plans for the future. In addition, it became clear that we do not have much time before 2025. The preparation for the new framework, including preparation for the approval process of internal models and validation framework, requires a great deal of time. In light of this, it is important that once this Council sets an overall direction, the authority pushes forward with preparations as quickly as possible for the remaining technical issues, so that they take shape to a certain extent by 2022.

- The introduction of an economic value-based regulation makes the role of actuaries even more important. However, the governance of actuaries is very difficult. Overseas, there have been cases where actuarial misjudgment has caused an insurer to go bankrupt. Some of the judgments by actuaries cannot be understood by anyone other than an expert. I think an important theme here is how to build a solid governance system while respecting the expertise of actuaries.

- Page 13 of Material 1 mentions the issue of resources for the validation function. It would be a huge problem if the validity of liabilities, which is one of important cornerstones of risk management, cannot be ensured internally at insurance companies and thus has to be outsourced. As other members pointed out at the previous meeting, the authority is the final backstop in this process. As such, the authority also needs to establish capacity and resources to check the validity of insurance liabilities. It is important for an insurance company to have solid internal governance so that they can conduct verification internally. However, given that internal validation may have limitations, it is also essential to build a framework where external actuaries conduct verifications. In the final stage, the authority needs to check the validity. The overall framework for validation will require multiple layers.

- Page 3 of Material 1 states that consideration will be given to the "adjustment of risk factors and subdivision of risk categories." In addition, the treatment of long-term non-life insurance, which is not reflected in the ICS, should also be examined.

- "Adjustments related to solo regulation" on page 4 of Material 1, is a key issue that should be considered going forward, given its impact mainly on the branches/subsidiaries of foreign groups that operate in Japan.

- The calculation method for MCR is discussed on page 8 of Material 1. If it differs dramatically from PCR, it may give rise to anomaly cases, for instance where MCR is breached before PCR. While some adjustments could be made to MCR, such as items to be excluded from calculation, a certain degree of consistency is required between PCR and MCR.

- I am very much in agreement with the vast majority of Material 2. It cannot be denied that the operations will become more challenging than under the existing regulations. However, the calculation of future cash flows from insurance products is crucial, and management and stakeholders will not be convinced merely by the calculation stipulated in the existing regulations. One of the goals of introducing an economic value-based regulation is to contribute to better risk management, and a validation framework would also be part of it. It is challenging and resource-intensive, but not everything should be outsourced to third parties. Working toward the 2025 deadline, I think it is necessary to strengthen in-house verification capacity, while borrowing the strength of external resources.

- Page 16 of Material 1 mentioned that "there are expectations as a communication tool with management." There is a problem if it is not used even at this point in time. To raise awareness (for an economic value-based approach), it is vital to clearly show the direction towards an economic value-based regulation.

- Page 3 of Material 1 asks whether it is "necessary to release a certain degree of detailed information from the perspective of enhancing transparency during the examination process." We need to consider how receptive the market will be to disclosed figures, including from an educational viewpoint. In conducting external validation, it is important to consider what types of discussions were held and what ideas were exchanged in the process of developing a regulatory framework. A key factor for successfully introducing the framework is information sharing. This not only includes insurance companies but also external experts and others involved with the framework. The scope and extent of information disclosure during the preparation period needs to be taken into consideration.

- As was with the comments made by other members on the MCR, if an economic value represents the actual condition of insurers and PCR is set in accordance with this, MCR will also better express the economic reality if it is set as an extension of PCR. Meanwhile, in the event of an actual bankruptcy, there will be impact from accounting-based financial statements, which may be at odds with MCR if the latter is based on fair value. It is not clear if the framework would function properly in a case where a company does breach MCR but is not legally bankrupt, and funds drop below the run-off threshold and corresponding supervisory measures are applied.

- In the timeline on page 9 of Material 1, during the time up to 2022, it proposes "checking the effectiveness and validity of adopting the same methodologies for both PCR and MCR via a field test.'' In this process, there is a possibility of running out of time, unless we also examine other possibilities as well by 2022 and perform refinements as necessary thereafter.

