EUROPEAN INSURANCE AND OCCUPATIONAL PENSIONS AUTHORITY

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EIOPA Draft Report

Equivalence assessment of the Japanese supervisory system in relation to article 172 of the Solvency II Directive

Please send your comments to EIOPA by email (equivalence@eiopa.europa.eu) by 23 September 17.30 CET, indicating the reference "EIOPA-CP-05-11".

Please note that comments submitted after the deadline or not submitted in the provided template format ***cannot*** *be processed.*

EIOPA will make all comments available on its website, except where respondents specifically request that their comments remain confidential.

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Chapter I: Introduction

Section 1 - Equivalence assessments under Solvency II – a brief summary:

1. Under the Solvency II directive the European Commission may determine whether the solvency regime of a third country is equivalent to that laid down in Solvency II in relation to three areas of focus. Article 172 relates to equivalence of the solvency regime applied to the reinsurance activities of insurers[1] with their head office in the third country concerned, where a positive determination would allow reinsurance contracts with insurers in that third country to be treated in the same way as reinsurance contracts with EEA insurers. Article 227 relates to third-country insurers which are part of EEA groups, where equivalence would allow groups to take into account the local calculation of capital requirements and available capital rather than calculating on a Solvency II basis for the purposes of the deduction and aggregation method. Article 260 relates to group supervision of EEA insurers with parents outside the EEA, where equivalence would mean EEA supervisors would rely on the group supervision of that third country.

2. The European Commission's Call for Advice of 11th June 2010 asked CEIOPS (EIOPA's predecessor organisation) to provide final advice on whether the supervisory regimes of certain countries satisfy the general criteria for assessing third country equivalence. In its letter of 29th October 2010 the European Commission indicated that Japan should be assessed for equivalence under article 172. EIOPA was invited to provide its advice by the end of September 2011, following full consultation.

3. In accordance with the methodology for equivalence assessments, which can be found in consultation paper 82, EIOPA published a Call for Evidence on 1st December 2010, in which interested parties were invited to provide information and evidence on relevant aspects of the supervisory practices and insurance regulatory regime in Japan, based on their own experiences. EIOPA also invited the Japanese Financial Services Agency (JFSA) to complete a questionnaire on its regulatory regime and supervisory practices, in particular in relation to those areas relevant to the equivalence criteria. Following receipt of the response, in February EIOPA commenced a desk-based review of the information received which lasted approximately three months and included an additional round of questions. This was followed by an on-site visit to clarify further our understanding of the Japanese regime and supervisory practices, which included meeting with members of the Japanese industry, followed by some further written queries.

4. Equivalence assessments are expected to take into account the principles contained in the Solvency II directive, as well as the general criteria for assessing third country equivalence to be found in the Level 2 Implementing Measures. The criteria (principles and objectives) set out in this report reflect those published in our previous consultation papers, however in our analysis we have aimed to take into account the most recent draft of the criteria which was available to us: we will review this advice again once the Level 2 Implementing Measures are finalised to check that it is consistent with the final published proposals.

5. Statements in this report are based on Japanese legislation and information received for the purposes of the assessment, predominantly from JFSA, including

[1] Please note that throughout this report, where reference is made to "reinsurers" this includes insurers and reinsurers, unless otherwise specified.

the responses to the questionnaire and further questions described above, as well as JFSA statements during our on-site visit.

6. EIOPA's advice on equivalence refers only to the regulatory regime applying to those insurers which would, by virtue of their size and the nature of their activities, fall within the scope of the Solvency II Directive.

Section 2 - EIOPA Methodology:

7. Our methodology is set out in greater detail in our consultation paper 82.

8. There are a number of over-arching principles under-pinning the assessment:

    - Equivalence assessments aim to determine whether the third country supervisory system provides a similar level of **policyholder and beneficiary protection**.
    - Supervisory cooperation under conditions of **professional secrecy** is a key, determinative element of a positive equivalence finding. When assessing the criteria relating to professional secrecy, the principle of proportionality will not apply.
    - The equivalence assessment is a **flexible process** based on principles and objectives (embedded in the general criteria for assessing third country equivalence). All the applicable criteria (the principles and objectives) need to be met for a positive equivalence assessment; there are a number of indicators associated with these principles to help to guide the assessment, but a positive equivalence assessment does not require that every indicator be fulfilled.
    - When pursuing an equivalence assessment, proper consideration should be given to the adequacy of third country practice in applying the **proportionality** principle. This is further developed below.
    - An equivalence judgement can only be made in respect of the **regime in existence** and applied by a third country supervisory authority at the time of the assessment. Plans and on-going initiatives for changing the national supervisory regime should not be considered an adequate support for a positive equivalence finding until the day of their actual implementation. Nevertheless, these initiatives should be taken into account, with due consideration given to their expected timing and the degree of commitment to them, when performing an equivalence assessment and providing advice to the Commission.
    - Assessments will be **kept under review** and take into account any developments that might lead to relevant changes in the third country supervisory regime. EIOPA will review its advice at least every 3 years or upon learning of significant developments within jurisdictions already found equivalent.

9. For a criterion to be considered equivalent, the third country supervisory authority must provide evidence that the relevant national provisions exist and are applied in practice. The process of assessing each principle and objective requires a judgmental weighting of numerous factors.

Proportionality

10. The proportionality principle is embedded in the Solvency II Directive, Article 29 (4) of which states that: "[…] Implementing measures [should ensure] the proportionate application of this Directive, in particular to small insurance undertakings". Consistently with this, the Directive:

- Recognises that the principle of proportionality should apply to captives, given that they only cover risks associated with the group to which they belong (Article 13 (2) and Recital 21 Solvency II Directive);
- Introduces a requirement for the system of governance to be proportionate to the nature, scale and complexity of the (re)insurance undertaking's operations (Article 41 (2) Solvency II Directive);
- Allows for simplified methods and techniques to calculate technical provisions in order to ensure that methods are proportionate to the nature, scale and complexity of the risk supported by the (re)insurance undertaking, including captive (re)insurance undertakings. (Article 86 (h) Solvency II Directive);
- Allows for simplified calculations for specific risk modules and sub-modules where this is justified taking into account the nature, scale and complexity of the risks faced by insurers, including captives (Articles 109 and 111 Solvency II Directive);
- Establishes an absolute floor for the MCR (Minimum Capital Requirement) of €1m for captive reinsurers, as opposed to €3.2m for other reinsurers (Article 129 (2d) (ii) Solvency II Directive); and
- Introduces a requirement for supervisory powers in deteriorating financial conditions to be proportionate and reflect the level and duration of the deterioration of the solvency position of the (re)insurance undertaking concerned.

11. In line with this, in its 1st April 2010 cover letter to the EC, EIOPA stated that equivalence was "a proportionate process. […] As such, under each of the Chapters, [EIOPA] has advised that the existence of a proportionality principle in the application of regulatory provisions in 3rd country jurisdictions (contingent upon the nature, scale and complexity of the risks inherent in the business) should not be in itself and obstacle […] to the recognition of equivalence." In its May 2008 advice on proportionality (paragraph 11, page 5), CEIOPS stated that "Proportionality does not mean the introduction of automatic and systematic simplifications for certain undertakings. […] The individual risk profile should be the primary guide in assessing the need to apply the proportionality principle."
12. EIOPA has taken the principle of proportionality into account in its equivalence assessments in a manner consistent with the above. Under this approach application of the proportionality principle could include discretion for the supervisory authority to apply the requirements in different ways as proportionate, but would not include discretion for the supervisory authority to exempt insurers from certain requirements. For instance, a proportionate application of a requirement for all insurers to have certain function holders could include the supervisory authority being comfortable with a small insurer having one person who holds for example the risk management function and actuarial function at the same time; it would not include a small insurer not having one or other of these functions at all.

EIOPA's advice

13. In undertaking the assessment, the finding for each criterion will be given using five categories: equivalent, largely equivalent, partly equivalent, not equivalent and not applicable.
14. EIOPA's overall advice to the European Commission on the country's equivalence for each article will be given as one of the following:

- Country A meets the criteria set out by the Commission.
- Country A meets the criteria but with certain caveats.
- Country A needs to undertake changes in the following areas (…) in order to meet the Commission criteria for equivalence.

Section 3 - The Japanese insurance sector – an overview:

Overview of the Japanese (re)insurance market

15. The Japanese insurance market is the second largest in the world (the largest in terms of a market overseen by a single supervisor), with (provisional) gross written premiums of ¥48,376 billion in the financial year to 31 March 2011. This compares with ¥48,485 billion in the previous year[2]. In terms of premium income, the market is dominated by the life sector, with non-life (property and casualty) premiums, including the vast majority of Japanese reinsurance business, accounting for ¥10,109 billion of the total. With 6.4% of global non-life business, the Japanese non-life market is the third largest in the world, broadly comparable in size with that of Germany, which ranks second.

16. Figures produced by the General Insurance Association of Japan (GIAJ), whose members cover around 95% of the market, show that non–life gross direct premiums in 2009 were ¥8,266 billion (€70.1 billion). For domestic Japanese insurers the gross written premium was ¥7,784 billion (including ¥ 61 billion of direct premiums written abroad by Japanese non-life insurers). Net premiums of domestic Japanese insurers were ¥6,971 billion.[3] The industry has experienced three years of declining net premium with gross premiums reducing significantly over the last decade.

17. The premium paid in outward reinsurance by Japanese insurers was ¥328 billion in 2009, with claims received being ¥148 billion. By comparison the inward reinsurance balance in the same year was ¥192 billion of premiums received and ¥194 billion in claims paid. It is clear that Japan is a net importer of reinsurance cover. It is difficult to arrive at figures for the reinsurance business conducted purely domestically within Japan.

18. GIAJ figures show that the 20-year average loss ratio for Japanese insurers is 58.5% with a combined ratio of 94.7%. Experience over 2008-9 has been worse than in the past, with the combined ratio slightly exceeding 100% for the first time. The influence of investment income on overall profit and net income performance has increased significantly since 2003 – and has been a positive influence in all years except 2008. The overall industry solvency margin in 2009 was 696.4%[4] under local rules. Net income of GIAJ members in the same year amounted to ¥207 billion (following a loss of ¥81 billion in 2008).

Market participants

19. To underwrite reinsurance in Japan, including life reinsurance, a licence for non-life business is normally required. There are 51 licensed insurers in the non-life market. Amongst the 29 licensed domestic insurers, 25 of which are members of the GIAJ, there are only two insurers that are solely engaged in reinsurance business: Toa Reinsurance Company Limited and the Japan Earthquake Reinsurance Company Limited. Toa Reinsurance Company has confirmed that – depending on the exact measure - they account for around 20% of the Japanese

[2] Figures from Swiss Re sigma No 2/2011. The non-life premium figures include reinsurance premiums.
[3] GIAJ Fact Book 2009-2010. Direct premiums written + inward reinsurance net premiums – outward reinsurance net premiums – savings portion of maturity refund type insurance premiums.
[4] Under Principle 6 the interpretation of the solvency ratio in comparison to Solvency II levels is discussed.

reinsurance market[5]. The remainder is handled by direct insurers that also underwrite reinsurance business, and foreign reinsurers present in the market.

20. Most[6] of the insurers in the GIAJ's membership are involved to a greater or lesser extent in reinsurance business. This includes mutual insurers who provide reinsurance mainly to those who are already participating members of the mutual. Amongst the 22 licensed foreign insurers, a number of global reinsurers are represented. There are no captive reinsurers licensed in Japan.

21. The Japan Earthquake Reinsurance Company plays a distinct role in the market, being a conduit for liability sharing between the government and insurers for household earthquake risk - the potential severity of this risk within Japan means that government support is required to maintain insurability.

