Enterprise risk management in Japan
Japan
Introduction

The Japanese insurance market is the second largest in the world and the largest one overseen by a single supervisor. Figures collected by the General Insurance Association of Japan, whose members cover more than 90% of the non-life insurance market, show that the total net premiums of those members were ¥7,116 billion and ¥6,971 billion in the fiscal years ended March 2012 and March 2011, respectively. According to the Life Insurance Association of Japan, life premiums amounted to ¥36,289 billion at the March 2012 year-end, compared with ¥34,454 billion the previous year.

Although the records show an increase in premium revenues in these years in both non-life and life markets, Japanese insurers are facing some significant concerns, such as an aging and shrinking population, financial market uncertainties, increasing natural disasters and a high loss ratio in automobile insurance. Under these circumstances, enhancement of enterprise risk management (ERM) has become critical for survival and growth. Accordingly, the Japan Financial Services Agency (JFSA) has been placing a greater emphasis on the importance of ERM. In 2009, the JFSA updated its Supervisory Guideline to deal more extensively with ERM, and in 2011, it updated its Inspection Manual to include a section devoted explicitly to this topic.

Recent JFSA developments

<table>
<thead>
<tr>
<th>Date</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>June 2009</td>
<td>Updated Supervisory Guidance (e.g., integrated risk management, stress test)</td>
</tr>
<tr>
<td>April 2010</td>
<td>Revised the standard for solvency margin ratio calculation</td>
</tr>
<tr>
<td>June-December 2010</td>
<td>Conducted field tests of the economic value-based solvency regime</td>
</tr>
<tr>
<td>February 2011</td>
<td>Updated Inspection Manual (e.g., ERM)</td>
</tr>
<tr>
<td>September 2012</td>
<td>Published summary results of ERM interview</td>
</tr>
<tr>
<td>2013, to date</td>
<td>ERM interview continuing</td>
</tr>
</tbody>
</table>

It should be noted that natural disasters, such as the Great East Japan Earthquake, the floods in Thailand and a spate of typhoons, have occurred frequently in recent years. These events have resulted in renewed awareness of the important role the insurance industry plays in stabilizing people’s lives and economic activities. At the same time, improving risk management with regard to such successive major disasters has become a significant challenge for insurers. Thus, the JFSA is prioritizing the promotion of sophisticated risk management in its current supervisory policy toward insurers.
Current state of play in Japan
As Japanese insurers expand their operations to diversify profit sources in light of the financial crises and the sluggish Japanese financial markets, it has become critical to recognize various risks related to insurers' financial groups as a whole. The JFSA introduced a consolidated solvency margin ratio from the fiscal year ended 31 March 2012 for insurers domiciled in Japan. Under this new consolidated basis standard, insurers are required to consider even the risks associated with their non-insurance subsidiaries, which may be substantially different from the risks taken into account under the previous solvency margin ratio requirements. The new consolidated basis standard also aims to encourage insurers to introduce group-level risk management.

Further, the JFSA revised the standard for the solvency margin ratio calculation, imposing stricter rules intended to respond to the changes in the financial markets and to improve financial conditions and risk management practices of insurers in Japan. The revised standard became effective at the end of March 2012. The primary elements of the revisions are as follows:

- Adopting a more rigorous approach to the inclusion of some items in the margin, which corresponds to the numerator of the solvency margin ratio calculation formula
- Introducing restrictions on the inclusion of the surplus portion of the insurance premium reserves in the margin
- Introducing restrictions on the inclusion of deferred tax assets related to carried-over deficits in the margin
- Making the measurement of risks more rigorous and precise, corresponding to the denominator of the solvency margin ratio calculation formula
- Raising the confidence level of the coefficient of each risk (from 90% to 95%)
- Renewing statistical data used as the basis of the coefficient of each risk
- Calculating the investment diversification effect related to price-change risk based on each company's portfolio (previously, only the ratios of 30% and 20% were applied for life insurance companies and non-life insurance companies, respectively)
- Including the risk-reduction effect of hedging transactions only when the hedging is actually effective
- Adopting a more rigorous risk coefficient related to (re) securitized products; creating credit-spread risk related to credit default swap transactions; and adopting a more rigorous risk coefficient related to financial guarantee insurance
With respect to the Solvency II equivalence assessment of the Japanese supervisory system, the European Insurance and Occupational Pensions Authority (EIOPA) concluded in its advice to the European Commission, issued in October 2011, that overall, Japan appears equivalent to the provisions of Article 172, subject to certain caveats.