- Page 13 of Material 1 explains the independence of the validation function. Independence is also critical in the world of accounting audits. On the same page, similar to this, is the "expectations in the professionalism of actuaries." However, independence is not visible and cannot be guaranteed. In light of this, the framework for accounting audits emphasizes the independence in appearance as a form of assurance (I.e. does not have an important connection with clients, including economic ties). The independence in appearance would also be important when economic value-based figures are used not only for management but also for third-parties, i.e. markets and regulators. It is necessary to have a multi-tiered structure to ensure validity, including a person who performs the calculation, a person who conducts checks internally, and a person who conduct external validation. It is important to develop a framework that is immune to biases, particularly where calculation is principle-based and the results could vary.

- Page 14 of Material 1 mentions the "possibility for a company that has voluntarily adopted IFRS to perform an efficient validation based on an IFRS accounting audit." I do believe that, to a certain extent, it is possible. However, there are limitations as the application of IFRS is voluntary in Japan, and it will only be applicable to consolidated financial statements. In all likelihood, accounting auditors will not state their opinion on solo-based IFRS financial statements. If the goal is to achieve a certain degree of efficiency, then, consideration needs to be given to requiring solo-based financial statements to undergo external validation. Note that with the Solvency II regime in Europe, a number of countries have actually developed a framework for external validation. Taking into account the development of the ICS, I hear that some of the countries that are currently without an eternal validation framework also plan to introduce one. I believe that the importance of external validation is being recognized.

- Regarding the validation framework, it seems realistic for the Institute of Actuaries of Japan to design calculation methodologies for insurance liabilities while sharing information with related parties. I think that it is important to have a two-tiered structure to ensure that operations are carried out as designed. While third-party verifiers may not have an understanding of some details, it is best to get their opinions to a certain extent.

- The calculation of economic value-based insurance liabilities is the visualization of elements that were not visible in the past, while improving transparency. The market and audit firms should be able to look at an insurance company and assess the level of risk, and whether proper governance and response measures are in place to address these risks. Consumers will be able to check if there are risks to the policy they have purchased and if the returns are commensurate with them. Particularly for long-term insurance, transparency has been lacking thus far. In light of this, it is important to visualize these aspects through information disclosure. In addition, unless information which the market deems appropriate is provided, then we only end up having just a complicated framework. External governance is important.

- The disclosure of complex and technical figures will not be understood by policyholders. One of the issues related to Pillar 3 is information disclosure that is easy to understand from the perspective of policyholders. This may include, for instance, what level of ESR can be secured in face of the events like the Great East Japan Earthquake or the Lehman Brothers' collapse.

- Regarding the topic of efficient verifications on page 14 of Material 1, I think it is possible to utilize the existing governance framework to some extent. However, we need to keep in mind that IFRS accounting audits are broad in scope and require a high level of expertise. For example, when scrutinizing insurance liabilities based on economic value in an M&A process, it is common to seek an expert opinion separately. Looking at an example with Solvency II, which is both similar to and different from IFRS 17, it appears that standardization of insurance liabilities have been abandoned in the recent EIOPA review. In particular, it is necessary to appropriately choose methodologies and assumptions based on individual goals. Furthermore, there has been an opinion that there is a limitation as the adoption of IFRS is on a voluntary basis and only applicable to consolidated financial statements. However, at present, companies are divided on the disclosure of EV, and there are many cases where the methodologies used in EV are also employed for calculations of an economic value-based solvency. Establishing EV or internal models requires a considerable amount of expertise, and some companies conduct external validation on a regular basis. Therefore it is conceivable that these existing practices will be utilized efficiently. Companies that adopt IFRS voluntarily may effectively use a different framework, for instance by providing feedback from economic value-based regulation to IFRS practices.

- As noted by other members regarding the "Positioning of MCR" on page 7 of Material 1, MCR should not interfere with controlling the ESR. Robustness and objectivity are required for MCR in Solvency II. Given that strong administrative orders can be issued upon a breach of MCR, I believe that some type of robustness and objectivity requirements are necessary also in the Japanese framework.