22. The Japanese non-life market is highly concentrated, with three groups accounting for around 90% of the business written. They are, in order of overall net premium written:

    - MS&AD Insurance Group Holdings Inc., created in April 2010 and incorporating Mitsui Sumitomo Insurance Group Holdings Inc., Aioi Insurance Company Ltd and Nissay Dowa General Insurance Co Ltd.
    - NKSJ Holdings Inc., also created in April 2010, and incorporating Sompo Japan Insurance Inc. and Nipponkoa Insurance Co Ltd.
    - Tokio Marine Holdings, incorporating Tokio Marine & Nichido Fire Insurance Co Ltd and Nisshin Fire & Marine Insurance Co Ltd.

23. It seems that without foreign reinsurers present in the market, Japanese insurers' ability to spread risk broadly through comprehensive reinsurance programmes would be very restricted. All three of the above-mentioned groups are active in the EU, and GIAJ member insurers together have over 70 offices in 15 European countries (including Switzerland). Worldwide GIAJ members have 206 offices.

24. A non-life licence is normally required to underwrite life reinsurance in Japan. Life insurers can underwrite life reinsurance if they obtain a specific authorisation to do so from the JFSA. In practice, very little life reinsurance is written by Japanese life insurers. The main participants in the life reinsurance market are Toa Re and foreign reinsurers. Japanese life insurers do not write life reinsurance risks outside Japan.

25. One feature of the Japanese market is the role played by the Non-Life Insurance Rating Organisation. It sets reference rates for various risks, which are clearly an important part of the overall approach to policyholder protection in insurers that also underwrite reinsurance. The JFSA is informed about the rates used for particular contracts, contributing to its understanding of an insurer's risk profile.

26. The Japanese insurance industry has clearly had to deal with extraordinary catastrophe events in 2011. EIOPA notes that the industry has responded well to these challenges, while recognising that the ultimate cost for reinsurers is still uncertain as claims develop. Insured current loss estimates are upwards of ¥2.7 trillion.

Brief overview of the institutional and legal framework for the financial sector of Japan

[5] Toa Re specifically holds licences for non-life reinsurance, life reinsurance (acquired in 1997) and the third-sector (acquired in 1998). In 2010, 23% of their net premium income was from life and co-operative business, 42 % from domestic non life, and 35% overseas non-life (5% EU).

[6] 19 involved in outward, 13 involved in inward.

27. The JFSA was established in July 2000, and its supervisory scope and powers cover all financial services sectors. The JFSA is established under the Cabinet Office, and this ensures a greater independence within the Japanese governmental system than if it was a body within a particular Ministry. The ultimate responsibility is given to the Prime Minister, as head of the Cabinet Office, for the JFSA's political accountability.

28. The JFSA organisation chart shows a reporting line up through a Minister for Financial Services, as distinct from the Minister of Finance. Specific powers delegated to the Minister for Financial Services include licensing and the cancellation of a licence. The Minister of Finance is consulted in advance when action against insurers and/or the activities of the Insurance Policyholders Protection Corporation of Japan pose the risk of making a serious impact on the maintenance of the credibility of insurance business.

29. In addition to legislative Acts, the JFSA operates through a variety of instruments: Orders, Ordinances, Stipulations (which contain more detail on what the law means) and Supervisory Guideline. Cabinet Ordinances, Stipulations and Supervisory Guideline are drafted by the FSA and finalised after public consultation. Ordinances and Stipulations have the status of legally binding regulations.

Chapter II: Overall assessment

EIOPA advice on Japan's equivalence under Article 172

30. EIOPA's advice is that Japan meets the criteria in EIOPA's methodology for equivalence assessments under Article 172 of Solvency II, but with certain caveats set out below.

31. We find the JFSA equivalent with regard to its powers and responsibilities as a supervisory authority.

32. We find the JFSA equivalent with regard to its professional secrecy obligations. We have no caveats to add in relation to this principle.

33. We find the JFSA largely equivalent with regard to its authorisation of reinsurance business as Japanese insurers are allowed to pursue incidental non-insurance business to an extent which is inconsistent with the general principles embedded in Solvency II. While recognising that the JFSA monitors this business closely, the possibility of carrying out both insurance and incidental non-insurance business in a single company represents a potential risk for reinsurance cedants, and constitutes a significant difference from the Solvency II regime.

34. We find the JFSA largely equivalent with regard to its governance and public disclosure requirements. There is scope for encouraging and facilitating further auditors' reporting to the supervisory authority where problems are discovered or the performance of the insurer is deteriorating. We also note that disclosure requirements could also be further improved.

35. We find the JFSA largely equivalent with regard to its requirements around changes in business, management and qualifying holdings. The Japanese law establishes licensing powers for the JFSA in relation to shareholder structure which allow it to control the fitness and propriety of shareholders with a qualifying holding but this is inconsistent with Solvency II approach to explicitly establish intervention thresholds as to ownership changes.

36. We find the JFSA partly equivalent with regard to its solvency regime for reinsurers taking into account, inter alia, the various reserving requirements applicable to Japanese insurers. We note that new entrants and those rapidly expanding their business will not be subject to the same level of prudence in those reserving requirements and that currently technical provisions are not calculated using market consistent valuation. We anticipate that the JFSA will be largely equivalent once the expected move to market consistent valuation of liabilities is finalised.

Chapter III: Assessment of each principle

Principle 1 - Powers and responsibilities of third country supervisory authorities

Objective - *The supervisory authorities of the third country have the necessary means, and the relevant expertise, capacity, and mandate to achieve the main objective of supervision, namely the protection of policyholders and beneficiaries regardless of their nationality or place of residence. In particular, the supervisory authorities in that third country shall have the necessary capacities, including financial and human resources.*

The supervisory authorities of the third country are empowered by law or regulation to effectively supervise domestic insurance or reinsurance undertakings carrying out reinsurance activities and to undertake a range of actions, including the ability to impose sanctions or take enforcement action in relation to the domestic insurance or reinsurance undertakings carrying out reinsurance activities that it supervises.

The supervisory authority

JFSA's responsibilities and enforcement powers

37. According to Article 3 of the Law on the Establishment of the Financial Services Agency (LEFSA), the JFSA is responsible for (i) ensuring the stability of the financial system in Japan, (ii) protecting depositors, insurance policyholders and securities investors, and (iii) ensuring the smooth functioning of financial markets. As such, the JFSA has full institutional powers as to:
    - Planning and policy-making for the financial system; and
    - Supervision by way of on-site inspections and off-site monitoring in order to ensure prompt corrective actions are taken when needed.
38. Aside from its supervision of the banking, insurance and securities sectors the JFSA is also responsible for supervision of the securities market and the audit professional body, with two councils established under its aegis:
    - Securities and Exchange Surveillance Commission (SESC): conducts daily market surveillance, inspections of investment firms (such as securities companies and investment management firms), enforcement investigations, inspections of disclosure documents and criminal investigations into securities fraud.
    - Certified Public Accountants and Auditing Oversight Board (CPAAOB): has three main responsibilities: (i) Oversight of the "quality control reviews" and inspections conducted by audit firms, (ii) Administration of CPA Examinations, and (iii) Disciplinary actions against CPAs and audit firms.
39. The actuarial professional body is also within the JFA's remit since it has a role in approvals for the purpose of enacting professional actuarial guidelines.
40. The JFSA has full corrective powers to restore compliance with the law where a supervised person or entity violates legislation in force. These powers include:
    - Administrative orders (Articles 128 and 132 of the Insurance Business Act – hereunder IBA) up to and including licence withdrawal (Article 133 IBA).
    - In cases where misconduct is found that it is deemed to impair the fairness of trading, the SESC may recommend that the JFSA take administrative disciplinary actions or file formal complaints with public prosecutors

(Financial Instruments and Exchange Act (FIEA)).

Freedom from undue political, governmental and industry interference in the performance of supervisory responsibilities

41. The JFSA is an extra-ministerial bureau of the Cabinet Office under Article 49 (3) of the Law on the Establishment of the Cabinet Office. In practice, all powers assigned to the Prime Minister in the IBA are, except for those delegated to the Minister for Financial Services, delegated to the Commissioner of the JFSA.

42. Within this institutional framework, the IBA provides the necessary legal basis for the JFSA to be competent for the supervision of insurers, including powers to require insurers to suspend or improve their business operations, to conduct on-site inspections and off-site monitoring, and to approve insurance products.

43. The JFSA's responsibilities are delivered through three main bureaus established within the JFSA:

    - Planning and Coordination Bureau: responsible for (i) coordinating of matters related to the JFSA as a whole (including coordination between bureaus within the FSA) and (ii) planning the regulatory regime (including developing draft laws);
    - Inspection Bureau: on-site inspections of financial institutions; and
    - Supervisory Bureau: off-site monitoring of financial institutions.

44. The Minister for Financial Services relies to a large extent on the input of the JFSA when delivering its statutory duties with regard to:

    - Licensing (Article 3 (1) IBA);
    - Cancellation of a licence granted (Article 133 IBA);
    - Approval of the establishment of a Policyholder Protection Corporation (Article 265-9 (9) IBA); and
    - Approval of the establishment of insurance holding companies (Article 271-18 (1) IBA).

Transparency of supervisory processes and procedures

45. Aside from the primary body of law applicable to insurers (IBA, Order for Enforcement of the Insurance Business Act (IB Order), and Ordinance for Enforcement of the Insurance Business Act (IB Ordinance)) which is publicly available, the JFSA is also keen to ensure that insurers within its jurisdiction are adequately informed as to its supervisory expectations. This purpose is served by the JFSA website, where a comprehensive Supervisory Guideline for Insurance Companies is made available for the industry and general public.

46. The JFSA Supervisory Guideline for Insurance Companies is not in itself legally binding for insurers, but it has been demonstrated that it is closely observed by insurers and as such is considered to have a strong contribution to ensuring orderly conduct in the market.

47. Further to these Guidelines, the JFSA annually publishes a document entitled "Basic Policy for Financial Inspections", which aims to establish and publicly announce the focus for the JFSA's supervisory activities and on-site inspections in the year ahead.

48. The JFSA has also established a "No-Action Letter system" for the purposes of its significant contribution to the Minister for Financial Services' licensing process and its own licensing of insurance products. Under this system insurers notify the

JFSA of proposed courses of action they wish to pursue (such as business expansion or a product launch), and if no response is received within the allotted time the JFSA can be assumed to have no objections. The JFSA has to answer enquiries within 30 days and make its reply available on its website. This "No-Action Letter system" does not prevent the JFSA from subsequently taking action in cases where problems are identified.

Adequate financial and non-financial resources

49. The JFSA expects to have 1537 employees in total in March 2012[7]. Of these approximately 100 are fully dedicated to insurance supervision (split between the Inspection and Supervision Bureaus) with additional resources also available from other parts of the organisation (legal, accounting and actuarial expertise).

50. The JFSA's budget is part of the overall Japanese Cabinet budget and is subject to the approval of the Diet (like any other governmental unit). The JFSA has been successful in increasing both its staff numbers and budget, even though in recent times the wider governmental staff numbers and budget have been reduced. In 2011 the total JFSA budget was ¥22 billion, compared to under ¥13 billion in 2003.

51. JFSA staff are subject to a general and periodical re-shuffle (every two to three years), although it was noted that for some experts the re-shuffle may take place less frequently (every 3 to 5 years). According to JFSA staff policy, any potential disruption to the JFSA's day-to-day activities is mitigated by, among other measures:

    - Extensive internal training in order to ensure handover of information and adequate continuity as to the supervisory approach;
    - Enhanced duty periods for key staff in supervisory units (longer intervals between moves);
    - Extensive use of the Supervisory Guidelines and Annual Supervisory Policy; and
    - Ensuring that the moves of staff in particular supervisory teams are staggered to allow some continuity.