The most substantive issue regards the apparent strength of the solvency basis – in particular, the lack of economic valuation of the technical provisions, the limited granularity of the lines of business and the distinct target calibrations of the various capital charges. EIOPA also pointed out that the JFSA’s capital requirement is less risk-sensitive than the Solvency II SCR.

The issues raised by EIOPA concerning “taking up the business” (the ability of insurers to undertake unrelated business, which may make supervision more difficult); “system of governance and public disclosure” (the role of auditors in reporting breaches and the extent of public disclosure); and “changes in business, management or qualifying holdings” (lack of explicit intervention thresholds for the regulator) appear either to be less significant or to be capable of easy resolution.

The main significance of Article 172 equivalence will be simplification for the Japanese general insurance companies that have subsidiaries in the European Economic Area (EEA), chiefly to cover insurance risks from Japanese companies operating in the EEA. These risks are often ceded to their parent companies in Japan. In addition to Article 172 equivalence, the JFSA was apparently interested in transitional equivalence for Article 227 (group solvency) and Article 260 (group supervision). However, Japan’s quest for third-country equivalence with Solvency II has been “more or less shelved” because the Solvency II directive amendment has been delayed.
Benefits and challenges of implementing capital requirements/Pillar II

During the last year, JFSA conducted interviews concerning ERM with representatives from 23 Japanese insurance companies (including foreign insurers' subsidiaries in Japan) in order to understand the current risk management practices adopted by insurance companies in Japan. The agency released the results of the interviews in September 2012 as part of its efforts to promote the development of ERM. JFSA plans to conduct further ERM interviews in 2013 to determine whether the insurers have developed risk management systems that take into consideration the nature, scale and complexity of the risks inherent to their business, under the leadership and strong commitment of top management. The agency believes such interviews are effective to encourage the adoption of sophisticated ERM systems in order to improve the insurance industry standard as a whole.

Items in the 2012 ERM interviews include the following:

• Current state and issues of risk governance schemes:
  ▶ Design of risk management policy and internal rules
  ▶ Roles and responsibilities of management, directors, risk management committee and internal audit
  ▶ State of risk reporting

• Current state and issues of risk appetite:
  ▶ Understanding of risk profile
  ▶ Framework of risk appetite

• Status of risk and own capital management:
  ▶ Current state and issues of risk management process
  ▶ Use and execution of integrated risk management tools
  ▶ Implementation status of stress test
  ▶ Implementation status of ALM reflecting characteristics of insurance liabilities
  ▶ Future risks and adequacy of own capital in line with the middle-term management plan
The JFSA concluded that the 2012 interview findings show some favorable progress in the Japanese insurers’ ERM frameworks. Many insurance companies have increased management awareness of risk management, enhanced cooperation between risk management divisions and strategic planning divisions, and continued to make efforts to improve their risk management processes. On the other hand, there are still some areas to improve, such as:

- Expertise of board members in charge of risk management
- Role and responsibility of internal audit
- Understanding and utilization of risk profile
- Policy and framework of risk appetite
- Management structure of overseas entities
- Examination of reasonableness of internal model revisions

The agency also noted that no standardized ERM framework has been established for insurers and that implementation and maintenance of ERM is a part of the self-management process. This may raise practical issues of how best to cover all regulatory requirements, leverage existing process to cover the gap, and ultimately develop a useful tool for business.

