



Accelerating expansion in Japan

Risk management frameworks
at a glance



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Executive summary

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As insurance regulators aim to reduce risk in financial markets, they are raising the bar on better risk management, governance and transparency in reporting. Emerging regulations are driving significant global reforms in everything from balance sheets and capital adequacy to consumer protection. In Japan, where the size of the insurance market is considerable, regulators are encouraging insurers to expand their enterprise risk management (ERM) frameworks.

Current Japanese reform is focused on supervision, inspection, capital adequacy, solvency position and the introduction of an economic value-based solvency regime. The stated regulatory intention is to gain “full equivalence” status under the European Solvency II regime – with many larger Japanese insurance companies already positioned to adopt this approach.

Since our last ERM report in 2013 (*Enterprise risk management in Japan*), the Japan Financial Services Agency (the insurance regulator or the JFSA) has continued to develop risk management and governance frameworks in response to overseas business expansion by local players.

In this updated report, we discuss key market and regulatory trends, the current state of play in Japan and the impact beyond the requirements on products, internal models, risk calculation and measurement. There is a significant opportunity for insurers in Japan to develop and refine sophisticated ERM systems as an integral part of their business strategies and management practices.

The Japanese life insurance market is currently the second largest in the world (behind the US) with 16.2% of global life insurance written premium or a value of JPY33.0t (US\$340.4b) in 2013. The non-life market ranks fourth globally and second to China in the Asian region. Gross written premiums for the non-life market are expected to increase from JPY9.0 t (US\$93.3b) in 2013 to JPY11.1t (US\$119.01b) in 2018, at a compound annual growth rate of 4.1%.

After a sluggish year, life insurance premiums rebounded in 2014; however, non-life premiums remained flat and Japanese non-life insurers continue to expand their footprint in high-growth emerging markets to compensate for slower growth in the domestic market over the past 10 years. These statistics, combined with slow organic growth in mature markets, make Japan an attractive market for global insurers.

Our enterprise risk management report focuses on risk and regulation in the Japanese insurance market and a new economic value-based solvency regime. As insurers move toward full Solvency II equivalence status, they must work together to overcome regulatory challenges in governance, risk and compliance.

– Martin Bradley



Introduction

The regulatory framework for governance, risk and compliance continues to evolve in Japan. The insurance industry and the JFSA recognize that growth and survival depend on the adoption of sophisticated ERM systems, under the leadership and commitment of top management. However, the Japanese market presents many challenges for life and non-life insurers as they move toward full Solvency II equivalence status.

As companies determine strategies and future direction, changing demographics, market uncertainties, the impact of a weaker yen, and a series of major catastrophic events highlight the importance of enhancing ERM practices. The Japanese insurance market is relatively mature and highly concentrated. This has compelled Japanese insurers to focus on other markets for expansion and foreign insurers to operate through branches, subsidiaries and representative offices.

Potential growth in Japan is being challenged by a shrinking and rapidly aging population that has greater demands for postretirement savings products and health benefits. By 2018, individuals aged 65 and over are expected to account for 28.4% of the total population, thus supporting whole life, pension and term life insurance products. With life premiums rising only moderately, insurers are diversifying their distribution channels to gain market share by selling directly to consumers.

Meanwhile, compliance with global regulatory reforms such as the International Financial Reporting Standards (IFRS) for accounting, due to be released by the end of 2016, will require significant change. The Japanese government is expected to implement the IFRS in tandem with its own version of Solvency II implementation.



Regulatory reform in the Japanese insurance industry: developments so far

As Japanese insurers expand their operations to diversify profit sources, there is a critical need to recognize various risks related to insurers' financial groups as a whole. After reviewing the results of the financial sector assessment program (FSAP), which was conducted by the International Monetary Fund (IMF) in 2011, the JFSA urged insurers in Japan to develop and enhance their ERM frameworks. They also required insurers to voluntarily prepare and submit their Own Risk and Solvency Assessment (ORSA) reports.

In August 2012, the IMF published the results of the stability assessment of the financial sector in Japan, based on the FSAP in 2011. Japan's insurance sector was included in the scope of this assessment, and many companies began implementing plans to realize their objectives.

