FINANCIAL SERVICES AGENCY
GOVERNMENT OF JAPAN

Keynote Address As Prepared for Delivery
"Key issues and challenges for a global capital standard"
- 4th Conference on Global Insurance Supervision -
Frankfurt am Main, 9 September 2015

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(Introduction)

It is my great pleasure and honor to be given this opportunity to deliver my remarks at the 4th Conference on Global Insurance Supervision. Today, I would like to briefly explain some issues and challenges in developing a global insurance capital standard. The points I make may be primarily from a Japanese regulator's perspective, but I would like to introduce the developments at the International Association of Insurance Supervisors (IAIS) of which the Financial Services Agency of Japan (JFSA) is an active member. I understand there will be a discussion of the ICS (Insurance Capital Standard) at the next panel session, so I hope I can give you some food for thought that may enrich that discussion I look forward to.

The standard disclaimer applies: i.e. any views I express today are my own, and are not necessarily identical to the official views of the FSA of Japan or any other national or international body I work with.

(Recent developments in designing the ICS framework)

As you are aware, the IAIS is currently in a critical stage of developing international capital standards for internationally active insurance groups (IAIGs). This is truly a groundbreaking piece of work, as there has never been an internationally

common standard for regulatory capital in insurance, unlike for banks.

Some recent developments at the IAIS are:

- **In December last year, the IAIS released its first public consultation document on the ICS applicable to internationally active insurance groups (IAIGs);**
- **From this April, it began a field-testing exercise for the ICS;**
- **The IAIS plans to publish its second consultation paper in next May or June, reflecting the comments received and the results of the field-testing exercise;**
- **And, it now plans to implement the ICS framework in 2020.**

(The ultimate goal for developing the ICS and the milestones)

In February this year, an agreement was reached at the IAIS on the 'ultimate goal' of the ICS. It is to develop a common methodology that would enable us to achieve comparable, i.e. substantially the same outcomes, across jurisdictions with respect to capital standards. It is also agreed that ongoing work is intended to lead to improved convergence over time on the key elements of the ICS, namely: valuation, capital resources, and capital requirements.

As this agreement shows, it is not intended at the IAIS to hastily put together a uniform set of prescriptive standards that will impose a one-size-fits-all for all insurers. If I interpret it from a national regulator's perspective, different jurisdictions may have different rules, but the aim will be to produce substantially the same results in terms of capital adequacy by developing a sufficiently flexible and robust methodology.

Towards this 'ultimate goal', the IAIS has set out two milestones in June this year – ICS version 1.0 and ICS version 2.0.

- **The IAIS intends to initially adopt ICS version 1.0 as the basis for reporting to supervisors on a confidential basis in May/June 2017. This version will present a standardized method for calculating capital requirements for the IAIGs,** but may include two approaches for valuation of insurance liabilities, i.e. the market-adjusted valuation approach and an approach based on Generally Accepted Accounting Principles (GAAP) with adjustments.

- Then the IAIS is planning to complete ICS version 2.0 in 2019. In this version, an improved level of comparability is to be achieved. This ICS version 2.0 may allow for both a standardized method and an internal model-based method for risk measurement and valuation of liabilities.

(Main issues for the ICS)

Now I would like to mention what I would consider most important in taking forward this work to develop the ICS.

- First, our over-reaching goal should be to build a framework which captures and takes appropriate account of the specificities of insurance. This naturally applies to the valuation of insurance liabilities, as well as to the definition of eligible capital and risk measurement. It is also important to ensure that the ICS would not produce unintended consequences on the availability of long-term insurance products or creates undue disincentives for long-term investment by insurance companies.

- Second, on the valuation of the insurance liabilities. As you may be aware, the IAIS proposed two approaches in the first public consultation of the ICS. They are: (1) the market-adjusted or current estimate approach and (2) the GAAP plus adjustments approach (so-called the GAAP plus approach).

  The current estimate approach requires IAIGs to reflect changes in the business environment such as long-term interest rates in the calculation of their solvency margins. Therefore, this approach would encourage IAIGs to enhance their ALM (asset liability management) and risk management systems. On the other hand, it is pointed out that: (1) there are cases in which duration matching between assets and liabilities is difficult due to a lack of sufficiently long-term assets in the investment market. As a consequence, net assets at fair value would become much smaller under the current estimate approach and (2) the required calculation is much too complex and burdensome for smaller insurers. Furthermore, it is stated that, (3) as a result of market valuation, insurance liabilities would become very volatile reflecting short-term fluctuations of interest rates, thereby making it more difficult for IAIGs to conduct proper risk management in the longer term.