52. The JFSA has recruited a number of staff from the private sector in recent times, and as at 1 June 2010 the total amounted to 316 people across the organisation – including 8 actuaries. Although the fact that the JFSA has supervisory powers in relation to the audit and actuarial professions, and can therefore place some reliance on their work for insurers, alleviates to some extent, the need for numerous staff with these skills, it does not entirely negate it. Although in comparison to other leading markets the number of insurers supervised by the JFSA is relatively low (fewer than 100), there would seem to be a need for additional specialised staff to deal with the future demands of supervision, particularly some insurers are developing their enterprise risk management systems and looking at internal models. The JFSA will need the input of specialised staff to be able to assess these developments and challenge the firms effectively.

Appropriate protection from being liable for actions taken in good faith

53. The State Redress Act (Article 1 (1 and 2)) provides that the Government shall assume the responsibility to provide compensation in cases where a public officer who exercises the public authority unlawfully inflicts damage on another person

[7] As of March 2009 it had 1417 employees.

in the course of his/her duties. The Government only has the right to obtain reimbursement from the public officer where there is proven intent or gross negligence on their part.

54. This ensures that appropriate protection from being liable for actions taken in good faith is provided to the JFSA staff, as all JFSA employees are public officers.

Powers to take preventative and corrective measures

55. The JFSA has provided evidence as to its powers to take preventative and corrective measures to ensure that insurers comply with the applicable laws, regulations and administrative provisions. This includes in particular the ability:

- to obtain all information necessary to conduct the supervision of the insurer (for example under Article 128 IBA);
- to ensure compliance on a continuous basis with laws, regulations and administrative provisions (including through on-site inspections) including measures to prevent or penalise further infringements (including preventing the conclusion of new contracts) (for example under Articles 128, 131 and 132 IBA);
- to communicate concerns, including those relating to the insurer's financial position (for example under Article 130 IBA by prescribing standards for financial soundness for the insurer and under the early warning system established under Supervisory Guideline II-2-3); and
- to oblige the insurer to respond to concerns raised by the supervisor (for example under Article 131 (1) IBA).

Financial Supervision

56. The Companies Act (CA) and the IBA provide the legal framework and requirements as to the governance of insurers (stock companies or mutuals). Those insurers that are listed also need to comply with the requirements of the FIEA.

57. Further to these, the Supervisory Guideline sets out in great detail the key points for the assessment of governance systems, including the general requirements for risk management, and requirements for the CEO, board members, auditors and actuaries.

58. Article 128 IBA establishes insurers' obligation to submit interim and annual financial reports to the JFSA, while Articles 59 et seq. IB Ordinance require insurers to provide a comprehensive overview as to the status of the business as well as a semi-annual financial performance report. Requirements for mutuals' financial reporting are also established in both legal acts.

59. A specificity of the JFSA supervisory approach is the way the JFSA encourages insurers to perform voluntary stress tests which are aimed at:

- providing forward-looking assessments of risk;
- overcoming the limitations of models and historical data;
- supporting internal and external communication;
- feeding into capital and liquidity planning procedures;
- informing the setting of risk tolerance; and
- facilitating the development of risk mitigation or contingency plans across a range of stressed conditions.

Accounting standards:

60. Insurers – whether stock companies or mutuals –use the J-GAAP (found to be equivalent to International Financial Reporting Standards (IFRS) in the EU - EC Decision of December 2008). Accounting requirements specific to insurance are provided by the IBA (Articles 109 to 118 for stock companies and Articles 54 to 59 for mutuals).

61. The reference date for insurers' submissions is 31 March, as the Japanese financial year starts on 1 April.

Qualifying holdings

62. Shareholders that directly or indirectly hold 5% or more of the voting rights in an insurer ("large shareholders") must notify the JFSA of their shareholding within five business days of the acquisition. Every further 1% change in the level of their voting rights also has to be notified. JFSA approval is required for "primary shareholders" defined as those which directly or indirectly, together with other persons acting in concert, hold 20% or more of the voting rights. This also applies to individuals holding 15% or more of the voting rights. Primary shareholders holding 50% or more of the voting rights of an insurer may be subject to an administrative order to develop and implement a remediation programme to ensure the soundness of the insurer. These are the only thresholds identified at the level of primary law with regard to changes in qualifying holdings. We note that in a risk-sensitive or risk-based rather than rule-based supervisory system, those powers applicable to shareholders holding 50% or more of the voting rights should equally apply to any controlling shareholder, even if this latter holds less than 50% of the voting rights.

63. This needs to be seen in the context of the JFSA's overall approach to supervision and the general reporting requirements applicable to the insurer. Insurers are required to submit information on its top 10 shareholders semi-annually, by which the FSA is able to check changes in participation (Article 59 (2) IBA Ordinance)..

64. Based on this information, the IBA provides the JFSA with extensive powers to request additional information from primary shareholders and take supervisory action (including corrective actions) in relation to them, where the JFSA considers that a decrease or increase in their holding may have a negative impact on the soundness of the insurer and, ultimately, on the level of policyholder protection.

65. It should be noted that failure to request a licence to become a primary shareholder prior to increasing a holding to the relevant level is a breach of the IBA and one who fails to get authorization of primary shareholder is required to decrease the holding (Article 271-10 (4) IBA).

Supervisory powers available to the JFSA in respect of insurers in difficulties

66. For the JFSA, the level of the solvency ratio is one of the main triggers for corrective actions. This is considered to be an objective criterion that enables the JFSA to ask insurers to take the necessary actions to maintain or regain financial soundness.

67. Among the actions that the JFSA may require at different solvency ratio intervention points are:
    - Submission of a plan deemed reasonable for improving the insurer's ability to pay insurance claims and similar, and implementation of that plan;
    - Prohibition or reduction of dividends;

- Prohibition or reduction of dividends to policyholders or distributions of surpluses to members;
- Changes to the methods for calculating premiums for new proposed insurance contracts (including any coefficients that form the basis of those calculations if required);
- Prohibition or reduction of directors' bonuses, or the reduction of other project expenses;
- Prohibition or reduction of certain methods of asset investment;
- Contraction of business operations at some business offices or branches or of the business operations of subsidiary companies;
- Abolition of some business offices or branches, excluding the head office or principal office;
- Disposal of shares or equity in subsidiary companies or similar; and
- Order for partial of full suspension of business (time limited).

Enforcement actions available to the JFSA

68. The legal framework provides a variety of supervisory actions to be taken depending on the gravity of the misconduct. For example, in the case of a major breach of the law or major violation of the licensing conditions, or in the case of acts prejudicial to the public interest, the JFSA will take severe measures, including withdrawal of licence as required in Article 133 IBA.

69. The FSA will undertake on-site inspections and issue an administrative order as provided for in Article 132 IBA.

Cooperation with other authorities or bodies

70. The JFSA is empowered at the level of the LEFSA and the IBA to cooperate with domestic authorities and in particular with the Ministry of Finance when deemed particularly necessary in relation to e.g. licence recall procedures and with the Prosecution office under Supervisory Guidance section "II-3-2 Supervisory Actions against Misconduct".

Type and frequency of accounting, prudential, statistical information obtainable by the supervisory authority from an insurer

71. Japanese insurers are required by law (Articles 110 and 111 IBA) to submit semi-annual and annual business reports to the JFSA. These reports cover the following:

    - Matters related to the overview and organisation of an insurer (including the structure of the company and names of major shareholders, directors and auditors).
    - Details of the principal business of an insurer.
    - Matters related to the principal business of an insurer (including an overview of the business for the most recent business year, and key financial figures (such as profits/losses, net assets, technical provisions, securities held, solvency margin ratio, dividends, contracts held) for the last five business years).
    - Matters related to the business operations of an insurer (including the framework for risk management and compliance).
    - Matters related to an insurer's key attributes for the last two business

years (including a balance sheet, a profit and loss statement, a cash flow statement, the amount of bad loans, the solvency margin ratio (including the amounts of individual margins) and the market value of securities/derivatives).

- In cases where, as of the last day of the business year, there exists any circumstance which gives rise to any material doubt that the insurer will continue its business activities in the future or any other circumstance which may have a material impact on the insurer (referred to as "Material Events"), the insurer is required to notify the JFSA of this fact and provide details and analysis of the Material Event, as well as details of the measures to be taken in order to improve such circumstances.

72. Furthermore, according to the Supervisory Guideline (III-1-1), as part of its off-site monitoring the JFSA will continuously collect financial and accounting information from insurers as well as information regarding various risks, including credit, market and liquidity risks.

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73. The JFSA has the necessary mandate and supervisory powers to effectively protect policyholders and beneficiaries regardless of their nationality or place of residence. The JFSA has the power to effectively supervise insurers established in Japan, and impose sanctions or take enforcement action where necessary.

74. With regard to the JFSA's resources, and the expertise and capacities necessary to deliver on its mandate, it should be noted that the JFSA is in relatively good standing from the perspective of the overall Japanese governmental system. Nevertheless, in respect of insurance supervision the JFSA could benefit from an additional increase in staff with specialist skills, in particular in order to ensure the JFSA is able to complete its transition to a fully economic and risk based supervisory approach while retaining the ability to effectively challenge the changing approaches to capital management proposed by the insurers it supervises.

75. Japan is considered to be equivalent under Principle 1 dealing with the powers and responsibilities of third country supervisory authorities.

Principle 2 - Professional secrecy, exchange of information and promotion of supervisory convergence

Objective – *The supervisory authorities of the third country and supervisory authorities of Member States involved in the supervision of domestic insurance and reinsurance undertakings shall cooperate and, where relevant, ensure the effective exchange of information.*

The supervisory authorities of the third country shall provide that all persons who are working or who have worked for the supervisory authorities, as well as auditors and experts acting on behalf of those authorities, are bound by obligations of professional secrecy.

The above mentioned obligations of professional secrecy shall extend to information received from the supervisory authorities of Member States.

Practical supervisory cooperation

Ability and willingness to communicate concerns regarding reinsurers including the sharing of confidential information

76. In Japan, the LEFSA stipulates that the JFSA is responsible for international cooperation related to its supervisory duties. This is elaborated on in an ordinance.

77. This responsibility includes the ability to exchange confidential information with foreign supervisory authorities.

78. Thus, the exchange of information pursuant to these provisions does not result in a violation of the National Public Service Act (NPSA) which stipulates that all national public servants – including former public servants - are required to keep confidential any information which they receive in the course of their duties.

79. Cases where information sharing with foreign supervisors has taken place include the licensing of foreign insurers, enquiries around the financial conditions of insurers, assessing the suitability of directors, and investigations regarding the branch offices of foreign insurers in Japan where the JFSA intends to take supervisory action.

80. All requests from foreign supervisors were answered in a professional manner. No request was refused.

Multilateral agreements

81. With regard to international cooperation, the JFSA complies with international principles and standards set by the International Association of Insurance Supervisors (IAIS).

82. The JFSA's application to enter the IAIS Multilateral Memorandum of Understanding (MMoU) was recently accepted by the IAIS Executive Committee and the JFSA became a signatory of the IAIS MMoU in July 2011. Information exchange with the IAIS MMoU signatory member countries will be carried out with reference to the IAIS MMoU text.

83. The JFSA has also signed the IOSCO MMoU and signed an MMoU with a number of major supervisors regarding the supervisory college of a large EEA group and use this as a basis to exchange information.

Bilateral agreements

84. The JFSA has signed several bilateral MoUs and has engaged in multiple ”Exchange of Letters” procedures with foreign insurance supervisors.

Conclusion

85. EIOPA therefore concludes that the JFSA is able to communicate and share confidential information with foreign supervisory authorities.

Exchange of information

86. When the JFSA provides information which it holds (such as information that it produces internally and that it receives from the insurers it licenses) to a foreign supervisory authority upon request, the JFSA checks, in practice:

    (i) that the confidentiality of the information will be ensured at the receiving foreign supervisory authority (including whether the foreign supervisory authority is subject to a confidentiality requirement equivalent to the one that the JFSA is subject to); and

    (ii) that the information the JFSA provides is used only for the purpose specified by the foreign authority (unless there is an MOU or exchange of letters between the JFSA and the foreign authority).