As many European insurers have already learned, some Japanese insurers are recognizing that one of the key criteria for establishing a sophisticated ERM is a “forward-looking” approach. An effective and holistic forward-looking approach must be based on transparency with regard to intercompany effects and the concentration of risks. Deep knowledge and understanding of the interrelations, and connectivity of risk exposures, as well as awareness of asset, capital and liquidity interconnections are essential, though they may require some effort to achieve.

Moreover, creating a “risk-based culture,” recognized as critical for ERM to permeate throughout the whole organization, may be a key challenge for Japanese insurers as it includes some characteristics different from their current culture and the functional alignment of strategic and business planning, capital planning, capital allocation and determination of risk appetite.

ERM’s objective is not to eliminate risks, but rather to manage them within a framework that includes self-imposed limits. In setting limits for risk, the insurer should consider its solvency position and risk tolerance. Within these limits, risks can be reduced if it is cost-effective to do so, or increased if it is justified by expectation of enhanced returns and the availability of additional capital. Sophisticated ERM could also give an insurer a better understanding of the interaction between risk, capital and value across different types of businesses and geographies. This would enable management to more efficiently target and address the risks the business is facing (from a resource allocation perspective, for example). For Japanese insurers facing major issues, such as the aging and shrinking population and recurrent natural disasters, ERM would be a beneficial base for the operation of their insurance business.
Pillar 1 initiative

The JFSA is currently considering the possibility of moving to a valuation approach that is more closely linked to economic value. It is also considering taking into account costs that relate to options and guarantees when insurance liabilities are calculated. Although no detailed proposals for this approach have yet been made public, in 2010 the JFSA conducted a field test for economic valuation of both assets and liabilities with introduction expected in the medium term. In the field test, the following methods of calculating economic value-based insurance liabilities and other items were provisionally adopted. As for changes in the discount rate and assumptions for the calculation of the risk amount, the agency designated for the tests universal rates and assumptions to be used by all companies.

1) Composition of economic value-based insurance liabilities

The economic value-based insurance liabilities as defined in the field tests comprise the present value of future cash flows for all insurance policies in force as of the base date, as well as reserves for outstanding claims and risk margins, where the current amount of reserves for outstanding claims was used.

2) Method of calculating the present value of future cash flows

It was requested that the future cash flows be estimated for each of all policies in force in principle as of the base date and that they be calculated by discounting the value of the future cash flows with the discount rate (yield based on the risk-free rate).

3) Method of calculating risk margins

The use of the cost-of-capital method was required although it is not established as a standard method. In the cost-of-capital method, the present value of future cash flow to be obtained based on a prescribed change in assumptions related to insurance underwriting (95% confidence level VaR in the field tests) is calculated, and the increase in the amount compared with the present value to be obtained based on no change in assumptions is deemed to be the required capital. The total of each year’s required capital multiplied by a prescribed coefficient (cost capital ratio) and then discounted by the discount rate is deemed to be the risk margin.

4) Method of measuring interest-rate risk

It was requested that interest-rate risk be measured on the basis of the net asset amount (assets minus liabilities), with the following three methods allowed as options.

Method 1: measuring the risk as the impact to be produced on the present value of cash flow by interest-rate changes that occur over the whole of the insured period

Method 2: measuring the risk with consideration given to the correlation between grid points

Method 3: measuring the risk based on a Monte Carlo simulation

The JFSA continues to study practical issues identified through the field test in cooperation with the Institute of Actuaries of Japan (IAJ) and others. In 2013, the IAJ will submit a report to the agency relating to practical actuarial issues.
The way forward in Japan

According to the report of the Financial Sector Assessment Program (FSAP), issued by the International Monetary Fund (IMF) in August 2012, Japan is the first jurisdiction assessed by the IMF under the newly revised version of the Insurance Core Principles that were published in October 2011. The recommendations made by the IMF are generally well received by the JFSA. With regard to ERM, the IMF recommended that the JFSA enhance its guidance to indicate that insurers should explicitly describe the relationship between their risk tolerance limits, regulatory capital requirements, economic capital and the processes and methods for monitoring risk. The IMF also suggested that the agency provide more explicit guidance regarding the performance of own risk and solvency assessment (ORSA). Accordingly, the JFSA commented in its statement of the results of the ERM interviews that it would consider introducing the ORSA process.