- When thinking of MCR based on PCR, there is a debate as to whether it is effective to use a MCR based on highly individualized PCR (or PCR based on an internal model), as a trigger for strong supervisory intervention.

- On page 13 of Material 2, a point is made on whether focus should be on individuality or uniformity when preparing a guidance (on insurance liabilities). However, if a broad range of individuality is permitted, then it could overlap with the approval criteria of the internal model.

- When calculating an economic value, we need to have an opinion of actuaries on why they think that their result is indeed the best estimate. There needs to be some type of checkpoints, in addition to simply providing a whitelist of examples.

- On page 8 of Material 2, interest rates were brought up as a situation unique to Japan. However, the yield curve in Japan is by no means unique in comparison with yield curves in Europe, and I do not view it as special.

- I am very grateful from the position of a verifier that the recommendation for preparing guidance for validation is made. European investors often ask about the validity of insurance liabilities, especially with regard to methodologies chosen. The reason why a certain methodologies are selected among many alternatives cannot be guaranteed solely through internal validation. In some areas, there is no choice but to rely on the knowledge of external experts. I believe this is also one limitation when it comes to preparing guidance.

- Some are of the opinion that Pillar 3 should be simple enough for consumers to understand. However, in Europe, detailed reports on Solvency II are read by investors, not consumers. Insurance is difficult and complex to begin with. We therefore need to accept the complexity and implement disclosure that will satisfy investors. In Europe, there is a trend to simplify disclosure to a certain extent. At the same time, some argue that important factors, including the movement of capital and sensitivities, should be disclosed in more detail based on a common framework.

- I agree with the opinion that validation guidance should be established in a somewhat more concrete manner, by showing both positive and negative examples. This will make it easier to gain trust externally even if an internal model is used for calculations. For example, discount rates with a matching premium could be taken into consideration. I think it is important to set guidelines on caps, and disclose them in official disclosure documents, so that external parties could analyze the necessary figures of insurers.

- Going forward, if economic value-based regulation becomes mainstream, some companies may stop disclosing EV reports. However, in these cases, explanations on the ESR, including methodologies used for calculating insurance liabilities and disclosure, are very important. Even if these are somewhat complex, I think we need to put forth an effort to understand them.

- I think MCR should be based on an economic value. In case of life insurance companies, figures based on J-GAAP substantially deviate from their economic reality. I therefore think that it is inevitable that current bankruptcy laws be reviewed.

- On page 5 of Material 1, it states that “policy adjustments and transitional measures will be considered after 2022.'' However, IAIGs would like domestic and international regulations to be aligned. Thus we should initiate the study prior to 2022, and aim for reflecting such elements in the ICS. I basically agree with other proposals on the timeline and schedule. With that said, I would like to confirm that this discussion will not assume that domestic and international regulations differ.

- Regarding the validation framework, I understand that the actuarial function is stipulated in detail in the ICP. It is necessary to basically comply with the ICP. Assuming that the current Appointed Actuary system broadly satisfies the ICP on a solo basis, we need to think about the framework on a group basis. Other members brought up the topic of external verification. From an insurance company’s perspective, factoring in ICP, it is my understanding that solid preparations must be made, including deciding on what type of validation framework should be established internally.

- I think today's discussion is the stage just before deciding on what should be disclosed. We are at the stage where we need to decide on principles, ideas and rules on where to draw a line. In other words, it is difficult to see whether or not an insurance company will be okay based on the figures currently in use, and we are at the stage of working out how this should be ensured. I think that disclosure to external parties, as was brought up as a concern by other members, is a key topic, but I think it should be discussed when we touch Pillar 3. Also, I think it is a good idea to make easy-to-understand disclosures for policyholders, including using past stress scenarios. First you have the ESR. For those who want more details, a step can be created to allow them to carefully look at the basis for the underlying calculations. We need to design a framework that fulfills both of these needs.