87. Where these preconditions are met the JFSA exchanges the information.

Regime with regard to the professional secrecy obligations the JFSA must observe

Legal duty to protect confidential information and applicability to staff

88. Professional secrecy requirements apply to all JFSA staff members. Under Article 100 NPSA, all national public servants – including former public servants - are required to keep confidential any information which they receive in the course of their duties. Unauthorised disclosure of confidential information can result in disciplinary actions as well as in criminal investigations and punishment.

89. According to a Supreme Court decision from 1977 confidential information is interpreted as being information which is not disclosed to the public and is deemed worth being protected as secret in practice.

90. Further details on the definition of confidential documents or confidential information are laid down in the Rule on the Management of Administrative Documents.

Use of confidential information

91. Information which the JFSA receives from a foreign supervisory authority and which is indicated to be confidential will be treated as such. In addition, when asking a foreign supervisor for information the JFSA specifies the purpose for which it will be used, and it uses the information provided only for the purpose specified.

92. There have not been any cases thus far where the JFSA has been required in a legally binding manner to pass on to a third party confidential information received from a foreign supervisory authority.

Prior consent to disclose confidential information

A. General

93. Where confidential information received from a foreign supervisor is requested by a third party, the following procedure applies:

- The JFSA asks for prior consent from the foreign supervisor which provided the information to the JFSA.
- If such prior consent is not obtained, the JFSA takes all available actions to resist the third party's request.
- If prior consent is obtained, the JFSA checks that the confidentiality of the information will be ensured and that the information will solely be used for the purpose specified, and passes it to the third party.

B. Disclosure to the Houses of the Diet or their Committees

94. According to Article 5 of the Law on Oaths, Testimony and Other Matters concerning Witnesses in the Houses of the Diet a public employee or former public employee needs the JFSA's permission if asked to disclose confidential information.

95. If the JFSA refuses to grant this permission, the Houses of the Diet or the respective Committee will assess the reasons for this. If these reasons are not acceptable to the Houses of the Diet or the respective Committee, they can request a Cabinet statement to the effect that if the testimony or document requested were to be provided, it would exert a material effect on important national interests. If this statement is provided the witness does not need to testify or submit the document.

96. Through the on-site visit, it was identified that confidential information provided by foreign supervisors was never disclosed by the JFSA. With regard to information from a foreign supervisor, such a case would be treated even more seriously as it would have negative political implications if the information were passed over without prior consent of the foreign supervisor. The JFSA would therefore not do this.

Conclusion

97. Given the JFSA's actions in the past with regard to requests from the Houses of the Diet, especially during the financial crises in the 1990s and 2008, confidential information provided by a foreign supervisor is sufficiently safeguarded.

Exceptions to professional secrecy

98. Subject to Article 100 (2 and 3) NPSA, officials may be requested to make statements concerning confidential information in the course of their duties as a witness, an expert witness or in other capacities provided for by laws and regulations. In these cases the witness is required to ask for permission to do so from the head of the government agency employing him/her, which shall only be refused in cases pertaining to the conditions and procedures provided for by law or by Cabinet Orders.

National Personnel Authority

99. Subject to Article 100 (4) NPSA, officials may be requested to make statements or testify on any confidential or restricted information requested by the National Personnel Authority as part of an investigation.

100. The National Personnel Authority is a neutral and specialised organisation responsible for ensuring fairness in personnel administration and for protecting the benefits of national public employees.

101. Its main functions are:

- to conduct recruitment examinations and training programmes, and to establish standards for appointment and dismissal which ensure fairness in personnel administration;
- to make recommendations to the Diet and the Cabinet regarding remuneration and other working conditions for national public employees as compensation for the restriction of fundamental labour rights; and
- to research domestic and international systems of personnel management and to enforce personnel management measures that can meet the needs of the times, as a specialised agency for personnel administration.

102. In the context of these tasks, it is very unlikely that the National Personnel Authority would request confidential information provided by foreign supervisory authorities from the FSA. Moreover, the staff of the National Personnel Authority are subject to the confidentiality requirements stipulated in the National Public Service Act.

Criminal Court Procedures

103. According to Article 144 of the Code of Criminal Procedure (CrCP) public officers or ex-public officers need permission to provide confidential information to the court, and such permission may only be refused where the sharing of such information may harm important national interests.

104. As criminal law procedures are generally excluded from the professional secrecy requirements, the procedure laid down in Article 144 CrCP should suffice.

Civil Court procedures

105. According to Article 191 of the Code of Civil Procedure public officers or ex-public officers need permission to provide confidential information to the court, and such permission may only be refused where the sharing of such information may harm public interests or substantially hinder the performance of public duties. The same applies to confidential documents.

Conclusion

106. The JFSA confirmed that it would not give permission for the disclosure of confidential information provided by a foreign supervisor without that supervisor's prior consent. With reference to the remarks above, confidential information is sufficiently safeguarded.

Breach of professional secrecy obligations

107. According to Article 109 (xii) NPSA, any person who has divulged confidential information in violation of Article 100 (1 or 2) NPSA may be punished by imprisonment or a fine.

108. Officers may also be subject to disciplinary actions such as admonishment, dismissal, suspension or reduction in pay, under Article 82 NPSA.

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109. The JFSA cooperates and exchanges information with foreign supervisors. For this the JFSA has entered into bilateral and multi-lateral agreements. Professional secrecy requirements are laid down in the national law and apply to all present and former staff members of the JFSA. A breach of secrecy requirements is

punishable under Japanese law. Information received from foreign supervisors and indicated as confidential is treated accordingly and will only be used for the purposes agreed with the foreign supervisor. In this respect the JFSA applies to the principle of prior consent. The JFSA is able to protect confidential information from disclosure to Civil Courts where such disclosure could harm national interests. In principle the JFSA can also refuse the disclosure of confidential information to the Houses of the Diet or their Committees. However, there remains a very small residual risk that the JFSA may be obliged to make such disclosure by a Cabinet statement although this had not happened in the past

110. Japan is considered to be equivalent under Principle 2 dealing with professional secrecy, exchange of information and promotion of supervisory convergence.

Principle 3 - Taking-up of business

Objective – *The taking-up of the business of reinsurance in the third country shall be subject to prior authorisation. Authorisation for the taking-up of business shall be conditional on the undertaking meeting a clear, objective and publicly available set of written standards on a continuous basis.*

Legal entity

111. According to the IBA and the IB Ordinance, a formal licensing procedure must be completed with the competent authorities (legally the power to grant licences is delegated to the Minister for Financial Services and the JFSA from the Prime Minister).

112. Article 5-2 (IBA) establishes the two types of legal entities that can apply for an insurance licence (a Joint Stock Company or a mutual company) and also sets the minimum requirements in terms of the insurer's internal bodies.

113. The conditions for licensing as well as a detailed overview of the documentation that needs to be provided as part of the licensing process can be found in the IBA (Articles 3 to 8-2 et seq.) and the IB Ordinance (Articles 4 to 14-2 et seq.).

114. Further to that, Article 7 (2) IB Ordinance also establishes a "pre-application" procedure for those wishing to obtain a licence to pursue insurance business in Japan. According to this article: "A party seeking a license under Article 3, paragraph (1) of the Act or a party intending to incorporate a stock company or a mutual company engaged in insurance business […] may make an application for the preliminary examination, by way of submitting to the Prime Minister, via the Commissioner of the Financial Services Agency, documents equivalent to those provided for in Article 4 of the act."

Reinsurer's operations

115. All insurers and reinsurers are required to obtain a licence in order to operate in the Japanese market, they are subject in full to the licensing requirements set out by the IBA and the IB Ordinance. This means that inter alia the insurer must submit to the JFSA the following items:
    - Licence application (to include inter alia the amount of start-up capital, details of senior management and auditors, the location of the insurer)
    - Articles of incorporation:
        - Statement of business procedures
        - General policy conditions
        - Statement of calculation procedures for insurance premiums and policy reserves
    - Business plan (insurance solicitation plan, forecast income and expenditure and supporting information)
    - Full documentation on company management and company auditors, etc.

116. A reinsurer needs to meet an extensive list of conditions in order to obtain its reinsurance business authorisation, including among others:
    - Adequate financial basis for sound and efficient undertaking of insurance business (minimum capital requirement of ¥1 billion)
    - Good income and expenditure prospects (scheme of operations aimed at positive net income or net surplus after five years of operation)

- Effective system of governance ensuring the sound and prudent management of the insurer (extensively provided for in the Supervisory Guideline), etc.

117. Under the Solvency II regime (Article 18 (1) and (2)) insurers are required to limit their activities to the business of insurance and operations arising directly therefrom while undertaking any other commercial business is explicitly not allowed. Subject to authorisation, Japanese insurers may also carry out the following incidental business stipulated under Article 98 IBA:
    - Representing the businesses of or carrying out services on behalf of other insurers
    - Entering into guarantees of obligation
    - Underwriting of national government bonds, local government bonds or government-guaranteed bonds, or handling the public offerings of the bonds being underwritten
    - Acquisition or transfer (not for the purpose of asset investment) of monetary claims
    - Underwriting (excluding that carried out for the purpose of secondary distribution) of specified company bonds issued by special purpose companies
    - Acquisition or transfer of short-term company bonds (except for the purpose of asset investment)
    - Handling of a private placement of securities
    - Acting as an intermediary, introducing brokerage or agency service in derivative transactions, including financial derivative transactions and Over-the-Counter transactions of securities-related derivatives
    - Entering into financial derivative transactions and Over-the-Counter transactions of securities-related derivatives
118. We note that the IBA requires that business conducted by an insurer should be limited to insurance business in principle, but an insurer is allowed to engage in incidental businesses to the extent that financial soundness and appropriateness of business operation of the insurer is not harmed by engaging in the incidental businesses.
119. We also note that in accordance with Supervisory Guideline III-2-14-1 (2), when conducting incidental business (other than that falling under Article 98 (1) IBA), an insurer is required to ensure:
    - Whether the business in question is similar to a business described under each item of Article 97 and 98(1) of the IBA;
    - Whether the scale of the business in question is not excessive relative to the scale of the insurance company’s primary business to which the said business is incidental.
    - Whether the business in question is deemed to be similar in terms of function of business and is homogeneous in terms of risk profile to the insurance business; and
    - Whether the business in question contributes to the utilisation of surplus capacity that has arisen legitimately in the course of the insurance company’s execution of the primary business.

120. This approach is inconsistent with the general principles embedded in the Solvency II where Article 18 specifically establishes restrictions/prohibitions as to the object of the reinsurer.

Information on shareholders/members

121. As part of the documentation requested for licensing purposes, the JFSA is to receive, according to Article 4 (2) IBA and Article 6 (viii) IB Ordinance, a "document describing the trade name or name of [primary] shareholders and the number of voting rights held by such [primary] shareholders (if the company is a mutual, the number of prospective members)."

122. Japanese law distinguishes between large and primary shareholders as follows:

    - Large shareholders are considered to be those natural or legal persons that directly or indirectly own 5% or more of the insurer. A large shareholder must notify the JFSA when it reaches the 5% threshold and also each time its ownership increases by 1%.
    - Primary shareholders are considered to be those that directly or indirectly own, together with other persons acting in concert, 20% or more of the voting rights of the insurer. This ownership threshold is subject to JFSA authorisation. Any natural or legal person intending to become a primary shareholder must meet a set of supervisory standards as follows: healthy financial condition, sufficient to enable it to support the insurer if needed; good reputation and understanding of the public nature of the insurance business; and sufficient proof that the applicant will not impair the sound management and proper business of the insurer it intends to acquire.

Close links

123. Insurers are classified as being in a close relationship based on the criteria established under Article 1-6 IBA Ordinance.