In contrast, the starting point for the GAAP-plus approach is the GAAP applied in each jurisdiction. While this has the advantage of being able to use audited financial statements and accounts in the jurisdiction, and could rely on the transparency and reliability of established accounting and auditing practices in the jurisdiction, ensuring full comparability and a level playing field across jurisdictions can be more challenging.

As I mentioned before, the objective of further work will be to find ways for convergence between the outcomes of the two approaches, and eventually, over time, to harmonize valuation practices among different jurisdictions under the ICS.

- The third point is about the definition of eligible capital. Currently, there are two types of regulatory capital resources, Tier1 and Tier2, indicated in the first consultation document on the ICS. Tier1 capital comprises equity and other high-quality capital elements that absorb losses in both going-concern and gone-concern situations. Tier2 capital comprises subordinated debt and other qualifying capital elements that are available to absorb losses in resolution.

One of the important elements of capital resources other than equity or subordinated debt is 'reserves'. Reserves would normally be classified according to the nature and timing of loss-absorbency as determined by the legal and accounting framework of the home jurisdiction of the insurer. In this respect, I would like to empathize that , as regulation and accounting principles that apply to reserves are currently very different from jurisdiction to jurisdiction, we should assess the loss absorbency capacity of those reserves on the basis of their actual loss absorbing capacity rather than simply relying on whether they are classified as liabilities or capital on the balance sheet. This point should be carefully examined in the ongoing field-testing exercise.

- The fourth point is about the measurement of risk in the calculation of capital requirements. As it stands, the methodologies used in measuring insurance risks vary widely across jurisdictions. As to the confidence level used in risk measurement, the IAIS has provided two options, which are 99.5% VaR and 90% Tail-VaR. In the current field-testing exercise, for practical reasons, only the 99.5% VaR is being tested. However, before completion of the basic design of the ICS, I would like to call on the IAIS to further test alternative methodologies and different confidence levels to the extent feasible. Only then would we be in a position to determine the appropriate formulation of the risk measurement methodology and a credible confidence level for use in the ICS.

- The fifth and last point is about the interaction between the ICS and national solvency regimes for solo insurance entities. The ICS is applicable to an IAIG on a globally consolidated basis. This means that national solvency regimes on a solo basis could remain applicable to each insurance entity under the authority of the supervisor in each jurisdiction. As a consequence, there could be an issue as to how we maintain a level playing field between IAIGs and other insurers in the domestic markets when both the ICS and national regimes apply. This is typical of the challenges we face when multiple rules apply to the same financial group operating cross-border, and conflicts, duplication, and gaps arise between the different rules simultaneously applicable.

(The case of Japan)

Japan currently has a capital standard for insurers called the "solvency margin ratio (SMR)" requirement. The solvency margin ratio is calculated as the amount of eligible capital divided by the amount of required capital, which in turn is a factor-based calculation of the major risks for insurance companies, including insurance risk, natural catastrophe risk, and investment risk. The SMR is used as a trigger for supervisory intervention by JFSA under the Prompt Corrective Action (PCA) regime. An amortized cost approach and a lock-in method are applied for the valuation of insurance liabilities. Under this approach, the base interest rates for the calculation of insurance liabilities are fixed when insurance policies are signed, unless any shortfalls of technical provisions are found through regular ex-post verifications by appointed actuaries with supervisory oversight. The SMR is applied both on a consolidated and solo basis.

If time permits, I would like to elaborate a little on this ex-post verification process, since there has been an important change in this area.

Under the current regime, the required level of technical provisions is calculated by discounting it at the assumed interest rate as of the time an insurance contract is made, i.e. the so-called lock-in method is used. Even if the interest rate changes subsequently, the discount rate would be left unchanged under this method.

However, there is an ex-post verification process that makes up for the drawback of the lock-in system. After an initial measurement of the adequacy of the accumulated technical provisions, the adequacy of those provisions is tested every year under the ex-post verification process. Through this process, cash flows over the next 10 years are estimated using conservative scenarios to judge whether the accumulated technical provisions are sufficient to meet future payments of claims. If the process shows that the technical provisions are insufficient with respect to the first five years of the analysis period, the shortfall is immediately recognized as a liability.

Insufficiencies recognized over the next five years (or beyond) are not required to be immediately provisioned, but the JFSA encourages insurers to make additional provisions for those subsequent five years. On the contrary, when excesses are recognized over and above the required level of provisions, it is not allowed to reduce the surplus portion of technical provisions until the insurance contracts to which they relate are terminated. In that sense, it will be safe to say that it is an economic valuation approach that is downward-elastic to fluctuations in interest rates.

This ex-post verification process was further strengthened from March this year. In addition to the cash flow analysis for the next ten years, a cash flow analysis for a "full time horizon" was introduced to enable a holistic assessment of insurance liabilities including their ultra-long-term portions. This is intended to promote more long-term risk management in the insurance companies.

