22-D-0414
July 20, 2022

Impact of Introduction of Economic Value-Based Solvency Regulation on Insurance Companies

The following is Japan Credit Rating Agency, Ltd. (JCR)'s opinion on the "Tentative Decision of Basic Content Regarding Economic Value-Based Solvency Regulation, etc." released by the Financial Services Agency (FSA).

(1) On June 30, the FSA released "Tentative Decision of Basic Content Regarding Economic Value-Based Solvency Regulation, etc." The economic value-based solvency regulation (the new regulation) is a regulatory change with a large impact for the life insurance industry, which has a long-term balance sheet, because it requires the mark-to-market valuation of insurance liabilities. While JCR has been taking into account the adequacy of capital on an economic value basis based on the characteristics of insurance liabilities in assessing the capital adequacy of life insurers, life insurers have steadily reduced the total amount of interest rate risk by lengthening asset durations and reviewing their liability structures. As JCR has been reflecting these factors in its review of life insurers' ratings over the past year, JCR does not believe that the introduction of the new regulation alone will have any impact on the creditworthiness of life insurers.

(2) The introduction of the new regulation is a major event that has been discussed for many years, dating back to 2007 when the advisory council indicated that "the future ideal solvency regulation should aim at a method to evaluate the solvency of insurance companies based on economic value." The FSA has been indicating in its financial administration policy that it would hold extensive discussions with relevant parties with a view to introducing solvency regulations at a timing that does not lag behind the Insurance Capital Standard (ICS). In June 2020, the council recommended in the "Final Report of the Advisory Council on the Economic Value-based Solvency Framework" that a steady study of a more holistic prudential policy that goes beyond solvency regulation of insurance companies and takes into account the internal management of insurers should be conducted, with a target introduction date of 2025, in order to develop a regulatory and competitive environment appropriate to changes in the environment and risks surrounding insurance companies. The fundamental elements of the new framework are scheduled to be tentatively determined by 2022, based on analysis through field tests and dialogue with related parties, and the announcement this time is positioned as being in line with this schedule.

(3) The new regulation is expected to be finalized around the spring of 2024 and to be implemented in 2025, and calculations based on the new standards are expected to start at the end of March 2026. Similar to the Basel regulations for banks, it consists of Pillar 1 (solvency regulation), Pillar 2 (risk management and supervisory review), and Pillar 3 (disclosure). The tentative decision this time centers on the "standard model" and the "validation framework for ESR" under Pillar 1, while only the main issues and directions for consideration were presented for the supervisory intervention based on ESR and Pillars 2 and 3.

(4) In rating insurance companies, JCR focuses on business base, financial base, and risk management system based on the characteristics of their business, but on the quantitative side, JCR places emphasis on the assessment of capital adequacy. In assessing capital adequacy, JCR takes into account not only adequacy of regulatory capital, but also economic value-based adequacy of capital based on the characteristics of insurance liabilities, and the higher the rating range, the more JCR increases the importance of the assessment. In general, since life insurers have a certain amount of very long-term insurance liabilities due to the nature of their business and duration of their liabilities (insurance policies) is long, a gap with their assets is inevitable, making their ESR structure susceptible to interest rate fluctuations. Therefore, not only the level of ESR but also the control of its sensitivity through reduction of interest rate risk and other measures is important.

(5) JCR has long been incorporating interest rate risk arising from the duration gap between assets and liabilities held by life insurers as a relatively large constraining factor in its ratings. With the impending introduction of the new regulation, the companies have clearly indicated in their medium-term management plans and asset management policies the direction of measures such as lengthening asset durations and reviewing liability structures, with the aim of reducing asset management risk

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and reducing/controlling interest rate risk. Although JCR has been thinking that it would take a considerable amount of time to reduce interest rate risk, considering balance between securing accounting-based profits and reducing economic value-based interest rate risk, momentum toward reducing interest rate risk is growing, and JCR believes that this trend will continue over a medium to long term. JCR believes that the reduction of sensitivity on economic value-based indicators through risk reduction will positively affect the creditworthiness of each company, as already indicated in the press release "JCR's Rating Review of Major Life Insurers" (21-D-1150) dated January 21, 2022.

(6) In order to enhance corporate value amidst a drastically changing business environment, it is important to manage an appropriate risk-return balance based on an economic value-based approach. Each company has built an integrated management system for earnings and capital based on risk management through the development of ERM. Although there are some differences among the companies, they are working to closely link ERM and management by incorporating economic value-based approach into their business plans, with risk appetite as the starting point, product strategies, asset management strategies, and capital policies.

(7) The directions of the new regulation and economic value-based risk management, which is implemented by each company as internal management under ERM, appear to be consistent. Nevertheless, with regard to the setting of assumptions that form the basis of calculations, internal management appears to be able to capture the risk characteristics of each company in a more realistic manner, while the assumptions for the new regulation are expected to be set in a manner that is common to all companies. JCR therefore believes that the impact on the management decisions of each company may differ to some extent between internal management and regulatory compliance. In addition, as the new regulation is more complex and requires heavier administrative work than the current regulations, it will be necessary to improve the expertise and understanding of human resources and take measures for systems. Securing resources related to these matters will become issues for each company.

(8) With the introduction of the new regulation, the system of eligible capital will be restructured. This will mean that the current somewhat divergent evaluations of regulatory capital and capital in terms of rating will converge under an economic value-based approach. It is expected that products for financing with equity nature that meets the requirements for eligible capital will be considered in the future. JCR will consider its methods for rating of such financing products with equity nature and evaluation of equity content of those products in preparation for the finalization of the regulation.

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