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Future Regulatory and Supervisory Changes in Japan – Adapting to Global Developments and Learning from the Crisis – An Industry View

Katsuo Matsushita

OUTLINE



- I. Solvency Margin Scheme in Japan; present and future
- II. The way we, as an industry, are going to adapt to global solvency margin standards
- III. Lessons learned and ramification of the current financial crisis
- IV. Conclusion

I. Solvency Margin Scheme in Japan; present and future

- 1) RBC-based
- 2) Introduced in 1996 along with comprehensive deregulation of our insurance market
- 3) Ongoing updates and revisions

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Features of Japanese Solvency Standards

- **Mostly risks are measured by simple factors**
- **90%/1yr confidence level is used for most of the risks (except cat and mortality risk)**
- **Risks reductions (diversification, hedging) are appropriately recognized**

$$\text{Solvency Margin Ratio} = \frac{\text{The sum total of Solvency Margin}}{\text{Total amount of Risks}} \times 100\%$$

$$\frac{1}{2} \times \left(\sqrt{A^2 + (B+C)^2} + D + E \right)$$

● <Risks>

○A: Ordinary Insurance Risk; Risk of occurrence of claims which exceeds underwriting reserve.

○B: Assumed Interest Rate Risk

○C: Asset Management Risk

○D: Business Administration Risk; Risk of occurrence of loss beyond the anticipation of business administration.

○E: Catastrophe Risk ; Risk of occurrence of catastrophe loss caused by natural disasters such as earthquakes, storms, floods, etc.

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JFSA views toward future solvency standards

Economic based solvency regime

- ✓ More incentive for ALM & risk management
- ✓ Introduce economic valuation for asset and liability simultaneously
- ✓ Careful consideration should be paid to revenue recognition, etc.

Group solvency

- ✓ International standard for internationally active insurance groups would enhance the comparability, credibility and transparency of the insurance market

Capital assessment, supervisory review and public disclosure

- ✓ International standard should be supported by enhanced supervisory review, supervisory cooperation and disclosure

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JFSA Approach toward More Risk Sensitive Solvency Regime (1)

Issues to be improved

Credibility of current regime

- ✓ Prompt actions can be taken in an appropriate timing
- ✓ Ensure the market credibility both of supervisor and industry
- ✓ Reflect Material risks (e.g. ALM mismatch) appropriately

Incentive for better risk and capital managements

- ✓ Introduction of incentive structure in required capital for better risk and capital management
- ✓ Supervisory review and disclosure of risk management practice



Directions that we should take

- ✓ Higher confidence level would enhance the market confidence
- ✓ Economic based solvency regime would allow better alliance with their own risk and capital management

JFSA Approach^(*) toward More Risk Sensitive Solvency Regime (2)

(*) The Solvency Margin Study Team proposed the reforms on April 3rd, 2007.

Current Reform

Risk Factors

- ✓ Higher confidence-level : 90 % (for asset mngmt risks) - 95 %
- ✓ Re-calibration with the current financial data
- ✓ Diversification factors reflected by risk management practices

Solvency Margins

- ✓ Assets which rely on the future profitability of the insurer itself (Deferred Tax Assets, Other Tax Benefits & Future Income) need to be considered for limitation to appropriate level

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Reform toward Economic Based Solvency Regime

Making continued efforts, considering Year 2010 as a target, to introduce

- ✓ Economic based valuation of insurance liability
- ✓ more sophisticated standard model, such as to reflect each insurer's ALM position appropriately, etc

Current Reform toward More Risk Sensitive Solvency Regime - detail (1) -

Risk Factors

	Current Regime	Current Reform
Assumed Interest Rate Risk	Calibrated data from 1988 – 1998	Update with current market data
Minimum Guaranteed Risk	Loss with 10 % reductions of assets	Loss with 95 % confidence level
Asset Management Risk	Loss with 90 % confidence level	Loss with 95 % confidence level
Diversification Factors	Uniform factors - 30 % for life - 20 % for non-life	Calibrated based on own portfolio with specified covariance matrix.

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Current Reform toward More Risk Sensitive Solvency Regime - detail (2) -

Solvency Margin

	Current Regime	Current Reform
Deferred Tax Assets	No limits	Limit up to 20 % of Capital + some reserves (e.g. cat. reserves)
Other Tax Benefits	No limits	Limit up to core capital
Future Income	Reserved amount for policyholder dividends / 2 (**)	Removed

(*)Core capital is defined after limiting deferred tax assets

(**)Minimum (Ave. reserved amount in current 5 years, reserved amount of last year)


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II. The way we, as an industry, are going to adapt to global solvency margin standards

1. We view this as a big challenge with positive momentum for:
 - 1) Strategic shift toward more focus on the quality of management and services rather than quantity
 - 2) Enhanced risk management and risk mitigation across the board; ERM
 - 3) Efficient capital allocation
 - 4) Efficient and effective group supervision, including group solvency
 - 5) From a fragmented regulatory regime to international regulatory harmonization, mutual recognition and supervisory cooperation /coordination