Assessing financial stability

The FSAP was developed by the IMF and World Bank in 1999 and reflected global financial issues including the Asian currency crisis. It assesses the stability of a financial sector, the quality of regulatory and supervisory framework, and the capacity to withstand financial crisis. Since September 2010, the assessment has been conducted by countries with a financial sector deemed to be systemically important every five years and is voluntary for others. Currently 29 countries, including Japan, have a financial sector that is considered systemically important. This assessment under FSAP was implemented for the first time in 2002, with the latest completed in 2011.

The insurance sector assessment was conducted using the revised Insurance Core Principle (ICP) set forth by the International Association of Insurance Supervisors (IAIS). ICP was first developed in 2003 and was thoroughly revised in 2011 to address defects in traditional risk management methodology, insufficiency in corporate governance and the lack of a group-level supervisory framework.

Evaluating ICP principles

The latest assessment is the first to be completed based on the revised ICP. The level of observance to the requirements is evaluated for each principle in accordance with a four-grade system: **observed**, **largely observed**, **partially observed** and **not observed**. These Japanese results included 12 items observed, 10 largely observed and 4 not observed. Recommendations were provided for each principle and were favorably accepted by the JFSA.

Among the 26 ICP principles, 2 directly relate to ERM: ICP 16, *Enterprise Risk Management for Solvency Purposes*, and ICP 17, *Capital Adequacy*. The IMF assessment of ICP 16 concluded that the principle was **largely observed** and recommended that the JFSA require insurers to explicitly describe the relationship between their risk tolerance limits, regulatory capital requirements, economic capital and processes and methods for monitoring risks to reinforce the guideline relating to ERM.

The IMF also recommended that the JFSA develop explicit guidelines to facilitate insurers conducting their ORSA. The IMF assessment of ICP17 (capital adequacy) further concluded that the principle was **largely observed** and recommended that the JFSA enhance the level of solvency control, suggesting that it encourage the use of internal models. They also required insurers to voluntarily prepare and submit their ORSA report to the JFSA.

In addition, the JFSA revised the ERM description in *Comprehensive Guidelines for Supervision of Insurance Companies and Inspection Manual for Insurance Companies*. In response to the comments on capital adequacy, the JFSA conducted field tests requesting insurers to calculate risks and equity based on economic value measurement, in order to understand their impact and thus inform the appropriate supervisory regime for capital adequacy.

Determining ERM implementation level



In 2013, the JFSA conducted interviews with executives in charge of risk management at 22 Japanese insurers to determine the current state of implementation for an ERM framework. This followed previous interviews or “ERM hearings” conducted in 2012 where the JFSA discussed ERM frameworks as a whole with each insurer.

The subsequent 2013 interviews focused on these key areas:

- ▶ **Risk appetite framework:** identifying the risk profile, understanding the risk taken and determining risk appetite and risk tolerance limits
- ▶ **ORSA:** risk measurement for each risk category and assessment of impact on solvency
- ▶ **Level of ERM utilization:** utilizing performance index results after risk adjustment (such as risk adjusted return on capital), integrating ERM into new product development and profit-monitoring processes for each line of business, and embedding ERM into the development phase of a midterm business plan
- ▶ **Other risks:** including group base ERM, internal audit framework for ERM, and preparing for natural catastrophes or a rapid increase in interest rates in the current low interest rate environment

In the summary of 2013 ERM hearing results, the JSFA commented on insurers’ progress in enhancing their level of ERM, such as identifying whole risks and emerging risks. However, they also identified these common issues that require immediate attention:

- ▶ Implementing a business plan and monitoring actual performance in relation to insurers’ risk appetite
- ▶ Developing the groupwide ERM framework
- ▶ Raising the level of involvement of internal audit and maintaining a balance with improvements in the ERM framework
- ▶ Establishing the model validation methodology for risks that are not easy to quantify, such as operational risks



2014 ERM hearings focus on ORSA

The JFSA conducted ERM hearings again in 2014, requesting 25 insurers to prepare a “try-on” version of their ORSA report for discussion. ORSA was defined as the process by which an insurer assesses its capital adequacy by comparing its current and future risks with its equity, taking into account its risk-taking strategy.