124. Furthermore, the JFSA supervisory guidelines cover extensively the topic of conflicts of interest between divisions within an insurer or between insurers within a financial group (Section II-3-7). When assessing insurers during off–site monitoring or on-site inspections, the JFSA will aim to determine whether the insurer has in place a strong framework for the identification of transactions potentially involving conflicts of interest as well as for managing conflicts of interest.

Withdrawal of authorisation

125. The granting of a licence for the pursuit of insurance business is subject to the insurer meeting the conditions established by way of primary law and submission of relevant supporting documentation. Accordingly, should an insurer be unable to meet the licensing conditions or fail to prove it meets them, a licence will not be granted.

126. In practice this also needs to be seen in conjunction with Article 7 (2) IB Ordinance, under which the insurer will be made aware as part of the pre-application procedure that it does not meet the legal requirements for obtaining a licence.

127. Under Article 133 IBA, the JFSA may propose that the licence be withdrawn in the following cases:

    - Major breach of the law;
    - Major violation of the licensing conditions; or

- Acts prejudicial to the public interest.

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128. The JFSA has a comprehensive legal framework available to it to ensure a thorough process for prior authorisation. Throughout the licensing process the JFSA is able to obtain a comprehensive overview of the insurer's business processes and financial resources. Moreover the JFSA closely monitors the fitness and propriety of insurers' shareholders and members.
129. Nevertheless, we note concerns with the ability of Japanese insurers to undertake significant types and amounts of incidental unrelated business which is inconsistent with the general principles embedded in Solvency II. In our view this constitutes a real difference from the provisions in Solvency II and has the potential to increase the risk profile of a reinsurer substantially, making supervision much more difficult.
130. Japan is considered to be largely equivalent under Principle 3 dealing with the taking up of business.

Principle 4 - System of Governance and Public Disclosure

Objective - *The solvency regime of the third country shall require domestic insurance and reinsurance undertakings carrying out reinsurance activities to have in place an effective system of governance which provides for sound and prudent management of the business. That system shall at least include an adequate transparent organisational structure with a clear allocation and appropriate segregation of responsibilities, requirements for ensuring that persons managing the undertaking are fit and proper and effective processes to ensure the timely transmission of information both within the undertaking and to the relevant supervisory authorities.*

The solvency regime of the third country shall require domestic insurance and reinsurance undertakings carrying out reinsurance activities to have in place an effective risk-management system comprising the strategies, processes and internal and supervisory reporting procedures necessary to identify, measure, monitor, manage and report, on a continuous basis and at an individual and an aggregated level, the risks to which the undertaking is or could be exposed, and their interdependencies, as well as an effective internal control system.

The solvency regime of the third country shall require domestic insurance and reinsurance undertakings carrying out reinsurance activities to establish and maintain risk-management, compliance, internal audit and actuarial functions.

The solvency regime of the third country shall require domestic insurance and reinsurance undertakings carrying out reinsurance activities to disclose publicly, on at least an annual basis, a report on their solvency and financial condition.

Role of supervisory guidelines

131. Some elements of the governance requirements relating to Japanese insurers are incorporated in law, but the more detailed provisions are contained in Supervisory Guidelines produced by the JFSA. The Supervisory Guidelines contain a detailed description of the issues supervisors are required to check in conducting their on-site and off-site examinations of insurers. The JFSA emphasises that the Supervisory Guidelines are prepared for the use of JFSA staff, however in publishing them the JFSA has, in effect, issued the industry with directions about expectations in the areas covered in the text. The JFSA consults on changes to the Guidelines, and the inspection manual for insurers is also shared with the industry. The industry feels comfortable that if it complies with the Guidelines it is unlikely to experience any surprises in terms of unexpected supervisory action in respect of governance and internal control issues. The Guidelines are therefore approaching de facto rules, although it is stated clearly that they should not be applied mechanistically. The JFSA considers the actual circumstances of insurers when evaluating compliance. It is also stated that even if an insurer fulfils all the supervisory evaluation points, the result may still be deemed inappropriate from the viewpoint of securing sound and appropriate business operations.

132. In its 2003 Financial Stability Assessment of Japan, the IMF commented on the use of Supervisory Guidelines to outline expectations as to corporate governance and internal control practices in insurers. The IMF noted that the Guidelines reflected commendable practices, and that the tool of issuing Guidelines functioned well. Nevertheless for the future they felt that it would be preferable if the rules were enshrined in statute or in formal regulation. In response the JFSA noted, amongst other things, that they did not have any problems with

enforcement, and this is clearly a critical point. It is understood that where the JFSA identifies material failings in governance and internal control issues it can require a business improvement plan.

General governance requirements

133. In addition to a Board of Directors, insurers are also required to have an Accounting Auditor and establish an (internal) Board of Company Auditors. (Article 5-2 IBA). There are legal provisions dealing with the qualifications of directors, company auditors and accounting auditors. Supervisory guidance covers the roles of these post-holders.

134. Mutual insurers (which may also provide reinsurance, though this is mainly to policyholders that are already participating members in the mutual) are required to hold a General Meeting every financial year.

135. The IBA requires insurers to manage their business operations in a sound and appropriate manner. The Supervisory Guidelines place emphasis on the need for directors and employees at all levels to understand their own roles and fully involve themselves in governance processes. The Guidelines lay down a series of expectations regarding how the directors, and the Board of Directors collectively, will oversee the business. These include, amongst other things, the expectation that there should be clear business plans established in accordance with management policy, which should be communicated throughout the company and monitored; that sincere efforts should be made to ensure legal compliance and that functions should be performed properly so as to establish a company-wide internal control environment; that the Board should have properly set the objectives of internal audits and should have established a control environment to enable the internal audit division to fully perform its functions in an environment that protects its independence.

136. As part of the JFSA's off-site monitoring, Comprehensive Hearings are held twice a year during which the insurer will be asked about management challenges, business strategies and the various risks involved therein, as well as the activities of the Board of Directors and the Board of Company Auditors.

Fit & proper

137. The qualifications of directors, company auditors and accounting auditors are set out in articles in the IBA and the CA. They include provisions relating to the exclusion of criminals in the CA and in relation to directors provisions relating to expertise and reputation in the IBA (Article 8-2). The CA also sets out provisions on the roles and responsibilities of directors covering conduct of business, monitoring of the operation of the business, internal control mechanisms, risk management and the internal audit function (Articles 348 and 362). In relation to the Board of Company Auditors the CA contains provisions relating to operational audit and accounting audit (Articles 381 and390).

138. Supervisory Guideline II-1-2 (2x) elaborates on the criteria that insurers might be expected to consider when appointing a director engaging in the ordinary business of an insurer. They include criteria relating to the knowledge and experience necessary to exercise appropriate, fair and efficient governance and factors related to sufficient social credibility (covering for example whether the candidate has been sentenced to imprisonment or fined for violation of domestic or foreign financial laws).

Risk management/effective internal control mechanisms

139. Japan does not have an own risk and solvency assessment requirement in name, but insurers are required to manage risks individually and comprehensively via enterprise risk management (ERM). Supervisory Guideline II-2-6-1 states that insurers need to conduct appropriate risk management in a systematic and comprehensive manner, in accordance with their respective management policies and risk characteristics. For insurers that are exposed to large-scale, complex risks, the need for them to manage those risks in an integrated manner is recognised. It is noted that the regulatory framework for ERM has not yet been established, but insurers are nevertheless exhorted to strive to advance their risk management further, and supervisors are expected to assess progress. This includes looking at how the insurer is organising its ERM; whether it addresses the relevant risks; the use of common calibrations and the objectivity and appropriateness of the standards for quantification; and the analysis of future capital adequacy in the light of matters related to the medium and long-term business strategies and the business environment. Where the JFSA recognises a problem with an insurer's ERM system an in-depth hearing is held with the insurer and it may be required to submit a report on the matter to the JFSA under Article 128 IBA.

140. During EIOPA's on-site visit presentations were given by two major players in the reinsurance market, Toa Re and the Tokio Marine Group, on how they were developing their ERM practices.

141. Supervisory Guideline II-2-6-2 states that insurers should voluntarily conduct stress tests suited to their financial conditions and the state of risk to which they are exposed while taking into consideration market trends. Insurers are required to consider simulated stress scenarios and not just look at historical scenarios, and the JFSA will look at the control processes surrounding the tests and whether people with the necessary expertise have been involved. In making disclosures on the risk management system under Article 59-2 of the IB, insurers should disclose, in an easy to understand manner, the key points of these stress tests and how they are using the results.

142. Under the CA and IBA, the Boards of Directors of all insurers are required to develop an internal control system and disclose it to the public. Listed companies are also required to file with the JFSA an internal control report which is again made public. It is understood that major non-listed insurers (mutual insurers) prepare the internal control report voluntarily.

143. Supervisory Guideline II-1 covers in some detail the areas of internal control which the JFSA will review. Internal control systems are expected to be maintained and improved under a Plan, Do, Check and Action (PDCA) cycle and findings from the inspection process are in the public domain.

Internal audit function

144. Supervisory Guideline II-1 (3) and (5) deal respectively with corporate auditors/the Board of Company Auditors and the internal audit division within an insurer respectively. The JFSA examines whether the independence of the Board of Company Auditors is ensured in accordance with the purpose of the board of auditors system, and in the exercise of audit provisions. The JFSA also checks whether individual corporate auditors recognise the importance of their own independence within the Board of Company Auditors and actively conduct audits based on their own responsibility.

145. The JFSA also considers whether an internal audit division has been established within the company that is independent from the divisions subject to audit, and that is sufficiently staffed and equipped to conduct effective internal audits. The JFSA checks how audits are conducted in practice; that there is appropriate reporting to the Board of Directors; and that the audit division properly oversees the status of improvements made following audit recommendations.

Contingency plans

146. Supervisory Guideline II-3-14 covers the requirement for an insurer to develop and maintain business continuity plans and crisis management manuals. The Guideline flags up as major supervisory viewpoints whether the insurer recognises what constitutes a crisis, strives as much as possible to avert a crisis, and prepares countermeasures against a crisis that cannot be averted. The crisis manual is expected to be updated constantly in the light of business operations and risk management.

Actuarial function

147. The Boards of Directors of insurers are required to appoint an actuary to participate in the calculation of insurance premiums, technical provisions and other matters. The relevant legal provisions are in Article 120 IBA and Articles 76 and 77 IB Ordinance. The qualifications that an appointed actuary must possess are also stipulated in law. The appointed actuary must be a member of the Institute of Actuaries of Japan. For non-life insurers five years' experience in actuarial matters in a non-life insurer or seven years' experience in actuarial matters is expected.

148. The duties of actuaries are set out in a combination of the IBA, the IB Ordinance and Supervisory Guideline II-1-2. The general duties relate to the verification of technical provisions, the distribution of dividends or surplus and that the business continues to operate in the light of the insurer's reasonably-estimated profit and loss. The actuary produces an opinion letter concerning these and other matters addressed to the Board of Directors, with a supplementary report specifying the means of verification and any other matters which served to form the basis of the verification. The JFSA receives both the written opinion and the supplementary report. The actuary may notify the company auditor (or a designated member of the audit committee) or accounting auditor of the contents of the opinion letter.

149. The appointed actuary system, and the fact that the JFSA oversees the development of actuarial standards by the Japanese Institute of Actuaries, allows the JFSA to rely to a significant extent on the figures provided to them. The JFSA will check whether the appointed actuary has been granted the authority necessary to discharge their functions within the insurer, and is independent from the profit-generating, profit management and product development divisions. This is to ensure that appropriate checks and balances are maintained within the insurer.

Outsourced functions

150. The JFSA is of the view that while insurers may outsource functions they cannot outsource responsibility. Under Article 145 IBA, any entrustment of business or property administration shall not become effective without the authorisation of the JFSA.

151. Where it is deemed necessary in order to protect policyholders by ensuring the sound and appropriate management of an insurer, the JFSA has the power under the IBA to require a subcontractor of the company to submit reports or materials

that would be helpful to understand the status of the business or property of the company. The JFSA can perform on-site inspections of external providers of services to insurers (Article 129-2 IBA). This is developed further under Principle 5.