- Let me touch on several issues for small and medium-sized insurance companies. The pet insurance market is growing at a double-digit pace annually on a premium basis. As a single insurance product, the scale of the market is reaching a sufficient size. At present, an independent category for pet insurance has not been established in the risk calculation in the field test. The insurance premium risk factor is 35% of the "Other" category. The “Other” category includes high-risk products such as nuclear power, and storm and flood damage. However, pet insurance is similar to the healthcare insurance for humans. Given the coverage and use restrictions, it is not a high risk product and the capital requirement for pet insurance is excessive. Based on a proprietary internal model based on historical loss ratios, the insurance risk factor will be lower than the one stipulated in the field test. In the new regulation, characteristics of risks and individual companies should be taken into account properly, for instance through adding a new category in the standardized model.

- Small and medium-sized insurance companies can only handle a limited number of products. In light of this, there is a bias in risk characteristics versus the industrywide average. For example, in the case of policy lapse risk, risk characteristics differ depending on the nature of the product and the amount of surrender value. Using a uniform coefficient to calculate this would result in a discrepancy with the actual condition. Using an internal model could be an option, but the resource could be an issue in that case. It is likely that the demand for actuaries under the new regulations will increase, which will make it challenging to secure an adequate number of staff. It also holds true for the validation framework. I think that certain considerations should be given to the size of a company and the complexity of the risks it faces.
- It is proven by history that there are limitations to internal validation. We do not see particular problems when a company is experiencing favorable performance. However, when a company goes through a difficult phase, there are limits to maintaining the independence of the internal verification. I agree that the final source of support is the authority, given that there are also limitations to the independence of an external verification. The authority needs to understand the limitations of each level of validation system and conduct proper supervision. Verification is very important, and supervision by the authority is crucial.
- If there is more than one actuary, each will have their own ideas. In addition, although some external experts are monitoring a certain number of companies, it is not necessarily easy to understand practices at other companies. Therefore, feedback must be given at each stage from the regulatory authority, who are able to oversee all the companies.
- The concept of economic value is very difficult and will require consumers to do some

homework. Through the discussions held by this Council, I came away with the feeling that a new industry or company is likely to emerge from the visualization and transparency of disclosures.

- Regarding the individuality and uniformity of guidance on page 13 of Material 2, the previous discussion on pet insurance also focuses on individuality. Discussions on the extent to which the range of individuality can be expanded and views on the internal model are linked closely. From such point of view, the framework for internal models needs to be established after the width of individuality in the said guidance is determined. If the framework for an internal model is designed first, it will become difficult to define the range of guidance in the standardized model.

- As mentioned above, the internal model is strongly linked to the reflection of individuality. For example, if there is also a certain scale for pet insurance, a certain degree of convergence is expected, which will make it possible to grasp fluctuation risk. However, many of the providers of pet insurance are small companies. Consequently, it is also a concern as to whether the level of risk will converge at the same level at these small-scale companies. Thus, there is room to consider whether making a table for pet insurance is truly valid or not. One way to deal with this variation is to create a single, general-purpose table, and the other is to rely on internal models. For instance, an examination needs to be made of the scope of coverage of the standardized table, and the remainder could be covered by internal models.

- I think it would be best for the small and medium-sized companies in Japan that participated today to continue to carry out dialogue with the FSA, with the possibility of adjusting the methodologies. Although this is a minute point, given that many reinsurance companies are conducting operations in Japan as well, it could be problematic if concentration and operational risk for reinsurers are overestimated. In light of the increasing number of natural disasters, non-life insurers would be in trouble if they cannot rely on reinsurance. Dialogue with those companies will be necessary on this issue. Many reinsurance companies are located in Europe and operate in accordance with Solvency II. In light of this, dialogue with these companies will also be beneficial for us, and is important from the perspective of securing reinsurance capacities in Japan.

- In addition to reinsurance companies, domestic insurance companies also conduct reinsurance operations within a group from the perspective of risk management and optimization. If there are excessive capital charges under the solo regulation, problems may arise in group-wide risk management. As such, consideration should be given to solutions and adjustments to reflect the reality.

- Regarding the validation framework, I came away with the impression that today's discussion revealed the importance of the role of the authority as a backstop. At the same time, resources form a critical issue to be addressed. Furthermore, management is also an important party, and it is meaningless to calculate something that management cannot use. Therefore, an essential point is the validity of models and figures that management can use.

END