Since 2006, the JFSA has been reviewing the solvency margin regime to find any deviations from insurance practices or any points to be improved to enhance risk management and to strengthen the financial soundness of insurers. In recent years, the JFSA has also been field-testing the application of an economic value-based solvency regime as part of the reviews.

Since the application of an economic value-based approach was seen to have a major impact on the valuation of insurance liabilities, we took care to conduct several rounds of the field tests I mentioned to carefully evaluate and analyze the likely impacts of that approach. In May 2011, JFSA announced the results of its first round of field tests using an economic value-based solvency regime. In June 2014, it announced the start of its second round of field tests and requested that all insurance companies established in Japan (43 life insurance companies and 53 non-life insurance companies in total) participate in them.

The latest field test was conducted as of end-March 2014 and the results of the test were published in June 2015. The results show that, as a whole, the total amount of economic value-based insurance liabilities was not significantly divergent from insurance liabilities under the current regime, even in the current low-interest rate environment. However, there were different tendencies between companies due to differences across the businesses of those companies in the composition of insurance policies outstanding, etc. There was a tendency that the total amount of insurance liabilities based on the economic value-based approach was slightly larger than that based on the current approach for life insurance companies. For non-life insurance companies, they were roughly the same. Among life insurance companies with a large proportion of long-term policies, increases in insurance liabilities tended to be greater for companies with a large share of savings-type insurance policies that were taken up in the past. So, the effect of a change in the valuation of insurance liabilities on its size depended on the composition of insurance policies in force at each company. Future exercises would need to examine the impact of changing the methodology for establishing discount rates, etc. to make for a stable and robust regime to be used in the future.

In the course of those field tests, there were many suggestions from participating companies. Regarding risk measurement methodologies, while some companies stated that the use of internal models should be allowed as much as possible, others suggested that only simple risk factors be employed to ensure comparability across companies. So, our challenge would be to analyze how to strike a proper balance between risk sensitivity and comparability. While the 99.5% VaR was used for this round of field testing, it is necessary to continuously review the appropriateness of the confidence level along with the methodology and compare those results with the results of other formulations. I believe that our experiences could be a useful input for the IAIS work in developing the ICS.

(Solvency II Equivalence Assessment)

By the way, I understand that our European colleagues are in the final stages of preparation for the implementation of Solvency II in January 2016. In this context, authorities of non-European jurisdictions including the JFSA are now engaged in the processes of equivalence assessments under Solvency II with our European colleagues. In these exercises, it is becoming increasingly necessary for European and non-European officials to work together closely and efficiently to establish equivalence in the interest of both parties.

A point I wish to make here is that equivalence should not be seen as a one-way determination to allow non-European firms to operate in Europe, or enable European firms to expand their businesses in non-European jurisdictions. The presence of well-regulated non-European insurers in the European markets would be sure to benefit European consumers, and also expand business opportunities for European insurers through mergers and acquisitions as well as business tie-ups. In other words, we see the equivalence exercises as journeys leading to a win-win relationship for both sides involved.

The JFSA has devoted significant resources to this exercise and I do hope that the ongoing exercise of establishing equivalence for Japanese insurers will be finalized in a prompt and transparent manner, in advance of the implementation date of Solvency II, i.e. before the end of this year.

(Conclusion – towards a truly workable ICS)

Now, I would like to refer to some important points to be

considered in developing the ICS. As you are aware, numerous comments were received from global stakeholders in response to the first round of public consultation. This demonstrates a strong and growing interest among stakeholders in the subject worldwide. Transparency and inclusiveness are key words in the development of a truly global international capital standard.

In the course of this work, one should bear in mind the possibility of unintended consequences arising from the implementation of a new standard. Therefore, one should be ready to conduct comprehensive field tests and impact assessments in the course of finalizing the ICS.

A major challenge in developing international standards is to balance the objective of international consistency and comparability with the need to maintain some elements of flexibility to respond to the needs of jurisdictions to account for idiosyncratic factors existing in each jurisdiction. The diversity in the business models of insurers and in the products and markets world-wide is still very large, and a one-size-fits-all approach would not be feasible. Laws and regulations, as well as accounting standards are still fairly diverse across jurisdictions. Striking the right balance between the two aspects in developing the ICS would require close engagement of global stakeholders and a thoughtful and inclusive process at the IAIS.

Finally, I would like to underline that an even stronger cooperative relationship between supervisors is becoming essential, given the realities of globalization and increase in cross-border activities in insurance. While, recently, supervisory colleges and crisis management groups have also started to operate in the area of insurance, a lot more can be done to enhance information-sharing and coordination among insurance supervisors globally. The IAIS should be the hub for such international cooperation and coordination, and a reference point for insurance authorities worldwide.

(End)