Compliance function

152. The Supervisory Guidelines encapsulate the JFSA's expectations in terms of the development and maintenance of an effective compliance system, and this is normally evaluated as part of an on-site inspection. However, depending on the outcome of an on-site inspection, there may be additional meetings and interviews conducted on an off-site basis.

153. Supervisory Guideline II-3-1 sets out the major supervisory viewpoints regarding the way compliance is embedded in the company, including: the attention given to compliance by the Board of Directors; and the development of a compliance policy and standards, compliance manuals and compliance programmes. Where problems are identified, the JFSA may require the submission of a report, or, in more serious cases, take administrative action under Articles 132 or 133 IBA. Guideline II-3-2 deals with supervisory actions against misconduct. There is an obligation on an insurer under Article 127 IBA to notify the JFSA if it comes to know of deplorable events within the insurer or a subsidiary.

Ensuring identification of deteriorating financial conditions

154. An insurer has to have an accounting auditor whose responsibility under the law is to audit the company's financial statements and prepare accounting audit reports. Furthermore the effectiveness of the insurer's internal control system, including its risk management system, has to be audited by external auditors at least annually.

155. As for listed companies, the accounting auditor has to inform the JFSA if the financial position of the company is deteriorating in an audit report submitted to the JFSA quarterly. The accounting auditor of a non-listed insurer does not have an obligation to inform the JFSA if the financial position of the company is deteriorating or not. However we note that, for both listed and non-listed, the appointed actuary is required to submit an opinion letter which he/she prepared to the JFSA, in which matters related to an insurer's financial conditions need to be covered (Articles 79-2 and 80 of the IBA Ordinance). The appointed actuary, as noted above, is required to verify the technical provisions and distribution of surplus, amongst other things, and submit an opinion letter. The JFSA also undertakes on-site inspections, and where it may have doubts about the data provided – or finds inconsistencies - it can organise separate interview sessions to explore the position. Taken together, these provisions provide a reasonable degree of comfort that deteriorating financial conditions will be identified.

Auditor's duty

156. Under Article 397 CA and Articles 52-3 IBA, an accounting auditor is required to report misconduct or material facts in violation of the laws or regulations or the Articles of Incorporation in connection with the execution of the duties of the directors to the company auditors without delay. If an accounting auditor's opinion on financial statements differs from the opinions of the Company auditors, the accounting auditor may attend the annual shareholders meeting and state its opinion.

157. In relation to listed insurers, when the accounting auditor detects during the performance of their duties facts in violation of laws and regulations and facts which may have an adverse impact on the properness of financial statements,

they are required to report them to the insurer in writing without delay (Article 193-3 FIEA). After a specified period, if appropriate action has not been taken and if the accounting auditor deems it necessary in order to avoid a material adverse impact on the company, they are required to report their opinions to the JFSA. They also have to notify the insurer in writing of their intention to do so.

158. There appear to be no provisions requiring company auditors to report breaches of laws or regulations, or other matters which may affect the continuous functioning of the company, to the JFSA This appears to be a gap in the system, though mitigated by the roles of the appointed actuary and accounting auditor.

Public disclosure

159. Each business year, an insurer is required to prepare explanatory documents describing the matters related to the status of its business and property, and keep them available to the public at its head office (Article 111 IBA and Articles 59-2 to 59-7 IB Ordinance). The items that need to be disclosed, which include details of its business, performance, governance system and risks and the amount of technical provisions, are stipulated by the IBA and IBA Ordinance. Listed insurers are also required to make timely disclosure of information in accordance with the rules set by the stock exchange. Items to be disclosed[8] include:

- Matters related to the overview and organisation of an insurer (including its history, organisation, location of branch offices, names of directors and company auditors, and average salary of employees)
- Details of the principal business of an insurer (including the management policy)
- The overview of the business for the most recent business year
- Major financial numbers for the last five business years
- Financial conditions (including a balance sheet, a profit and loss statement, solvency margin ratio, market values of securities and derivatives)
- Matters related to its business
    - Information on its main business (including the amount of policies in force -per individual policy type-, the amount of new policies, dividends)
    - Information on policies (including lapse rate, expense ratio, the number of reinsurance underwriters, the portion of reinsurance fees paid to the top five reinsurance underwriters out of all reinsurance fees paid, and the portion of reinsurance fees per rating of reinsurance underwriters)
    - Financial information (including the amount and breakdown of technical provisions)
    - Information on asset management (including asset earned ratio, profit/loss from asset management, profit/loss from securities transactions, the amount of securities per maturity, and names of the industry in which an insurer lends its money)
- Information on risk management and compliance system
- Information on special accounts (including the amount of assets corresponding to variable insurance contracts and the amount of individual variable insurance)
- Information on an insurer’s subsidiaries, etc. (including subsidiaries’ business and performance)

[8] i.e. made available for public inspection as per language of art. 111 IBA

160. The Life Insurance Association of Japan and the General Insurance Association of Japan have elaborated additional items to be disclosed, and all member insurers comply with these additional disclosure provisions on a voluntary basis.

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161. In several areas, the Supervisory Guidelines are critical to determining the equivalence of the provisions covering oversight of insurers' systems of governance and public disclosure. While the Supervisory Guidelines are not enshrined in law, we are satisfied that – in effect - they constitute a body of requirements that insurers abide by in practice, and that the JFSA pursues the necessary checks through both on-site inspection and its off-site work.
162. In relation to the duties on auditors, there would appear to be scope for encouraging and facilitating further reports to the supervisory authority where problems are discovered or the performance of the insurer is deteriorating.
163. In the case of the disclosure requirements, not all reinsurers operating in Japan will be members of the two main industry trade associations. However, taking the voluntary provisions into account, there is a reasonable level of disclosure.
164. Given these caveats, Japan is considered largely equivalent under Principle 4 dealing with systems of governance and public disclosure.

Principle 5 - Changes in business, management or qualifying holdings

Objective – *The solvency regime of the third country shall require that proposed changes to the business or management of domestic insurance or reinsurance undertakings carrying out reinsurance activities, or to qualifying holdings in such undertakings are consistent with maintaining the sound and prudent management of the domestic insurance or reinsurance undertaking.*

Acquisitions of insurers

Notification of intention to directly or indirectly hold or increase a qualifying holding

165. Although the legal framework does not prescribe many specific points of intervention related to the size of a primary shareholder ownership, the JFSA has general powers to ensure the insurer is fit both from a financial and a governance perspective.

166. Notification and authorisation requirements for large and primary shareholders are established under Japanese law as a continuous obligation:

   - Large shareholders must notify the JFSA when they reach the 5% of voting rights threshold and also each time its ownership increases by 1% ("change report" to be filed in accordance with Articles 271-3 to 271-9 IBA).
   - Primary shareholders are considered to be those directly or indirectly owning, together with other persons acting in concert, 20% or more of the voting rights in the insurer. An individual holding 15% or more of the voting rights accompanied with significant influence over an insurer is also a primary shareholder. This ownership threshold is subject to JFSA authorisation (Article 271-10 IBA).

Assessment of acquisition

167. A natural or legal person intending to become a primary shareholder must be subject to authorisation by the JFSA and meet the following regulatory requirements (Article 271-11 of the IBA): healthy financial condition, sufficient to enable it to support the insurer if needed; good reputation and an understanding of the public nature of the insurance business; and sufficient proof that the applicant will not impair the sound management and proper business of the insurer it intends to acquire. Further to this, the IBA provides JFSA with specific powers of intervention only as to major shareholders with +50% ownership of the undertaking (Article 271-15 paragraph 2).

168. We note that in a risk-sensitive or risk-based rather than rule-based supervisory system, the power applicable to shareholders holding 50% or more of the voting rights (Article 271-15) should equally apply to any controlling shareholder, even if this latter holds less than 50% of the voting rights [9]

169. The notification requirements for large shareholders, although subject to lighter scrutiny from the JFSA, also ensure that the JFSA has timely access to information as to the shareholder structure of the insurer.

[9] Such situation may happen, for instance, in the case of a listed insurer, when a share holder holds *e.g.* 40% of the shares or voting rights and when the rest of the shares are scattered among the public.

Existence of provisions in relation to disposals

170. The only notification requirement relating to disposals applies to primary shareholders, which in accordance with Article 271-10 (3) IBA must notify the JFSA immediately of any changes to their participation in an insurer.

171. Large shareholders are required under the IBA to submit the same "change report" to the JFSA whether their participation increases or decreases.

Information obtainable from an insurer regarding acquisitions and disposals

172. As stated above, Japanese law establishes an automatic system of notifications for any acquisitions or disposals that may lead to changes in shareholders' large or primary shareholder status.

173. The JFSA also twice a year receives a full update as to the shareholder structure of each insurer under its supervision.

174. Further to that it should also be noted that according to Article 271-12 IBA, when it is deemed necessary for the protection of policyholders, the insurer may be required to submit reports or materials that provide information on the financial situation of a primary shareholder in order to demonstrate compliance with the general duty to ensure the sound and appropriate management of the insurer.

175. Based on those reports or materials, the JFSA has the power to conduct on-site inspections with a primary shareholder or to issue business improvement orders (similar to those under Article 132 IBA) when deemed necessary (as per Article 271-13 IBA).

Existence of provisions in relation to outsourcing

176. Although not specifically covered in primary legislation, outsourcing practices are fully recognised and covered in the JFSA Supervisory Guidance (Section II-4-1 Outsourcing of Administrative Processes of Insurance Companies).

177. During its on-site inspections, the JFSA will aim to establish whether the insurer has successfully delivered on the following items:

    - outsourcing of business operations does not cause any change in the contractual relationship of rights and obligations between the insurer and policyholder;
    - establishment of a response system to ensure adequate provision of services even in the case of third party provider default;
    - establishment of a customer data management system, including the prohibition of the use of data by outsourcing service providers for purposes other than the intended ones, as well as an obligation of confidentiality on the outsourcing service providers; and
    - establishment of a process to handle customer complaints and queries, such as by establishing a system for the direct reporting of complaints from customers to the insurer

178. Furthermore, the JFSA will also assess whether the insurer has established clear selection criteria for the third party provider such as: ability to provide a high quality service; sound financial situation so as to be able to cover any liabilities arising from damage caused as a third party provider; and good overall reputation.

179. In addition, the JFSA will also check the outsourcing contracts themselves so as to ensure a minimum set of requirements are in place to govern the contractual relationship between the insurer and the third party provider.

180. The outsourcing agreement has to be in writing and has to specify, inter alia, the following issues:

- Contents and level of the service to be provided and cancellation procedures.
- Obligations to be discharged by the outsourcing service provider in cases where it fails to provide service as prescribed under the contract. Matters related to how to cover losses that may rise in relation to the outsourcing, and the reasons for and intended benefit of outsourcing.
- The contents of reports to be received by the insurer from the outsourcing service provider with regard to the outsourced business operation and the outsourcing service provider's financial condition, as well as its data protection procedures and ability to meet costs it is liable for.
- Arrangements concerning how to meet requests from the supervisory authorities to the insurer in relation to inspection and supervision.

181. As per the JFSA's general powers, where these major supervisory viewpoints are not adequately met by an insurer, the JFSA will require the insurer to improve its practice and business performance (Article 132 IBA).

182. Furthermore, under Article 129-2 IBA, the JFSA can perform on-site inspections of the third party provider in order to satisfy itself as to the soundness of the overall business of the insurer.

Ongoing assessment, approval and disclosure of relevant information, including portfolio transfers, changes to the Board or senior management and scheme of operation

183. According to Article 139 (1) IBA, a portfolio transfer from a Japanese insurer to another insurer has to be authorised by the JFSA. This is not applicable to reinsurers, however the transfer of reinsurance contracts to another company does require the consent of the respective ceding insurers and must be notified to the JFSA.