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2. Driving forces of enhanced quality management and risk management

- 1) Policyholders' increasing concerns about the security of insurers and the cost of insurance in the current difficult economic climate
- 2) Empowered consumers
- 3) Increasing responsibility of management, along with the shift to principle-based regulation. From an "Is this compliant?" mindset to an "Is this the best way and fair to customer?" mindset

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2. Driving forces of enhanced quality management and risk management

- 4) More diversification of the insurance portfolio geographically
- 5) Catastrophic risks/emerging risks and the difficult capital market demand developed/sophisticated risk management and risk mitigation methodologies
- 6) Serious risk to reputation caused by inefficient use of capital and other resources

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3. Our challenges and opportunities

- 1) Developing various works in progress - changing the corporate culture (from silo to holistic), evolving risk mitigation methodology and ERM, developing internal models and impact studies etc.) - and translating them into real value for customers, shareholders and other stakeholders
- 2) Translating a risk-sensitive solvency framework into truly risk-based underwriting (pricing, and terms and conditions, etc.) and strategic capital allocation. This is an essential pre-condition of a sustainable insurance market

III. Lessons learned and ramification of the current financial crisis

1. Many important lessons have already been articulated by academics, the media and governments. The main lesson I took from this crisis is that we need to re-focus on the fundamental role of insurance in society and the economy, both domestic and international. This is a wake-up call for our industry




Basic role of insurance

Role A:
To act as an indispensable social infrastructure. To provide policyholders and society with protection against and mitigation of the risks they will encounter and to facilitate business activities; manufacturing, operation of supply chains, international trade/investment and development of emerging regions

Role B:
To act as a stock company or publicly-traded stock company, sometimes with a geographically diversified investor base, generating an expected level of return

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These two roles are not mutually exclusive. Rather they are complementary each other.

Without a sustainable and reasonable return under Role B, insurance companies are unable to access capital markets in order to play Role A; to finance the underwriting of risks or accumulate a financial buffer against the occurrence of unexpected large losses etc.

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While a re-focus on Role A does correspond with a Back to Basics philosophy, it never means standing still. On the contrary, it contemplates that innovation is needed to provide solutions to the new risks customers face in their every day lives and business activities.

Role B does not have a monopoly on innovation.

One of the lessons we can learn from certain banks is that too much emphasis on Role B (excessive risk taking and profit for profit's sake) caused devastating systemic risk.

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2. Ramifications of a re-focus on the fundamental role of insurance

- 1) Consistent with G-20/FSF recommendations and ongoing work/roadmap of the IAIS
- 2) Promotion of supervisory cooperation and college of supervisors to minimize systemic risk
- 3) Need to look after corporate governance, including broad oversight of risk management issues and a more justifiable remuneration system etc.
- 4) Control over excessive leverage and risk taking
- 5) Counter-cyclical solvency/capital requirement with building financial buffer in benign times

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3. Challenges for the regulator and the regulated emerging from a re-focus on Role A

1) Possible conflict with investors, especially in terms of pressure for short term ROE and capital efficiency.

We need to develop an appropriate valuation methodology in order to reconcile optimizing balance between long term and shorter term returns.

Is this a pipe-dream?



3. Challenges for the regulator and the regulated emerging from a re-focus on Role A

2) If we cannot address such challenges due to lack of data or limitations in our risk management skills, what should we, the regulator and the regulated, do as an alternative response?

* Enhanced monitoring capability by supervisors

* Encourage insurers to further improve internal models, risk based pricing, USE tests and disclosure

* Supervisory review of ORSA would be another effective policy tool



3. Challenges for the regulator and the regulated emerging from a re-focus on Role A

3) A robust, effective and efficient regulatory regime is a must.

In difficult times, people are concerned about both the security of risk carriers and the cost of insurance coverage.

So we welcome the ongoing effort of the IAIS toward regulatory harmonization, (reinsurance) mutual recognition and more streamlined group supervision, so as to offer customers with transparent prudential information of insurers.



For a sustainable market, we need a regulatory regime that encourages and does not hinder risk-based underwriting and pricing.

We would also like to continue to work with customers to improve their risks and enhance the quality of risk information provided. Situation where risk to be transferred explains its own profile would help making efficient and transparent market.

4) Let us optimize our role as a facilitator of international trade and its finance, vital part of solution to the global economic crisis

IV. CONCLUSION

1. Re-focusing on Role A or Back to Basics is not standing still. Instead, it nurtures robust innovation and competition, and pushes us to deliver creative solutions
2. Re-regulation and re-focused regulation are necessary. Effective and efficient regulation which supports risk-based underwriting and pricing is not only required, but is also consistent with risk-based solvency framework
3. We have to address challenges to reconcile Back to Basics and investor demand. In the post-crisis market economy, can we expect a slightly changed mindset from the capital market? Or is this a pipe-dream?
4. As always, human resource development and life-long learning should not be forgotten. "A principle-based approach does not work with individuals who have no principles" (Mr. Hector Sants, UKFSA)