As for the valuation of assets and liabilities for solvency purposes, as mentioned earlier, the JFSA is now weighing a move to an approach more closely related to economic value. Introducing a solvency regime predicated on economic value-based calculations of insurance liabilities would require corresponding revisions of the business management and risk management methods that have until now been used by insurers. The agency will therefore make steady efforts to establish a new framework through continuing dialogue with the relevant parties while developing a roadmap in advance to sufficiently enhance predictability and ensure a smooth introduction.

Next Steps

As Japan moves towards the introduction economic value-based calculation of insurance liabilities and the continuing JFSA focus on ERM, insurers in Japan need to develop sophisticated ERM systems. For improving risk management practices, the insurers need to assess all material risk in their ERM/ORSA and to develop/improve their internal model for quantifying risks. For explaining their ERM/ORSA process and result to internal management, regulation authorities, rating agencies and related parties, the ORSA report is the most appropriate document. And, as management practices are increasingly based on ERM systems, there will need to be changes in practice in various business areas for optimizations from an ERM point of view such as pricing, asset management, and reorganization of the group. To develop sophisticated ERM systems and ORSA reporting, the leadership and strong commitment of top management is needed for Japanese insurers.

Capabilities in Japan and contact names

Our Japanese insurance sector has more than 100 professionals able to provide assurance and risk management advisory services to insurance companies. Regarding ERM/ORSA, we can provide a number of services such as assistance in design/improve ERM/ORSA, assistance in design and enhancement of specific risk management practices and risk quantification, pertaining to regulatory capital requirements and support to obtain regulator’s approval.
Enterprise risk management in Japan
Contacts

Yuji Ozawa
Senior Partner, Assurance
EY ShinNihon LLC
Email: ozawa-yja@shinnihon.or.jp
Tel: +81 3 3503 3199

Toshikdo Kawasaki
Executive Director, Actuary
EY ShinNihon LLC
Email: kawasaki-tshhk@shinnihon.or.jp
Tel: +81 3 3503 1762

Koichi Dezuka
Executive Director, Advisory
EY ShinNihon LLC
Email: dezuka-kch@shinnihon.or.jp
Tel: +81 3 3503 3144

Peter Gaydon
Partner, Assurance
EY ShinNihon LLC
Email: gaydon-ptr@shinnihon.or.jp
Tel: +81 3 3503 2998

Hiroshi Ishii
Senior Manager, Assurance/Advisory
EY ShinNihon LLC
Email: ishii-hrh@shinnihon.or.jp
Tel: +81 3 3503 1898

Shoji Asada, Manager
Assurance/Advisory
EY ShinNihon LLC
Email: asada-shj@shinnihon.or.jp
Tel: +81 3 3503 3130

Atsushi Kominato
Manager, Actuary
EY ShinNihon LLC
Email: kominato-tssh@shinnihon.or.jp
Tel: +81 3 3503 1248

EY | Assurance | Tax | Transactions | Advisory

About EY
EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

About EY’s Global Insurance Center
Insurers must increasingly address more complex and converging regulatory issues that challenge their risk management approaches, operations and financial reporting practices. EY’s Global Insurance Center brings together a worldwide team of professionals to help you succeed – a team with deep technical experience in providing assurance, tax, transaction and advisory services. The Center works to anticipate market trends, identify the implications and develop points of view on relevant sector issues. Ultimately it enables us to help you meet your goals and compete more effectively.