Recognizing the central role of ORSA within the ERM framework, the JFSA requested that insurers describe at least the following items in their ORSA reports: the relationship between business strategy and risks, ERM organizational structure and assessment for risk and solvency, and validation of ORSA results. This should also include a risk management policy with risk profiling and measurement, and explanation of how ERM would be used in the business.

In this review, the JFSA concluded that ORSA reports are a useful tool to understand the current financial status of each insurer especially when compared to others. Referring to the comments from many insurers that implementing the ORSA process was a positive influence to cultivate the insurers’ risk culture and familiarize employees with ERM, the JFSA decided to continue a regulatory review of insurers’ ORSA reports.

“The JFSA may be encouraged by insurers’ progress in enhancing their ERM frameworks. Their efforts to focus on risk appetite, ORSA and embedding ERM into their product development and business processes are commendable.”

— Yuji Ozawa

The JFSA noted improvement in building and enhancing ERM frameworks in some life insurers that had commenced later than non-life insurers. However, they pointed out that the same issues from the previous ERM hearings remain, and that it is important for insurers to address them.

Furthermore, Japanese insurers’ efforts regarding ERM and ORSA have resulted in improvement to their operations. Since these are regarded as the most critical tasks for many insurers in Japan, the level of management commitment is higher than ever. As management’s attitude toward ERM and ORSA has changed, employees’ understanding of ERM and ORSA is also gradually changing as well.



An economic, value-based solvency regime

ERM efforts underline the improvement in the Japanese risk culture and continuing steps toward risk-oriented governance. When the JFSA field tests were conducted in 2010, many companies recognized the importance of economic value-based calculation of insurance liabilities. This contributes to promoting asset liability management (ALM) and enhancing risk management by enabling the consistent management of assets and liabilities.

In recent years, many companies have supported the introduction of a solvency regime based on the economic value-based calculation of insurance liabilities. This is in light of the consistency with the economic value-based risk management that they have been promoting, as well as IFRS developments and similar overseas regulations. However, as ALM may not produce sufficient effects due to the inadequate development of the market for hyper-long-term bonds that correspond to long-term insurance liabilities, some companies asked for this point to be considered when the solvency margin is introduced.

Practical issues and challenges ahead

In the 2010 testing, many insurance companies noted that estimating future cash flow (which must be calculated for every contract in force for the entire insured period) as part of the calculation of insurance liabilities, imposes a heavy burden on calculation work. Therefore, it is necessary to consider introducing a simplified calculation method within reasonable limits, such as a calculation based on a sampling of policies and a summary calculation of insurance policies with the same actuarial assumptions.

In discussions of the internal model approach, insurers noted the need for improvement in the reliability of measurement. However, as many insurance companies are already conducting measurement using internal models, it is necessary to establish the criteria for regulatory approval before introducing regulation.

Regarding the development of institutions' internal systems for the economic value-based calculation of insurance liabilities, many companies recognize the challenge of employing and training actuaries and other personnel with relevant professional skills, and developing infrastructure, such as IT systems and databases; for example, confirming consistency with IFRS from the perspective of minimizing the cost of developing IT and other systems.

Finally, in discussing the solvency evaluation based on economic value-based calculation of insurance liabilities, many companies commented that consideration should be given to the existing process of preparing financial reports and accounting statements.

Insurance companies are making progress

In summarizing the testing results, approximately half of the life insurers responded that they had introduced economic value-based risk management (in some form or other) or had the capabilities to do so. Most of the remaining companies were considering developing internal systems, while others were exploring a future direction following the implementation of the field tests.

Many of the non-life insurance companies were promoting economic value-based risk management as part of the development of integrated risk management systems. However, some said they did not necessarily recognize the need in light of the characteristics of their products. Likewise, branches of foreign insurance companies were considering developing risk management systems in cooperation with their home office headquarters.

Understanding how insurers calculate liabilities

In June 2014, the JFSA again conducted field tests for all insurance companies, with the aim of introducing an economic value-based solvency regime and gaining full equivalence status for Japan. To appropriately recognize the financial condition of an insurance company, they reviewed proposals from global organizations such as the International Association of Insurance Supervisors.

