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Fundraising and Equity Content Assessment for Insurance Companies under Economic Value-Based Solvency Regulations

The following is Japan Credit Rating Agency, Ltd. (JCR)'s opinion on "Partial Amendments of the Regulation for Enforcement of the Insurance Business Act Concerning Economic Value-Based Solvency Regulations, etc." promulgated by Financial Services Agency on July 23.

(1) The Regulation for Enforcement and other regulations pertaining to economic value-based solvency regulations (the new regulations) have been promulgated. The new regulations, centered on the calculation of the Economic Value-Based Solvency Ratio (ESR), have been the subject of extensive discussions over a considerable period of time. The Financial Services Agency held repeatedly discussions at the advisory council and analyzed the results of field tests, and gradually disclosed the status of the study on regulations and standard proposals from 2022 to 2024. After it conducted public comments twice in October 2024 and January 2025 toward the finalization of the International Capital Standards (ICS), it promulgated the Regulation for Enforcement, etc., with no significant changes made to the regulatory content. Insurance companies will begin calculating and reporting ESR under the new regulations from the end of FY2025. JCR perceives that the framework of the new regulations is consistent with the assumptions previously incorporated into its ratings. JCR is focusing on points including that a certain degree of uniformity will be achieved in the underlying assumptions for calculating ESR that are available to all insurers, which will enhance comparability.

(2) Under the new regulations, structure for eligible capital has been rebuilt. In assessing the creditworthiness of insurance companies, JCR places emphasis on capital adequacy in quantitative terms, and how regulatory capital is treated in ratings is an important issue. Eligible capital is categorized into "Tier 1 Unlimited capital," "Tier 1 Limited capital," and "Tier 2 Paid-Up capital." While similar to the "Tier 1 capital" and "Tier 2 capital" categories under Basel regulations for banks, etc., insurance companies are not required for a specific capital level for each category, such as "common equity Tier 1 capital ratio (CET1 ratio)" for banks, resulting in simpler regulatory treatment.

(3) Hybrid securities (including subordinated loan) such as perpetual subordinated bonds and dated subordinated bonds issued primarily by life insurance companies are both counted as Tier 2 capital. Going forward, based on perspectives such as reduction of fundraising costs in a phase of rising interest rate environment, it is anticipated that insurance companies will consider fundraising through bonds and other instruments falling into Tier 2 capital with slightly shorter maturities. As there are differences in conditions between joint-stock companies and mutual companies, such as limit of inclusion in eligible capital of required capital (risk amount), JCR believes that their fundraising policies will vary by company. In some cases, they may consider issuing bonds and other instruments falling into Tier 1 Limited capital.

(4) JCR has been evaluating equity content of hybrid securities issued by insurance companies based on the same considerations as those applied to operating companies, while taking into account their status as financial institutions subject to prudential regulation. With introduction of the new regulations, JCR believes that it will remain necessary to consider a certain degree of subordination for notching. On the other hand, considering that regulations are shifting to an economic value-based approach and that the direction to look in capital evaluation of ratings and regulatory capital will become consistent, JCR believes that the need for a limited evaluation of equity content of bonds and other instruments to be included in regulatory eligible capital is diminishing. Additionally, soundness of each company in terms of economic value-based indicators and sensitivity to market fluctuations is currently at a high level. Based on this recognition, JCR is proceeding with organizing the issues.

(5) Regarding notching, as in the past, JCR will make decisions, considering the following factors: (a) Hybrid securities are subordinated to senior debt in the order of claims at the time of issuer's bankruptcy and hence their recoverability is lower; and (b) Distance to loss occurrence could be shorter than distance to legal default due to deferral of interest or dividend payments based on the deferral clause. For bonds and other instruments to be included in Tier 1 Limited capital, it is likely

that both subordination clauses and the distance to loss occurrence will be considered in many cases. On the other hand, for bonds and other instruments included in Tier 2 capital, if the loss absorption at company liquidation is explicitly stated and the level of loss occurrence triggers determined by contractual clauses is considered extremely low, it is considered that there is little need to consider notching based on the distance to loss occurrence. Additionally, for bonds and other instruments issued by insurance holding companies that are included in Tier 2 capital, since the holding company itself has a structural subordination in that it allocates the funds raised to its insurance subsidiaries, JCR considers that there is little need to consider an additional notch-down from the holding company's rating.

(6) JCR has been placing importance on ESR in evaluating the capital adequacy of insurance companies even before introduction of the new regulations. JCR mainly evaluates ESR based on internal monitoring, which reflects characteristics of each company. The indicator subject to monitoring under prudential regulation is regulatory ESR, and there are no hierarchically defined indicators such as ESR applied only for Tier 1 capital. JCR has a policy to appropriately evaluate equity content of bonds and other instruments to be included in Tier 2 capital, including that of ESR based on internal monitoring. Additionally, JCR believes it is necessary to reconsider the approach to equity content assessment for funds, which are a unique fundraising instrument for mutual companies. Under the new regulations, funds with a maturity of over 10 years are permitted to be included in Tier 1 capital if they meet certain product design requirements. JCR will proceed to study whether it is consistent to recognize the equity content of such funds in rating, including funds falling into Tier 2 capital, from perspectives such as that of the permanence of principal.

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