184. Furthermore, the JFSA must also licence any assignment or acquisition of business involving an insurer or insurers.

Details as to the existence and content of standards in respect of the insurer's obligation to provide information on its assessment of the reputation and financial soundness of the acquirer

185. A JFSA licence is needed in order for such transactions to become effective. Changes to the insurer's circumstances as they were assessed at the time of the initial licensing are subject to JFSA approval. As stated above, primary shareholders cannot be recognised as such in the absence of a JFSA licence.

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186. The JFSA has adequate scrutiny over changes in business, management and qualifying holdings and provides for adequate on-going supervision of the sound and prudent management of the insurers.

187. We note that the Japanese law establishes licensing powers for the JFSA in relation to shareholder structure which allow it to control the fitness and propriety of shareholders with a qualifying holding but this is inconsistent with Solvency II approach to establish explicit intervention thresholds as to ownership changes.

188. Japan is considered to be largely equivalent in relation to Principle 5 dealing with changes in business, management or qualifying holdings.

Principle 6 – Solvency Assessment (Reinsurance)

Objective *The solvency regime of the third country shall require domestic insurance and reinsurance undertakings carrying out reinsurance activities to hold adequate financial resources.*

The assessment of the financial position of domestic insurance and reinsurance undertakings carrying out reinsurance activities in the third country shall rely on sound economic principles and solvency requirements shall be based on an economic valuation of all assets and liabilities.

The solvency regime of the third country shall require domestic insurance and reinsurance undertakings carrying out reinsurance activities to establish technical provisions with respect to all of their reinsurance obligations towards policyholders and beneficiaries of reinsurance contracts.

The solvency regime of the third country shall require that assets held to cover technical provisions are invested in the best interests of all policyholders and beneficiaries taking into account any disclosed policy objective and that domestic insurance and reinsurance undertakings carrying out reinsurance activities only invest in assets and instruments whose risks the undertaking concerned can properly identify, measure, monitor, manage, control and report.

The solvency regime of the third country shall require domestic insurance and reinsurance undertakings carrying out reinsurance activities to meet capital requirements that are set at a level which ensures that in the event of significant losses policyholders and beneficiaries are adequately protected and continue to receive payments as they fall due to a level of confidence at least equivalent to that achieved by Article 101 of Directive 2009/138/EC. Those capital requirements shall be risk-based with the objective of capturing quantifiable risks. Where a significant risk is not captured in the capital requirements, then that risk shall be addressed through another supervisory mechanism. The calculation of capital requirements shall ensure accurate and timely intervention by supervisory authorities of the third country.

The solvency regime of the third country shall require domestic insurance and reinsurance undertakings carrying out reinsurance activities to maintain a minimum level of capital, non-compliance with which shall trigger immediate and ultimate supervisory intervention.

The solvency regime of the third country shall require domestic insurance and reinsurance undertakings carrying out reinsurance activities to meet the capital requirements referred to above with own funds that are of a sufficient quality and which are able to absorb significant losses. Own-fund items considered by the supervisory authorities to be of the highest quality shall absorb losses both in a going concern and in case of a winding up.

Financial supervision

189. The Japanese solvency regime is evolving, with a number of new requirements having been introduced following the recent financial turmoil. These include: measures to enhance risk management introduced in June 2009 (ERM, stress testing and risk management for complex instruments); a strengthening of the risk factors in April 2010; and a revision of the IBA to introduce group-based solvency requirements in May 2010. The supervisory regime is not based on an

overall confidence level in the way Solvency II is, with instead different confidence levels being applied in respect of different risks. The JFSA has recently conducted a field test for market-consistent (economic) valuation of both assets and liabilities with the aim of its introduction in the near future.

190. There are currently provisions in place that allow the JFSA to fully exercise supervision in normal circumstances, including:

- communication of concerns relating to the insurer's financial position;
- obligation on the insurer to respond to concerns raised; and
- obligation to submit financial reporting to the supervisor.

However, on the first and third of the above-mentioned points, the following weaknesses were noted:

A) There is no positive obligation on the external auditor to communicate "the impairment of the continuous functioning of the [insurer]" (Article 72 (1d) Solvency II Directive). Auditors are only obliged to report violations of laws and regulations that may have adverse material impact on the properness of the insurer's financial statements, or when the insurer does not take appropriate action in relation to matters reported by the auditor.

During the on-site visit, it was stated that an auditor who reported a concern to the supervisor without the above-mentioned conditions being met, would be in breach of their confidentiality obligation towards the insurer. In contrast to this, Article 72 (1) Solvency II Directive provides that disclosure made to supervisors by auditors in good faith "shall not constitute a breach of any restriction on disclosure of information imposed by contract [...] and shall not involve such persons in liability of any kind."

B) Financial reporting to the JFSA does not include loss triangles consistent with that required under Solvency II, beyond those provided by provisions relating to public disclosure. These are discussed hereunder.

191. Article 59-2 (iii) (e) IBA Ordinance requires that Japanese non-life insurers disclose run-off triangles. During the on-site visit, the JFSA stated that the disclosure obligation related to the *three* following Lines of Business (LoBs): Automobile, Accident, Damage compensation. These three LoBs may thus be regarded as not granular enough (for example they do not differentiate between motor vehicle liability and damage to motor vehicles) and not inclusive enough (it does not cover long-tail business or non-proportional accepted reinsurance).

192. From 2010 on, the disclosure will cover the claims incurred during the past five years[10]. This period could be regarded as too short, in the event that these triangles covered long-tail business.

193. During the on-site visit, the JFSA stated that long-tail business or accepted reinsurance was not significant in Japan; it thus was not felt necessary to provide reporting requirements covering this type of business. However, we note that this is the current state in the context of equivalence, it is possible that the materiality of such business may increase.

194. Loss triangles, which are mentioned under IAIS developments[11], or equivalent items enabling the supervisor to assess the prudence of TPs will be an item

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[10] See Article 59-2 (iii) (e) IBA Ordinance. As the disclosure requirement was introduced in year 2005, the 2009 disclosure covers only 4 years, etc.

[11] As well as in current standards – Standard #9, §§23 to 28 – as well as in draft revised Insurance Core Principles to be endorsed by the next General Meeting of the IAIS.

required to be reported under Solvency II. Their future use by the JFSA may require a larger staff pool with actuarial expertise.

Valuation of assets

195. Assets are to be valued in accordance with the Japanese GAAP (J–GAAP). According to J–GAAP, most assets have to be valued at fair value. Some assets, though, have to be valued at historical cost. For these latter, however, most of the unrealised gains and losses are taken into account for determining available own funds. It could thus be considered that overall assets are valued at fair value. It should be noted that J-GAAP has been found equivalent to IFRS by the EU.

Technical provisions:

196. For life and health business, mortality and morbidity rates are set on the basis of mortality and morbidity tables prepared by the Institute of Actuaries of Japan and verified by the JFSA. These tables are based on actual experience, plus a level of confidence calibrated at 97.7%.[12]

197. For life and long-term non-life business, TP are currently discounted at 1.5% (from 2001 on). The fact that they are valued at a prescribed rate, rather than an economic rate, may raise questions as regards their resilience, insofar as the regulatory discount rate for liabilities is 1.5%, while the returns on bonds seem to be around 1.2%.

198. To assess whether non-life TP were calculated in a prudent manner, the JFSA was asked to provide market aggregated loss triangles. As previously noted, however, the aggregated data may not cover all relevant LoBs or all relevant years of incurred losses. As a proportion of the initial loss estimation and estimated as of end year 2009, the result of the run-off for the three LoBs are as follows: losses incurred in 2006, increase of 3.3%; incurred in 2007, increase of 0.2%; incurred in 2008, decrease of 0.6%.

199. EIOPA asked the JFSA to provide an example of an anonymised report by the actuary of a non-life insurer. It was noted that the report provided did not in itself contain any data related to loss triangles. It was felt that the JFSA perhaps put too much reliance on insurers' actuaries, and should complement this reliance with their own assessment of the accuracy of TP and/or of the work of the actuaries'.

200. Any comment on the accurate segmentation of TP must be qualified by the fact that there are only *three* LoBs where Japanese insurers have to disclose loss triangles, and, as outlined below, only *six* LoBs that are used to determine the insurance risk capital requirement.

201. In response to one of EIOPA's further questions, the JFSA referred to Article II-2-1-4 (17) of the Supervisory Guideline, which lists the following eight LoBs: fire, marine, casualty, automobile, compulsory automobile liability, (general) liability, credit/guarantee insurance and other insurance. General liability and credit/guarantee insurance can however be classified under 'other insurance', as can any LoB where written premiums account for less than 5% of the insurer's total written premiums.

202. Non-life TP are not discounted, except for long-term business (see above). Non-life long-term TP, in particular, include the refund reserve (¥787 trillion, or 36% of total non-life TP, which amount to ¥2,197 trillion). It follows that, strictly

[12] EIOPA understood that this level of confidence corresponded to an increase in mortality/morbidity rates of twice the standard deviation, under the assumption that the distributions of mortalitymorbidity rates were normal distributions.

speaking, non-life TP are not market-consistently valued. The JFSA has stated that (apart from the refund reserve) they have little in the way of long-tail TP, however, which qualifies this statement.

203. EIOPA notes that in 2012 the JFSA will take into account whether IFRS is endorsed as the mandatory accounting rules for listed companies in Japan.

Own funds

204. JFSA regulation provides a list of own funds which includes the net assets, the Price Fluctuation Reserve, and the Catastrophe Reserve. Solvency margin includes 90% of unrealised gains on available-for-sale securities and 85% of unrealised gains on property[13].

205. Pursuant to provisions of the IBA, Japanese non-life insurers are required to accumulate, for example:

- Reserve for price fluctuations: a reserve designed to cover losses due to price fluctuations in assets subject to market price volatility, particularly stocks, bonds and foreign currency-denominated investments. The IBA establishes the accumulation standard and a minimum amount of reserve for each asset to provide and to reverse the reserve for price fluctuations. The reserve for price fluctuations may be reversed to reduce deficits arising from price fluctuations of those assets.
- Catastrophe reserve: a reserve designed to cover losses due to catastrophic events, with the amount calculated based on premium income. The catastrophe reserve acts as a provision against risks to which the law of large numbers is not applicable on a single-year basis, in consideration of the particular characteristics of Japanese non-life insurance business, which covers a wide range of risks including disasters. The catastrophe reserve shall be reversed during the fiscal year in which a catastrophe occurs. The catastrophe reserve is accounted for as part of underwriting reserves (TP) on the balance sheet, but it is included in the available own funds.

206. The following table summarises how catastrophe reserves are built[14].

Catastrophe Reserves

Group of Business	Accumulation Rate (A)	Accumulation Rate (B)	Ratio of Balance	Maximum Accumulation Rate	Disposition of Reserves
Marine Hull and Aviation	3.0%	3.0%	50%	250%	80%
Fire, Marine Cargo, and Inland Transit	3.8% or 2.0%	2.0% (4.0%)	35%	160%	50%
Automobile, Personal Accident, and Miscellaneous Casualty	3.2%	-	15%	160%	50%
Nursing Care Expenses	3.2%	-	15%	160%	50%
Surety Bonds	3.2%	-	15%	160%	50%
Atomic Energy	50%	50%	-	-	Full amount of net claims paid
Life Reinsurance	24%	-	-	24%	100%

(Notes)
1. Accumulation Rate (A) means the minimum percentage of net premiums stipulated under a statement showing the basis of working out premiums and underwriting reserves.
2. Accumulation Rate (B) means the maximum percentage of net premiums allowed under the Special Taxation Measures Law.