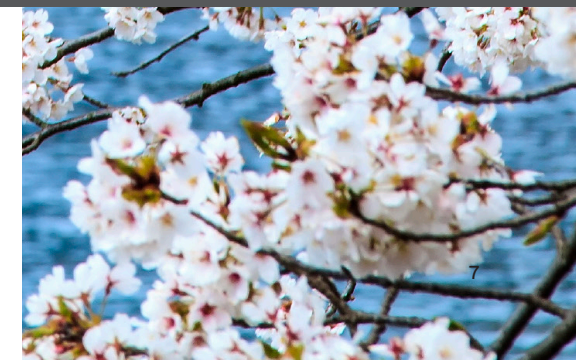
The JFSA field tests focused primarily on quantitative requirements similar to Pillar I of Solvency II including trial calculations of the economic value of insurance liabilities. The aim was to understand to what practical extent insurers are dealing with the calculation of insurance liabilities on an economic value basis. Findings from the tests, including any practical issues, will be taken into consideration in introducing an economic value-based solvency regime.

In a questionnaire, all insurance companies were requested to (1) calculate the value of insurance liabilities based on economic value; (2) measure risks, such as interest rate risks, and consider assets and liabilities comprehensively; and (3) submit a report on any findings.

The JFSA used calculation methods and assumptions, such as interest rates and risk coefficients. These are generally consistent with those of organizations such as the IAIS and other jurisdictions, including the European Union (EU). As to the confidence level for the calculation of risks, 99.5% is applied under this test, considering the economic value-based solvency regime in the EU. For advanced insurers that have used internal models and managed their risks voluntarily based on the economic value of insurance liabilities, additional questions were added regarding the actual operation of internal models.

After the reports have been summarized, they will be made public. However, individual company results will not be released. The timeline is as follows:

June 2014	Field tests conduction for all insurance companies
December 2014	Due date of submission of results
May 2015	Summary of results to be made public



Significance of being systemically important

An insurance company that had been assigned as an IAIG and/or a Global Systemically Important Insurer (G-SII) may see a major impact on its business to comply with additional regulatory requirements. The JFSA may be neutral against G-SII implementation currently; however, it may be more interested in the ICS implementation as an IAIG company.

In particular, the largest insurance companies in Japan seem to be interested in the wave of new regulations, if they were to be deemed as an IAIG or G-SII in the near future.

ICS consultation for Japan

The insurance capital standard (ICS) is currently taking a similar approach to the JFSA field testing to introduce an economic value-based solvency regime. Although the current situation in the Japanese insurance industry may change to some extent from that in 2010, the practical issues and challenges will likely remain. It is expected that ICS requirements will be almost the same as those for 2010 field tests for potential Japanese Internationally Active Insurance Groups (IAIG).

In order to improve comparability, more detailed guidance on valuation methodology will be required. For example, the treatment of future cash flow projection for discretionary dividends is unclear, although Japanese life insurers have a significant in-force business with discretionary dividend features.

Conclusion

While the JFSA has led the ERM initiatives, some large Japanese insurers have upgraded ERM frameworks – beyond the insurance requirements. The perceived expectation is that by implementing strong corporate management functions, the rating agencies will grant them a good ERM rating (e.g., excellent, very strong). The JFSA has also been working to instill a practice of ORSA reporting and to encourage insurance company management to simultaneously implement and upgrade the ERM framework.

What should insurers be considering for the future? If regulatory compliance is the only objective, the framework will be a minimum cost design with only risk control functions. However, insurers applying ERM frameworks as strategic tools will increasingly achieve results such as capturing a competitive position in the industry, increasing profits, developing products, talent and diversity, entering the global market and reducing costs.

Presently, the impact of ERM is mainly attributable to the domestic insurance regulatory requirements imposed by the JFSA – and listed or large insurers are running ahead to meet the requirements. It is also expected that, in addition to the ORSA documentation workload, the industry will be affected by EU or other new solvency regimes as they are introduced. It is likely that the JFSA will model regulations to some extent on information from the EU Solvency II internal model approval process when that is released.



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