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[13] In case of unrealised losses, 100% of the loss is deducted.
[14] Source: The general insurance association of Japan (GIAJ) http://www.sonpo.or.jp/en/regulations/005.html

3. Insurers are legally required to accumulate either of the percentages or more, i.e. Accumulation (A) or Accumulation (B) of net premiums as catastrophe reserves, depending on which is greater. They are allowed to accumulate an extra amount subject to notification to the FSA, but if the Ratio of Balance comes under the specified level mentioned in the table, they can accumulate an extra amount without such notification within the limit of 150%.
4. Disposition of Reserves occurs when the loss ratio exceeds the specified level as a Group of Business, and the excess portion of the claims can be withdrawn from the catastrophe reserves.
5. Accumulation Rate (A) of Fire, Marine Cargo, and Inland Transit Group is 3.8% for fire insurance, and 2.0% for marine cargo, inland transit, general liability, contractors' all risks, movables comprehensive, and windstorm & flood.
6. Accumulation Rate (B) of Fire, Marine Cargo, and Inland Transit Group is 4.0% from fiscal 2010 to fiscal 2012 as a transitional measure by the government. In cases where the tax-free balance in the said group is over 30% at the end of each fiscal year, an accumulation rate of 2.0% will be applied.

207. The Ministry of Finance Notice No. 50 "Calculation methods...", art. 1.4.(v) (b) provides that, "subject to restrictions", subordinated debts with a term of five years or longer are eligible own funds. In a risk-based system, the relevant criteria would be the relative duration of the loan as compared to the duration of the insurer's insurance obligations, rather than the absolute duration of the loan: cf. Article 93 (2) Solvency II Directive which provides that "Where an own-fund item is dated, the relative duration of the item as compared to the duration of the insurance obligations shall be considered".

Capital requirements

The JFSA's three levels of supervisory intervention

208. JFSA regulation defines a capital requirement that is named the 'total risk' in Ministry of Finance Notice No. 50 "Calculation methods..." [15]. This capital requirement broadly corresponds to the Solvency II Solvency Capital Requirement (SCR) (see below).

209. JFSA regulation defines a 'Solvency Margin Ratio' (hereunder SMR), which equates to double the own funds divided by the 'total risk'.

210. JFSA regulation defines three levels of supervisory intervention:

    - Even when the SMR is **above 200%,** the JFSA may require insurers to adopt 'improvement measures', notably on profitability, credit risk (including a reduction to their credit concentration risk), stability (reduction to their market and interest rate risks) and liquidity risk. The JFSA refers to this 'early' supervisory intervention as the "early warning system".
    - When the SMR is **between 100% and 200%**, the JFSA may order insurers to submit and implement an improvement plan for ensuring managerial soundness
    - When the SMR is **between 0% and 100%**, the JFSA may order a series of measures such as reduction of dividends to shareholders, reduction of dividends to policyholders, and contraction of business operations.
    - When the SMR is below **0%**, JFSA may order the total or partial suspension of business.

211. The JFSA defines the SMR as twice the own funds over the 'total risk'. The team considered it would be clearer to define the SMR as the own funds over the 'total risk', and redefine the above-mentioned levels of intervention as equating to 100%, 50% and 0% of the SMR.

[15] See Article 3 and Appended Table 18 in Ministry of Finance Notice No. 50 "Calculation methods…"

212. From the above description, it follows that in terms of supervisory action the JFSA system has at least one supplementary level of intervention, compared to the Solvency II system. It also follows that 200% of the SMR would, broadly speaking, correspond to the Solvency II SCR level of intervention in terms of the actions taken —even though JFSA may interviene in a legally binding manner even if the SMR is more than 200%—, while 0% of the SMR along with actions taken at the level of 100% of the SMR would, broadly speaking,correspond to possible actions under the Solvency II MCR[16].

213. The levels of intervention are further explained in the table below (IBA Article 132 (2))

Ratio	Category	Order
Above 200%		-
Less than 200%	1	• Submission and implementation of management plan
Less than 100%	2	• Submission of capital increase plan • Restriction/prohibition on paying dividends or bonuses to policyholders and directors • Changes of procedures for calculating premiums for new insurance contracts • Curtailment of currently operating offices • Curtailment of business activities of subsidiaries
Less than 0%	3	• Suspension of the whole or part of the insurance business

JFSA 'total risk' formula

214. The formula is as follows (for non-life insurers):

Total risk = $[(R_5 + R_8)^2 + (R_2 + R_3)^2]^{0.5} + R_4 + R_6$[17],

where:

- R_5 and R_8 are, respectively, the underwriting risks of the "general" sector and of the "third" sector —this latter, broadly speaking, corresponds to personal (health, accident) insurance;
- R_2 and R_3 are the interest rate and market risks;
- R_4 is the operational risk; and
- R_6 is the catastrophe risk.

215. The following observations do not aim to be exhaustive. Their purpose is rather to highlight points where, in EIOPA's view, the JFSA requirements most markedly diverge from, or are substantively less risk-based than, the Solvency II SCR. Those differences would not necessarily mean that the level of policyholder protection under the Japanese solvency regime is lower than that established under Solvency II.

216. The JFSA's 'total risk' capital requirement does not cover currency and concentration risks.

217. The capital charges are calibrated according to the following levels of confidence: R5: 95%; R8: 99%; R2 and R3: 95%; R6: 99.5% for earthquake risk, 98.6% for storm and flood risk. For R4 (operational risk), see below.

[16] See Articles 139 and 144 (1) Solvency II Directive.
[17] See the JFSA's "Calculation methods..." Notice, Appended Table 18

218. It is difficult to compare:

- The overall Japanese system, which includes regulatory elements in the calculation of some TP (such as the requirements relating to the discount and mortality/morbidity rates) and uses various different confidence levels in determining the 'total risk' capital requirement; and
- The Solvency II system, where TPs are market-consistently valued and where the SCR is determined using a single 99.5% confidence level. The underwriting risk capital charge comprises six sub-capital charges corresponding to six LoBs (see the "Calculation Requirements..." Notice Appended Table 3). Each sub-capital charge is the higher of two amounts that are proportional to premiums and claims — for instance, for the 'fire' LoB, 15% of premiums and 33% of claims.

219. It might be considered that the division into only six LoBs does not provide sufficient granularity. For instance, damage to motor vehicles and motor liability are not differentiated. More importantly, there are no specific LoBs corresponding to (non-proportional) inward reinsurance. It follows that for direct motor insurance and for non-proportional accepted motor reinsurance, for example, the capital charge would be 13% of premiums in both cases.

220. The assumed correlation between any two of the six LoBs is 0.05[18]. This may lead to a substantial reduction in the capital charge: for instance, for an insurer writing business in three LoBs, the diversification effect can[19] lead to a reduction of around 40% of the capital charge.

221. The overall calibration of the credit risk capital charge seems low in comparison with Solvency II.

222. The capital charge corresponding to operational risk (R4) is calibrated as 2% or 3% of R5 + R8 + R2 + R3, depending on whether the insurer incurred a profit (2%) or a loss (3%) in the past financial year. Overall, it seems that the operational risk capital charge could not be substantively higher than 4% of the total capital requirement[20].

223. Some of the insurers met during the on-site visit seem to have more granular and/or more conservative internal capital requirements.

The lower level of control where the supervisor can invoke its strongest actions

224. The Solvency II Directive requires that this lower capital requirement be calibrated at a confidence level of 85%, and shall not fall below 25% of the upper and more sophisticated capital requirement (Article 129 (1c) and (3)). These provisions aim to ensure that the lower capital requirement is sufficiently risk-based.

225. As mentioned above, the lowest level of control where the JFSA could invoke its strongest actions corresponds to 0% of the SRM – although some actions available to EU supervisors when the MCR is breached correspond to actions available to the JFSA when the 100% threshold is breached. In the event that an

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[18] In comparison, for determining the Solvency II non-life underwriting risk capital charge, twelve LoBs are used, and the assumed correlations between them are 25% or 50%.

[19] If the business is well-distributed between the three LoBs.
As an example, if an insurer writes 100 in fire insurance, 100 in personal accident and 100 in automobile, where the respective capital charges are 15%, 14% and 13% of the written premiums, the overall capital charge is 8.5% of the premiums.

[20] Where $R_5 + R_8 = 15$ and $R_2 + R_3 = 20$, if we do not consider the catastrophe risk capital charge and if the insurer incurred a loss in the past financial year, the operational risk capital charge amounts to 3%*(15 + 20) = 1.05. Apart from the operational risk capital charge, the total capital charge would amount to $(15^2 + 20^2)^{0.5} = 25$. In this (simplified) example, the operational risk capital charge amounts to 4.2% of the total capital charge.

insurer's TP included a fair amount of prudence, a 0% level of own funds could still allow an insurer to conduct a run-off where insurance obligations could be appropriately settled. In any event, such a system makes international comparability and the assessment of equivalence challenging.

Other regulatory own funds requirements

226. In listing insurers' available own funds, the JFSA mentioned various regulatory reserves, such as the Catastrophe Reserve, the Contingency reserve, etc. As these reserves are compulsory, they can also be seen as capital requirements. It follows that for many insurers, the actual capital requirement may well be higher than the 'total risk' requirement discussed in the above paragraphs; consequently, they may well provide increased prudence in the overall financial position of an insurer.

227. However, EIOPA understood that these reserve requirements functioned on an accumulation basis and are built up gradually over the years. It follows that for an insurer that is newly authorised or that is rapidly expanding its business, these requirements do not amount to much. They can therefore hardly be deemed risked-based.

Internal models

228. JFSA regulation provides limited acceptance of internal models: they are only accepted for catastrophe and minimum guarantee risks.

229. As such limited acceptance may prove inadequate in the context of the internationalisation of insurance business, and in particular, in the context of increased accepted reinsurance, JFSA is currently exploring how better internal models can be used. Naturally, greater acceptance by the JFSA of internal models would require more actuarial resources to assess these models.

Investments

230. It is noted that the Japanese regime allows insurers to invest in instruments such as derivatives for purposes other than hedging, in a way that would not be allowed under Solvency II. However, an insurer needs to be authorised by the JFSA when engaging such business and will be subject to closemonitoring by the JFSA. It is also clear that investment returns have played a significant role in the profitability of Japanese insurers in recent years. Following the financial crisis the JFSA has acted to encourage insurers to disclose their holdings of securitised products, and it is understood that the JFSA closely monitors investments in more speculative instruments.

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231. The JFSA's provisions relating to financial supervision do not raise substantive issues; however, the capacity of auditors to report concerns to the supervisor could be enhanced.

232. While assets are by and large valued at market value, it is difficult to reach conclusions on the prudence included in the TP for the reasons presented in paragraphs 195 to 202 above.

233. Standards on available own funds do not raise substantive issues but more granular tiering could be introduced, and the risk-sensitivity of the tiering could be improved, in particular relating to subordinated loans.

234. Overall, the JFSA's upper capital requirement is calibrated at a lower confidence level than the Solvency II SCR, and in various respects seems markedly less risk-sensitive than the Solvency II SCR.

235. The JFSA's lower capital requirement is highly dependent on the level of prudence embedded in TP. We cannot positively conclude on the equivalence of this aspect.

236. In the context of increased accepted reinsurance business, greater allowance should be made for internal models.

237. There are provisions that insurers should invest in assets in a prudent manner, with however the reservation that they have much wider discretion to invest in derivatives and other products than under Solvency II.

238. Overall, the current JFSA's requirements could be regarded as providing a level of protection to policyholders that is partly equivalent to that of Solvency II, taking into account, *inter alia*, their various reserving requirements, but with the qualification that newcomers and those rapidly expanding their business will not be covered by the prudence of these reserving requirements.

239. As noted in paragraphs 188 and 202 above, JFSA has recently conducted a field test for economic valuation of both assets and liabilities with the aim of its introduction in the near future, and it is expected that the JFSA will consider the timing of mandatory endorsement of IFRSs for listed companies in Japan in 2012. At this stage, we would consider that the JFSA requirements are likely to provide a level of protection of policyholders in a fashion that is largely equivalent to that of Solvency II.